Large Filing Separator Sheet

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conditions exist. SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," governs the accounting treatment for impairments of long-lived assets and indicates that companies are required to test long-lived assets for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. Examples of such events or changes include a significant decrease in the market price of a long-lived asset or a significant adverse change in the manner in which an asset is being used or its physical condition.

For long-lived assets that are expected to be held and used, SFAS No. 144 requires that an impairment loss be recognized only if the carrying amount of an asset is not recoverable and exceeds its fair value. For long-lived assets that can be classified as assets to be disposed of by sale under SFAS No. 144, an impairment loss will be recognized to the extent their carrying amount exceeds their fair value including costs to sell.

During 2003, PHI recorded an impairment charge of $53.3 million from the cancellation of a combustion turbine purchase contract and an impairment charge of $11.0 million related to aircraft investments held for lease by PCI.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, money market funds, and commercial paper with original maturities of three months or less.

Restricted Cash

Restricted cash represents cash either held as collateral or pledged as collateral that is restricted from use for general corporate purposes.

Prepaid Expenses and Other

The prepaid expenses and other balance primarily consists of prepayments and the current portion of deferred income tax assets.

Accounts Receivable and Allowance for Uncollectible Accounts

Pepco Holdings' subsidiaries' accounts receivable balances primarily consist of customer accounts receivable, other accounts receivable, and accrued unbilled revenue. Accrued unbilled revenue represents revenue earned in the current period but not billed to the customer until a future date (usually within one month after the receivable is recorded). PHI uses the allowance method to account for uncollectible accounts receivable.

Capitalized Interest and Allowance for Funds Used During Construction

In accordance with the provisions of SFAS No. 34, "Capitalization of Interest Cost," the cost of financing the construction of Pepco Holdings' non-regulated subsidiaries' electric generating plants is capitalized. Other non-utility construction projects also include financing costs in accordance with SFAS No. 34. In accordance with the provisions of SFAS No. 71, utilities can capitalize Allowance for Funds Used During Construction (AFUDC) as part of the cost of plant and equipment. AFUDC recognizes that utility construction is financed partially by debt and partially by equity.

Pepco Holdings recorded AFUDC for borrowed funds of $3.3 million, $2.8 million, and $3.0 million for the years ended December 31, 2005, 2004, and 2003, respectively. These amounts are recorded as a reduction of "interest expense" in the accompanying Consolidated Statements of Earnings.

Pepco Holdings recorded amounts for the equity component of AFUDC of $4.7 million, $4.1 million and $4.6 million for the years ended December 31, 2005, 2004 and 2003, respectively. The amounts are included in the "other income" caption of the accompanying Consolidated Statements of Earnings.

Leasing Activities

Pepco Holdings accounts for leases entered into by its subsidiaries in accordance with the provisions of SFAS No. 13, "Accounting for Leases." Income from investments in direct financing leases and leveraged lease transactions, in which PCI is an equity participant, is accounted for using the financing method. In accordance with the financing method, investments in leased property are recorded as a receivable from the lessee to be recovered through the collection of future rentals. For direct financing leases, unearned income is amortized to income over the lease term at a constant rate of return on the net investment. Income, including investment tax credits, on leveraged equipment leases is recognized over the life of the lease at a constant rate of return on the positive net investment. Investments in equipment under capital leases are stated at cost, less accumulated depreciation. Depreciation is recorded on a straight-line basis over the equipment's estimated useful life.

Amortization of Debt Issuance and Reacquisition Costs

Expenses incurred in connection with the issuance of long-term debt, including premiums and discounts associated with such debt, are deferred and amortized over the lives of the respective debt issues. Costs associated with the reacquisition of debt for PHI's regulated operations are also deferred and amortized over the lives of the new issues.

Pension and Other Postretirement Benefit Plans

Pepco Holdings sponsors a retirement plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries (Retirement Plan). Pepco Holdings also provides supplemental retirement benefits to certain eligible executives and key employees through nonqualified retirement plans and provides certain postretirement health care and life insurance benefits for eligible retired employees.

Pepco Holdings accounts for the Retirement Plan in accordance with SFAS No. 87, "Employers' Accounting for Pensions," and its postretirement health care and life insurance benefits for eligible employees in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." PHI's financial statement disclosures are prepared in accordance with SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," as revised.

Severance Costs

In 2004, PHI's Power Delivery business reduced its work force through a combination of retirements and targeted reductions. This reduction plan met the criteria for the accounting treatment provided under SFAS No. 88, "Employer's Accounting for Settlements and

Curtailments of Defined Benefit Pension Plans and for Termination Benefits," and SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," as applicable. Additionally, during 2002, Pepco Holdings' management approved initiatives by Pepco and Conectiv to streamline their operating structures by reducing the number of employees at each company. These initiatives met the criteria for the accounting treatment provided under EITF No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." A roll forward of PHI's severance accrual balance is as follows (Millions of dollars):

Balance, December 31, 2003	$ 7.9
Accrued during 2004	11.7
Payments during 2004	(12.5)
Balance, December 31, 2004	7.1
Accrued during 2005	5.0
Payments during 2005	(9.6)
Balance, December 31, 2005	$ 2.5

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. The carrying value of property, plant and equipment is evaluated for impairment whenever circumstances indicate the carrying value of those assets may not be recoverable under the provisions of SFAS No. 144. Upon retirement, the cost of regulated property, net of salvage, is charged to accumulated depreciation. For non-regulated property, the cost and accumulated depreciation of the property, plant and equipment retired or otherwise disposed of are removed from the related accounts and included in the determination of any gain or loss on disposition. For additional information regarding the treatment of asset removal obligations, see the "Asset Retirement Obligations" section included in this Note.

The annual provision for depreciation on electric and gas property, plant and equipment is computed on a straight-line basis using composite rates by classes of depreciable property. Accumulated depreciation is charged with the cost of depreciable property retired, less salvage and other recoveries. Property, plant and equipment other than electric and gas facilities is generally depreciated on a straight-line basis over the useful lives of the assets. The system-wide composite depreciation rates for 2005, 2004 and 2003 for Pepco's transmission and distribution system property were approximately 3.4%, 3.5% and 3.5%, respectively. The system-wide composite depreciation rates for 2005, 2004 and 2003 for DPL's transmission and distribution system property was approximately 3.1%. The system-wide composite depreciation rates for 2005, 2004 and 2003 for ACE's generation, transmission and distribution system property were 3.1%, 3.3% and 3.2%, respectively.

Asset Retirement Obligations

Pepco Holdings adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," on January 1, 2003 and FIN 47 as of December 31, 2005. This statement and related interpretation establish the accounting and reporting standards for measuring and recording asset retirement obligations. Based on the implementation of SFAS No. 143, $244.2 million of accrued asset removal costs ($179.2 million for DPL and $65.0 million for Pepco) at December 31, 2005, and $254.1 million of accrued asset removal costs ($176.9 million for DPL and $77.2 million for Pepco) at December 31, 2004, are reflected as regulatory liabilities in the accompanying

Consolidated Balance Sheets. Commission-approved depreciation rates for ACE do not contain components for the recovery of removal cost; therefore, the recording of asset retirement obligations for ACE associated with accruals for removal cost is not required. Additionally, in 2005, Pepco Holdings recorded conditional asset retirement obligations of approximately $1.5 million. Accretion expense for 2005, which relates to the regulated Power Delivery segment, has been recorded as a regulatory asset.

Stock-Based Compensation

Pepco Holdings accounts for its stock-based employee compensation under the intrinsic value method of expense recognition and measurement prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees, and related Interpretations" (APB No. 25). As required by SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," a tabular presentation of the pro-forma stock-based employee compensation cost, net income, and basic and diluted earnings per share as if the fair value based method of expense recognition and measurement prescribed by SFAS No. 123 had been applied to all options follows:

	For the Year Ended December 31,		
	2005	2004	2003
	(In millions, except per share data)		
Net Income, as reported	$ 371.2	$ 260.6	$ 107.3
Add: Total stock-based employee compensation expense included in net income as reported (net of related tax effect of $1.8 million, $1.7 million and $1.2 million, respectively)	2.6	2.6	2.0
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards (net of related tax effect of $2.0 million, $2.5 million and $1.5 million, respectively)	(2.8)	(3.8)	(2.6)
Pro forma net income	$ 371.0	$ 259.4	$ 106.7
Basic earnings per share as reported	$ 1.96	$ 1.48	$ .63
Pro forma basic earnings per share	$ 1.96	$ 1.47	$ .63
Diluted earnings per share as reported	$ 1.96	$ 1.48	$ .63
Pro forma diluted earnings per share	$ 1.96	$ 1.47	$ .63

Accumulated Other Comprehensive Loss

A detail of the components of Pepco Holdings' Accumulated Other Comprehensive Loss is as follows. For additional information, see the Consolidated Statements of Comprehensive Earnings.

	Commodity Derivatives	Treasury Lock	Interest Rate Swaps	Marketable Securities	Other (a)	Accumulated Other Comprehensive (Loss) Income
			(Millions of dollars)			
Balance, December 31, 2002	$17.2	$(59.7)	$(9.6)	($.8)	$ -	$(52.9)
Current year change	15.0	5.4	6.0	3.8	-	30.2
Balance, December 31, 2003	32.2	(54.3)	(3.6)	3.0	-	(22.7)
Current year change	(32.7)	7.2	3.3	(3.0)	(4.1)	(29.3)
Balance, December 31, 2004	$ (.5)	$(47.1)	$ (.3)	$ -	$(4.1)	$(52.0)
Current year change	25.1	7.0	.3	-	(3.2)	29.2
Balance, December 31, 2005	$24.6	$(40.1)	$ -	$ -	$(7.3)	$(22.8)

(a) Represents an adjustment for nonqualified pension plan minimum liability.

A detail of the income tax expense (benefit) allocated to the components of Pepco Holdings' Other Comprehensive Earnings (Loss) for each year is as follows.

Year Ended	Commodity Derivatives	Treasury Lock	Interest Rate Swaps	Marketable Securities	Other(a)	Other Comprehensive (Loss) Income
			(Millions of dollars)			
December 31, 2003	$ 11.1	$ 6.3	$ 3.0	$ 2.0	$ -	$ 22.4
December 31, 2004	$(21.6)	$ 4.5	$ 1.8	$(1.4)	$(2.8)	$(19.5)
December 31, 2005	$ 15.9	$ 4.7	$ .1	$ -	$(2.0)	$ 18.7

(a) Represents the income tax benefit on an adjustment for nonqualified pension plan minimum liability.

