PENN NATIONAL GAMING INC
Form 10-Q
November 09, 2006

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

o 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: 0-24206

PENN NATIONAL GAMING, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2234473**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

825 Berkshire Blvd., Suite 200
Wyomissing, PA 19610
(Address of principal executive offices)

610-373-2400
(Registrant s telephone number including area code)

Not Applicable
(Former name, former address, and former fiscal year, if changed since last report)

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 x No o

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 x Accelerated filer o Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date.

Title	**Outstanding as of November 3, 2006**
Common Stock, par value $.01 per share	84,919,324 (includes 440,000 shares of restricted stock)

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may vary materially from expectations. Although Penn National Gaming, Inc. and its subsidiaries (collectively, the Company) believe that their expectations are based on reasonable assumptions within the bounds of their knowledge of its business and operations, there can be no assurance that actual results will not differ materially from the Company s expectations. Meaningful factors which could cause actual results to differ from expectations include, but are not limited to, risks related to the following: the ability of the Company to recover under its insurance policies for Hurricane Katrina damage; the passage of state, federal or local legislation that would expand, restrict, further tax or prevent gaming operations in the jurisdictions in which we do business; the activities of our competitors; increases in the effective rate of taxation at any of our properties or at the corporate level; successful completion of capital projects at our gaming and pari-mutuel facilities; the existence of attractive acquisition candidates, the costs and risks involved in the pursuit of those acquisitions and our ability to integrate those acquisitions; our ability to maintain regulatory approvals for our existing businesses and to receive regulatory approvals for our new businesses (including, without limitation, the issuance of a final operator s license in Pennsylvania); the maintenance of agreements with our horsemen, pari-mutuel clerks and other organized labor groups; our dependence on key personnel; the impact of terrorism and other international hostilities; the availability and cost of financing; and other factors as discussed in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 filed with the United States Securities and Exchange Commission. The Company does not intend to update publicly any forward-looking statements except as required by law.

PENN NATIONAL GAMING, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Penn National Gaming, Inc. and Subsidiaries

Consolidated Balance Sheets

(in thousands, except share and per share data)

	September 30, 2006 (unaudited)	December 31, 2005
Assets		
Current assets		
Cash and cash equivalents	$ 136,322	$ 132,620
Receivables, net of allowance for doubtful accounts of $3,046 and $2,994 at September 30, 2006 and December 31, 2005, respectively	58,857	47,632
Insurance receivable		51,160
Prepaid expenses and other current assets	53,083	26,780
Deferred income taxes	33,992	48,150
Total current assets	282,254	306,342
Property and equipment, net	1,317,614	1,059,892
Other assets		
Investment in and advances to unconsolidated affiliate	16,277	17,184
Goodwill	1,894,074	1,848,661
Other intangible assets	727,555	743,521
Deferred financing costs, net of accumulated amortization of $13,629 and $7,349 at September 30, 2006 and December 31, 2005, respectively	60,196	70,960
Other assets	72,954	92,861
Restricted assets held for sale		50,983
Total other assets	2,771,056	2,824,170
Total assets	$ 4,370,924	$ 4,190,404
Current liabilities		
Current maturities of long-term debt	$ 18,481	$ 18,567
Accounts payable	43,472	25,549
Accrued expenses	105,821	116,552
Accrued interest	30,449	33,303
Accrued salaries and wages	59,108	54,579
Gaming, pari-mutuel, property, and other taxes	56,176	47,724
Income taxes payable	26,168	18,284
Insurance financing	26,490	6,115
Other current liabilities	27,857	20,636
Total current liabilities	394,022	341,309
Long-term liabilities		
Long-term debt, net of current maturities	2,783,713	2,767,662
Deferred income taxes	370,222	259,708
Other noncurrent liabilities	244	659
Liabilities held for sale		274,523
Total long-term liabilities	3,154,179	3,302,552
Shareholders equity		
Preferred stock ($.01 par value, 1,000,000 shares authorized, none issued and outstanding at September 30, 2006 and December 31, 2005)		
Common stock ($.01 par value, 200,000,000 shares authorized, 86,533,864 shares at September 30, 2006, and 85,064,886 shares at December 31, 2005, issued)	865	850
Treasury stock (1,698,800 shares issued at September 30, 2006 and December 31, 2005)	(2,379)	(2,379)

Additional paid-in capital	241,299	206,763
Retained earnings	580,207	340,469
Accumulated other comprehensive income	2,731	840
Total shareholders equity	822,723	546,543
Total liabilities and shareholders equity	$ 4,370,924	$ 4,190,404

See accompanying notes to consolidated financial statements.

Penn National Gaming, Inc. and Subsidiaries

Consolidated Statements of Income

(in thousands, except per share data)

(unaudited)

	For the Three Months Ended September 30, 2006	2005	For the Nine Months Ended September 30, 2006	2005
Revenues				
Gaming	$ 536,901	$ 249,824	$ 1,531,155	$ 749,962
Racing	13,075	11,627	40,277	36,731
Management service fee	4,819	5,201	14,127	13,968
Food, beverage and other	59,198	34,113	164,183	111,263
Gross revenues	613,993	300,765	1,749,742	911,924
Less promotional allowances	(27,882)	(13,828)	(78,056)	(47,353)
Net revenues	586,111	286,937	1,671,686	864,571
Operating expenses				
Gaming	278,079	136,535	788,705	403,557
Racing	10,094	9,173	31,020	28,241
Food, beverage and other	52,703	25,603	149,931	75,328
General and administrative	85,984	39,248	234,595	131,488
Hurricane expense		19,142		19,142
Settlement costs				28,175
Depreciation and amortization	31,196	14,942	88,642	46,406
Total operating expenses	458,056	244,643	1,292,893	732,337
Income from continuing operations	128,055	42,294	378,793	132,234
Other income (expenses)				
Interest expense	(49,732)	(12,824)	(145,927)	(41,652)
Interest income	882	958	2,652	3,180
(Loss) earnings from joint venture	(1,665)	230	(678)	1,216
Other	(593)	532	(519)	438
Loss on early extinguishment of debt			(10,022)	(16,673)
Total other expenses	(51,108)	(11,104)	(154,494)	(53,491)
Income from continuing operations before income taxes	76,947	31,190	224,299	78,743
Taxes on income	36,548	11,386	99,222	27,793
Net income from continuing operations	40,399	19,804	125,077	50,950
Loss from discontinued operations, net of tax		(2,291)		(5,512)
Gain on sale of discontinued operations, net of tax	114,661	37,888	114,661	37,888
Net income	$ 155,060	$ 55,401	$ 239,738	$ 83,326
Earnings per share-Basic				
Income from continuing operations	$ 0.48	$ 0.24	$ 1.49	$ 0.62
Discontinued operations, net of tax	1.36	0.43	1.36	0.39
Basic earnings per share	$ 1.84	$ 0.67	$ 2.85	$ 1.01
Earnings per share-Diluted				
Income from continuing operations	$ 0.47	$ 0.23	$ 1.45	$ 0.59
Discontinued operations, net of tax	1.32	0.41	1.32	0.38
Diluted earnings per share	$ 1.79	$ 0.64	$ 2.77	$ 0.97

See accompanying notes to consolidated financial statements.

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Penn National Gaming, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders Equity

(in thousands, except share data) (unaudited)

	Common Stock Shares	Amount	Treasury Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity	Comprehensive Income
Balance, December 31, 2005	85,064,886	$ 850	$ (2,379)	$ 206,763	$ 340,469	$ 840	$ 546,543	
Stock option activity, including tax benefit of $9,405	1,028,978	11		33,249			33,260	$
Restricted stock activity	440,000	4		1,287			1,291	
Change in fair value of interest rate swap contracts, net of income taxes of $1,041						1,823	1,823	1,823
Foreign currency translation adjustment						68	68	68
Net income					239,738		239,738	239,738
Balance, September 30, 2006	86,533,864	$ 865	$ (2,379)	$ 241,299	$ 580,207	$ 2,731	$ 822,723	$ 241,629
Balance, December 31, 2004	83,131,940	$ 831	$ (2,379)	$ 178,459	$ 219,539	$ 1,642	$ 398,092	
Exercise of stock options, including tax benefit of $16,754	1,841,946	18		27,114			27,132	$
Restricted stock activity				358			358	
Change in fair value of interest rate swap contracts, net of income taxes of $563						(1,046)	(1,046)	(1,046)
Amortization of unrealized loss on interest rate swap contracts, net of income taxes of $29						(54)	(54)	
Foreign currency translation adjustment						106	106	106
Net income					83,326		83,326	83,326
Balance, September 30, 2005	84,973,886	$ 849	$ (2,379)	$ 205,931	$ 302,865	$ 648	$ 507,914	$ 82,386

See accompanying notes to consolidated financial statements.

Penn National Gaming, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(in thousands) (unaudited)

	Nine Months Ended September 30, 2006	2005 *Revised - see Note 2*
Operating activities		
Net income	$ 239,738	$ 83,326
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	88,642	46,406
Amortization of deferred financing costs charged to interest expense	8,551	2,318
Amortization of the unrealized gain on interest rate swap contracts charged to interest expense, net of income tax benefit		(54)
Loss on sale of fixed assets	792	2,185
Book value of assets tranferred to insurance receivable		29,770
Loss (earnings) from joint venture	678	(1,215)
Loss relating to early extinguishment of debt	2,255	7,246
Deferred income taxes	(14,766)	(87,112)
Charge for stock compensation	15,235	358
Gain on sale of discontinued operations	(114,661)	(37,888)
Tax benefit from stock options exercised		16,754
(Increase) decrease, net of businesses acquired		
Accounts receivable	(11,225)	2,862
Insurance receivable	(22,809)	(38,870)
Prepaid expenses and other current assets	(23,440)	(2,475)
Prepaid income taxes		5,706
Other assets	19,158	(10,717)
Increase (decrease), net of businesses acquired		
Accounts payable	17,923	(4,864)
Accrued expenses	(9,511)	16,211
Accrued interest	(2,854)	(7,421)
Accrued salaries and wages	4,529	1,642
Gaming, pari-mutuel, property and other taxes	7,868	4,575
Income taxes payable	8,663	87,177
Other current and non-current liabilities	2,320	(11,757)
Operating cash flows from discontinued operations	12	(4,259)
Net cash provided by operating activities	217,098	99,904
Investing activities		
Expenditures for property and equipment	(246,673)	(68,485)
Proceeds from sale of property and equipment	2,270	690
Proceeds from sale of business		274,523
Acquisition of businesses, net of cash acquired		(1,050)
Payments to joint venture		(20)
Investing cash flows from discontinued operations		(1,131)
Net cash (used in) provided by investing activities	(244,403)	204,527
Financing activities		
Proceeds from exercise of options	9,911	10,376
Proceeds from issuance of long-term debt	167,383	250,000
Principal payments on long-term debt	(176,025)	(470,797)

Increase in deferred financing cost	(42)	(7,687)
Proceeds from insurance financing	29,432	
Payments on insurance financing	(9,057)	
Tax benefit from stock options exercised	9,405	
Net cash provided by (used in) financing activities	31,007	(218,108)
Net increase in cash and cash equivalents	3,702	86,323
Cash and cash equivalents at beginning of period	132,620	87,620
Cash and cash equivalents at end of period	$ 136,322	$ 173,943
Supplemental disclosure		
Interest expense paid	$ 148,216	$ 46,508
Income taxes paid	$ 94,069	$ 21,456

See accompanying notes to consolidated financial statements.

Penn National Gaming, Inc. and Subsidiaries
Notes to the Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Penn National Gaming, Inc. (Penn) and subsidiaries (collectively, the Company) have been prepared in accordance with United States (U.S.) generally accepted accounting principles (GAAP) for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The notes to the consolidated financial statements contained in the Annual Report on Form 10-K for the year ended December 31, 2005 should be read in conjunction with these consolidated financial statements. For purposes of comparability, certain prior year amounts have been reclassified to conform to the current year presentation. Operating results for the nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

2. Summary of Significant Accounting Policies

Revenue Recognition and Promotional Allowances

Gaming revenue is the aggregate net difference between gaming wins and losses, with liabilities recognized for funds deposited by customers before gaming play occurs and for chips in the customers possession.

Racing revenue includes the Company s share of pari-mutuel wagering on live races after payment of amounts returned as winning wagers, and the Company s share of wagering from import and export simulcasting, as well as its share of wagering from its off-track wagering facilities (OTWs).

Revenue from the management service contract for Casino Rama is based upon contracted terms and is recognized when services are performed.

Food, beverage and other revenue is recognized as services are performed.

Revenues are recognized net of certain sales incentives in accordance with the Emerging Issues Task Force (EITF) consensus on Issue 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s products) (EITF 01-9). The consensus in EITF 01-9 requires that sales incentives and points earned in point-loyalty programs be recorded as a reduction of revenue. The Company recognizes incentives related to gaming play and points earned in point-loyalty programs as a direct reduction of gaming revenue.

During the second quarter of 2006, as a result of the Company s review of trends in interpreting accounting pronouncements and gaming industry practices for accounting for customer cash incentives, the Company reclassified cash redemption coupons to contra-revenue from operating expense. The reclassification had no effect on operating income, net income or earnings per share for the three and nine months ended September 30, 2005.

The retail value of accommodations, food and beverage, and other services furnished to guests without charge is included in gross revenues and then deducted as promotional allowances. The estimated cost of providing such promotional allowances is primarily included in gaming expenses. The amounts included in promotional allowances for the three and nine months ended September 30, 2006 and 2005 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
Rooms	$ 3,200	$ 1,604	$ 8,780	$ 5,196
Food and beverage	22,950	11,053	62,186	35,250
Other	1,732	1,171	7,090	6,907
Total promotional allowances	$ 27,882	$ 13,828	$ 78,056	$ 47,353

The estimated cost of providing such complimentary services for the three and nine months ended September 30, 2006 and 2005 that is included in operating expenses was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
Rooms	$ 1,341	$ 891	$ 3,656	$ 3,028
Food and beverage	15,737	7,335	43,322	23,600
Other	939	530	4,552	2,131
Total cost of complimentary services	$ 18,017	$ 8,756	$ 51,530	$ 28,759

Earnings Per Share

Basic earnings per share (EPS) is computed by dividing net income applicable to common stock by the weighted-average common shares outstanding during the period. Diluted EPS reflects the additional dilution for all potentially-dilutive securities, such as stock options.

The following table reconciles the weighted-average common shares outstanding used in the calculation of basic earnings per share to the weighted-average common shares outstanding used in the calculation of diluted earnings per share. Options to purchase 2,147,084 and 2,090,016 shares of common stock were outstanding for the three and nine months ended September 30, 2006, respectively, but were not included in the computation of diluted earnings per share because they are antidilutive. Options to purchase 60,000 and 75,000 shares of common stock were outstanding for the three and nine months ended September 30, 2005, respectively, but were not included in the computation of diluted earnings per share because they are antidilutive.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
Determination of shares:				
Weighted-average common shares outstanding	84,385	83,259	84,124	82,754
Assumed conversion of dilutive stock options	2,195	2,927	2,381	3,023
Diluted weighted-average common shares outstanding	86,580	86,186	86,505	85,777

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which requires the Company to expense the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This expense must be recognized ratably over the requisite service period following the date of grant.