Financial Investment Liquidation

In October 2005, PCI received $13.3 million in cash related to the liquidation of a preferred stock investment that was written-off in 2001 and recorded an after tax gain of $8.9 million.

Income Taxes

PHI and the majority of its subsidiaries file a consolidated Federal income tax return. Federal income taxes are allocated among PHI and the subsidiaries included in its consolidated group pursuant to a written tax sharing agreement which was approved by the SEC pursuant to regulations under PUHCA 1935 in connection with the establishment of PHI as a holding company as part of Pepco's acquisition of Conectiv on August 1, 2002. Under this tax sharing agreement, PHI's consolidated Federal income tax liability is allocated based upon PHI's and its subsidiaries' separate taxable income or loss amounts, with the exception of the tax benefits applicable to non-acquisition debt expenses of PHI. Such tax benefits are allocated only to subsidiaries with taxable income.

The Consolidated Financial Statements include current and deferred income taxes. Current income taxes represent the amounts of tax expected to be reported on PHI's and its subsidiaries' federal and state income tax returns. Deferred income taxes are discussed below.

Deferred income tax assets and liabilities represent the tax effects of temporary differences between the financial statement and tax basis of existing assets and liabilities and are measured using presently enacted tax rates. The portion of Pepco's, DPL's, and ACE's deferred tax liability applicable to its utility operations that has not been recovered from utility customers represents income taxes recoverable in the future and is included in "regulatory assets" on the Consolidated Balance Sheet. For additional information, see the preceding discussion under "Regulation of Power Delivery Operations."

Deferred income tax expense generally represents the net change during the reporting period in the net deferred tax liability and deferred recoverable income taxes.

Investment tax credits from utility plants purchased in prior years are reported on the Consolidated Balance Sheet as "Investment tax credits." These investment tax credits are being amortized to income over the useful lives of the related utility plant.

FIN 46R

Subsidiaries of Pepco Holdings have power purchase agreements (PPAs) with a number of entities, including three ACE Non-Utility Generation contracts (ACE NUGs) and an agreement of Pepco (Panda PPA) with Panda-Brandywine, L.P. (Panda). Due to a variable element in the pricing structure of the ACE NUGs and the Panda PPA, the Pepco Holdings' subsidiaries potentially assume the variability in the operations of the plants related to these PPAs and therefore have a variable interest in the counterparties to these PPAs. As required by FIN 46R, Pepco Holdings continued, during 2005, to conduct exhaustive efforts to obtain information from these four entities, but was unable to obtain sufficient information to conduct the analysis required under FIN 46R to determine whether these four entities were variable interest entities or if Pepco Holdings' subsidiaries were the primary beneficiary. As a result, Pepco Holdings has applied the scope exemption from the application of FIN 46R for enterprises that have conducted exhaustive efforts to obtain the necessary information, but has not been able to obtain such information.

Net purchase activities with the counterparties to the ACE NUGs and the Panda PPA for the years ended December 31, 2005, 2004, and 2003, were approximately $419 million, $341 million, and $326 million, respectively, of which approximately $381 million, $312 million, and $299 million, respectively, related to power purchases under the ACE NUGs and the Panda PPA. Pepco Holdings' exposure to loss under the agreement with Panda entered into in 1991, pursuant to which Pepco is obligated to purchase from Panda 230 megawatts of capacity and energy annually through 2021, is discussed in Note (12), Commitments and Contingencies, under "Relationship with Mirant Corporation." Pepco Holdings does not have loss exposure under the ACE NUGs because cost recovery will be achieved from ACE's customers through regulated rates.

Other Non-Current Assets

The other assets balance principally consists of real estate under development, equity and other investments, unrealized derivative assets, and deferred compensation trust assets.

Other Current Liabilities

The other current liability balance principally consists of customer deposits, accrued vacation liability, current unrealized derivative liabilities, and the current portion of deferred income taxes.

Other Deferred Credits

The other deferred credits balance principally consists of non-current unrealized derivative liabilities and miscellaneous deferred liabilities.

New Accounting Standards

SFAS No. 154

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections (SFAS No. 154), a replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. The reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS No. 154. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 (the year ended December 31, 2006 for Pepco Holdings). Early adoption is permitted.

SFAS No. 155

In February 2006, the FASB issued Statement No. 155, "Accounting for Certain Hybrid Financial Instruments-an amendment of FASB Statements No. 133 and 140" (SFAS No. 155). This Statement amends FASB Statements No. 133, "Accounting for Derivative Instruments and Hedging Activities", and No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Pepco Holdings is in the process of evaluating the impact of SFAS No. 155 but does not anticipate that its implementation will have a material impact on Pepco Holdings overall financial condition, results of operations, or cash flows.

SAB 107 and SFAS No. 123R

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) which provides implementation guidance on the interaction between FASB Statement No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R), and certain SEC rules and regulations, as well as guidance on the valuation of share-based payment arrangements for public companies.

In April 2005, the SEC adopted a rule delaying the effective date of SFAS No. 123R for public companies. Under the rule, most registrants must comply with SFAS No. 123R beginning with the first interim or annual reporting period of their first fiscal year beginning after June 15, 2005 (the year ended December 31, 2006 for Pepco Holdings).

In November 2005, the FASB published FASB Staff Position (FSP) FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards" (FSP FAS 123(R)-3, which provides guidance regarding an alternative transition election for accounting for the tax effects of share-based payments. FSP FAS 123(R)-3 was effective upon issuance.

In February 2006, the FASB published FASB Staff Position FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation that Allow for Cash Settlement upon the Occurrence of a Contingent Event" (FSP FAS 123(R)-4), which incorporate the concept of when cash settlement features of options and similar instruments meet the condition outlined in SAFS No. 123R. FSP FAS 123(R)-4 is effective upon initial adoption of SFAS No.123R or the first reporting period after its issuance if SFAS No. 123R has been adopted.

Pepco Holdings is in the process of completing its evaluation of the impact of SFAS No. 123R, FSP FAS 123(R)-3, and FSP FAS 123(R)-4, and does not anticipate that their implementation or SAB 107 will have a material effect on Pepco Holdings' overall financial condition, results of operations or cash flows.

EITF 04-13

In September 2005, the FASB ratified EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" (EITF 04-13), which addresses circumstances under which two or more exchange transactions involving inventory with the same counterparty should be viewed as a single exchange transaction for the purposes of evaluating the effect of APB Opinion 29. EITF 04-13 is effective for new arrangements entered into, or modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006 (April 1, 2006 for Pepco Holdings). EITF 04-13 would not affect Pepco Holdings' net income, overall financial condition, or cash flows, but rather could result in certain revenues and costs, including wholesale revenues and purchased power expenses, being presented on a net basis. Pepco Holdings is in the process of evaluating the impact of EITF 04-13 on its Consolidated Statements of Earnings presentation of purchases and sales.

(3) <u>SEGMENT INFORMATION</u>

Based on the provisions of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," Pepco Holdings' management has identified its operating segments at December 31, 2005 as Power Delivery, Conectiv Energy, Pepco Energy Services, and Other Non-Regulated. Intercompany (intersegment) revenues and expenses are not eliminated at the segment level for purposes of presenting segment financial results. Elimination of these intercompany amounts is accomplished for PHI's consolidated results through the "Corporate and Other" column. Segment financial information for the years ended December 31, 2005, 2004, and 2003, is as follows.

Year Ended December 31, 2005
(Millions of dollars)

		Competitive Energy Segments				
	Power Delivery	Conectiv Energy	Pepco Energy Services	Other Non-Regulated	Corp. & Other(a)	PHI Cons.
Operating Revenue	$4,702.9	$2,603.6 (b)	$1,487.5	$ 81.9	$(810.4)	$ 8,065.5
Operating Expense (g)	4,032.1 (b)(e)	2,499.7	1,445.1	(5.0) (f)	(811.8)	7,160.1
Operating Income	670.8	103.9	42.4	86.9	1.4	905.4
Interest Income	8.3	31.9	2.5	112.3	(139.0)	16.0
Interest Expense	175.0	58.7	5.6	146.1	(47.8)	337.6
Other Income	20.2	3.6	1.7	7.9	2.7	36.1
Preferred Stock Dividends	2.6	-	-	-	(.1)	2.5
Income Taxes	228.6 (c)	32.6	15.3	13.1	(34.4)	255.2
Extraordinary Item (net of income tax of $6.2 million)	9.0 (d)	-	-	-	-	9.0
Net Income (loss)	302.1	48.1	25.7	47.9	(52.6)	371.2
Total Assets	8,720.3	2,227.6	511.6	1,404.0	1,154.3	14,017.8
Construction Expenditures	$ 432.1	$ 15.4	$ 11.3	$ -	$ 8.3	$ 467.1

Note:

(a) Includes unallocated Pepco Holdings' (parent company) capital costs, such as acquisition financing costs, and the depreciation and amortization related to purchase accounting adjustments for the fair value of Conectiv assets and liabilities as of the August 1, 2002 acquisition date. Additionally, the Total Assets line item in this column includes Pepco Holdings' goodwill balance.

(b) Power Delivery purchased electric energy and capacity and natural gas from Conectiv Energy in the amount of $565.3 million for the year ended December 31, 2005.

(c) Includes $10.9 million in income tax expense related to IRS Revenue Ruling 2005-53.

(d) Relates to ACE's electric distribution rate case settlement that was accounted for in the first quarter of 2005. This resulted in ACE's reversal of $9.0 million in after tax accruals related to certain deferred costs that are now deemed recoverable. This amount is classified as extraordinary since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.

(e) Includes $70.5 million ($42.2 million after tax) gain (net of customer sharing) from the settlement of the Pepco TPA Claim and the Pepco asbestos claims against the Mirant bankruptcy estate. Also includes $68.1 million ($40.7 million after tax) from the sale by Pepco of non-utility land owned at Buzzard Point.

(f) Includes $13.3 million gain ($8.9 million after tax) recorded by PCI as a result of the receipt, in the fourth quarter of 2005, of proceeds from the final liquidation of a financial investment that was written off in 2001.

(g) Includes depreciation and amortization of $422.6 million, consisting of $361.4 million for Power Delivery, $40.4 million for Conectiv Energy, $14.5 million for Pepco Energy Services, and $6.3 million for Corp. & Other.

	Year Ended December 31, 2004 (As Restated) (Millions of dollars)					
		Competitive Energy Segments				
	Power Delivery	Conectiv Energy	Pepco Energy Services	Other Non-Regulated	Corp. & Other(a)	PHI Cons.
Operating Revenue	$4,377.7	$2,409.8 (b)	$1,166.6	$ 87.9	$(818.9)	$ 7,223.1
Operating Expense (j)	3,840.7 (b)(c)	2,282.6	1,148.8	(1.1) (d)	(820.0)	6,451.0
Operating Income	537.0	127.2	17.8	89.0	1.1	772.1
Interest Income	4.7	9.9	.7	58.8	(65.4)	8.7
Interest Expense	178.1	47.8 (e)	2.8	94.8	49.8	373.3
Other Income (expense)	16.0	11.0 (g)	2.5	(12.3) (h)	6.0	23.2
Preferred Stock Dividends	2.3	-	-	-	.5	2.8
Income Taxes (f)	150.2	40.1	5.3	15.1 (i)	(43.4)	167.3
Net Income (loss)	227.1	60.2	12.9	25.6	(65.2)	260.6
Total Assets	8,379.3	1,896.5	542.4	1,319.2	1,213.4	13,350.8
Construction Expenditures	$ 479.5	$ 11.6	$ 21.2	$ -	$ 5.1	$ 517.4

(a) Includes unallocated Pepco Holdings' (parent company) capital costs, such as acquisition financing costs, and the depreciation and amortization related to purchase accounting adjustments for the fair value of Conectiv assets and liabilities as of the August 1, 2002 acquisition date. Additionally, the Total Assets line item in this column includes Pepco Holdings' goodwill balance.

(b) Power Delivery purchased electric energy and capacity and natural gas from Conectiv Energy in the amount of $563.5 million for the year ended December 31, 2004.

(c) Includes a $14.7 million gain ($8.6 million after tax) recognized by Power Delivery from the condemnation settlement associated with the transfer of certain distribution assets in Vineland, New Jersey. Also, includes a $6.6 million gain ($3.9 million after tax) recorded by Power Delivery from the sale of non-utility land during the first quarter of 2004.

(d) Includes an $8.3 million gain ($5.4 million after tax) recorded by Other Non-Regulated from the sale of PCI's final three aircraft investments.

(e) Includes $12.8 million loss ($7.7 million after tax) associated with the pre-payment of the debt incurred by Conectiv Bethlehem, LLC.

(f) In February 2004, a local jurisdiction issued final consolidated tax return regulations, which were retroactive to 2001. These regulations provided Pepco Holdings (parent company) and its affiliated companies doing business in this location the guidance necessary to file a consolidated income tax return. This allows Pepco Holdings' subsidiaries with taxable losses to utilize those losses against tax liabilities of Pepco Holdings' companies with taxable income. During the first quarter of 2004, Pepco Holdings and its subsidiaries recorded the impact of the new regulations of $13.2 million for the period of 2001 through 2003. The $13.2 million consists of $.8 million for Power Delivery, $1.5 million for Pepco Energy Services, $8.8 million for Other Non-Regulated, and $2.1 million for Corporate & Other.

(g) Includes an $11.2 million pre-tax gain ($6.6 million after tax) recognized by Conectiv Energy from the disposition of a joint venture associated with a co-generation facility.

(h) Includes an $11.2 million pre-tax impairment charge ($7.3 million after tax) to reduce the value of PHI's investment in Starpower Communications, LLC to $28 million at June 30, 2004.

(i) Includes a $19.7 million charge related to an IRS settlement.

(j) Includes depreciation and amortization expense of $440.5 million, which consists of $373.0 million for Power Delivery, $45.2 million for Conectiv Energy, $11.9 million for Pepco Energy Services, $.2 million for Other Non-Regulated, and $10.2 million for Corp. & Other.

	Year Ended December 31, 2003 (As Restated) (Millions of dollars)					
		Competitive Energy Segments				
	Power Delivery	Conectiv Energy	Pepco Energy Services	Other Non-Regulated	Corp. & Other(a)	PHI Cons.
Operating Revenue	$4,015.7	$2,857.5 (b)	$1,126.2	$ 100.1	$ (830.8)	$ 7,268.7
Operating Expense (h)	3,512.1(b)	2,984.0 (c)(d)(e)	1,120.5	(44.1)(g)	(914.5)(c)(d)	6,658.0
Operating Income (loss)	503.6	(126.5)	5.7	144.2	83.7	610.7
Interest Income	21.9	5.7	.8	49.0	(60.1)	17.3
Interest Expense	170.2	32.3	10.2	96.4	63.7	372.8
Other Income (expense)	(6.2)	15.1	4.6	(99.5)(f)	8.2	(77.8)
Preferred Stock Dividends	13.9	-	-	-	-	13.9
Income Taxes (benefit)	134.3	(53.0)	.3	(10.1)	(9.4)	62.1
Extraordinary Item (net of income taxes of $4.1 million)	5.9	-	-	-	-	5.9
Net Income (loss)	206.8	(85.0)	.6	7.4	(22.5)	107.3
Total Assets	8,385.5	1,964.5	547.9	1,384.5	1,086.6	13,369.0
Construction Expenditures	$ 383.9	$ 199.4	$ 10.8	$ -	$ 4.1	$ 598.2

Note: The 2003 operating results have been revised for the full year to reflect: (1) the operations of Pepco Power Delivery and Conectiv Power Delivery as a single Power Delivery segment, (2) the transfer of the operations of Conectiv Thermal Systems, Inc. from Conectiv Energy to Pepco Energy Services, (3) the transfer of the operations of the Deepwater power generation plant from Power Delivery to Conectiv Energy, and (4) the transfer of operations of Pepco Enterprises, Inc. from Other Non-Regulated to Pepco Energy Services.

(a) Includes unallocated Pepco Holdings' (parent company) capital costs, such as acquisition financing costs, and the depreciation and amortization related to purchase accounting adjustments for the Conectiv assets and liabilities as of the August 1, 2002 acquisition date. Additionally, the Total Assets line item in this column includes Pepco Holdings' goodwill balance.

(b) Power Delivery purchased electric energy and capacity and natural gas from Conectiv Energy in the amount of $653.3 million for the year ended December 31, 2003.

(c) Conectiv Energy's results include a charge of $108.0 million ($64.1 million after tax) related to the cancellation of a combustion turbine contract. This was partially offset by $57.9 million ($34.6 million after tax) in Corp. & Other, resulting from the reversal of a purchase accounting fair value adjustment made on the date of the acquisition of Conectiv. Overall, the net impact of these two transactions is $29.5 million reduction of consolidated net income.

(d) Conectiv Energy's results include a charge of $32.8 million ($19.4 million after tax) related to an impairment of its combustion turbine inventory. This charge was partially offset by $29.6 million ($17.7 million after tax) in Corp. & Other, resulting from the reversal of a purchase accounting fair value adjustment made on the date of the acquisition of Conectiv. Overall, the net impact of these two transactions is $1.7 million reduction of consolidated net income.

(e) Conectiv Energy's results include a charge of $44.3 million ($26.6 million after tax) resulting from trading losses prior to the cessation of proprietary trading.

(f) Other Non-Regulated results include a non-cash impairment charge of $102.6 million ($66.7 million after tax) related to PHI's investment in Starpower Communications, LLC.

(g) Includes a gain of $68.8 million ($44.7 million after tax) on the sale of the Edison Place office building and an impairment charge of $11.0 million ($7.2 million after tax) on PCI's aircraft investments.

(h) Includes depreciation and amortization expense of $422.1 million, consisting of $356.0 million for Power Delivery, $39.3 million for Conectiv Energy, $11.5 million for Pepco Energy Services, $2.4 million for Other Non-Regulated, and $12.9 million for Corp. & Other.

(4) LEASING ACTIVITIES

Financing lease balances were comprised of the following at December 31:

	2005	2004
	(Millions of dollars)	
Energy leveraged leases	$ 1,264.4	$ 1,183.1
Other	33.5	35.6
Total	$ 1,297.9	$ 1,218.7

Pepco Holdings' $1,264.4 million equity investment in energy leveraged leases at December 31, 2005, consists of electric power plants and natural gas distribution networks located outside of the United States. Of this amount, $439.4 million of equity is attributable to facilities located in The Netherlands, $649.5 million in Austria and $175.5 million in Australia.

The components of the net investment in finance leases at December 31, 2005 and 2004 are summarized below (millions of dollars):

At December 31, 2005:	Leveraged Leases	Direct Finance Leases	Total Finance Leases
Scheduled lease payments, net of non-recourse debt	$2,315.4	$24.1	$2,339.5
Residual value	-	12.5	12.5
Less: Unearned and deferred income	(1,051.0)	(3.1)	(1,054.1)
Investment in finance leases held in trust	1,264.4	33.5	1,297.9
Less: Deferred taxes	(584.3)	(8.7)	(593.0)
Net Investment in Finance Leases Held in Trust	$ 680.1	$24.8	$ 704.9

At December 31, 2004:	Leveraged Leases	Direct Finance Leases	Total Finance Leases
Scheduled lease payments, net of non-recourse debt	$2,315.4	$26.4	$2,341.8
Residual value	-	12.5	12.5
Less: Unearned and deferred income	(1,132.3)	(3.3)	(1,135.6)
Investment in finance leases held in trust	1,183.1	35.6	1,218.7
Less: Deferred taxes	(494.6)	(8.1)	(502.7)
Net Investment in Finance Leases Held in Trust	$ 688.5	$27.5	$ 716.0

Income recognized from leveraged leases (included in "Other Operating Revenue") was comprised of the following for the years ended December 31:

	2005	2004	2003
		(Millions of dollars)	
Pre-tax earnings from leveraged leases	$81.5	$83.5	$84.2
Income tax expense	20.6	26.8	21.2
Net Income from Leveraged Leases Held in Trust	$60.9	$56.7	$63.0

Scheduled lease payments from leveraged leases are net of non-recourse debt. Minimum lease payments receivable from PCI's finance leases for each of the years 2006 through 2010 and thereafter are $30.7 million for 2006, $3.5 million for 2007, zero for 2008, zero for 2009, $32.1 million for 2010, and $1,231.6 million thereafter. For a discussion of the Federal tax treatment of cross-border leases, see to Note (12) "Commitments and Contingencies."

Lease Commitments

Pepco leases its consolidated control center, an integrated energy management center used by Pepco's power dispatchers to centrally control the operation of its transmission and distribution systems. The lease is accounted for as a capital lease and was initially recorded at the present value of future lease payments, which totaled $152 million. The lease requires semi-annual payments of $7.6 million over a 25-year period beginning in December 1994 and provides for transfer of ownership of the system to Pepco for $1 at the end of the lease term. Under SFAS No. 71, the amortization of leased assets is modified so that the total interest on the obligation and amortization of the leased asset is equal to the rental expense allowed for rate-making purposes. This lease has been treated as an operating lease for rate-making purposes.