The Company elected the modified prospective application method for adoption, which results in the recognition of compensation expense using the provisions of SFAS 123(R) for all share-based awards granted or modified after December 31, 2005, and the recognition of compensation expense using the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), with the exception of the method of recognizing forfeitures, for all unvested awards outstanding at the date of adoption. Under this transition method, the results of operations of prior periods have not been restated. Accordingly, the Company will continue to provide pro forma financial information for prior periods to illustrate the effect on net income and earnings per share of applying the fair value recognition provisions of SFAS 123, as amended by SFAS 148.

Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic-value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB

25), as interpreted by Financial Accounting Standards Board (FASB) Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation. Under the intrinsic-value method, because the exercise price of the Company s employee stock options was equal to the market price of the underlying stock on the date of grant, no compensation expense was recognized. However, there were situations that could have occurred, such as the accelerated vesting of options or the issuance of restricted stock, that required a current charge to income.

The most significant difference between the fair value approaches prescribed by SFAS 123 and SFAS 123(R) and the intrinsic-value method prescribed by APB 25 related to the recognition of compensation expense for stock option awards based on their grant-date fair value. Under SFAS 123, the Company estimated the fair value of stock option grants using the Black-Scholes option-pricing model. The following table reflects the pro forma impact on net income and earnings per share for the three and nine months ended September 30, 2005 of accounting for the Company s stock-based compensation using the fair value provisions of SFAS 123, as amended by SFAS 148. The effects of applying SFAS 123 and SFAS 148 in the pro forma disclosure below are not indicative of future amounts. Additional awards in future years are anticipated.

	Three Months Ended September 30, 2005 (in thousands)	**Nine Months Ended September 30, 2005**
Net income, as reported	$ 55,401	$ 83,326
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	76	232
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(2,487)	(7,525)
Pro forma net income	$ 52,990	$ 76,033
Earnings per share:		
Basic-as reported	$ 0.67	$ 1.01
Basic-pro forma	0.64	0.92
Diluted-as reported	0.64	0.97
Diluted-pro forma	0.62	0.89

Prior to the adoption of SFAS 123(R), the Company included all tax benefits associated with stock-based compensation as operating cash flows in the consolidated statements of cash flows. SFAS 123(R) requires any reduction in taxes payable resulting from tax deductions that exceed the recognized compensation expense (excess tax benefits) to be classified as financing cash flows. The Company included $9.4 million of excess tax benefits in the Company s cash flows from financing activities for the nine months ended September 30, 2006 that would have been classified as operating cash flows had the Company not adopted SFAS 123(R).

The fair value for stock options was estimated at the date of grant using the Black-Scholes option-pricing model, which requires management to make certain assumptions. The risk-free interest rate was based on the U.S. Treasury spot rate with a remaining term equal to the expected life assumed at the date of grant. Expected volatility was estimated based on the historical volatility of the Company s stock price over a period of 4.26 years, in order to match the expected life of the options at the grant date. There is no expected dividend yield since the Company has not paid any cash dividends on its common stock since its initial public offering in May 1994, and since the Company intends to retain all of its earnings to finance the development of its business for the foreseeable future. The weighted-average expected life was based on the contractual term of the stock option and expected employee exercise dates, which was based on the historical exercise behavior of the Company s employees. Forfeitures are estimated at the date of grant based on historical experience. Prior to the adoption of SFAS 123(R), the Company recorded forfeitures as they occurred for purposes of estimating pro forma compensation expense under SFAS 123. The following are the weighted-average assumptions used in the Black-Scholes option-pricing model at September 30, 2006 and 2005:

	September 30,	
	2006	2005
Risk-free interest rate	5.11 %	3.40 %
Expected volatility	43.29 %	40.00 %
Dividend yield		
Weighted-average expected life (years)	4.26	6.00
Forfeiture rate	4.00 %	

Beginning on January 1, 2006, the Company s estimated forfeiture rate was 2.00%. During the third quarter of 2006, due to the departure of one of the Company s senior executives, the Company changed its estimated forfeiture rate to 4.00%.

Statements of Cash Flows

Beginning with the year ended December 31, 2005, the Company changed the presentation of its cash flows to separately disclose the operating, investing and financing portions of cash flows attributable to the Company s discontinued operations. The Company had previously reported these amounts on a combined basis. This change was in response to public statements by the Securities and Exchange Commission Staff concerning the classification of discontinued operations on the statements of cash flows. For the nine months ended September 30, 2006 and 2005, cash flows relating to discontinued operations have been separately disclosed within operating and investing activities. For the nine months ended September 30, 2006 and 2005, there were no cash flows relating to discontinued operations that were financing activities.

Certain Risks and Uncertainties

The Company s operations are dependent on its continued licensing by state gaming commissions. The loss of a license in any jurisdiction in which the Company operates could have a material adverse effect on future results of operations.

The Company is dependent on each gaming property s local market for a significant number of its patrons and revenues. If economic conditions in these areas deteriorate or additional gaming licenses are awarded in these markets, the Company s results of operations could be adversely affected.

The Company is also dependent upon a stable gaming and admission tax structure in the states in which it operates. Any change in the tax structure could have a material adverse effect on future results of operations.

3. New Accounting Pronouncement

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which is an interpretation of SFAS No. 109, Accounting for Income Taxes (SFAS 109).

FIN 48 creates a single model to address uncertainty in tax positions, and clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109 by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in an enterprise s financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition, and clearly scopes out income taxes from SFAS No. 5, Accounting for Contingencies.

FIN 48 is effective for fiscal years beginning after December 15, 2006, but earlier application of the provisions of FIN 48 is encouraged if an enterprise has not yet issued financial statements, including interim financial statements, in the period that FIN 48 is adopted. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption should be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings.

The Company is currently determining the impact of FIN 48 on its consolidated financial statements.

4. Acquisitions

Argosy Gaming Company

On October 3, 2005, the Company acquired 100% of the stock of Argosy Gaming Company (Argosy). The acquisition reflects the continuing efforts of the Company to diversify by reducing its dependency on individual properties and

legislative jurisdictions. The transaction was accounted for as a purchase transaction, in accordance with SFAS No. 141, Business Combinations. As a result, the net assets of Argosy were recorded at their fair value, with the excess of the purchase price over the fair value of the net assets acquired allocated to goodwill.

In order to assist the Company in assigning values of assets acquired and liabilities assumed in this transaction, the Company obtained a third-party valuation of significant identifiable intangible assets acquired, as well as other assets acquired. In addition, the Company recorded a current tax liability for identified tax contingencies and an estimate for the deferred tax liability arising from the acquisition due to the difference between the fair value and the tax basis of the net assets acquired. The current and deferred tax liabilities, which increased the amount of goodwill recorded in the acquisition, are subject to change upon recognition and/or settlement of tax contingencies. These changes, if any, will also affect goodwill, and will not have a material impact on the Company s consolidated statements of income.

The pro forma consolidated results of operations for the three and nine months ended September 30, 2005, as if the acquisition of Argosy had occurred on January 1, 2005, are as follows (in thousands, except per share data):

	Three Months Ended September 30, 2005	**Nine Months Ended September 30, 2005**
Pro Forma		
Net revenues	$ 537,971	$ 1,605,077
Income from continuing operations	92,802	278,533
Net income from continuing operations	27,989	73,905
Basic earnings per share	0.34	0.89
Diluted earnings per share	0.33	0.86

Note 5: Acquisitions of the Company s Annual Report on Form 10-K for the year ended December 31, 2005 provides further detail regarding the Argosy acquisition.

5. Hurricane Katrina

As a result of Hurricane Katrina s direct hit on the Mississippi Gulf Coast on August 29, 2005, two of the Company s casinos, Hollywood Casino Bay St. Louis (formerly known as Casino Magic Bay St. Louis) and Boomtown Biloxi, were significantly damaged, many employees were displaced and operations ceased at the two properties. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

The Company had significant levels of insurance in place at the time of Hurricane Katrina to cover the losses resulting from the hurricane, including an all risk insurance policy covering named windstorm damage, flood damage, debris removal, preservation of property expense, demolition and increased cost of construction expense, losses resulting from business interruption and extra expenses, all as defined in the policies. The comprehensive business interruption and property damage insurance policies had an overall limit of $400 million, and was subject to property damage deductibles for Hollywood Casino Bay St. Louis and Boomtown Biloxi of approximately $6.0 million and $3.5 million, respectively. The business interruption insurance component of this policy was subject to a five-day deductible.

The Company recognized a pre-tax charge of $19.1 million associated with the expenses incurred from Hurricane Katrina during the nine months ended September 30, 2005. The costs included property insurance and business interruption policy deductible expense, compensation being paid to employees through November 30, 2005 that exceeded the ordinary payroll limits under the business interruption policy, the purchase of replacement flood insurance for coverage during the remaining insurance policy term, contributions to the Penn National Gaming Foundation s Hurricane Katrina Relief Project and costs for insurance claim consultants. The charge did not reflect any loss resulting from the damage to the land-based facilities and casino barges at Hollywood Casino Bay St. Louis and Boomtown Biloxi, as this amount was not yet known. Although the Company believes that insurance proceeds will be sufficient to fund replacement costs, at September 30, 2006, a $3.9 million liability is included within other current liabilities on the Company s balance sheet, since the refunds received are considered advances against the overall claim and the details of the claim are not yet settled. The $51.2 million insurance receivable recorded at December 31, 2005 was limited to the net historical book value of assets believed to be damaged, destroyed or abandoned, fixed business expenses and out-of-pocket costs for certain additional expenses incurred during the period as a direct result of the hurricane. During the three and nine months ended September 30, 2006, the Company received $27.1 million and $79.4 million, respectively, from its insurance carriers relating to Hurricane Katrina. Through December 31, 2005, the Company received $27.3 million from its insurance carriers relating to Hurricane Katrina.

On August 8, 2006, the Company renewed its property insurance coverage in the amount of $200 million. The $200 million coverage is all risk , including named

windstorm , flood and earthquake. Also, the Company purchased an additional $250 million of all risk coverage that is subject to certain exclusions including, among others, exclusion for named windstorms and floods. There is a $25 million deductible for named windstorm events, and lesser deductibles as they apply to other perils.

6. Property and Equipment

Property and equipment, net, consists of the following (in thousands):

	September 30, 2006	December 31, 2005
Land and improvements	$ 179,768	$ 155,735
Building and improvements	770,650	699,584
Furniture, fixtures, and equipment	394,163	314,741
Transportation equipment	2,281	1,401
Leasehold improvements	14,947	13,175
Construction in progress	242,126	82,971
Total property and equipment	1,603,935	1,267,607
Less accumulated depreciation and amortization	(286,321)	(207,715)
Property and equipment, net	$ 1,317,614	$ 1,059,892

Depreciation and amortization expense, for property and equipment, totaled $29.5 million and $83.7 million for the three and nine months ended September 30, 2006, respectively, as compared to $14.3 million and $44.5 million for the three and nine months ended September 30, 2005, respectively. Interest capitalized in connection with major construction projects was $5.6 million and $.7 million for the nine months ended September 30, 2006 and 2005, respectively.

7. Goodwill and Other Intangible Assets

The Company s goodwill and intangible assets had a gross carrying value of $2.6 billion at September 30, 2006 and December 31, 2005, and accumulated amortization of $17.8 million and $12.8 million at September 30, 2006 and December 31, 2005, respectively. The table below presents the gross carrying value, accumulated amortization, and net book value of each major class of goodwill and intangible asset at September 30, 2006 and December 31, 2005 (in thousands):

	September 30, 2006			December 31, 2005		
	Gross Carrying Value	Accumulated Amortization	Net Book Value	Gross Carrying Value	Accumulated Amortization	Net Book Value
Goodwill	$ 1,894,074	$	$ 1,894,074	$ 1,848,661	$	$ 1,848,661
Gaming licenses and trademarks	700,198		700,198	711,174		711,174
Other intangible assets	45,126	17,769	27,357	45,126	12,779	32,347
Total	$ 2,639,398	$ 17,769	$ 2,621,629	$ 2,604,961	$ 12,779	$ 2,592,182

During the nine months ended September 30, 2006, goodwill increased by $45.4 million, primarily due to the finalization of certain fixed asset and deferred tax valuations associated with the Argosy and Bangor Historic Track, Inc. acquisitions. This increase was partially offset by an $11.0 million decrease in the value assigned to the Argosy gaming license intangible asset.

The Company s intangible asset amortization expense was $1.7 million and $5.0 million for the three and nine months ended September 30, 2006, respectively.

The following table presents expected intangible asset amortization expense based on existing intangible assets at September 30, 2006 (in thousands):

2006 (three months)	$ 1,665
2007	6,655
2008	6,488
2009	5,988
2010	5,119
Thereafter	1,442
Total	$ 27,357

8. Long-term Debt

Long-term debt, net of current maturities, is as follows (in thousands):

	September 30, 2006	December 31, 2005
Senior secured credit facility	$ 2,316,000	$ 2,148,875
$175 million 87/8% senior subordinated notes		175,000
$200 million 67/8% senior subordinated notes	200,000	200,000
$250 million 6¾% senior subordinated notes	250,000	250,000
$200 million 9% senior subordinated notes	10	10
$350 million 7% senior subordinated notes		153
Other long term obligations	24,607	
Capital leases	11,577	12,191
	2,802,194	2,786,229
Less current maturities of long-term debt	(18,481)	(18,567)
	$ 2,783,713	$ 2,767,662

The following is a schedule of future minimum repayments of long-term debt as of September 30, 2006 (in thousands):

Within one year	$ 18,481
1-3 years	193,190
3-5 years	558,629
Over 5 years	2,031,894
Total minimum payments	$ 2,802,194

At September 30, 2006 and December 31, 2005, the Company was contingently obligated under letters of credit issued pursuant to its senior secured credit facility with face amounts totaling $83.6 million and $72.5 million, respectively.

Senior Secured Credit Facility

On October 3, 2005, the Company entered into a $2.725 billion senior secured credit facility to fund the Company s acquisition of Argosy, including payment for all of Argosy s outstanding shares, the retirement of certain long-term debt of Argosy and its subsidiaries, the payment of related transaction costs, and to provide additional working capital.

The senior secured credit facility is secured by substantially all of the assets of the Company.

Interest Rate Swap Contracts

The Company has a policy designed to manage interest rate risk associated with its current and anticipated future borrowings. This policy enables the Company to use any combination of interest rate swaps, futures, options, caps and similar instruments. To the extent the Company employs such financial instruments pursuant to this policy, they are generally accounted for as hedging instruments. In order to qualify for hedge accounting, the underlying hedged item must expose the

Company to risks associated with market fluctuations and the financial instrument used must be designated as a hedge and must reduce the Company s exposure to market fluctuations throughout the hedge period. If these criteria are not met, a change in the market value of the financial instrument is recognized as a gain or loss in the period of change. Net settlements pursuant to the financial instrument are included as interest expense in the period.

In accordance with the terms of its $2.725 billion senior secured credit facility, the Company was required to enter into interest rate swap agreements in an amount equal to 50% of the outstanding term loan balances within 100 days of the closing date of the credit facility. On October 27, 2005, the Company entered into four interest rate swap contracts with terms from three to five years, notional amounts of $224 million, $274 million, $225 million, and $237 million, for a total of $960 million and fixed interest rates ranging from 4.678% to 4.753%. The annual weighted-average interest rate of the four contracts is 4.71%. On May 8, 2006, the Company entered into three interest rate swap contracts with a term of five years, notional amounts of $100 million each, for a total of $300 million and fixed interest rates ranging from 5.263% to 5.266%. The annual weighted-average interest rate of the three contracts is 5.26%. Under these contracts, the Company pays a fixed interest rate against a variable interest rate based on the 90-day LIBOR rate. The 90-day LIBOR rate relating to these contracts as of September 30, 2006 was 5.49% for the $960 million swaps and 5.50% for the $300 million swaps.