Rental expense for operating leases was $51.2 million, $46.2 million and $32.9 million for the years ended December 31, 2005, 2004, and 2003, respectively.

The approximate annual commitments under all operating leases are $38.3 million for 2006, $38.2 million for 2007, $39.0 million for 2008, 2009, and 2010, and $367.5 million thereafter.

Capital lease assets recorded within Property, Plant and Equipment at December 31, 2005 and 2004, in millions of dollars, are comprised of the following:

At December 31, 2005	Original Cost	Accumulated Amortization	Net Book Value
Transmission	$ 76.0	$ 15.7	$ 60.3
Distribution	79.7	19.3	60.4
General	2.8	1.8	1.0
Total	$158.5	$36.8	$121.7
At December 31, 2004			
Transmission	$ 76.0	$ 13.6	$ 62.4
Distribution	79.7	16.9	62.8
General	2.8	1.2	1.6
Total	$158.5	$31.7	$126.8

The approximate annual commitments under all capital leases are $15.8 million for 2006, $15.5 million for 2007, $15.4 million for 2008, $15.2 million for 2009 and 2010, and $137.1 million thereafter.

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is comprised of the following:

At December 31, 2005	Original Cost	Accumulated Depreciation	Net Book Value
		(Millions of dollars)	
Generation	$ 1,795.1	$ 558.4	$1,236.7
Distribution	5,985.5	2,219.9	3,765.6
Transmission	1,773.5	680.4	1,093.1
Gas	339.5	100.7	238.8
Construction work in progress	364.1	-	364.1
Non-operating and other property	1,126.5	512.8	613.7
Total	$11,384.2	$4,072.2	$7,312.0
At December 31, 2004			
Generation	$ 1,847.6	$ 520.4	$1,327.2
Distribution	5,712.9	2,193.7	3,519.2
Transmission	1,653.1	648.9	1,004.2
Gas	326.7	93.8	232.9
Construction work in progress	409.8	-	409.8
Non-operating and other property	1,097.7	500.4	597.3
Total	$11,047.8	$3,957.2	$7,090.6

The non-operating and other property amounts include balances for general plant, distribution and transmission plant held for future use as well as other property held by non-utility subsidiaries.

Pepco Holdings' utility subsidiaries use separate depreciation rates for each electric plant account. The rates vary from jurisdiction to jurisdiction.

Gain on Sale of Assets

In August 2005, Pepco sold for $75 million in cash 384,051 square feet of excess non-utility land owned by Pepco located at Buzzard Point in the District of Columbia. The sale resulted in a pre-tax gain of $68.1 million which was recorded as a reduction of Operating Expenses in the Consolidated Statements of Earnings.

In 2004, PHI recorded pre-tax gains of $14.7 million from the condemnation settlement with the City of Vineland relating to the transfer of its distribution assets and customer accounts, $8.3 million on the sale of aircraft investments by PCI, and $6.6 million on the sale of land.

Jointly Owned Plant

PHI's Consolidated Balance Sheet includes its proportionate share of assets and liabilities related to jointly owned plant. PHI's subsidiaries have ownership interests in electric generating plants, transmission facilities, and other facilities in which various parties have ownership interests. PHI's proportionate share of operating and maintenance expenses of the jointly owned plant is included in the corresponding expenses in PHI's Consolidated Statements of Earnings. PHI is responsible for providing its share of financing for the jointly owned facilities. Information with respect to PHI's share of jointly owned plant as of December 31, 2005 is shown below.

Jointly Owned Plant	Ownership Share	Megawatt Capability Owned	Plant in Service	Accumulated Depreciation	Construction Work in Progress
			(Millions of dollars)		
Coal-Fired Electric Generating Plants					
Keystone	2.47%	42	$19.9	$ 6.5	$ .9
Conemaugh	3.83%	65	37.6	13.9	.9
Transmission Facilities	Various		35.8	21.7	-
Other Facilities	Various		5.1	1.9	-
Total			$98.4	$44.0	$1.8

As discussed in Note (12), Commitments and Contingencies, on November 15, 2005, ACE announced an agreement to sell its undivided interests in the Keystone and Conemaugh generating facilities to Duquesne Light Holdings Inc. for $173.1 million. The sale, subject to approval by the NJBPU, as well as other regulatory agencies and certain other legal conditions, is expected to be completed mid-year 2006.

(6) PENSIONS AND OTHER POSTRETIREMENT BENEFITS

Pension Benefits

Pepco Holdings sponsors a defined benefit Retirement Plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries. Pepco Holdings also provides supplemental retirement benefits to certain eligible executive and key employees through nonqualified retirement plans.

Other Postretirement Benefits

Pepco Holdings provides certain postretirement health care and life insurance benefits for eligible retired employees. Certain employees hired on January 1, 2005 or later will not have company subsidized retiree medical coverage; however, they will be able to purchase coverage at full cost through PHI.

During 2004, PHI amended its postretirement health care plans for certain groups of eligible employees effective January 1, 2005 or January 1, 2006. The amendments included changes to coverage and retiree cost-sharing, and are reflected as a reduction in PHI's 2004 net periodic benefit cost and a reduction of $42 million in the projected benefit obligation at December 31, 2004.

Pepco Holdings uses a December 31 measurement date for its plans. Plan assets are stated at their market value as of the measurement date, December 31. All dollar amounts in the following tables are in millions of dollars.

	Pension Benefits		Other Postretirement Benefits	
Change in Benefit Obligation	**2005**	**2004**	**2005**	**2004**
Benefit obligation at beginning of year	$1,648.0	$1,579.2	$593.5	$511.9
Service cost	37.9	35.9	8.5	8.6
Interest cost	96.1	94.7	33.6	35.4
Amendments	-	-	-	(42.4)
Actuarial loss	81.1	51.4	12.8	117.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Benefit obligation at end of year	$1,746.0	$1,648.0	$610.2	$593.5
Change in Plan Assets				
Fair value of plan assets at beginning of year	$1,523.5	$1,462.8	$164.9	$145.2
Actual return on plan assets	106.4	161.1	10.0	15.7
Company contributions	65.6	12.8	37.0	41.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$173.7	$164.9

The following table provides a reconciliation of the projected benefit obligation, plan assets and funded status of the plans.

	Pension Benefits		Other Postretirement Benefits	
	2005	**2004**	**2005**	**2004**
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$ 173.7	$164.9
Benefit obligation at end of year	1,746.0	1,648.0	610.2	593.5
Funded status (plan assets less than plan obligations)	(167.6)	(124.5)	(436.5)	(428.6)
Amounts not recognized:				
Unrecognized net actuarial loss	350.5	261.2	188.6	188.5
Unrecognized prior service cost	1.9	3.0	(26.2)	(29.5)
Net amount recognized	$ 184.8	$ 139.7	$(274.1)	$(269.6)

The following table provides a reconciliation of the amounts recognized in PHI's Consolidated Balance Sheet as of December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	**2004**	**2005**	**2004**
Prepaid benefit cost	$208.9	$165.7	$ -	$ -
Accrued benefit cost	(24.1)	(26.0)	(274.1)	(269.6)
Additional minimum liability for nonqualified plan	(12.2)	(7.0)	-	-
Intangible assets for nonqualified plan	.1	.1	-	-
Accumulated other comprehensive income for nonqualified plan	12.1	6.9	-	-
Net amount recognized	$184.8	$139.7	$(274.1)	$(269.6)

The accumulated benefit obligation for the Retirement Plan (the qualified defined benefit pension plan) was $1,556.2 million and $1,462.9 million at December 31, 2005, and 2004, respectively. The table below provides the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for the PHI nonqualified pension plan with an accumulated benefit obligation in excess of plan assets at December 31, 2005 and 2004.

	Pension Benefits	
	2005	2004
Projected benefit obligation for nonqualified plan	$38.6	$35.3
Accumulated benefit obligation for nonqualified plan	$36.3	$32.9
Fair value of plan assets for nonqualified plan	-	-

In 2005 and 2004, PHI was required to recognize an additional minimum liability and an intangible asset related to its nonqualified pension plan as prescribed by SFAS No. 87. The liability was recorded as a reduction to shareholders' equity (other comprehensive income), and the equity will be restored to the balance sheet in future periods when the accrued benefit liability exceeds the accumulated benefit obligation at future measurement dates. The amount of reduction to shareholders' equity (net of income taxes) in 2005 was $7.3 million and in 2004 was $4.1 million. The recording of this reduction did not affect net income or cash flows in 2005 or 2004 or compliance with debt covenants.

The table below provides the components of net periodic benefit costs recognized for the years ended December 31.

	Pension Benefits			Other Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Service cost	$ 37.9	$ 35.9	$ 33.0	$ 8.5	$ 8.6	$ 9.5
Interest cost	96.1	94.7	93.7	33.6	35.4	32.9
Expected return on plan assets	(125.5)	(124.2)	(106.2)	(10.9)	(9.9)	(8.3)
Amortization of prior service cost	1.1	1.1	1.0	-	-	-
Amortization of net loss	10.9	6.5	13.9	8.0	9.5	8.0
Net periodic benefit cost	$ 20.5	$ 14.0	$ 35.4	$39.2	$43.6	$42.1

The 2005 combined pension and other postretirement net periodic benefit cost of $59.7 million includes $28.9 million for Pepco, $(2.0) million for DPL and $16.9 million for ACE. The remaining net periodic benefit cost includes amounts for other PHI subsidiaries.

The 2004 combined pension and other postretirement net periodic benefit cost of $57.6 million includes $24.1 million for Pepco, $1.0 million for DPL and $17.6 million for ACE. The remaining net periodic benefit cost includes amounts for other PHI subsidiaries.

The 2003 combined pension and other postretirement net periodic benefit cost of $77.5 million includes $33.7 million for Pepco, $7.1 million for DPL and $20.8 million for ACE. The remaining net periodic benefit cost includes amounts for other PHI subsidiaries.

The following weighted average assumptions were used to determine the benefit obligations at December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	**2004**	**2005**	**2004**
Discount rate	5.625%	5.875%	5.625%	5.875%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%
Health care cost trend rate assumed for next year	n/a	n/a	8.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)			5.00%	5.00%
Year that the rate reaches the ultimate trend rate			2009	2009

Assumed health care cost trend rates may have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects (millions of dollars):

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on total of service and interest cost	$ 1.8	$ (1.7)
Effect on postretirement benefit obligation	27.0	(25.1)

The following weighted average assumptions were used to determine the net periodic benefit cost for years ended December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	**2004**	**2005**	**2004**
Discount rate	5.875%	6.250%	5.875%	6.250%
Expected long-term return on plan assets	8.500%	8.750%	8.500%	8.750%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%

A cash flow matched bond portfolio approach to developing a discount rate is used to value FAS 87 and FAS 106 liabilities. The hypothetical portfolio includes high quality instruments with maturities that mirror the benefit obligations.

In selecting an expected rate of return on plan assets, PHI considers actual historical returns, economic forecasts and the judgment of its investment consultants on expected long-term performance for the types of investments held by the plan. The plan assets consist of equity and fixed income investments, and when viewed over a long time horizon, are expected to yield a return on assets of 8.50%.

Plan Assets

Pepco Holdings' Retirement Plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

Asset Category	Plan Assets at December 31 2005	2004	Target Plan Asset Allocation	Minimum/ Maximum
Equity securities	62%	66%	60%	55% - 65%
Debt securities	37%	33%	35%	30% - 50%
Other	1%	1%	5%	0% - 10%
Total	100%	100%	100%	

Pepco Holdings' other postretirement plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

Asset Category	Plan Assets at December 31 2005	2004	Target Plan Asset Allocation	Minimum/ Maximum
Equity securities	67%	65%	60%	55% - 65%
Debt securities	24%	32%	35%	20% - 50%
Cash	9%	3%	5%	0% - 10%
Total	100%	100%	100%	

In developing an asset allocation policy for its Retirement Plan and Other Postretirement Plan, PHI examined projections of asset returns and volatility over a long-term horizon. In connection with this analysis, PHI examined the risk/return tradeoffs of alternative asset classes and asset mixes given long-term historical relationships, as well as prospective capital market returns. PHI also conducted an asset/liability study to match projected asset growth with projected liability growth and provide sufficient liquidity for projected benefit payments. By incorporating the results of these analyses with an assessment of its risk posture, and taking into account industry practices, PHI developed its asset mix guidelines. Under these guidelines, PHI diversifies assets in order to protect against large investment losses and to reduce the probability of excessive performance volatility while maximizing return at an acceptable risk level. Diversification of assets is implemented by allocating monies to various asset classes and investment styles within asset classes, and by retaining investment management firm(s) with complementary investment philosophies, styles and approaches. Based on the assessment of demographics, actuarial/funding, and business and financial characteristics, PHI believes that its risk posture is slightly below average relative to other pension plans. Consequently, Pepco Holdings believes that a slightly below average equity exposure (i.e., a target equity asset allocation of 60%) is appropriate for the Retirement Plan and the Other Postretirement Plan.

On a periodic basis, Pepco Holdings reviews its asset mix and rebalances assets back to the target allocation over a reasonable period of time.

No Pepco Holdings common stock is included in pension or postretirement program assets.

Cash Flows

Contributions - Retirement Plan

Pepco Holdings' funding policy with regard to the Retirement Plan is to maintain a funding level in excess of 100% with respect to its accumulated benefit obligation (ABO). PHI's Retirement Plan currently meets the minimum funding requirements of ERISA without any additional funding. In 2005 and 2004, PHI made discretionary tax-deductible cash contributions to the plan of $60.0 million and $10.0 million, respectively, in line with its funding policy. Assuming no changes to the current pension plan assumptions, PHI projects no funding will be required under ERISA in 2006; however, PHI may elect to make a discretionary tax-deductible contribution, if required to maintain its plan assets in excess of its ABO.

Contributions - Other Postretirement Benefits

In 2005, PHI combined its health and welfare plans and the existing IRC 501 (c) (9) Voluntary Employee Beneficiary Association (VEBA) trusts for Pepco, DPL and ACE to fund a portion of their estimated postretirement liabilities. Pepco funded the 2004 portion of its estimated liability for postretirement medical costs through the use of an Internal Revenue Code (IRC)401(h) account, within PHI's Retirement Plan. The trust was depleted in 2004 and a VEBA will be used for future funding. In 2005 and 2004, Pepco contributed $3.1 million and $4.7 million, respectively, DPL contributed $6.0 million and $9.5 million, respectively, and ACE contributed $7.0 million and $9.3 million, respectively, to the plans. Contributions of $6.4 million and $5.0 million, respectively, were made by other PHI subsidiaries. Assuming no changes to the other postretirement benefit pension plan assumptions, PHI expects similar amounts to be contributed in 2006.

Expected Benefit Payments

Estimated future benefit payments to participants in PHI's qualified pension and postretirement welfare benefit plans, which reflect expected future service as appropriate, as of December 31, 2005 are in millions of dollars:

Years	Pension Benefits	Other Postretirement Benefits
2006	$ 91.6	$ 37.2
2007	99.7	39.5
2008	102.2	41.7
2009	104.7	43.1
2010	106.1	44.3
2011 through 2015	553.0	229.7

(7) DEBT

LONG-TERM DEBT

The components of long-term debt are shown below.

Interest Rate	Maturity	At December 31, 2005	2004
		(Millions of dollars)	
First Mortgage Bonds			
Pepco:			
6.50%	2005	$ -	$ 100.0
6.25%	2007	175.0	175.0
6.50%	2008	78.0	78.0
5.875%	2008	50.0	50.0
5.75% (a)	2010	16.0	16.0
4.95% (a)	2013	200.0	200.0
4.65% (a)	2014	175.0	175.0
6.00% (a)	2022	30.0	30.0
6.375% (a)	2023	37.0	37.0
5.375% (a)	2024	42.5	42.5
5.375% (a)	2024	38.3	38.3
7.375%	2025	-	75.0
5.75% (a)	2034	100.0	100.0
5.40% (a)	2035	175.0	-
DPL:			
7.71%	2025	-	100.0
ACE:			
6.18% - 7.15%	2005 - 2008	116.0	156.0
7.25% - 7.63%	2010 - 2014	8.0	8.0
6.63%	2013	68.6	68.6
7.68%	2015 - 2016	17.0	17.0
6.80% (a)	2021	38.9	38.9
5.60% (a)	2025	4.0	4.0
Variable (a)	2029	54.7	54.7
5.80% (a)	2034	120.0	120.0
Amortizing First Mortgage Bonds			
DPL:			
6.95%	2005 - 2008	10.5	13.2
Total First Mortgage Bonds		$ 1,554.5	$ 1,697.2

(a) Represents a series of First Mortgage Bonds issued by the indicated company as collateral for an outstanding series of senior notes or tax-exempt bonds issued by the same company. The maturity date, optional and mandatory prepayment provisions, if any, interest rate, and interest payment dates on each series of senior notes or tax-exempt bonds are identical to the terms of the collateral First Mortgage Bonds by which it is secured. Payments of principal and interest on a series of senior notes or tax-exempt bonds satisfy the corresponding payment obligations on the related series of collateral First Mortgage Bonds. At such time as there are no First Mortgage Bonds of an issuing company outstanding, other than collateral First Mortgage Bonds securing payment of senior notes and tax-exempt bonds, each outstanding series of senior notes and tax-exempt bonds of the company will automatically cease to be secured by the corresponding series of collateral First Mortgage Bonds and all of the outstanding collateral First Mortgage Bonds of the company will be cancelled. Because each series of senior notes and tax-exempt bonds and the series of collateral First Mortgage Bonds securing that series of senior notes or tax-exempt bonds effectively represents a single financial obligation, the senior notes and the tax-exempt bonds are not separately shown on the table.

NOTE: Schedule is continued on next page.

Interest Rate	Maturity	At December 31, 2005	2004
		(Millions of dollars)	
Unsecured Tax-Exempt Bonds			
DPL:			
5.20%	2019	$ 31.0	$ 31.0
3.15%	2023	18.2	18.2
5.50%	2025	15.0	15.0
4.90%	2026	34.5	34.5
5.65%	2028	16.2	16.2
Variable	2030 - 2038	93.4	93.4
Total Unsecured Tax-Exempt Bonds		208.3	208.3
Medium-Term Notes (unsecured)			
Pepco:			
7.64%	2007	35.0	35.0
6.25%	2009	50.0	50.0
DPL:			
6.75%	2006	20.0	20.0
7.06% - 8.13%	2007	61.5	61.5
7.56% - 7.58%	2017	14.0	14.0
6.81%	2018	4.0	4.0
7.61%	2019	12.0	12.0
7.72%	2027	10.0	10.0
ACE:			
7.52%	2007	15.0	15.0
Conectiv:			
5.30%	2005	-	250.0
6.73%	2006	-	50.0
Total Medium-Term Notes (unsecured)		$ 221.5	$ 521.5

NOTE: Schedule is continued on next page.

Interest Rate	Maturity	At December 31, 2005	2004
		(Millions of dollars)	
Recourse Debt			
PCI:			
6.59% - 6.69%	2005 - 2014	$ 11.1	$ 71.1
7.62%	2007	34.3	34.3
6.57%	2008	92.0	92.0
Total Recourse Debt		137.4	197.4
Notes (secured)			
Pepco Energy Services:			
7.85%	2017	9.2	9.2
Notes (unsecured)			
PHI:			
3.75%	2006	300.0	300.0
5.50%	2007	500.0	500.0
Variable	2010	250.0	-
4.00%	2010	200.0	200.0
6.45%	2012	750.0	750.0
7.45%	2032	250.0	250.0
Pepco			
Variable	2006	50.0	100.0
DPL:			
5.0%	2014	100.0	100.0
5.0%	2015	100.0	-
Total Notes (unsecured)		2,500.0	2,200.0
Nonrecourse debt			
PCI:			
6.60%	2018	15.9	17.1
Acquisition fair value adjustment		.1	.2
Total Long-Term Debt		4,646.9	4,850.9
Net unamortized discount		(5.9)	(6.1)
Current maturities of long-term debt		(438.1)	(482.7)
Total Net Long-Term Debt		$ 4,202.9	$ 4,362.1
Transition Bonds Issued by ACE Funding			
2.89%	2010	$ 55.2	$ 75.2
2.89%	2011	31.3	39.4
4.21%	2013	66.0	66.0
4.46%	2016	52.0	52.0
4.91%	2017	118.0	118.0
5.05%	2020	54.0	54.0
5.55%	2023	147.0	147.0
Total		523.5	551.6
Net unamortized discount		(.2)	(.2)
Current maturities of long-term debt		(29.0)	(28.1)
Total Transition Bonds issued by ACE Funding		$ 494.3	$ 523.3

The outstanding First Mortgage Bonds issued by each of Pepco, DPL and ACE are secured by a lien on substantially all of the issuing company's property, plant and equipment.