Redemption of 87/8% Senior Subordinated Notes

In February 2006, the Company called for the redemption of its $175 million 87/8% senior subordinated notes. The redemption price was $1,044.38 per $1,000 principal amount, plus accrued and unpaid interest and was made on March 15, 2006. The Company funded the redemption of the notes from available cash and borrowings under its revolving credit facility.

67/8% Senior Subordinated Notes

On December 4, 2003, the Company completed an offering of $200 million of 67/8% senior subordinated notes that mature on December 1, 2011. Interest on the notes is payable on June 1 and December 1 of each year, beginning June 1, 2004. The Company used the net proceeds from the offering, totaling approximately $196.6 million after deducting underwriting discounts and related expenses, to repay term loan indebtedness under its previous senior secured credit facility.

The Company may redeem all or part of the notes on or after December 1, 2007 at certain specified redemption prices. Prior to December 1, 2006, the Company may redeem up to 35% of the notes from proceeds of certain sales of its equity securities. The notes are also subject to redemption requirements imposed by state and local gaming laws and regulations.

The 67/8% notes are general unsecured obligations and are guaranteed on a senior subordinated basis by certain of the Company s current and future wholly-owned domestic subsidiaries. The 67/8% notes rank equally with the Company s future senior subordinated debt and junior to its senior debt, including debt under the Company s senior secured credit facility. In addition, the 67/8% notes will be effectively junior to any indebtedness of Penn s non-U.S. Unrestricted Subsidiaries.

The 67/8% notes and guarantees were originally issued in a private placement pursuant to an exemption from the registration requirements of the Securities Act of 1933 (the Securities Act). On August 27, 2004, the Company completed an offer to exchange the notes and guarantees for notes and guarantees registered under the Securities Act having substantially identical terms.

6¾% Senior Subordinated Notes

On March 9, 2005, the Company completed an offering of $250 million of 6¾% senior subordinated notes that mature on March 1, 2015. Interest on the notes is payable on March 1 and September 1 of each year, beginning September 1, 2005. The 6¾% notes are general unsecured obligations and are not guaranteed by the Company s subsidiaries. The 6¾% notes were issued in a private placement pursuant to an exemption from the registration requirements of the Securities Act. The Company used the net proceeds from the offering to redeem its $200 million 11 % senior subordinated notes due March 1, 2008 and to repay a portion of the term loan indebtedness under the previous senior secured credit facility.

Other long-term obligations

On October 15, 2004, the Company announced the sale of The Downs Racing, Inc. and its subsidiaries to the Mohegan Tribal Gaming Authority (the MTGA). In January 2005, the Company received $280 million from the MTGA, and transferred the operations of The Downs Racing, Inc. and its subsidiaries to the MTGA. The sale was not considered final for accounting purposes until the third quarter of 2006, as the MTGA had certain post-closing termination rights that remained outstanding until August 7, 2006. Under the terms of the agreement, MTGA acquired The Downs Racing, Inc. and its subsidiaries, including Pocono Downs (a standardbred horse racing facility located on 400 acres in Wilkes-Barre, Pennsylvania) and five Pennsylvania off-track wagering facilities located in Carbondale, East Stroudsburg, Erie, Hazelton and

the Lehigh Valley (Allentown). The sale agreement provided the MTGA with certain post-closing termination rights in the event of certain materially adverse legislative or regulatory events.

On August 7, 2006, the Company entered into the Second Amendment to the Purchase Agreement and Release of Claims (Amendment and Release) with the MTGA pertaining to the October 14, 2004 Purchase Agreement (the Purchase Agreement), and agreed to pay the MTGA an aggregate of $30 million over five years, beginning on the first anniversary of the commencement of slot operations at Mohegan Sun at Pocono Downs, in exchange for the MTGA s agreement to release various claims it raised against the Company under the Purchase Agreement and the MTGA s surrender of all post-closing termination rights it might have had under the Purchase Agreement. The Company recorded the $24.6 million present value of this liability within long-term debt, as the amount due to the MTGA is payable over five years, with the first payment date estimated to occur in late 2007.

Covenants

The Company s senior secured credit facility and $200 million 6 7/8% and $250 million 6¾% senior subordinated notes require it, among other obligations, to maintain specified financial ratios and to satisfy certain financial tests, including fixed charge coverage, senior leverage and total leverage ratios. In addition, the Company s senior secured credit facility and $200 million 6⅞% and $250 million 6¾% senior subordinated notes restrict, among other things, the Company s ability to incur additional indebtedness, incur guarantee obligations, amend debt instruments, pay dividends, create liens on assets, make investments, make acquisitions, engage in mergers or consolidations, make capital expenditures, or engage in certain transactions with subsidiaries and affiliates and otherwise restricts corporate activities.

During the three months ended September 30, 2006, the Company made certain amendments to its existing $2.725 billion senior secured credit facility, including the modification of the applicable covenants to enable the Company to repurchase up to $200 million of its equity or debt securities, the modification of the Company s capital expenditure covenant to increase certain permitted expenditures consistent with the Company s development and expansion projects, and the modification of the Company s collateral documents in accordance with requirements of the Pennsylvania gaming authorities.

At September 30, 2006, the Company was in compliance with all required financial covenants.

9. Commitments and Contingencies

The Company is subject to various legal and administrative proceedings relating to personal injuries, employment matters, commercial transactions and other matters arising in the normal course of business. The Company does not believe that the final outcome of these matters will have a material adverse effect on the Company s consolidated financial position or results of operations. In addition, the Company maintains what it believes is adequate insurance coverage to further mitigate the risks of such proceedings. However, such proceedings can be costly, time consuming and unpredictable and, therefore, no assurance can be given that the final outcome of such proceedings may not materially impact the Company s consolidated financial condition or results of operations. Further, no assurance can be given that the amount or scope of existing insurance coverage will be sufficient to cover losses arising from such matters.

The following proceedings could result in costs, settlements, damages, or rulings that materially impact the Company s consolidated financial condition or operating results. In each instance, the Company believes that it has meritorious defenses, claims and/or counter-claims and intends to vigorously defend itself or pursue its claim.

In October 2002, in response to the Company s plans to relocate the river barge underlying the Boomtown Biloxi casino to an adjacent property, the lessor of the property on which the Boomtown Biloxi casino conducts a portion of its dockside operations filed a lawsuit against the Company in the U.S. District Court for the Southern District of Mississippi seeking a declaratory judgment that (i) the Company must use the leased premises for a gaming use or, in the alternative, (ii) after the move, the Company will remain obligated to make the revenue-based rent payments to plaintiff set forth in the lease. The plaintiff filed this suit immediately after the Mississippi Gaming Commission approved the Company s request to relocate the barge. Since such approval, the Mississippi Department of Marine Resources and the U.S. Army Corps of Engineers have also approved the Company s plan to relocate the barge. In March 2004, the trial court ruled in favor of the Company on all counts. The plaintiff appealed the decision to the Fifth Circuit, and on May 3, 2005, the Fifth Circuit ruled that the trial court s decision should be affirmed in part and reversed and remanded in part. In its decision, the Fifth Circuit upheld the tenant s right to relocate but remanded the case to the trial court because there was insufficient evidence in the record to determine whether the casino barge would be relocated to a place which would trigger the increased rent obligation under the lease. The Court has set a scheduling order setting the trial date for February 26, 2007. The Company intends to file dispositive motions by December 1, 2006. The parties have also engaged in active settlement negotiations, but have not yet reached a final

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settlement of this matter.

In November 2005, Capital Seven, LLC and Shawn A. Scott (Capital Seven), the sellers of Bangor Historic Track (BHT), filed a demand for arbitration with the American Arbitration Association seeking $30 million plus interest and other damages. Capital Seven alleges a breach of contract by the Company based on the Company s payment of a $51 million purchase price for the purchase of BHT instead of an alleged $81 million purchase price the sellers claim is due under the purchase agreement. The parties had agreed that the purchase price of BHT would be determined, in part, by the applicable gaming taxes imposed by Maine on the Company s operations, and currently are disputing the effective tax rate. The dispute is currently in its initial stages. Pursuant to the dispute resolution procedures, the Company deposited $30 million in escrow, pending a resolution. This amount is included within the other assets line item on the Company s consolidated balance sheets at September 30, 2006 and December 31, 2005. The parties are currently in the process of choosing arbitrators.

In conjunction with the Company s merger with Argosy, the Company became responsible for litigation initiated over eight years ago related to the Baton Rouge property formerly owned by Argosy. On November 26, 1997, Capitol House filed an amended petition in the Nineteenth Judicial District Court for East Baton Rouge Parish, State of Louisiana, amending its previously filed but unserved suit against Richard Perryman, the person selected by the Louisiana Gaming Division to evaluate and rank the applicants seeking a gaming license for East Baton Rouge Parish, and adding state law claims against Jazz Enterprises, Inc., the former Jazz Enterprises, Inc. Shareholders, Argosy Gaming Company, Argosy of Louisiana, Inc. and Catfish Queen Partnership in Commendam, d/b/a the Belle of Baton Rouge Casino. This suit alleges that these parties violated the Louisiana Unfair Trade Practices Act in connection with obtaining the gaming license that was issued to Jazz Enterprises, Inc./Catfish Queen Partnership in Commendam. The plaintiff, an applicant for a gaming license whose application was denied by the Louisiana Gaming Division, seeks to prove that the gaming license was invalidly issued and seeks to recover lost gaming revenues that the plaintiff contends it could have earned if the gaming license had been properly issued to the plaintiff. The Company has filed numerous dispositive motions. On October 2, 2006, the Company prevailed on a partial summary judgment motion which limited plaintiff s damages to its out-of-pocket costs in seeking its gaming license, thereby eliminating any recovery for potential lost profits. The plaintiff is attempting to appeal this ruling. Three other motions for summary judgment filed by the Company are currently pending and will be heard in November and December of 2006. Plaintiff has filed a partial summary judgment motion on liability which will be heard in December. The trial is scheduled for late January 2007.

The Company has the right to seek indemnification from two of the former Jazz Enterprises, Inc. shareholders for any liability suffered as a result of such cause of action, however, there can be no assurance that the former Jazz Enterprises, Inc. shareholders will have assets sufficient to satisfy any claim in excess of Argosy s recoupment rights.

In May 2006, the Illinois Legislature passed into law House Bill 1918, effective May 26, 2006, which singled out four of the nine Illinois casinos, including the Company s Empress Casino Hotel and Hollywood Casino Aurora, for a 3% tax surcharge to subsidize local horse racing interests. The Company began paying this tax surcharge during the three months ended June 30, 2006, and the Company will continue to pay this tax surcharge in upcoming periods. On May 30, 2006, Empress Casino Hotel and Hollywood Casino Aurora joined with the two other riverboats affected by the law, Harrah s Joliet and the Grand Victoria Casino in Elgin, and filed suit in the Circuit Court of the Twelfth Judicial District in Will County, Illinois (the Court), asking the Court to declare the law unconstitutional. The State agreed to the entry of an order that establishes a protest fund for all of the tax surcharge payments and enjoins the Treasurer from making any payments out of that fund pending the final outcome of the litigation. Should the casinos prevail with their challenge, the incremental taxes paid under protest would be refunded. The Company anticipates a long process before a resolution to this matter can be reached.

Operating Lease Commitments

The Company is liable under numerous operating leases for airplanes, automobiles, land for the property on which some of its casinos operate, other equipment and buildings, which expire at various dates through 2093. Total rental expense under these agreements was $7.9 million and $20.9 million for the three and nine months ended September 30, 2006, respectively.

The leases for land consist of annual base lease rent payments, plus a percentage rent based on a percent of adjusted gaming wins, as described in the respective leases.

The Company has an operating lease with the City of Bangor for a permanent facility which the Company expects to open in the second quarter of 2008, at a budgeted cost of $90.0 million. This permanent facility is subject to a percentage rent equaling 3% of gross slot revenue. The lease is for an initial term of fifteen years with three ten-year renewal options. The initial term begins with the opening of the permanent facility. An agreement with the City of Bangor calls for a two-year rent moratorium for 2006 and 2007.

The future minimum lease commitments relating to the base lease rent portion of noncancelable operating leases at September 30, 2006 are as follows (in thousands):

Within one year	$ 13,110
1-3 Years	21,127
3-5 Years	15,364
Over 5 years	218,487
Total	$ 268,088

Capital Expenditure Commitments

At September 30, 2006, the Company is contractually committed to spend approximately $52.2 million in capital expenditures for projects in progress.

10. Stock-Based Compensation

In April 1994, the Company s Board of Directors and shareholders adopted and approved the 1994 Stock Option Plan (the 1994 Plan). The 1994 Plan permitted the grant of options to purchase up to 12,000,000 shares of Common Stock, subject to antidilution adjustments, at a price per share no less than 100% of the fair market value of the Common Stock on the date an option is granted with respect to incentive stock options only. The price would be no less than 110% of fair market value in the case of an incentive stock option granted to any individual who owns more than 10% of the total combined voting power of all classes of outstanding stock. The 1994 Plan provided for the granting of both incentive stock options intended to qualify under Section 422 of the Internal Revenue Code of 1986, as amended, and nonqualified stock options, which do not so qualify. The 1994 Plan terminated in April 2004.

On April 16, 2003, the Company s Board of Directors adopted and approved the 2003 Long Term Incentive Compensation Plan (the 2003 Plan). On May 22, 2003, the Company s shareholders approved the 2003 Plan. The 2003 Plan was effective June 1, 2003 and permits the grant of options to purchase Common Stock and other market-based and performance-based awards. Up to 12,000,000 shares of Common Stock are available for awards under the 2003 Plan. The 2003 Plan provides for the granting of both incentive stock options intended to qualify under Section 422 of the Internal Revenue Code of 1986, as amended, and nonqualified stock options, which do not so qualify. The exercise price per share may be no less than (i) 100% of the fair market value of the Common Stock on the date an option is granted for incentive stock options and (ii) 85% of the fair market value of the Common Stock on the date an option is granted for nonqualified stock options. Unless this plan is extended, no awards shall be granted or exchanges effected under this plan after May 31, 2013. At September 30, 2006, there were 4,215,500 options available for future grants under the 2003 Plan.

Stock options that expire between February 8, 2007 and January 12, 2016 have been granted to officers, directors and employees to purchase Common Stock at prices ranging from $2.03 to $41.37 per share. All options were granted at the fair market value of the Common Stock on the date the options were granted.

The following table contains information on stock options for the nine months ended September 30, 2006:

	Number of Option Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	7,733,814	$ 17.09		
Granted	1,746,500	33.24		
Exercised	(1,028,978)	9.63		
Canceled	(92,500)	21.57		
Outstanding at September 30, 2006	8,358,836	$ 21.33	5.13	$ 145,835

Included in the above are common stock options that were issued in 2003 to the Company s Chairman outside of the 1994 Plan and the 2003 Plan. These options were issued at $7.95 per share, and are exercisable through February 6, 2013. At September 30, 2006 and December 31, 2005, the number of these common stock options that were outstanding was 23,750 and 95,000, respectively. In addition, the Company issued

160,000 restricted stock awards in 2004, which fully vest in May 2009,

and issued 280,000 restricted stock awards in 2006, which fully vest by 2011. The weighted-average grant-date fair value of options granted during the nine months ended September 30, 2006 and 2005 were $14.55 and $12.15, respectively.