Atlantic City Electric Transition Funding L.L.C. (ACE Funding) was established in 2001 solely for the purpose of securitizing authorized portions of ACE's recoverable stranded costs through the issuance and sale of bonds (Transition Bonds). The proceeds of the sale of each series of Transition Bonds have been transferred to ACE in exchange for the transfer by ACE to ACE Funding of the right to collect a non-bypassable transition bond charge from ACE customers pursuant to bondable stranded costs rate orders issued by the NJBPU in an amount sufficient to fund the principal and interest payments on the Transition Bonds and related taxes, expenses and fees (Bondable Transition Property). The assets of ACE Funding, including the Bondable Transition Property, and the Transition Bond charges collected from ACE's customers, are not available to creditors of ACE. The holders of Transition Bonds have recourse only to the assets of ACE Funding.

The aggregate amounts of maturities for long-term debt and Transition Bonds outstanding at December 31, 2005, are $467.1 million in 2006, $854.8 million in 2007, $323.6 million in 2008, $82.2 million in 2009, $531.9 million in 2010, and $2,910.7 million thereafter.

Pepco Energy Services Notes, referred to as "Project Funding Secured by Customer Accounts Receivable" (Project Funding) represent funding for energy savings contracts performed by Pepco Energy Services. The aggregate amounts of maturities for the Project Funding debt outstanding at December 31, 2005, are $2.5 million in 2006, zero in 2007, $1.0 million in 2008, zero in 2009, $2.1 million in 2010, and $22.4 million thereafter, and includes the current portion of project funding that was provided in exchange for the sale of the customers' accounts receivable.

SHORT-TERM DEBT

Pepco Holdings and its regulated utility subsidiaries have traditionally used a number of sources to fulfill short-term funding needs, such as commercial paper, short-term notes, and bank lines of credit. Proceeds from short-term borrowings are used primarily to meet working capital needs, but may also be used to temporarily fund long-term capital requirements. A detail of the components of Pepco Holdings' short-term debt at December 31, 2005 and 2004 is as follows.

	2005	2004
	(Millions of dollars)	
Commercial paper	$ -	$111.3
Floating rate note	-	50.0
Variable rate demand bonds	156.4	158.4
Total	$156.4	$319.7

Commercial Paper

Pepco Holdings maintains an ongoing commercial paper program of up to $700 million. Pepco, DPL, and ACE have ongoing commercial paper programs of up to $300 million, $275 million, and $250 million, respectively. The commercial paper programs of PHI, Pepco, DPL and ACE are backed by a $1.2 billion credit facility, which is described under the heading "Credit Facility" below.

Pepco Holdings, Pepco, DPL and ACE had no commercial paper outstanding at December 31, 2005. The weighted average interest rate for commercial paper issued during 2005 was 3.02%. Interest rates for commercial paper issued during 2004 ranged from 1.05% to 2.63%. The weighted average maturity was two days for all commercial paper issued during 2005.

Floating Rate Note

In December 2004, Pepco Holdings issued a $50 million floating rate note that was paid at maturity in December 2005. The weighted average interest rate on this note was 3.61%.

Variable Rate Demand Bonds

Variable Rate Demand Bonds ("VRDB") are subject to repayment on the demand of the holders and for this reason are accounted for as short-term debt in accordance with GAAP. However, bonds submitted for purchase are remarketed by a remarketing agent on a best efforts basis. PHI expects that the bonds submitted for purchase will continue to be remarketed successfully due to the credit worthiness of the issuing company and because the remarketing resets the interest rate to the then-current market rate. The issuing company also may utilize one of the fixed rate/fixed term conversion options of the bonds to establish a maturity which corresponds to the date of final maturity of the bonds. On this basis, PHI views VRDBs as a source of long-term financing. The VRDBs outstanding in 2005 and 2004 mature in 2006 to 2009 ($10.5 million), 2014 to 2017 ($48.6 million), 2024 ($33.3 million) and 2028 to 2031 ($64.0 million). The weighted average interest rate for VRDB was 2.61% during 2005 and interest rates ranged from .82% to 2.47% in 2004.

Credit Facility

In May 2005, Pepco Holdings, Pepco, DPL and ACE entered into a five-year credit agreement with an aggregate borrowing limit of $1.2 billion. This agreement replaces a $650 million five-year credit agreement that was entered into in July 2004 and a $550 million three-year credit agreement entered into in July 2003. Pepco Holdings' credit limit under this agreement is $700 million. The credit limit of each of Pepco, DPL and ACE is the lower of $300 million and the maximum amount of debt the company is permitted to have outstanding by its regulatory authorities, except that the aggregate amount of credit used by Pepco, DPL and ACE at any given time under the agreement may not exceed $500 million. Under the terms of the credit agreement, the companies are entitled to request increases in the principal amount of available credit up to an aggregate increase of $300 million, with any such increase proportionately increasing the credit limit of each of the respective borrowers and the $300 million sublimits for each of Pepco, DPL and ACE. The interest rate payable by the respective companies on utilized funds is determined by a pricing schedule with rates corresponding to the credit rating of the borrower. Any indebtedness incurred under the credit agreement would be unsecured.

The credit agreement is intended to serve primarily as a source of liquidity to support the commercial paper programs of the respective companies. The companies also are permitted to use the facility to borrow funds for general corporate purposes and issue letters of credit. In order for a borrower to use the facility, certain representations and warranties made by the borrower at the time the credit agreement was entered into also must be true at the time the facility is utilized, and the borrower must be in compliance with specified covenants, including the financial covenant described below. However, a material adverse change in the borrower's business, property, and results of operations or financial condition subsequent to the entry into the credit agreement is not a condition to the availability of credit under the facility. Among the covenants contained in the credit agreement are (i) the requirement that each borrowing company maintain a ratio of total indebtedness to total capitalization of 65% or less, computed in accordance with the terms of the credit agreement, (ii) a restriction on sales or other dispositions of assets, other than sales and dispositions permitted by the credit agreement, and (iii) a restriction on the incurrence of liens on the assets of a borrower or any of its significant subsidiaries other than liens permitted by the credit agreement. The failure to satisfy any of the covenants or the occurrence of specified events that constitute an event of default could result in the acceleration of the repayment obligations of the borrower. The events of default include (i) the failure of any borrowing company or any of its significant subsidiaries to pay when due, or the acceleration of, certain indebtedness under other borrowing arrangements, (ii) certain bankruptcy events, judgments or decrees against any borrowing company or its significant subsidiaries, and (iii) a change in control (as defined in the credit agreement) of Pepco Holdings or the failure of Pepco Holdings to own all of the voting stock of Pepco, DPL and ACE. The agreement does not include any ratings triggers. There were no balances outstanding at December 31, 2005 and 2004.

(8) INCOME TAXES

PHI and the majority of its subsidiaries file a consolidated federal income tax return. Federal income taxes are allocated among PHI and its subsidiaries included in its consolidated group pursuant to a written tax sharing agreement which was approved by the SEC pursuant to regulations under PUHCA 1935 in connection with the establishment of PHI as a holding company as part of Pepco's acquisition of Conectiv on August 1, 2002. Under this tax sharing agreement, PHI's consolidated Federal income tax liability is allocated based upon PHI's and its subsidiaries' separate taxable income or loss, with the exception of the tax benefits applicable to non-acquisition debt expenses of PHI. Such tax benefits are allocated only to subsidiaries with taxable income.

The provision for income taxes, reconciliation of consolidated income tax expense, and components of consolidated deferred tax liabilities (assets) are shown below.

Provision for Income Taxes

	For the Year Ended December 31, 2005	2004	2003
	(Millions of dollars)		
Operations			
Current Tax Expense (Benefit)			
Federal	$236.2	$(33.2)	$(130.3)
State and local	81.9	(9.0)	36.0
Total Current Tax (Benefit) Expense	318.1	(42.2)	(94.3)
Deferred Tax (Benefit) Expense			
Federal	(24.4)	185.1	172.6
State and local	(33.4)	32.4	(10.9)
Investment tax credits	(5.1)	(8.0)	(5.3)
Total Deferred Tax (Benefit) Expense	(62.9)	209.5	156.4
Total Income Tax Expense from Operations	$255.2	$167.3	$ 62.1
Extraordinary Item			
Deferred Tax Expense			
Federal	4.8	-	3.2
State and local	1.4	-	.9
Total Deferred Tax on Extraordinary Item	6.2	-	4.1
Total Income Tax Expense	$261.4	$167.3	$ 66.2

Reconciliation of Consolidated Income Tax Expense

	For the Year Ended December 31, 2005		2004		2003	
	Amount	Rate	Amount	Rate	Amount	Rate
	(Millions of dollars)					
Income Before Income Taxes	$ 617.4		$ 427.9		$ 163.5	
Preferred dividends	2.5		2.8		4.7	
Income Before Income Taxes	$ 619.9		$ 430.7		$ 168.2	
Income tax at federal statutory rate	$ 217.1	.35	$ 150.7	.35	$ 58.9	.35
Increases (decreases) resulting from						
Depreciation	7.8	.01	9.4	.02	8.2	.05
Asset removal costs	(3.3)	(.01)	(1.7)	-	(4.6)	(.02)
State income taxes, net of federal effect	30.8	.05	27.4	.06	15.9	.09
Tax credits	(4.7)	(.01)	(5.9)	(.01)	(5.1)	(.03)
Cumulative effect of local tax consolidation	-	-	(13.2)	(.03)	-	-
IRS settlement	-	-	19.7	.05	-	-
Company dividends reinvested in 401(k) plan	(2.1)	-	(2.1)	-	(1.4)	(.01)
Leveraged leases	(7.8)	(.01)	(8.2)	(.02)	(8.2)	(.05)
Adjustment to estimates related to prior years under audit	17.9	.03	(1.0)	(.01)	-	-
Other	(0.5)	-	(7.8)	(.02)	(1.6)	(.01)
Total Income Tax Expense	$ 255.2	.41	$ 167.3	.39	$ 62.1	.37

Components of Consolidated Deferred Tax Liabilities (Assets)

	At December 31, 2005	At December 31, 2004
	(Millions of dollars)	
Deferred Tax Liabilities (Assets)		
Depreciation and other book to tax basis differences	$ 1,630.8	$ 1,709.8
Deferred taxes on amounts to be collected through future rates	53.5	57.1
Deferred investment tax credit	(29.4)	(30.9)
Contributions in aid of construction	(57.9)	(56.9)
Goodwill, accumulated other comprehensive income, and valuation adjustments	(116.8)	(161.4)
Deferred electric service and electric restructuring liabilities	(21.7)	(5.2)
Finance and operating leases	516.9	434.8
NUG contracts	77.3	82.1
Capital loss carryforward	(1.2)	(14.3)
Federal net operating loss	(64.7)	(65.7)
Federal Alternative Minimum Tax credit	(6.9)	(5.6)
State net operating loss	(54.0)	(63.7)
Valuation allowance (State NOLs)	30.0	33.9
Other postretirement benefits	(43.4)	(36.2)
Unrealized losses on fair value declines	(13.3)	(6.2)
Property taxes, contributions to pension plan, and other	(51.4)	11.5
Total Deferred Tax Liabilities, Net	1,847.8	1,883.1
Deferred tax assets included in Other Current Assets	87.2	70.2
Total Deferred Tax Liabilities, Net Non-Current	$ 1,935.0	$ 1,953.3

The net deferred tax liability represents the tax effect, at presently enacted tax rates, of temporary differences between the financial statement and tax basis of assets and liabilities. The portion of the net deferred tax liability applicable to PHI's operations, which has not been reflected in current service rates, represents income taxes recoverable through future rates, net and is recorded as a regulatory asset on the balance sheet.