The aggregate intrinsic value of stock options exercised during the nine months ended September 30, 2006 and 2005 was $28.7 million and $50.7 million, respectively.

At September 30, 2006, there were 2,954,836 shares that were exercisable, with a weighted-average exercise price of $13.51, a weighted-average remaining contractual term of 3.83 years, and an aggregate intrinsic value of $74.7 million.

The following table summarizes information about stock options outstanding at September 30, 2006:

	Exercise Price Range			Total
	$2.03 to $12.15	**$14.56 to $29.22**	**$30.18 to $41.37**	**$2.03 to $41.37**
Outstanding options				
Number outstanding	3,557,676	2,872,160	1,929,000	8,358,836
Weighted-average remaining contractual life (years)	3.69	5.80	6.80	5.13
Weighted-average exercise price	$ 9.57	$ 27.92	$ 33.24	$ 21.33
Exercisable options				
Number outstanding	2,213,676	708,660	32,500	2,954,836
Weighted-average exercise price	$ 8.80	$ 27.28	$ 33.95	$ 13.51

Compensation costs related to stock-based compensation for the nine months ended September 30, 2006 totaled $15.2 million pre-tax ($11.0 million after-tax), or $.13 per diluted share, and are included in the consolidated statements of income under general and administrative expenses.

At September 30, 2006, the total compensation cost related to nonvested awards not yet recognized equaled $50.1 million, including $42.4 million for stock options and $7.7 million for restricted stock. This cost is expected to be recognized over the remaining vesting periods, which will not exceed five years.

11. Segment Information

In accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131), the Company views each property as an operating segment. Historically, the Company aggregated its gaming properties that were economically similar, offered similar types of products and services, catered to the same types of customers and were similarly regulated into a reportable segment called gaming, and aggregated its racing properties that were economically similar, offered similar products and services, catered to the similar types of customers and were similarly regulated into a reportable segment called racing.

Beginning in the first quarter of 2006, the Company modified its segment reporting from two reportable segments to one reportable segment, as the Company believes that its gaming and racing properties can now be aggregated together in accordance with SFAS 131, due to ongoing changes at its racing properties, including the upcoming introduction of slot machines at Penn National Race Course.

Note 15: Segment Information of the Company s Annual Report on Form 10-K for the year ended December 31, 2005, provides further detail regarding the Company s historical segment reporting.

12. Subsidiary Guarantors

Under the terms of the $2.725 billion senior secured credit facility, all of the Company s subsidiaries are guarantors under the agreement, with the exception of several minor subsidiaries with total assets of $16.3 million (less than .4 % of total assets at September 30, 2006). Each of the subsidiary guarantors are 100% owned by Penn. In addition, the guarantees provided by the Company s subsidiaries under the terms of the $2.725 billion senior secured credit facility are full and unconditional, joint and several, and Penn has no significant independent assets and no independent operations at, and for the three and nine months ended, September 30, 2006. There are no significant restrictions within the $2.725 billion senior secured credit facility on the Company s ability to obtain funds from its subsidiaries by dividend or loan. However, in

certain jurisdictions, the gaming authorities may impose restrictions pursuant to the authority granted to them with regard to the Company s ability to obtain funds from its subsidiaries.

With regard to the $2.725 billion senior secured credit facility, the Company has not presented condensed consolidating balance sheets, condensed consolidating statements of income and condensed consolidating statements of cash flows at, and for the three and nine months ended, September 30, 2006, as Penn had no significant independent assets and no independent operations at, and for the three and nine months ended, September 30, 2006, the guarantees are full and

unconditional and joint and several, and any subsidiaries of the parent company other than the subsidiary guarantors are considered minor.

Under the terms of the $200 million 6 % senior subordinated notes, most of the Company s subsidiaries are guarantors. Each of the subsidiary guarantors are 100% owned by Penn. In addition, the guarantees provided by the Company s subsidiaries under the terms of the $200 million 6 % senior subordinated notes are full and unconditional, joint and several, and Penn had no significant independent assets and no independent operations at, and for the three and nine months ended, September 30, 2006. There are no significant restrictions within the $200 million 6 % senior subordinated notes on the Company s ability to obtain funds from its subsidiaries by dividend or loan. However, in certain jurisdictions, the gaming authorities may impose restrictions pursuant to the authority granted to them with regard to the Company s ability to obtain funds from its subsidiaries.

Summarized financial information, excluding discontinued operations, at, and for the three and nine months ended, September 30, 2006 and 2005 for Penn, the subsidiary guarantors of the 6 % senior subordinated notes and subsidiary non-guarantors is presented below. For purposes of comparability, certain prior year amounts have been reclassified to conform to the current year presentation.

	Penn	Subsidiary Guarantors	Subsidiary Non-Guarantors	Eliminations	Consolidated
At September 30, 2006					
Condensed Consolidating Balance Sheet (in thousands)					
Current assets	$ (34,743)	$ 298,602	$ 15,729	$ 2,666	$ 282,254
Property and equipment, net	166,258	1,151,356			1,317,614
Other assets	3,486,461	2,684,761	(5,055)	(3,395,111)	2,771,056
Total	$ 3,617,976	$ 4,134,719	$ 10,674	$ (3,392,445)	$ 4,370,924
Current liabilities	47,531	340,291	6,768	(568)	394,022
Long-term liabilities	2,750,881	3,423,333		(3,020,035)	3,154,179
Shareholders equity	819,564	371,095	3,906	(371,842)	822,723
Total	$ 3,617,976	$ 4,134,719	$ 10,674	$ (3,392,445)	$ 4,370,924
Three months ended September 30, 2006					
Condensed Consolidating Statement of Income (in thousands)					
Net revenues	$	$ 581,353	$ 4,819	$ (61)	$ 586,111
Total operating expenses	20,156	433,244	4,717	(61)	458,056
(Loss) income from operations	(20,156)	148,109	102		128,055
Other expenses	4,987	142,834	16		147,837
(Loss) income before income taxes	(15,169)	290,943	118		275,892
Taxes on income	(14,811)	135,533	110		120,832
Net (loss) income	$ (358)	$ 155,410	$ 8	$	$ 155,060
Nine months ended September 30, 2006					
Condensed Consolidating Statement of Income (in thousands)					
Net revenues	$	$ 1,657,764	$ 14,127	$ (205)	$ 1,671,686
Total operating expenses	51,768	1,227,615	13,715	(205)	1,292,893
(Loss) income from operations	(51,768)	430,149	412		378,793
Other expenses	(15,697)	60,208	(60)		44,451
(Loss) income before income taxes	(67,465)	490,357	352		423,244
Taxes on income	(47,896)	231,075	327		183,506
Net (loss) income	$ (19,569)	$ 259,282	$ 25	$	$ 239,738
Nine months ended September 30, 2006					
Condensed Consolidating Statement of Cash Flows (in thousands)					
Net cash provided by (used in) operating activities	$ 125,855	$ 91,529	$ (286)	$	$ 217,098
Net cash used in investing activities	(156,089)	(88,314)			(244,403)
Net cash provided by (used in) financing activities	31,774	(767)			31,007
	1,540	2,448	(286)		3,702

Net increase (decrease) in cash and cash equivalents												
Cash and cash equivalents at beginning of period		(1,841	)		133,863			598				132,620
Cash and cash equivalents at end of period	$	(301	)	$	136,311	$		312		$	$	136,322

	Penn	Subsidiary Guarantors	Subsidiary Non-Guarantors	Eliminations	Consolidated
At December 31, 2005 Condensed Consolidating Balance Sheet (in thousands)					
Current assets	$ 3,125	$ 273,840	$ 17,622	$ 11,788	$ 306,375
Property and equipment, net	14,739	1,079,537			1,094,276
Other assets	3,171,884	3,145,822	(4,575)	(3,523,378)	2,789,753
Total	$ 3,189,748	$ 4,499,199	$ 13,047	$ (3,511,590)	$ 4,190,404
Current liabilities	$ 61,537	$ 270,307	$ 9,376	$ 89	$ 341,309
Long-term liabilities	2,757,359	3,831,787	-	(3,286,594)	3,302,552
Shareholders equity	370,852	397,105	3,671	(225,085)	546,543
Total	$ 3,189,748	$ 4,499,199	$ 13,047	$ (3,511,590)	$ 4,190,404
Three months ended September 30, 2005 Condensed Consolidating Statement of Income (in thousands)					
Net revenues	$	$ 281,849	$ 12,516	$ (113)	$ 294,252
Total operating expenses	7,137	232,634	9,679	(113)	249,337
(Loss) income from operations	(7,137)	49,215	2,837		44,915
Other income (expenses)	8,872	(23,846)	56,009		41,035
Income before income taxes	1,735	25,369	58,846		85,950
Taxes on income	22,950	7,496	103		30,549
Net (loss) income	$ (21,215)	$ 17,873	$ 58,743	$	$ 55,401
Nine months ended September 30, 2005 Condensed Consolidating Statement of Income (in thousands)					
Net revenues	$	$ 852,756	$ 81,495	$ (491)	$ 933,760
Total operating expenses	21,837	699,234	78,254	(491)	798,834
(Loss) income from operations	(21,837)	153,522	3,241		134,926
Other income (expenses)	20,442	(77,750)	50,903	10	(6,395)
(Loss) income before income taxes	(1,395)	75,772	54,144	10	128,531
Taxes on income	38,433	6,591	181		45,205
Net (loss) income	$ (39,828)	$ 69,181	$ 53,963	$ 10	$ 83,326
Nine months ended September 30, 2005 Condensed Consolidating Statement of Cash Flows (in thousands)					
Net cash provided by (used in) operating activities	$ 84,833	$ 42,570	$ (27,499)	$	$ 99,904
Net cash provided by (used in) investing activities	244,447	(39,920)			204,527
Net cash used in financing activities	(216,950)	(1,157)	(1)		(218,108)
Net increase (decrease) in cash and cash equivalents	112,330	1,493	(27,500)		86,323
Cash and cash equivalents at beginning of period	3,020	56,307	28,293		87,620
Cash and cash equivalents at end of period	$ 115,350	$ 57,800	$ 793	$	$ 173,943

13. Discontinued Operations Hollywood Casino Shreveport

On August 27, 2004, the Company s unrestricted subsidiary, Hollywood Casino Shreveport (HCS), in cooperation with an Ad Hoc Committee representing a majority of its noteholders, entered into an agreement with Eldorado Resorts LLC (Eldorado) providing for the acquisition of HCS by certain affiliates of Eldorado. On September 10, 2004, a group of HCS s creditors, led by Black Diamond Capital Management, LLC, filed with the U.S. Bankruptcy Court, Western District of Louisiana (U.S. Bankruptcy Court), located in Shreveport, Louisiana, an involuntary petition against HCS for relief under Chapter 11 of the U.S. Bankruptcy Code. On October 30, 2004, HCS agreed to the entry of an order for relief in the Chapter 11 case that had been filed against it, and HCS I, Inc., HCS II, Inc., HWCC-Louisiana, Inc. and Shreveport Capital Corporation commenced voluntary cases under Chapter 11 of the Bankruptcy Code. HCS s debt was non-recourse to the Company and its other subsidiaries.

On July 6, 2005, the U.S. Bankruptcy Court entered an order confirming a Chapter 11 plan that provided for the acquisition of HCS by certain affiliates of Eldorado and, on July 22, 2005, the acquisition was completed.

The Company has historically reflected the results of this transaction by classifying the assets, liabilities and results of operations of HCS as assets and liabilities held for sale and discontinued operations in accordance with the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). The Company held no HCS assets or liabilities at September 30, 2006 and December 31, 2005. Net revenues, income from continuing operations and net loss for HCS for the three months ended September 30, 2005 equaled $7.3 million, $2.6 million and $2.3 million, respectively. Net revenues, income from continuing operations and net loss for HCS for the nine months ended September 30, 2005 equaled $67.5 million, $2.8 million and $5.5 million, respectively.

14. Discontinued Operations Sale of The Downs Racing, Inc. and Subsidiaries

On October 15, 2004, the Company announced the sale of The Downs Racing, Inc. and its subsidiaries to the MTGA. In January 2005, the Company received $280 million from the MTGA, and transferred the operations of The Downs Racing, Inc. and its subsidiaries to the MTGA. The sale was not considered final for accounting purposes until the third quarter

of 2006, as the MTGA had certain post-closing termination rights that remained outstanding until August 7, 2006. Reflecting taxes, post closing adjustments, fees and other expenses, the Company realized net proceeds of approximately $175 million, which, in accordance with the Company s credit agreement, were used to retire debt or to reinvest in capital expenditures. The Company recorded the net proceeds, after paying down approximately $60 million of the senior credit facility, as restricted cash. The Company applied the remaining balance of the restricted cash, of approximately $97.0 million, to senior debt reduction in April 2005. Under the terms of the agreement, MTGA acquired The Downs Racing, Inc. and its subsidiaries, including Pocono Downs (a standardbred horse racing facility located on 400 acres in Wilkes-Barre, Pennsylvania) and five Pennsylvania off-track wagering facilities located in Carbondale, East Stroudsburg, Erie, Hazelton and the Lehigh Valley (Allentown). The sale agreement also provided the MTGA with certain post-closing termination rights in the event of certain materially adverse legislative or regulatory events. On August 7, 2006, the Company entered into the Amendment and Release with the MTGA pertaining to the October 14, 2004 Purchase Agreement, and agreed to pay the MTGA an aggregate of $30 million over five years, beginning on the first anniversary of the commencement of slot operations at Mohegan Sun at Pocono Downs, in exchange for the MTGA s agreement to release various claims it raised against the Company under the Purchase Agreement and the MTGA s surrender of all post-closing termination rights it might have had under the Purchase Agreement. As a result of the Amendment and Release, the Company recorded, in accordance with GAAP, a net book gain on the $250 million sale ($280 million initial price, less $30 million payable pursuant to the Amendment and Release) of The Downs Racing, Inc. and its subsidiaries to the MTGA of $114.7 million (net of $84.3 million of income taxes) during the three and nine months ended September 30, 2006. In addition, the Company recorded the $24.6 million present value of the $30 million liability within long-term debt, as the amount due to the MTGA is payable over five years, with the first payment date estimated to occur in late 2007.

At December 31, 2005, the Company reflected the results of this transaction by classifying the assets, liabilities and results of operations of The Downs Racing, Inc. and its subsidiaries as restricted assets and liabilities held for sale and discontinued operations in accordance with the provisions of SFAS 144.

Summarized financial information at September 30, 2006 and December 31, 2005, and for the three and nine months ended September 30, 2006 and 2005, for The Downs Racing, Inc. and its subsidiaries is as follows:

The Downs Racing, Inc. and Subsidiaries
Consolidated Balance Sheets
(in thousands)

	September 30, 2006	December 31, 2005
Assets		
Current assets	$	$ 33
Property and equipment, net		34,385
Other assets		16,565
Total assets held for sale	$	$ 50,983
Liabilities		
Current liabilities	$	$
Other noncurrent liabilities		
Total liabilities held for sale	$	$

The Downs Racing, Inc. and Subsidiaries
Consolidated Statements of Income
(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net revenues	$	$	$	$ 1,813
Loss from continuing operations				(86)
Net loss				(38)

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15. Subsequent Events

On November 7, 2006, Zia Park, LLC (the Buyer), a wholly-owned subsidiary of the Company, entered into an Asset Purchase Agreement (the Asset Purchase Agreement) with Zia Partners, LLC (Zia) and (solely with respect to specified sections thereof which relate to the Company s guarantee described below) the Company, whereby the Buyer will acquire from Zia the Black Gold Casino and Zia Park Racetrack, located on approximately 320 acres in Hobbs, New Mexico, and all related assets of Zia for a purchase price of $200 million in cash, subject to a working capital adjustment and certain other adjustments, and will assume specified liabilities of Zia. Upon the execution of the Asset Purchase Agreement, the Buyer made a deposit of $10 million toward the purchase price. The Company has guaranteed the payment and performance of the Buyer s obligations under the Asset Purchase Agreement. The closing of the transaction is subject to regulatory approvals and other customary closing conditions. The Company intends to fund this purchase with additional borrowings under its existing $750 million revolving credit facility.

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

Our Operations

We are a leading, diversified, multi-jurisdictional owner and operator of gaming properties, as well as horse racetracks and associated off-track wagering facilities (OTWs), which we collectively refer to as our pari-mutuel operations. We now own or operate fourteen gaming properties located in Colorado, Illinois, Indiana, Iowa, Louisiana, Maine, Mississippi, Missouri, Ontario and West Virginia that are focused primarily on serving customers within driving distance of the properties. We also own or operate one racetrack and six OTWs in Pennsylvania, one racetrack in each of West Virginia, Maine, and Ohio, and, through a joint venture, own 50% of a racetrack in New Jersey. On October 3, 2005, we acquired Argosy Gaming Company (Argosy), which included seven properties, of which one has been divested. We believe that our portfolio of assets provides us with a diversified cash flow from operations.

We have made significant acquisitions in the past few years and expect to continue to pursue additional acquisition and development opportunities in the future. As mentioned above, on October 3, 2005, we completed our largest acquisition to date, acquiring Argosy. On March 3, 2003, we acquired Hollywood Casino Corporation, which significantly increased our revenues and cash flow. On February 12, 2004, we purchased Bangor Historic Track, Inc., in Bangor, Maine. In early November 2005, we opened a temporary gaming facility in Bangor, Maine. On July 5, 2004, Pennsylvania Governor Edward G. Rendell signed into law the Pennsylvania Race Horse Development and Gaming Act. Our plan is to develop a completely new gaming and racing facility at our Penn National Race Course in Grantville, Pennsylvania. Under this plan, we expect to open a new permanent facility with 2,000 slot machines around the first quarter of 2008 at an estimated cost of $310 million, inclusive of the $50 million gaming license fee, with the ability to add 1,000 machines as soon as demand warrants. We plan to eventually expand to up to 5,000 gaming devices, based on demand. In late September 2006, the Pennsylvania Gaming Control Board granted us a conditional Category 1 slot machine license.

While we would have preferred to develop the site, as a result of the ownership restrictions on a second slot license in the Pennsylvania gaming law, on October 15, 2004, we announced our agreement to sell The Downs Racing, Inc., its subsidiaries, land and OTWs to the Mohegan Tribal Gaming Authority (MTGA). In January 2005, we received $280 million from the MTGA, and transferred the operations of The Downs Racing, Inc. and its subsidiaries to the MTGA. The sale was not considered final for accounting purposes until the third quarter of 2006, as the MTGA had certain post-closing termination rights that remained outstanding. On August 7, 2006, we entered into the Second Amendment to the Purchase Agreement and Release of Claims (Amendment and Release) with the MTGA pertaining to the October 14, 2004 Purchase Agreement (the Purchase Agreement), and agreed to pay the MTGA an aggregate of $30 million over five years, beginning on the first anniversary of the commencement of slot operations at Mohegan Sun at Pocono Downs, in exchange for the MTGA s agreement to release various claims it raised against us under the Purchase Agreement and the MTGA s surrender of all post-closing termination rights it might have had under the Purchase Agreement. As a result of the Amendment and Release, we recorded, in accordance with GAAP, a net book gain on the $250 million sale ($280 million initial price, less $30 million payable pursuant to the Amendment and Release) of The Downs Racing, Inc. and its subsidiaries to the MTGA of $114.7 million (net of $84.3 million of income taxes) during the three and nine months ended September 30, 2006.

We reflected the results of the transactions for the disposition of Hollywood Casino Shreveport (HCS) and The Downs Racing, Inc. by classifying their assets, liabilities and results of operations as assets and liabilities held for sale and discontinued operations, in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). See Discontinued Operations below for further information about our discontinued operations.

The vast majority of our revenues is gaming revenue, derived primarily from gaming on slot machines and, to a lesser extent, table games. Racing revenue is derived from wagering on our live races, wagering on import simulcasts at our racetracks and OTWs and through telephone account wagering, and fees from wagering on export simulcasting our races. Other revenues are derived from hotel, dining, retail, admissions, program sales, concessions and certain other ancillary activities.

Beginning in the first quarter of 2006, we modified our segment reporting from two reportable segments to one reportable segment, as we believe that our gaming and racing properties can now be aggregated together in accordance with Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131), due to ongoing changes at our racing properties, including the upcoming introduction of slot machines at Penn National Race Course.

We intend to continue to expand our gaming operations through the implementation of a disciplined capital expenditure program at our existing properties and the continued pursuit of strategic acquisitions of gaming properties, particularly in attractive regional markets.

Key performance indicators related to revenues are:

Gaming revenue indicators slot handle (volume indicator), table game drop (volume indicator) and win or hold percentages. Our typical property slot win percentage is in the range of 6% to 10% of slot handle and our typical table games win percentage is in the range of 15% to 25% of table game drop; and

Racing revenue indicators pari-mutuel wagering commissions (volume indicator) earned on wagering on our live races, wagering on import simulcasts at our racetracks and OTWs and through telephone account wagering, and fees from wagering on export simulcasting our races at out-of-state locations.

Our properties generate significant operating cash flow, since most of our revenue is cash-based from slot machines and pari-mutuel wagering. Our business is capital intensive, and we rely on cash flow from our properties to generate operating cash to repay debt, fund capital maintenance expenditures, fund new capital projects at existing properties and provide excess cash for future development and acquisitions.

Executive Summary

Factors affecting our results for the three months ended September 30, 2006, as compared to the three months ended September 30, 2005, included the October 2005 Argosy acquisition, the contribution of Hollywood Slots at Bangor (which opened in November 2005), a full-quarter s contribution from Boomtown Biloxi (which re-opened in June 2006), the recognition of a $114.7 million net book gain on the sale of discontinued operations, a partial quarter s contribution from Hollywood Casino Bay St. Louis (which was formerly known as Casino Magic Bay St. Louis, and which reopened in late August 2006), as well as the impact of higher expenses caused in part by the 3% Illinois tax surcharge on our two Chicagoland boats, increased windstorm and flood insurance costs, and income taxes.

Highlights for the quarter:

Net revenues increased $299.2 million, or 104.3%, for the three months ended September 30, 2006, as compared to the same period in 2005, primarily due to the acquisition of Argosy, the contribution of Hollywood Slots at Bangor, and a full-quarter s contribution from Boomtown Biloxi.

Overall profit margin improved to 21.8% for the three months ended September 30, 2006, as compared to 14.7% for the same period in 2005. The overall profit margin for the three months ended September 30, 2005 included $19.1 million in hurricane expenses related to our Hollywood Casino Bay St. Louis and Boomtown Biloxi properties, which were closed in late August 2005 as a result of extensive damage caused by Hurricane Katrina.

Net income and diluted earnings per share increased by approximately 180% for the three months ended

September 30, 2006, as compared to the same period in 2005.

The results of operations of Argosy, which we acquired on October 3, 2005, have been included in our consolidated financial statements since the October 1, 2005 acquisition effective date.

As a result of our entry into the Amendment and Release with the MTGA, we recorded, in accordance with GAAP, a net book gain on the $250 million sale ($280 million initial price, less $30 million payable pursuant to the Amendment and Release) of The Downs Racing, Inc. and its subsidiaries to the MTGA of $114.7 million (net of $84.3 million of income taxes) during the three and nine months ended September 30, 2006.

On August 8, 2006, we renewed our property insurance coverage in the amount of $200 million. The $200 million coverage is all risk , including named windstorm , flood and earthquake. Also, we purchased an additional $250 million of all risk coverage that is subject to certain exclusions including, among others, exclusion for named windstorms and floods. There is a $25 million deductible for named windstorm events, and lesser deductibles as they apply to other perils. The premium for this coverage was $4.0 million higher during the three months ended September 30, 2006, as compared to the three months ended September 30, 2005.

Other Developments:

On July 27, 2006, we announced that, by mutual agreement, Kevin DeSanctis, our President and Chief Operating Officer, would be leaving us. In accordance with an agreement effective October 9, 2006, Mr. DeSanctis ceased to be an executive officer. In order to facilitate an orderly transition, Mr. DeSanctis will remain an employee through February 9, 2007. We have retained Heidrick & Struggles International, Inc. to assist us in identifying a successor.

Boomtown Biloxi, which had been closed since late August 2005 as a result of extensive damage caused by Hurricane Katrina, reopened on June 29, 2006 with a re-modeled interior, including approximately 1,100 new slot machines, 22 table games and a 350-seat buffet. In early September 2006, Boomtown Biloxi opened its pier-based expansion, with 300 additional slot machines, 8 poker tables and a full-service restaurant.

Hollywood Casino Bay St. Louis, which had been closed since late August 2005 as a result of extensive damage caused by Hurricane Katrina, reopened on August 31, 2006 as a 40,000 square foot temporary casino, which we plan to replace with a permanent land-based casino. In addition, the damaged areas of the existing 290-room hotel tower were completely refurbished. Upon reopening, Hollywood Casino Bay St. Louis featured approximately 20 table games, six live poker tables and 887 slot machines, with room to expand to 1,270 slot machines.

Argosy Casino Lawrenceburg continues to move forward with the construction of a planned casino development. The development includes a 1,500 space parking garage, which is expected to open in the fourth quarter of 2007, a two-level 250,000 square foot barge, and numerous infrastructure upgrades to allow more convenient access to the property, which are expected to open in the fourth quarter of 2008. The new barge will allow up to 4,000 positions on one level, and another 400 positions will be added to the second level, along with restaurants and other amenities on the gaming barge.

In late September 2006, the Pennsylvania Gaming Control Board granted us a conditional Category 1 slot machine license for the placement of slot machines at our planned Hollywood Casino racing and gaming facility at our Penn National Race Course. In August 2006, we commenced construction on the integrated racing and gaming facility at Penn National Race Course. In preparation for the construction, we previously closed and razed the aging grandstand and clubhouse at Penn National Race Course, and opened a new 24,000 square foot temporary facility offering pari-mutuel wagering, food and beverage services, more than 250 television monitors, administrative offices and facilities for jockeys. The Hollywood Casino at Penn National will be a 365,000 square foot facility, and will be sized for 3,000 slot machines, with 2,000 positions planned at opening.

During the third quarter of 2006, we presented to local leaders our plans for the proposed Hollywood Slots at Bangor permanent facility. The proposed permanent facility includes a parking garage, restaurants, retail space and an

off-track wagering facility. Construction on the facility, which will open with 1,000 slot machines and have capacity for 1,500 gaming machines, is planned to commence in early 2007.

At the Charles Town Entertainment Complex, we recently completed construction of a 400-seat buffet and construction of a new parking garage, which doubled our structured parking to 5,000 spaces. In addition, we continue to build and develop the Charles Town Entertainment Complex, with the current expansion of the property including a hotel and a 65,000 square foot expansion of the gaming floor. The expansion of the gaming floor will enable us to initially add 800 more slot machines, with capacity for an additional 1,000 slot machines thereafter. The expanded gaming floor is expected to be completed in two phases, with the first phase being completed in the first quarter of 2007.

Argosy Casino Riverside continues to make progress on the 258-room hotel that is expected to open mid-2007.

In May 2006, the Illinois Legislature passed into law House Bill 1918, effective May 26, 2006, which singled out four of the nine Illinois casinos, including our Empress Casino Hotel and Hollywood Casino Aurora, for a 3% tax surcharge to subsidize local horse racing interests. We began paying this tax surcharge during the three months ended June 30, 2006, and we will continue to pay this tax surcharge in upcoming periods. On May 30, 2006, Empress Casino Hotel and Hollywood Casino Aurora joined with the two other riverboats affected by the law, Harrah s Joliet and the Grand Victoria Casino in Elgin, and filed suit in the Circuit Court of the Twelfth Judicial District in Will County, Illinois (the Court), asking the Court to declare the law unconstitutional. The State agreed to the entry of an order that establishes a protest fund for all of the tax surcharge payments and enjoins the Treasurer from making any payments out of that fund pending the final outcome of the litigation. Should the casinos prevail with their challenge, the incremental taxes paid under protest would be refunded. We anticipate a long process before a resolution to this matter can be reached.

In Ohio, as the owner of Raceway Park in Toledo, we provided support for a proposed constitutional amendment that would have established a tuition grant program for Ohio students to attend public or private colleges in the state by allowing up to 3,500 slot machines at each of the state s seven existing racetracks and two locations in downtown Cleveland. On November 7, 2006, the proposed constitutional amendment was voted down by Ohio citizens. Our efforts and funding of this referendum reduced our earnings on a short-term basis.

In April 2006, we entered into $300 million of new interest rate swap agreements, which brought our swapped portion of LIBOR rate debt to $1.3 billion. The effective date of the swap agreements was May 8, 2006, and will be for a period of five years.

On March 15, 2006, we redeemed $175 million in aggregate principal amount of our outstanding 8 7/8% senior subordinated notes due March 15, 2010. The redemption price was $1,044.38 per $1,000 principal amount, plus accrued and unpaid interest to the scheduled redemption date. We funded the redemption of the notes from available cash and borrowings under our revolving credit facility.

Critical Accounting Policies

We make certain judgments and use certain estimates and assumptions when applying accounting principles in the preparation of our consolidated financial statements. The nature of the estimates and assumptions are material due to the levels of subjectivity and judgment necessary to account for highly uncertain factors or the susceptibility of such factors to change. We have identified the policies related to the accounting for long-lived assets, goodwill and other intangible assets, income taxes and litigation, claims and assessments as critical accounting policies, which require us to make significant judgments, estimates and assumptions.

We believe the current assumptions and other considerations used to estimate amounts reflected in our consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts reflected in our consolidated financial statements, the resulting changes could have a material adverse effect on our consolidated results of operations, and in certain situations, could have a material adverse effect on our financial condition.

The development and selection of the critical accounting policies, and the related disclosures, have been reviewed with the Audit Committee of our Board of Directors.

Long-lived assets

At September 30, 2006, we had a net property and equipment balance of $1,317.6 million, representing 30% of total assets. We depreciate property and equipment on a straight-line basis over their estimated useful lives. The estimated useful lives are determined based on the nature of the assets as well as our current operating strategy. We review the carrying value of our property and equipment whenever events and circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. The factors considered by us in performing this assessment include current operating results, trends and prospects, as well as the effect of obsolescence, demand, competition and other economic factors. In estimating expected future cash flows for determining whether an asset is impaired, assets are grouped at the individual property level. In assessing the recoverability of the carrying value of property and equipment, we must make assumptions regarding future cash flows and other factors. If these estimates or

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the related assumptions change in the future, we may be required to record an impairment loss for these assets. Such an impairment loss would be recognized as a non-cash component of operating income.