The Tax Reform Act of 1986 repealed the Investment Tax Credit (ITC) for property placed in service after December 31, 1985, except for certain transition property. ITC previously earned on Pepco's, DPL's and ACE's property continues to be normalized over the remaining service lives of the related assets.

PHI files a consolidated federal income tax return. PHI's federal income tax liabilities for Pepco legacy companies for all years through 2000, and for Conectiv legacy companies for all years through 1997, have been determined, subject to adjustment to the extent of any net operating loss or other loss or credit carrybacks from subsequent years.

Non Financial Lease Asset

The IRS, as part of its normal audit of PHI's income tax returns, has questioned whether PHI is entitled to certain ongoing tax deductions being taken by PHI as a result of the adoption by PHI of a carry-over tax basis for a non-lease financial asset acquired in 1998 by a subsidiary of PHI. On December 14, 2004, PHI and the IRS agreed to a Notice of Proposed Adjustment settling this and certain other tax matters. This settlement will result in a cash outlay during 2006 for additional taxes and interest of approximately $23.3 million associated with the examination of PHI's 2001-2002 tax returns and an anticipated refund of taxes and interest of approximately $7.1 million when the examination of PHI's 2003 return is completed. In addition, in the fourth quarter of 2004, PHI took a tax charge to earnings of approximately $19.7 million for financial reporting purposes related to this matter. The charge consisted of approximately $16.3 million to reflect the reversal of tax benefits recognized by PHI prior to September 30, 2004, and approximately $3.4 million of interest on the additional taxes. During 2005 PHI recorded a tax charge to earnings of approximately $.9 million for interest on the additional taxes.

Taxes Other Than Income Taxes

Taxes other than income taxes for each year are shown below. The majority of these amounts relate to the Power Delivery businesses and are recoverable through rates.

	2005	2004	2003
	(Millions of dollars)		
Gross Receipts/Delivery	$148.3	$138.1	$138.4
Property	60.4	60.1	57.6
County Fuel and Energy	89.0	70.6	36.7
Environmental, Use and Other	44.5	42.6	39.5
Total	$342.2	$311.4	$272.2

(9) PREFERRED STOCK OF SUBSIDIARIES

Preferred stock amounts outstanding as of December 31, 2005 and 2004 are as follows:

Issuer and Series		Redemption Price	Shares Outstanding 2005	Shares Outstanding 2004	December 31, 2005	December 31, 2004
					(Millions of dollars)	
Serial Preferred (1)						
Pepco	$2.44 Series of 1957	$51.00	216,846	239,641	$ 10.9	$ 12.0
Pepco	$2.46 Series of 1958	$51.00	99,789	173,892	5.0	8.7
Pepco	$2.28 Series of 1965	$51.00	112,709	125,857	5.6	6.3
					$ 21.5	$ 27.0
Redeemable Serial Preferred						
ACE	$100 per share par value, 4.00% - 5.00%	$100 - $105.5	62,145	62,305	$ 6.2	$ 6.2
DPL	$100 per share par value, 3.70% - 5.00%	$103 - $105	181,698	181,698	18.2	18.2
	6.75% (2)	$100	-	35,000	-	3.5
					$ 24.4	$ 27.9

(1) In September and October of 2004, Pepco redeemed 81,400 and 84,502 shares, respectively, of its $2.28 Series 1965 Serial Preferred Stock for aggregate redemption amounts of $4.1 million and $4.2 million, respectively. In October 2005, Pepco redeemed 74,103 shares of its $2.46 Series 1958 Serial Preferred Stock, 13,148 shares of its $2.28 Series 1965 Serial Preferred Stock and 22,795 shares of its $2.44 Series 1957 Serial Preferred Stock for an aggregate redemption amount of $3.7 million, $.7 million and $1.1 million, respectively. On March 1, 2006, Pepco redeemed all outstanding shares of its Serial Preferred Stock of each series, at 102% of par, for an aggregate redemption amount of $21.9 million.

(2) In December 2005, DPL redeemed all outstanding shares of its 6.75% Serial Preferred Stock, at par, for an aggregate redemption amount of $3.5 million.

(10) STOCK-BASED COMPENSATION, DIVIDEND RESTRICTIONS, AND CALCULATIONS OF EARNINGS PER SHARE OF COMMON STOCK

Stock-Based Compensation

PHI maintains a Long-Term Incentive Plan (LTIP), the objective of which is to increase shareholder value by providing a long-term incentive to reward officers, key employees, and directors of Pepco Holdings and its subsidiaries and to increase the ownership of Pepco Holdings' common stock by such individuals. Any officer or key employee of Pepco Holdings or its subsidiaries may be designated by the Board as a participant in the LTIP. Under the LTIP, awards to officers and key employees may be in the form of restricted stock, options, performance units, stock appreciation rights, and dividend equivalents. Up to 10,000,000 shares of common stock initially were available for issuance under the LTIP over a period of 10 years commencing August 1, 2002.

Prior to acquisition of Conectiv by Pepco, each company had a long-term incentive plan under which stock options were granted. At the time of the acquisition, certain Conectiv options vested and were canceled in exchange for a cash payment. Certain other Conectiv options were exchanged on a 1 for 1.28205 basis for Pepco Holdings stock options under the LTIP: 590,198 Conectiv stock options were converted into 756,660 Pepco Holdings stock options. The Conectiv stock options were originally granted on January 1, 1998, January 1, 1999, July 1, 1999, October 18, 2000, and January 1, 2002, in each case with an exercise price equal to the market price (fair value) of the Conectiv stock on the date of the grant. The exercise prices of these options, after adjustment to give effect to the conversion ratio of Conectiv stock for Pepco Holdings stock, are $17.81, $18.91, $19.30, $13.08 and $19.03, respectively. All of the Pepco Holdings options received in exchange for the Conectiv options are exercisable.

At the time of the acquisition of Conectiv by Pepco, outstanding Pepco options were exchanged on a one-for-one basis for Pepco Holdings stock options granted under the LTIP. The options were originally granted under Pepco's long-term incentive plan in May 1998, May 1999, January 2000, May 2000, January 2001, May 2001, January 2002, and May 2002. The exercise prices of the options are $24.3125, $29.78125, $22.4375, $23.15625, $24.59, $21.825, $22.57 and $22.685, respectively, which represent the market prices (fair values) of the Pepco common stock on its original grant dates. All the options granted in May 1998, May 1999, January 2000, May 2000, January 2001, and May 2001 are exercisable. Seventy-five percent of the options granted on January 1, 2002 are exercisable and the remaining options became exercisable on January 1, 2006. Seventy-five percent of the options granted on May 1, 2002 are exercisable and the remaining options will become exercisable on May 1, 2006.

Stock option activity for the three years ended December 31 is summarized below. The information presented in the table is for Pepco Holdings, including converted Pepco and Conectiv options.

	2005			2004			2003		
	Number of Options		Weighted Average Price	Number of Options		Weighted Average Price	Number of Options		Weighted Average Price
Beginning-of-year balance	2,063,754	$	21.8841	2,115,037	$	21.8131	2,122,601	$	21.8031
Options granted	-	$	-	-	$	-	-	$	-
Options exercised	196,299	$	18.9834	41,668	$	18.9385	-	$	-
Options forfeited	3,205	$	19.0300	9,615	$	19.0300	7,564	$	19.0300
End-of-year balance	1,864,250	$	22.1944	2,063,754	$	21.8841	2,115,037	$	21.8131
Exercisable at end of year	1,814,350	$	22.1840	1,739,032	$	21.9944	1,211,448	$	22.8386

As of December 31, 2005, an analysis of options outstanding by exercise prices is as follows:

Range of Exercise Prices	Number Outstanding At December 31, 2005	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
\$13.08 to \$19.30	498,309	18.8036	6.4
\$21.83 to \$29.78	1,365,941	23.4314	4.6
\$13.08 to \$29.78	1,864,250	22.1944	5.1

Pepco Holdings recognizes compensation costs for the LTIP based on the accounting prescribed by APB No. 25, "Accounting for Stock Issued to Employees." There were no stock-based employee compensation costs charged to expense in 2005, 2004 and 2003 with respect to stock options granted under the LTIP.

There were no options granted in 2005, 2004, or 2003.

The Performance Restricted Stock Program and the Merger Integration Success Program have been established under the LTIP. Under the Performance Restricted Stock Program, performance criteria are selected and measured over a three-year period. The target number of share award opportunities established in 2001 under Pepco's Performance Restricted Stock Program, a component of the LTIP, for performance periods 2002-2004 was 57,000. The target number of share award opportunities established in 2005, 2004 and 2003 under Pepco Holdings' Performance Restricted Stock Program for performance periods 2006-2008, 2005-2007 and 2004-2006 were 218,108, 247,400 and 292,100, respectively. The fair value per share on award date for the performance restricted stock was \$22.235 for the 2006-2008 award, \$21.060 for the 2005-2007 award, and \$19.695 for the 2004-2006 award. Depending on the extent to which the performance criteria are satisfied, the executives are eligible to earn shares of common stock under the Performance Restricted Stock Program ranging from 0% to 200% of the target share award opportunities. No awards were earned with respect to the 2003-2005 share award opportunity.