Goodwill and other intangible assets

At September 30, 2006, we had $1,894.1 million in goodwill and $727.6 million in other intangible assets on our consolidated balance sheet, representing 43% and 17% of total assets, respectively, resulting from our acquisition of other businesses. Two issues arise with respect to these assets that require significant management estimates and judgment: (i) the valuation in connection with the initial purchase price allocation; and (ii) the ongoing evaluation for impairment.

In connection with our acquisitions, valuations were completed to determine the allocation of the purchase prices. The factors considered in the valuations included data gathered as a result of our due diligence in connection with the acquisitions and projections for future operations. The annual evaluation of goodwill and other intangible assets requires the use of estimates about future operating results of each reporting unit to determine their estimated fair value. Changes in forecasted operations can materially affect these estimates. Once an impairment of goodwill or other intangible assets has been recorded, it cannot be reversed. Because our goodwill and indefinite-life intangible assets are not amortized, there may be volatility in reported income because impairment losses, if any, are likely to occur irregularly and in varying amounts.

Income taxes

We account for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes (SFAS 109). Under SFAS 109, deferred tax assets and liabilities are determined based on the differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities and are measured at the prevailing enacted tax rates that will be in effect when these differences are settled or realized. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized.

The realizability of the deferred tax assets is evaluated quarterly by assessing the valuation allowance and by adjusting the amount of the allowance, if necessary. The factors used to assess the likelihood of realization are the forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. We have used tax-planning strategies to realize or renew net deferred tax assets in order to avoid the potential loss of future tax benefits.

In addition, we operate within multiple taxing jurisdictions and are subject to audit in each jurisdiction. These audits can involve complex issues that may require an extended period of time to resolve. In our opinion, adequate provisions for income taxes have been made for all periods.

Litigation, claims and assessments

We utilize estimates for litigation, claims and assessments. These estimates are based on our knowledge and experience regarding current and past events, as well as assumptions about future events. If our assessment of such a matter should change, we may have to change the estimate, which may have an adverse effect on our results of operations. Actual results could differ from these estimates.

Results of Operations

The following are the most important factors and trends that contribute to our operating performance:

Most of our properties operate in mature competitive markets. As a result, we expect a majority of our future growth to come from prudent acquisitions of gaming properties, jurisdictional expansions and property expansion in under-penetrated markets.

The continued pressure on governments to balance their budgets could intensify the efforts of state and local governments to raise revenues through increases in gaming taxes.

A number of states are currently considering or implementing legislation to legalize or expand gaming. Such legislation presents both potential opportunities to establish new properties (for instance, in Pennsylvania and Ohio) and potential competitive threats to business at our existing properties (such as Maryland, Ohio, Kentucky, and Kansas). The timing and occurrence of these events remain uncertain. Legalized gaming from casinos located on

Native American lands can also have a significant competitive effect.

The continued demand for, and our emphasis on, slot wagering entertainment at our properties.

The ongoing successful expansion and revenue gains at our Charles Town Entertainment Complex, Argosy Casino Lawrenceburg, Hollywood Casino at Penn National Race Course, Hollywood Slots at Bangor and Argosy Casino Riverside facilities.

Financing in a favorable interest rate environment and under an improved credit profile that facilitates our growth.

The impact of Hurricane Katrina on our facilities, our future insurance rates and the Mississippi Gulf Coast market.

The successful execution of the development and construction activities currently underway at a number of our facilities, as well as the risks associated with the costs, regulatory approval, and the timing for these activities.

The results of continuing operations by property level for the three and nine months ended September 30, 2006 and 2005 are summarized below (in thousands):

	Net Revenues (1) For the Three Months Ended September 30,		Income (loss) from Continuing Operations For the Three Months Ended September 30,	
	2006	2005	2006	2005
Charles Town Entertainment Complex	$ 126,973	$ 118,403	$ 31,917	$ 29,408
Argosy Casino Lawrenceburg (2)	120,206		35,599	
Hollywood Casino Aurora	61,781	58,619	16,680	17,842
Empress Casino Hotel (2)	59,852		10,768	
Argosy Casino Riverside (2)	37,999		8,451	
Casino Rouge	33,333	28,877	11,564	8,897
Argosy Casino Alton (2)	29,090		5,573	
Hollywood Casino Tunica	27,089	26,855	4,785	5,096
Casino Magic-Bay St. Louis	10,767	16,366	2,163	(10,809)
Argosy Casino Sioux City (2)	13,319		3,133	
Boomtown Biloxi	27,927	10,782	10,959	(5,236)
Hollywood Slots at Bangor	11,187	733	2,130	(780)
Bullwhackers	6,903	7,888	350	876
Casino Rama management service contract	4,819	5,201	4,466	4,829
Pennsylvania Racing Operations	12,691	13,213	439	(75)
Raceway Park (2)	2,175		(190)	
Corporate overhead			(20,732)	(7,754)
Total	$ 586,111	$ 286,937	$ 128,055	$ 42,294

	Net Revenues (1) For the Nine Months Ended September 30,		Income (loss) from Continuing Operations For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Charles Town Entertainment Complex	$ 366,343	$ 334,390	$ 92,301	$ 83,300
Argosy Casino Lawrenceburg (2)	355,363		105,469	
Hollywood Casino Aurora	184,234	169,862	53,924	48,371
Empress Casino Hotel (2)	179,904		38,645	
Argosy Casino Riverside (2)	114,601		28,371	
Casino Rouge	111,900	86,428	43,136	(1,865)
Argosy Casino Alton (2)	86,814		16,478	
Hollywood Casino Tunica	82,146	79,553	15,814	14,029
Casino Magic-Bay St. Louis	10,767	69,576	1,789	(4,436)
Argosy Casino Sioux City (2)	40,566		10,121	
Boomtown Biloxi	28,937	45,837	11,221	1,123
Hollywood Slots at Bangor	30,001	1,215	5,260	(990)
Bullwhackers	20,525	21,992	842	1,705
Casino Rama management service contract	14,127	13,968	13,098	12,959
Pennsylvania Racing Operations	38,851	41,750	1,288	2,086
Raceway Park (2)	6,607		(369)	
Corporate overhead			(58,595)	(24,048)
Total	$ 1,671,686	$ 864,571	$ 378,793	$ 132,234

(1) Reflects reclassification for cash redemption coupons to contra-revenue from operating expense described in Note 2: Summary of Significant Accounting Policies Revenue Recognition and Promotional Allowances in the Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q. In addition, net

revenues are net of promotional allowances.

(2) Reflects results since the October 1, 2005 acquisition effective date.

Revenues

Revenues for the three and nine months ended September 30, 2006 and 2005 are as follows (in thousands):

	For the Three Months Ended September 30, 2006	2005	Variance	Percentage Variance
Gaming (1)	$ 536,901	$ 249,824	$ 287,077	114.9 %
Racing	13,075	11,627	1,448	12.5 %
Management service fee	4,819	5,201	(382)	(7.3)%
Food, beverage and other	59,198	34,113	25,085	73.5 %
Gross revenue	613,993	300,765	313,228	104.1 %
Less promotional allowances	(27,882)	(13,828)	(14,054)	101.6 %
Net revenues	$ 586,111	$ 286,937	$ 299,174	104.3 %

	For the Nine Months Ended September 30, 2006	2005	Variance	Percentage Variance
Gaming (1)	$ 1,531,155	$ 749,962	$ 781,193	104.2 %
Racing	40,277	36,731	3,546	9.7 %
Management service fee	14,127	13,968	159	1.1 %
Food, beverage and other	164,183	111,263	52,920	47.6 %
Gross revenue	1,749,742	911,924	837,818	91.9 %
Less promotional allowances	(78,056)	(47,353)	(30,703)	64.8 %
Net revenues	$ 1,671,686	$ 864,571	$ 807,115	93.4 %

(1) Reflects reclassification for cash redemption coupons to contra-revenue from operating expense described in Note 2: Summary of Significant Accounting Policies Revenue Recognition and Promotional Allowances in the Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q. In addition, net revenues are net of promotional allowances.

Gaming revenue

Gaming revenue increased by $287.1 million or 114.9% and $781.2 million or 104.2% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The increase in gaming revenue for the three months ended September 30, 2006 was primarily driven by the Argosy acquisition, growth at Charles Town Entertainment Complex, Casino Rouge, and Hollywood Casino Aurora, the reopening of Boomtown Biloxi, and the introduction of the Hollywood Slots at Bangor temporary facility, partially offset by a decrease at Hollywood Casino Bay St. Louis. The increase in gaming revenue for the nine months ended September 30, 2006 was primarily driven by the Argosy acquisition, growth at Charles Town Entertainment Complex, Casino Rouge and Hollywood Casino Aurora, and the introduction of the Hollywood Slots at Bangor temporary facility, partially offset by decreases at Hollywood Casino Bay St. Louis and Boomtown Biloxi.

Gaming revenue at the Argosy properties represented $249.4 million and $743.6 million of the increases for the three and nine months ended September 30, 2006, respectively.

Gaming revenue at the Charles Town Entertainment Complex increased by $8.5 million and $33.1 million for the three and nine months ended September 30, 2006, respectively, as a result of an increase in patronage due to increased market awareness and expansion of the property. The total average gaming machines on the floor was 4,153 for the three months ended September 30, 2006, as compared to 4,473 for the three months ended September 30, 2005, while the win per unit per day increased to $307 for the three months ended September 30, 2006, as compared to $264 for the three months ended September 30, 2005. The total average gaming machines on the floor increased to 4,132 for the nine months ended September 30, 2006, as compared to 4,101 for the nine months ended September 30, 2005, while the win per unit per day increased to $301 for the nine months ended September 30, 2006, as compared to $274 for the nine months ended September 30, 2005.

Gaming revenue at Casino Rouge increased by $4.3 million and $25.0 million for the three and nine months ended September 30, 2006, respectively, as a result of the growth in patron visits and win per patron visit as the population of Baton Rouge grew with residents evacuating New Orleans and southeast Louisiana area after Hurricane Katrina.

Gaming revenue at Hollywood Casino Aurora increased by $3.1 million and $14.8 million for the three and nine months ended September 30, 2006, respectively, as a result of our marketing efforts to increase the number of visitations by our customers and changes to the slot floor. During the third quarter of 2005, Illinois rolled back its gaming tax to pre-June 2003 levels and reduced the admissions tax from $4.00 to $3.00 per person. As a result, Hollywood Casino Aurora initiated a number of marketing programs that are focused on bringing back customers affected by the operational and marketing changes Hollywood Casino Aurora made in response to the gaming and admissions tax increases in 2003. These programs included the elimination of admissions charges, significant advertising of the free admission policy and the mailing of cash and food incentives to individuals who had not visited our property since 2003.

The Hollywood Slots at Bangor temporary facility, which opened to customers in November 2005, generated gaming revenue of $10.3 million and $27.4 million for the three and nine months ended September 30, 2006, respectively.

Gaming revenue at Boomtown Biloxi increased by $16.7 million for the three months ended September 30, 2006, as Boomtown Biloxi, which had been closed effective August 28, 2005, reopened on June 29, 2006.

Gaming revenue at Hollywood Casino Bay St. Louis decreased by $3.8 million for the three months ended September 30, 2006, as Hollywood Casino Bay St. Louis was closed effective August 28, 2005. Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Gaming revenue at Hollywood Casino Bay St. Louis and Boomtown Biloxi for the nine months ended September 30, 2006 decreased by $48.5 million and $14.0 million, as both properties were closed effective August 28, 2005 due to extensive Hurricane Katrina damage. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Racing revenue

Racing revenue increased by $1.4 million or 12.5% and $3.5 million or 9.7% for the three and nine months ended September 30, 2006, as compared to the same periods in 2005, respectively. The increase in racing revenue was a result of the acquisition of Raceway Park as part of the Argosy acquisition, offset by a decline in racing revenue for our Pennsylvania racing operations.

Food, beverage and other

Food, beverage and other increased by $25.1 million or 73.5% and $52.9 million or 47.6% for the three and nine months ended September 30, 2006, as compared to the same periods in 2005, respectively. The Argosy properties contributed $24.8 million and $75.0 million of the increase for the three and nine months ended September 30, 2006. The increase from the Argosy properties for the nine months ended September 30, 2006 was partially offset by decreases of $18.1 million and $5.0 million at Hollywood Casino Bay St. Louis and Boomtown Biloxi for the nine months ended September 30, 2006, respectively, as both properties were closed effective August 28, 2005 due to extensive Hurricane Katrina damage. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Promotional allowances

Promotional allowances increased by $14.1 million or 101.6% and $30.7 million or 64.8% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The Argosy properties accounted for $13.5 million and $40.8 million of the increase for the three and nine months ended September 30, 2006 For the nine months ended September 30, 2006, the increase from the Argosy properties was partially offset by decreases of $7.8 million and $2.0 million at Hollywood Casino Bay St. Louis and Boomtown Biloxi, respectively, as both properties were closed effective August 28, 2005 due to extensive Hurricane Katrina damage. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Operating expenses

Operating expenses for the three and nine months ended September 30, 2006 and 2005 are as follows (in thousands):

	For the Three Months Ended September 30, 2006	2005	Variance	Percentage Variance
Gaming (1)	$ 278,079	$ 136,535	$ 141,544	103.7 %
Racing	10,094	9,173	921	10.0 %
Food, beverage and other	52,703	25,603	27,100	105.8 %
General and administrative	85,984	39,248	46,736	119.1 %
Hurricane expense		19,142	(19,142)	(100.0)%
Settlement costs				
Depreciation and amortization	31,196	14,942	16,254	108.8 %
Total operating expenses	$ 458,056	$ 244,643	$ 213,413	87.2 %

	For the Nine Months Ended September 30, 2006	2005	Variance	Percentage Variance
Gaming (1)	$ 788,705	$ 403,557	$ 385,148	95.4 %
Racing	31,020	28,241	2,779	9.8 %
Food, beverage and other	149,931	75,328	74,603	99.0 %
General and administrative	234,595	131,488	103,107	78.4 %
Hurricane expense		19,142	(19,142)	(100.0)%
Settlement costs		28,175	(28,175)	(100.0)%
Depreciation and amortization	88,642	46,406	42,236	91.0 %
Total operating expenses	$ 1,292,893	$ 732,337	$ 560,556	76.5 %

(1) Reflects reclassification for cash redemption coupons to contra-revenue from operating expense described in Note 2: Summary of Significant Accounting Policies Revenue Recognition and Promotional Allowances in the Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

Gaming expenses

Gaming expenses increased by $141.5 million or 103.7% and $385.1 million or 95.4% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The increase in gaming expenses for the three months ended September 30, 2006 was primarily driven by the Argosy acquisition, increases at Charles Town Entertainment Complex and Hollywood Casino Aurora, the reopening of Boomtown Biloxi, and the introduction of the Hollywood Slots at Bangor temporary facility, partially offset by a decrease at Hollywood Casino Bay St. Louis. The increase in gaming expenses for the nine months ended September 30, 2006 was primarily driven by the Argosy acquisition, an increase at Charles Town Entertainment Complex, and the introduction of the Hollywood Slots at Bangor temporary facility, partially offset by decreases at Hollywood Casino Bay St. Louis and Boomtown Biloxi.

Gaming expenses at the Argosy properties represented $128.2 million and $375.5 million of the increases for the three and nine months ended September 30, 2006, respectively.

Gaming expenses at the Charles Town Entertainment Complex increased by $4.6 million and $20.7 million for the three and nine months ended September 30, 2006, respectively, primarily due to increases in gaming taxes of $4.4 million and $19.6 million, respectively.

Gaming expenses at Hollywood Casino Aurora increased by $3.0 and $6.5 million for the three and nine months ended

September 30, 2006, respectively, due to higher gaming taxes, which resulted from the 3% Illinois tax surcharge.

Gaming expenses at Boomtown Biloxi increased by $3.6 million for the three months ended September 30, 2006, as Boomtown Biloxi, which had been closed effective August 28, 2005, reopened on June 29, 2006.

The Hollywood Slots at Bangor temporary facility, which opened to customers in November 2005, generated gaming expenses of $6.0 million and $15.9 million for the three and nine months ended September 30, 2006, respectively.

Gaming expenses at Hollywood Casino Bay St. Louis decreased by $6.1 million for the three months ended September 30, 2006, as Hollywood Casino Bay St. Louis was closed effective August 28, 2005. Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Gaming expenses at Hollywood Casino Bay St. Louis and Boomtown Biloxi for the nine months ended September 30, 2006 decreased by $34.1 million and $8.3 million, as both properties were closed effective August 28, 2005 due to extensive Hurricane Katrina damage. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Racing expenses

Racing expenses increased by $.9 million or 10.0% and $2.8 million or 9.8% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The increase in racing expenses was a result of the acquisition of Raceway Park as part of the Argosy acquisition, offset by a decline in racing expenses for our Pennsylvania racing operations.

Food, beverage and other expenses

Food, beverage and other expenses increased by $27.1 million or 105.8% and $74.6 million or 99.0% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The increase in food, beverage and other was primarily a result of the Argosy acquisition, which accounted for $29.2 million and $86.9 million of the increase for the three and nine months ended September 30, 2006, respectively. This increase was partially offset by a decrease at Hollywood Casino Bay St. Louis in the amount of $2.8 million for the three months ended September 30, 2006, and decreases at Hollywood Casino Bay St. Louis and Boomtown Biloxi of $9.9 million and $3.2 million for the nine months ended September 30, 2006, respectively, as both properties were closed effective August 28, 2005 due to extensive Hurricane Katrina damage. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

General and administrative expenses

General and administrative expenses increased by $46.7 million or 119.1% and $103.1 million or 78.4% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The increase in general and administrative expenses for the three months ended September 30, 2006 was primarily driven by the Argosy acquisition, increases at our corporate office, the introduction of the Hollywood Slots at Bangor temporary facility, and the reopening of Hollywood Casino Bay St. Louis and Boomtown Biloxi. The increase in general and administrative expenses for the nine months ended September 30, 2006 was primarily driven by the Argosy acquisition, increases at our corporate office, and the introduction of the Hollywood Slots at Bangor temporary facility, all of which were offset by decreases at Hollywood Casino Bay St. Louis and Boomtown Biloxi. General and administrative expenses at the properties include facility maintenance, utilities, property and liability insurance, housekeeping, and all administrative departments such as accounting, purchasing, human resources, legal, compliance and internal audit.

General and administrative expenses at the Argosy properties represented $28.6 million and $81.1 million of the increases for the three and nine months ended September 30, 2006, respectively.

At our corporate office, general and administrative expenses increased by $12.9 million and $29.4 million for the three and nine months ended September 30, 2006, respectively, as a result of the addition of Argosy and other personnel to our corporate office, increases in salaries and wages, and the charge related to stock compensation described below.

The addition of Argosy personnel to our corporate office represented $1.6 million and $5.2 million of the increases for the three and nine months ended September 30, 2006, respectively.

The charge related to stock compensation totaled $4.8 million and $15.2 million for the three and nine months ended

September 30, 2006, respectively. The net impact to earnings for the nine months ended September 30, 2006 was $11.0 million ($.13 per share).

On January 1, 2006, we adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which requires us to expense the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This expense must be recognized ratably over the requisite service period following the date of grant.

We elected the modified prospective application method for adoption, which results in the recognition of compensation expense using the provisions of SFAS 123(R) for all share-based awards granted or modified after December 31, 2005, and the recognition of compensation expense using the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), with the exception of the method of recognizing forfeitures, for all unvested awards outstanding at the date of adoption. Under this transition method, the results of operations of prior periods have not been restated. Accordingly, we will continue to provide pro forma financial information for prior periods to illustrate the effect on net income and earnings per share of applying the fair value recognition provisions of SFAS 123, as amended by SFAS 148.

Prior to January 1, 2006, we accounted for stock-based compensation using the intrinsic-value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), as interpreted by FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation. Under the intrinsic-value method, because the exercise price of our employee stock options was equal to the market price of the underlying stock on the date of grant, no compensation expense was recognized. However, there were situations that could have occurred, such as the accelerated vesting of options or the issuance of restricted stock, that required a current charge to income.

The most significant difference between the fair value approaches prescribed by SFAS 123 and SFAS 123(R) and the intrinsic-value method prescribed by APB 25 related to the recognition of compensation expense for stock option awards based on their grant-date fair value. Under SFAS 123, we estimated the fair value of stock option grants using the Black-Scholes option-pricing model. Additional awards in future years are anticipated.

The fair value for stock options was estimated at the date of grant using the Black-Scholes option-pricing model, which requires management to make certain assumptions. The risk-free interest rate was based on the U.S. Treasury spot rate with a remaining term equal to the expected life assumed at the date of grant. Expected volatility was estimated based on the historical volatility of our stock price over a period of 4.26 years, in order to match the expected life of the options up to the grant date. There is no expected dividend yield since we have not paid any cash dividends on our common stock since our initial public offering in May 1994, and since we intend to retain all of our earnings to finance the development of our business for the foreseeable future. The weighted-average expected life was based on the contractual term of the stock option and expected employee exercise dates, which was based on the historical exercise behavior of our employees. Forfeitures are estimated at the date of grant based on historical experience. Prior to the adoption of SFAS 123(R), we recorded forfeitures as they occurred for purposes of estimating pro forma compensation expense under SFAS 123. The impact of forfeitures is not material. The following are the weighted-average assumptions used in the Black-Scholes option-pricing model for the nine months ended September 30, 2006 and 2005:

	September 30,	
	2006	2005
Risk-free interest rate	5.11 %	3.40 %
Expected volatility	43.29 %	40.00 %
Dividend yield		
Weighted-average expected life (years)	4.26	6.00
Forfeiture rate	4.00 %	

At September 30, 2006, the total compensation cost related to nonvested awards not yet recognized equaled $50.1 million, including $42.4 million for stock options and $7.7 million for restricted stock. This cost is expected to be recognized over the remaining vesting periods, which will not exceed five years.

General and administrative expenses at the Hollywood Slots at Bangor temporary facility, which opened to customers in November 2005, increased by $2.3 million and $6.4 million for the three and nine months ended September 30, 2006, respectively.

General and administrative expenses at Hollywood Casino Bay St. Louis and Boomtown Biloxi increased by $3.2 million and $3.0 million for the three months ended September 30, 2006, respectively, as each incurred less general and administrative expense for the three months ended September 30, 2005 as both properties were closed effective August 28,

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2005 due to extensive Hurricane Katrina. General and administrative expenses at Hollywood Casino Bay St. Louis and Boomtown Biloxi decreased by $3.9 million and $7.5 million for the nine months ended September 30, 2006, respectively, as both properties were closed effective August 28, 2005 due to extensive Hurricane Katrina damage. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Hurricane expense

We recorded a pre-tax charge of $19.1 million associated with the expenses incurred from Hurricane Katrina for the three and nine months ended September 30, 2005. The costs include property insurance and business interruption policy deductible expense (approximately $10.2 million), compensation being paid to employees that exceeds the ordinary payroll limits under the business interruption policy (approximately $4.1 million), the purchase of replacement flood insurance for coverage during the remaining insurance policy term (approximately $3.6 million) contributions to the Penn National Gaming Foundation s Hurricane Katrina Relief Project (approximately $1 million) and costs for insurance claim consultants (approximately $.2 million). The charge does not reflect any loss resulting from the damage to the land-based facilities and casino barges at Hollywood Casino Bay St. Louis and Boomtown Biloxi, as this amount is not yet known. However, we believe that insurance proceeds will be sufficient to fund replacement costs.

Settlement costs

Casino Rouge recorded one-time settlement costs of $28.2 million ($16.8 million after-tax) for the nine months ended September 30, 2005. The charge was part of the $30.5 million Settlement and Property Purchase Agreement, which terminated litigation between the parties, terminated the lease and mutually released all claims of the parties. The property acquired consists of land on the Mississippi River on which Casino Rouge conducts a significant portion of its dock-side operations.

Depreciation and amortization expense

Depreciation and amortization expense increased by $16.3 million or 108.8% and $42.2 million or 91.0%, for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The increase in depreciation and amortization expense for the three months ended September 30, 2006 was primarily due to the Argosy acquisition and the introduction of the Hollywood Slots at Bangor temporary facility. The increase in depreciation and amortization expense for the nine months ended September 30, 2006 was primarily due to the Argosy acquisition and the introduction of the Hollywood Slots at Bangor temporary facility, offset by decreases at Hollywood Casino Bay St. Louis and Boomtown Biloxi.

Depreciation and amortization expense at the Argosy properties represented $14.0 million and $43.6 million of the increases for the three and nine months ended September 30, 2006, respectively.

Depreciation and amortization expense at the Hollywood Slots at Bangor temporary facility, which opened to customers in November 2005, increased by $1.1 million and $2.8 million for the three and nine months ended September 30, 2006, respectively.

Depreciation and amortization expense at Hollywood Casino Bay St. Louis and Boomtown Biloxi decreased by $4.8 million and $1.3 million for the nine months ended September 30, 2006, respectively, as both properties were closed effective August 28, 2005 due to extensive Hurricane Katrina damage. Boomtown Biloxi reopened on June 29, 2006 and Hollywood Casino Bay St. Louis reopened on August 31, 2006.

Income from continuing operations

Income from continuing operations increased by $85.8 million or 202.8% and $246.6 million or 186.5% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. The increase was primarily due to our increased gaming revenues, particularly relating to the Argosy properties that we acquired in October 2005. Our overall profit margin increased to 21.8% and 22.7% for the three and nine months ended September 30, 2006, respectively, as compared to 14.7% and 15.3% for the three and nine months ended September 30, 2005, respectively. The overall profit margin for the three months ended September 30, 2005 included $19.1 million in hurricane expenses related to our Hollywood Casino Bay St. Louis and Boomtown Biloxi properties, which were closed in late August 2005 as a result of extensive damage caused by Hurricane Katrina, while the overall profit margin for the nine months ended September 30, 2005 included $19.1 million in hurricane expenses, as well as $28.2 million in settlement costs related to Casino Rouge.

Other income (expenses)

Other income (expenses) for the three and nine months ended September 30, 2006 and 2005 are as follows (in thousands):

	For the Three Months Ended September 30, 2006	2005	Variance	Percentage Variance
Interest expense	$ (49,732)	$ (12,824)	$ (36,908)	287.8 %
Interest income	882	958	(76)	(7.9)%
Earnings from joint venture	(1,665)	230	(1,895)	(823.9)%
Other	(593)	532	(1,125)	(211.5)%
Loss on early extinguishment of debt				
Total other income (expenses)	$ (51,108)	$ (11,104)	$ (40,004)	360.3 %

	For the Nine Months Ended September 30, 2006	2005	Variance	Percentage Variance
Interest expense	$ (145,927)	$ (41,652)	$ (104,275)	250.3 %
Interest income	2,652	3,180	(528)	(16.6)%
Earnings from joint venture	(678)	1,216	(1,894)	(155.8)%
Other	(519)	438	(957)	(218.5)%
Loss on early extinguishment of debt	(10,022)	(16,673)	6,651	(39.9)%
Total other income (expenses)	$ (154,494)	$ (53,491)	$ (101,003)	188.8 %

Interest expense increased by $36.9 million or 287.8% and $104.3 million or 250.3% for the three and nine months ended September 30, 2006, respectively, as compared to the same periods in 2005. On October 3, 2005, we entered into a $2.725 billion new senior secured credit facility. The credit facility is comprised of a $750.0 million revolving credit facility, a $325.0 million Term Loan A facility and a $1.65 billion Term Loan B facility. The proceeds of the credit facility were used to, among other things, fund the consummation of our acquisition of Argosy, repay our and Argosy s existing credit facilities, fund Argosy s repurchase of all of its 9% senior subordinated notes and 7% senior subordinated notes tendered in the previously-announced tender offers and pay certain fees and expenses in connection with the aforementioned transactions.

We recorded a $10.0 million loss on early extinguishment of debt for the nine months ended September 30, 2006, as a result of the redemption of $175 million in aggregate principal amount of our outstanding 87/8% senior subordinated notes due March 15, 2010. As a result of the redemption, we recorded a loss on early extinguishment of debt of $10.0 million for the call premium and the write-off of the associated deferred financing fees. The $16.7 million loss on early extinguishment of debt for the nine months ended September 30, 2005 was a result of accelerated principal payments on our 2003 senior secured credit facility and the redemption of our $200 million 11 1/8% senior subordinated notes.

Taxes

The increase in our effective tax rate to 47.5% and 44.2% for the three and nine months ended September 30, 2006, respectively, as compared to 36.5% and 35.3% for the three and nine months ended September 30, 2005, respectively, reflects the impact of a discrete item relating to estimated state tax rates, operating results in jurisdictions with higher state income tax, an adjustment for items identified in preparation of our tax returns, and the non-deductibility of permanent differences.

Discontinued operations

We reflected the results of the transactions for the disposition of Hollywood Casino Shreveport (HCS) and The Downs Racing, Inc. by classifying their assets, liabilities and results of operations as assets and liabilities held for sale and discontinued operations, in accordance with the provisions of SFAS 144. We had a loss, net of tax benefit, from discontinued operations of $2.3 million and $5.5 million for the three and nine months ended September 30, 2005, respectively.

On August 27, 2004, HCS, in cooperation with an Ad Hoc Committee representing a majority of its noteholders, entered into an agreement with Eldorado Resorts LLC (Eldorado) providing for acquisition of HCS by certain affiliates of

Eldorado. On September 10, 2004, a group of HCS s creditors, led by Black Diamond Capital Management, LLC, filed with the U.S. Bankruptcy Court, Western District of Louisiana (U.S. Bankruptcy Court), located in Shreveport, Louisiana, an involuntary petition against HCS for relief under Chapter 11 of the U.S. Bankruptcy Code. On October 30, 2004, HCS agreed to the entry of an order for relief in the Chapter 11 case that had been filed against it, and HCS I, Inc., HCS II, Inc., HWCC-Louisiana, Inc. and Shreveport Capital Corporation commenced voluntary cases under Chapter 11 of the Bankruptcy Code. HCS s debt was non-recourse to us and our other subsidiaries.

On July 6, 2005, the U.S. Bankruptcy Court entered an order confirming a Chapter 11 plan that provided for the acquisition of HCS by certain affiliates of Eldorado and, on July 22, 2005, the acquisition was completed.

On October 15, 2004, we announced the sale of The Downs Racing, Inc. and its subsidiaries to the MTGA. In January 2005, we received $280 million from the MTGA, and transferred the operations of The Downs Racing, Inc. and its subsidiaries to the MTGA. The sale was not considered final for accounting purposes until the third quarter of 2006, as the MTGA had certain post-closing termination rights that remained outstanding until August 7, 2006. Reflecting taxes, post closing adjustments, fees and other expenses, we realized net proceeds of approximately $175 million, which, in accordance with our credit agreement, were used to retire debt or to reinvest in capital expenditures. We recorded the net proceeds, after paying down approximately $60 million of the senior credit facility, as restricted cash. We applied the remaining balance of the restricted cash, of approximately $97.0 million, to senior debt reduction in April 2005. Under the terms of the agreement, MTGA acquired The Downs Racing, Inc. and its subsidiaries, including Pocono Downs (a standardbred horse racing facility located on 400 acres in Wilkes-Barre, Pennsylvania) and five Pennsylvania off-track wagering facilities located in Carbondale, East Stroudsburg, Erie, Hazelton and the Lehigh Valley (Allentown). The sale agreement also provided the MTGA with certain post-closing termination rights in the event of certain materially adverse legislative or regulatory events. On August 7, 2006, we entered into the Second Amendment to the Amendment and Release with the MTGA pertaining to the October 14, 2004 Purchase Agreement, and agreed to pay the MTGA an aggregate of $30 million over five years, beginning on the first anniversary of the commencement of slot operations at Mohegan Sun at Pocono Downs, in exchange for the MTGA s agreement to release various claims it raised against us under the Purchase Agreement and the MTGA s surrender of all post-closing termination rights it might have had under the Purchase Agreement. As a result of the Amendment and Release, we recorded, in accordance with GAAP, a net book gain on the $250 million sale ($280 million initial price, less $30 million payable pursuant to the Amendment and Release) of The Downs Racing, Inc. and its subsidiaries to the MTGA of $114.7 million (net of $84.3 million of income taxes) during the three and nine months ended September 30, 2006. In addition, we recorded the $24.6 million present value of the $30 million liability within long-term debt, as the amount due to the MTGA is payable over five years, with the first payment date estimated to occur in late 2007.

Liquidity and Capital Resources

Historically, our primary sources of liquidity and capital resources have been cash flow from operations, borrowings from banks and proceeds from the issuance of debt and equity securities.

Net cash provided by operating activities was $217.1 million and $99.9 million for the nine months ended September 30, 2006 and 2005, respectively. Net cash provided by operating activities for the nine months ended September 30, 2006 consisted of net income of $239.7 million, non-cash reconciling items, such as depreciation and amortization, the charge for stock compensation, and the gain on the sale of discontinued operations of $(13.3) million, and net changes in current asset and liability accounts of $(9.4) million.

Cash flows used in investing activities totaled $244.4 million for the nine months ended September 30, 2006. Cash flows provided by investing activities totaled $204.5 million for the nine months ended September 30, 2005. Cash flows used in investing activities for the nine months ended September 30, 2006 included expenditures for property and equipment totaling $246.7 million, offset by proceeds from the sale of property and equipment totaling $2.3 million.

Cash flows provided by financing activities totaled $31.0 million for the nine months ended September 30, 2006. Cash flows used in financing activities totaled $218.1 million for the nine months ended September 30, 2005. Cash flows provided by financing activities for the nine months ended September 30, 2006 included net proceeds from the exercise of stock options totaling $9.9 million, proceeds from the issuance of long-term debt equaling $167.4 million, the majority of which was from our new credit facility, and principal payments on long-term debt totaling $176.0 million. The principal payment on long-term debt included the call for redemption of all $175 million in aggregate principal amount of our outstanding 87/8% senior subordinated notes due March 15, 2010. Cash flows provided by financing activities for the nine months ended September 30, 2006 also included $29.4 million in proceeds from insurance financing, offset by $9.1 million in payments on insurance financing, as well as the tax benefit from stock options exercised, which equaled $9.4 million for the nine months ended September 30, 2006.

Capital Expenditures

Capital expenditures are accounted for as either capital project or capital maintenance (replacement) expenditures. Capital project expenditures are for fixed asset additions that expand an existing facility. Capital maintenance (replacement) expenditures are expenditures to replace existing fixed assets with a useful life greater than one year that are obsolete, worn out or no longer cost effective to repair.

The following table summarizes our capital project expenditures by property for the fiscal year ended December 31, 2006, and actual expenditures for the nine months ended September 30, 2006, other than capital maintenance expenditures and expenditures related to the repair of Boomtown Biloxi and Hollywood Casino Bay St. Louis, which are assumed to be funded through insurance recoveries (in millions):

Property	Expected for Year Ended December 31, 2006	Expenditures Through September 30, 2006	Balance to Expend in 2006
Charles Town Entertainment Complex	$ 46.8	$ 41.4	$ 5.4
Hollywood Casino at Penn National	26.2	17.4	8.8
Hollywood Slots at Bangor	12.9	3.8	9.1
Argosy Casino Riverside	43.4	30.4	13.0
Argosy Casino Lawrenceburg	36.5	30.0	6.5
Boomtown Biloxi	15.2	15.2	
Other	5.3	4.1	1.2
Totals	$ 186.3	$ 142.3	$ 44.0

At the Charles Town Entertainment Complex, we recently completed construction of a 400-seat buffet and construction of a new parking garage, which doubled our structured parking to 5,000 spaces. In addition, we continue to build and develop the Charles Town Entertainment Complex, with the current expansion of the property including a hotel and a 65,000 square foot expansion of the gaming floor. The expansion of the gaming floor will enable us to initially add 800 more slot machines, with capacity for an additional 1,000 slot machines thereafter. The expanded gaming floor is expected to be completed in two phases, with the first phase being completed in the first quarter of 2007.

In late September 2006, the Pennsylvania Gaming Control Board granted us a conditional Category 1 slot machine license for the placement of slot machines at our planned Hollywood Casino racing and gaming facility at our Penn National Race Course. In August 2006, we commenced construction on the integrated racing and gaming facility at Penn National Race Course. In preparation for the construction, we previously closed and razed the aging grandstand and clubhouse at Penn National Race Course, and opened a new 24,000 square foot temporary facility offering pari-mutuel wagering, food and beverage services, more than 250 television monitors, administrative offices and facilities for jockeys. The Hollywood Casino at Penn National will be a 365,000 square foot facility, and will be sized for 3,000 slot machines, with 2,000 positions planned at opening.

During the third quarter of 2006, we presented to local leaders our plans for the proposed Hollywood Slots at Bangor permanent facility. The proposed permanent facility includes a parking garage, restaurants, retail space and an off-track wagering facility. Construction on the facility, which will open with 1,000 slot machines and have capacity for 1,500 gaming machines, is planned to commence in early 2007.

At Argosy Casino Riverside, we are continuing to make progress on the 258-room hotel that is expected to open mid-2007.

We continue to move forward with the construction of a planned casino development at Argosy Casino Lawrenceburg. The development includes a 1,500 space parking garage, which is expected to open in the fourth quarter of 2007, a two-level 250,000 square foot barge, and numerous infrastructure upgrades to allow more convenient access to the property, which are expected to open in the fourth quarter of 2008. The new barge will allow up to 4,000 positions on one level, and another 400 positions will be added to the second level, along with restaurants and other amenities on the gaming barge.

During the three and nine months ended September 30, 2006, we spent approximately $85.3 million and $138.9 million, respectively, for capital project expenditures related to Boomtown Biloxi and Hollywood Casino Bay St. Louis.

During the three and nine months ended September 30, 2006, we spent approximately $13.8 million and $44.9 million, respectively, for capital maintenance expenditures at our properties. The majority of the capital maintenance expenditures were for slot machines and related slot machine equipment, including ticket-in, ticket-out (TITO) equipment. We expect that all of our facilities will be 100% TITO, with the exception of Bullwhackers, by the end of 2007.

Cash generated from operations and cash available under the revolver portion of our credit facility funded our capital expenditure and capital maintenance expenditures in 2006.

Debt

Senior Secured Credit Facility

During the nine months ended September 30, 2006, we borrowed under our senior secured credit facility, in order to fund the redemption of the 87/8% senior subordinated notes due March 15, 2010 and for capital expenditures.

87/8% Senior Subordinated Notes

During the nine months ended September 30, 2006, we redeemed $175 million in aggregate principal amount of our outstanding 87/8% senior subordinated notes due March 15, 2010. The redemption price was $1,044.38 per $1,000 principal amount, plus accrued and unpaid interest to the scheduled redemption date, which was March 15, 2006. We funded the redemption of the notes from available cash and borrowing under our revolving credit facility. As a result of the redemption, we recorded a pre-tax loss on early extinguishment of debt of $10.0 million for the call premium and the write-off of the associated deferred financing fees.

Covenants

Our senior secured credit facility and $200 million 67/8% senior subordinated notes and $250 million 6¾% senior subordinated notes require us, among other obligations, to maintain specified financial ratios and to satisfy certain financial tests, including fixed charge coverage, senior leverage and total leverage ratios. In addition, our senior secured credit facility and our $200 million 67/8% and our $250 million 6¾% senior subordinated notes restrict, among other things, our ability to incur additional indebtedness, incur guarantee obligations, amend debt instruments, pay dividends, create liens on assets, make investments, make acquisitions, engage in mergers or consolidations, make capital expenditures, or engage in certain transactions with subsidiaries and affiliates and otherwise restricts corporate activities.

During the three months ended September 30, 2006, we made certain amendments to our existing $2.725 billion senior secured credit facility, including the modification of the applicable covenants to enable us to repurchase up to $200 million of its equity or debt securities, the modification of our capital expenditure covenant to increase certain permitted expenditures consistent with our development and expansion projects, and the modification of our collateral documents in accordance with requirements of the Pennsylvania gaming authorities.

At September 30, 2006, we were in compliance with all required financial covenants.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The table below provides information at September 30, 2006, about our financial instruments that are sensitive to changes in interest rates, including debt obligations and interest rate swaps. For debt obligations, the table presents principal amounts maturing and weighted-average interest rates during the period. For interest rate swaps, the table presents notional amounts and weighted average interest rates outstanding during the period. Notional amounts are used to calculate the contractual payments to be exchanged under the contract and the weighted-average variable rates are based on implied forward rates in the yield curve as of September 30, 2006.

	10/01/06-9/30/07 (in thousands)	10/01/07-9/30/08	10/01/08-9/30/09	10/01/09-9/30/10	10/01/10-9/30/11	Thereafter	Total	Fair Value 9/30/06
Long-term debt:								
Fixed rate	$ 10	$ 3,733	$ 5,910	$ 5,807	$ 5,697	$ 453,460	$ 474,617	$ 469,055
Average interest rate	9.00 %	7.00 %	7.00 %	7.00 %	7.00 %	6.82 %		
Variable rate	$ 16,500	$ 81,500	$ 97,750	$ 97,750	$ 447,126	$ 1,575,374	$ 2,316,000	$ 2,316,000
Average interest rate (1)	7.06 %	6.64 %	6.67 %	6.80 %	6.92 %	6.97 %		
Leases	$ 1,971	$ 2,190	$ 2,107	$ 1,209	$ 1,040	$ 3,060	$ 11,577	$ 11,577
Average interest rate	6.68 %	6.68 %	6.68 %	6.65 %	6.65 %	6.65 %		
Interest rate derivatives:								
Interest rate swaps								
Variable to fixed (2)	$ 1,260,000	$ 1,260,000	$ 811,000	$ 574,000	$	$	N/A	$ 3,162
Average pay rate	4.84 %	4.84 %	4.93 %	5.02 %			N/A	
Average receive rate (3)	5.31 %	4.89 %	4.92 %	5.05 %			N/A	

(1) Estimated rate, reflective of forward LIBOR plus the spread over LIBOR applicable to variable-rate borrowing.

(2) Notional amounts outstanding at each year-end.

(3) Estimated rate, reflective of forward LIBOR.

In accordance with the terms of its $2.725 billion senior secured credit facility, we were required to enter into interest rate swap agreements in an amount equal to 50% of the outstanding term loan balances within 100 days of the closing date of the credit facility. On October 27, 2005, we entered into four interest rate swap contracts with terms from three to five years, notional amounts of $224 million, $274 million, $225 million, and $237 million, for a total of $960 million and fixed interest rates ranging from 4.678% to 4.753%. The annual weighted-average interest rate of the four contracts is 4.71%. On May 8, 2006, we entered into three interest rate swap contracts with a term of five years, notional amounts of $100 million each, for a total of $300 million and fixed interest rates ranging from 5.263% to 5.266%. Under these contracts, we pay a fixed interest rate against a variable interest rate based on the 90-day LIBOR rate. The 90-day LIBOR rate relating to these contracts as of September 30, 2006 was 5.49% for the $960 million swaps and 5.50% for the $300 million swaps.

ITEM 4. CONTROLS AND PROCEDURES

Our management, under the supervision and with the participation of our principal executive officer and principal financial officer, have evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2006, which is the end of the period covered by this Quarterly Report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well-designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on that evaluation, our principal executive officer and principal financial officer have concluded that these disclosure controls and procedures are sufficient to provide that (a) material information relating to us, including our consolidated subsidiaries, is made known to these officers by other employees of us and our consolidated subsidiaries, particularly material information related to the period for which this periodic report is being prepared; and (b) this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There were no changes that occurred during the fiscal quarter covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonable likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information in response to this Item is incorporated by reference to the information set forth in Note 9. Commitments and Contingencies in the Notes to Consolidated Financial Statements in Part I of this Quarterly Report on Form 10-Q.

ITEM 6. EXHIBITS

Exhibit	**Description of Exhibit**
2.2	Second Amendment to Purchase Agreement and Release of Claims, dated as of August 7, 2006, between PNGI Pocono Inc. and The Mohegan Tribal Gaming Authority, and joined in by Penn National Gaming, Inc. (incorporated by reference to Exhibit 2.2 to the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2006)
10.1	Employment Agreement dated July 31, 2006 between Penn National Gaming, Inc. and Leonard DeAngelo (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed on August 2, 2006)
10.2	Amendment, dated September 18, 2006, to the Credit Agreement by and among the Company, the subsidiary guarantors party thereto, Deutsche Bank Securities Inc., Goldman Sachs Credit Partners L.P. and Lehman Brothers Inc., as Joint Lead Arrangers and Joint Bookrunners, Goldman Sachs Credit Partners L.P. and Lehman Commercial Paper Inc., as Co-Syndication Agents, Deutsche Bank Trust Company Americas, as Swingline Lender, Administrative Agent and as Collateral Agent, and Calyon New York Branch, Wells Fargo Bank, National Association and Bank of Scotland, as Co-Documentation Agents, and the lenders party thereto (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed on September 21, 2006)
10.3	Separation Agreement and General Release dated October 3, 2006 between Penn National Gaming, Inc. and Kevin DeSanctis (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed on October 6, 2006)
31.1	CEO Certification pursuant to rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934
31.2	CFO Certification pursuant to rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934
32.1	CEO Certification pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002
32.2	CFO Certification pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PENN NATIONAL GAMING, INC.

November 9, 2006

By: /s/ William J. Clifford
William J. Clifford
Senior Vice President-Finance and Chief Financial Officer

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