The maximum number of share award opportunities granted under the Merger Integration Success Program during 2002 was 241,075. The fair value per share on grant date was \$19.735. Of those shares, 96,427 were restricted and have time-based vesting over three years: 20%

vested in 2003, 30% vested in 2004, and 50% vested in 2005. The remaining 144,648 shares are performance-based award opportunities that may be earned based on the extent to which operating efficiencies and expense reduction goals were attained through December 31, 2003 and 2004, respectively. Although the goals were met in 2003, it was determined that 63,943 shares, including shares reallocated from participants who did not meet performance goals as well as shares reflecting accrued dividends for the period August 1, 2002 to December 31, 2003, granted to certain executives, would not vest until 2005, and then only if the cost reduction goals were maintained and Pepco Holdings' financial performance were satisfactory. A total of 9,277 shares of common stock vested under this program on December 31, 2003 for other eligible employees. On March 11, 2005, 70,315 shares, including reinvested dividends, vested for the performance period ending on December 31, 2004. A total of 44,644 shares, including reinvested dividends, vested on March 7, 2006, for the original performance period ended December 31, 2003, that was extended to December 31, 2005.

Under the LTIP, non-employee directors are entitled to a grant on May 1 of each year of a non-qualified stock option for 1,000 shares of common stock. However, the Board of Directors has determined that these grants will not be made.

On August 1, 2002, the date of the acquisition of Conectiv by Pepco, in accordance with the terms of the merger agreement, 80,602 shares of Conectiv performance accelerated restricted stock (PARS) were converted to 103,336 shares of Pepco Holdings restricted stock. The PARS were originally granted on January 1, 2002 at a fair market price of $24.40. All of the converted restricted stock has time-based vesting over periods ranging from 5 to 7 years from the original grant date.

In June 2003, the President and Chief Executive Officer of PHI received a retention award in the form of 14,822 shares of restricted stock. The shares will vest on June 1, 2006, if he is continuously employed by PHI through that date.

Dividend Restrictions

PHI generates no operating income of its own. Accordingly, its ability to pay dividends to its shareholders depends on dividends received from its subsidiaries. In addition to their future financial performance, the ability of PHI's direct and indirect subsidiaries to pay dividends is subject to limits imposed by: (i) state corporate and regulatory laws, which impose limitations on the funds that can be used to pay dividends and, in the case of regulatory laws, as applicable, may require the prior approval of the relevant utility regulatory commissions before dividends can be paid; (ii) the prior rights of holders of existing and future preferred stock, mortgage bonds and other long-term debt issued by the subsidiaries, and any other restrictions imposed in connection with the incurrence of liabilities; and (iii) certain provisions of the charters of Pepco, DPL and ACE, which impose restrictions on payment of common stock dividends for the benefit of preferred stockholders.

Calculations of Earnings Per Share of Common Stock

Reconciliations of the numerator and denominator for basic and diluted earnings per share of common stock calculations are shown below.

	For the Year Ended December 31,		
	2005	2004	2003
	(In millions, except per share data)		
Income (Numerator):			
Net Income	$ 371.2	$ 260.6	$ 107.3
Add: (Loss) gain on redemption of subsidiary's preferred stock	(.1)	.5	-
Earnings Applicable to Common Stock	$ 371.1	$ 261.1	$ 107.3
Shares (Denominator) (a):			
Weighted average shares outstanding for computation of basic earnings per share of common stock	189.0	176.8	170.7
Weighted average shares outstanding for diluted computation:			
Average shares outstanding	189.0	176.8	170.7
Adjustment to shares outstanding	.3	-	-
Weighted average Shares Outstanding for Computation of Diluted Earnings Per Share of Common Stock	189.3	176.8	170.7
Basic earnings per share of common stock	$ 1.96	$ 1.48	$ .63
Diluted earnings per share of common stock	$ 1.96	$ 1.48	$ .63

(a) Options to purchase shares of common stock that were excluded from the calculation of diluted EPS as they are considered to be anti-dilutive were approximately 1.4 million for the years ended December 31, 2005 and 2004, and approximately 2.0 million for the year ended December 31, 2003, respectively.

PHI maintains a Shareholder Dividend Reinvestment Plan (DRP) through which shareholders may reinvest cash dividends and both existing shareholders and new investors can make purchases of shares of PHI common stock through the investment of not less than $25 each calendar month nor more than $200,000 each calendar year. Shares of common stock purchased through the DRP may be original issue shares or, at the election of PHI, shares purchased in the open market. There were 1,228,505; 1,471,936; and 1,706,422 original issue shares sold under the DRP in 2005, 2004 and 2003, respectively.

The following table presents Pepco Holdings' common stock reserved and unissued at December 31, 2005:

Name of Plan	Number of Shares
DRP	4,946,124
Conectiv Incentive Compensation Plan	1,569,062
Potomac Electric Power Company Long-Term Incentive Plan	1,400,000
Pepco Holdings, Inc. Long-Term Incentive Plan	9,773,810
Pepco Holdings, Inc. Stock Compensation Plan for Directors (a)	-
Pepco Holdings, Inc. Non-Management Directors Compensation Plan	497,976
Potomac Electric Power Company Savings Plans consisting of (i) the Retirement Savings Plan for Management Employees and (ii) the Savings Plan for Bargaining Unit Employees (b),(c)	3,000,000
Conectiv Savings and Investment Plan (c)	20,000
Atlantic Electric 401(k) Savings and Investment Plan-B (c)	25,000
Total	21,231,972

(a) Plan was terminated in 2005.

(b) Effective January 1, 2005, the Savings Plan for Non-Bargaining Unit, Non-Exempt Employees was merged with and into the Savings Plan for Exempt Employees which was renamed the Retirement Savings Plan for Management Employees.

(c) Effective January 13, 2006, Pepco Holdings established the Pepco Holdings, Inc. Retirement Savings Plan which is an amalgam of, and a successor to, (i) the Potomac Electric Power Company Savings Plan for Bargaining Unit Employees, (ii) the Retirement Savings Plan for Management Employees, (iii) the Conectiv Savings and Investment Plan, and (iv) the Atlantic City Electric 401(k) Savings and Investment Plan - B. As of January 20, 2006, there are 5,000,000 reserved and unissued shares under the Retirement Savings Plan (including the 3,045,000 shares previously reserved and unissued under the predecessor Plans.)

(11) FAIR VALUES OF FINANCIAL INSTRUMENTS

The estimated fair values of Pepco Holdings' financial instruments at December 31, 2005 and 2004 are shown below.

	At December 31,			
	2005		2004	
	(Millions of dollars)			
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets				
Derivative Instruments	$ 260.0	$ 260.0	$ 111.2	$ 111.2
Liabilities and Capitalization				
Long-Term Debt	$ 4,202.9	$ 4,308.0	$ 4,362.1	$ 4,575.3
Transition Bonds issued by ACE Funding	$ 494.3	$ 496.7	$ 523.3	$ 537.5
Derivative Instruments	$ 201.3	$ 201.3	$ 78.0	$ 78.0
Long-Term Project Funding	$ 25.5	$ 25.5	$ 65.3	$ 65.3
Serial Preferred Stock	$ 21.5	$ 18.2	$ 27.0	$ 21.7
Redeemable Serial Preferred Stock	$ 24.4	$ 17.2	$ 27.9	$ 18.7

The methods and assumptions described below were used to estimate, at December 31, 2005 and 2004, the fair value of each class of financial instruments shown above for which it is practicable to estimate a value.

The fair values of derivative instruments were derived based on quoted market prices.

Long-Term Debt includes recourse and non-recourse debt issued by PCI. The fair values of this PCI debt, excluding amounts due within one year, were based on current rates offered to similar companies for debt with similar remaining maturities. The fair values of all other Long-Term Debt and Transition Bonds issued by ACE Funding, excluding amounts due within one year, were derived based on current market prices, or for issues with no market price available, were based on discounted cash flows using current rates for similar issues with similar terms and remaining maturities.

The fair values of the Serial Preferred Stock and Redeemable Serial Preferred Stock, excluding amounts due within one year, were derived based on quoted market prices or discounted cash flows using current rates of preferred stock with similar terms.

The carrying amounts of all other financial instruments in Pepco Holdings' accompanying financial statements approximate fair value.

(12) COMMITMENTS AND CONTINGENCIES

REGULATORY AND OTHER MATTERS

Relationship with Mirant Corporation

In 2000, Pepco sold substantially all of its electricity generation assets to Mirant Corporation, formerly Southern Energy, Inc. As part of the Asset Purchase and Sale Agreement, Pepco entered into several ongoing contractual arrangements with Mirant Corporation and certain of its subsidiaries. In July 2003, Mirant Corporation and most of its subsidiaries filed a voluntary petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the U.S.

Bankruptcy Court for the Northern District of Texas (the Bankruptcy Court). On December 9, 2005, the Bankruptcy Court approved Mirant's Plan of Reorganization (the Reorganization Plan) and the Mirant business emerged from bankruptcy on January 3, 2006 (the Bankruptcy Emergence Date), in the form of a new corporation of the same name (together with its predecessors, Mirant). However, as discussed below, the Reorganization Plan did not resolve all of the outstanding matters between Pepco and Mirant relating to the Mirant bankruptcy and the litigation between Pepco and Mirant over these matters is ongoing.

Depending on the outcome of ongoing litigation, the Mirant bankruptcy could have a material adverse effect on the results of operations and cash flows of Pepco Holdings and Pepco. However, management believes that Pepco Holdings and Pepco currently have sufficient cash, cash flow and borrowing capacity under their credit facilities and in the capital markets to be able to satisfy any additional cash requirements that may arise due to the Mirant bankruptcy. Accordingly, management does not anticipate that the Mirant bankruptcy will impair the ability of either Pepco Holdings or Pepco to fulfill its contractual obligations or to fund projected capital expenditures. On this basis, management currently does not believe that the Mirant bankruptcy will have a material adverse effect on the financial condition of either company.

Transition Power Agreements

As part of the Asset Purchase and Sale Agreement, Pepco and Mirant entered into Transition Power Agreements for Maryland and the District of Columbia, respectively (collectively, the TPAs). Under the TPAs, Mirant was obligated to supply Pepco with all of the capacity and energy needed to fulfill Pepco's SOS obligations during the rate cap periods in each jurisdiction immediately following deregulation, which in Maryland extended through June 2004 and in the District of Columbia extended until January 22, 2005.

To avoid the potential rejection of the TPAs by Mirant in the bankruptcy proceeding, Pepco and Mirant in October 2003 entered into an Amended Settlement Agreement and Release (the Settlement Agreement) pursuant to which the terms of the TPAs were modified to increase the purchase price of the capacity and energy supplied by Mirant. In exchange, the Settlement Agreement provided Pepco with an allowed, pre-petition general unsecured claim against Mirant Corporation in the amount of $105 million (the Pepco TPA Claim).

On December 22, 2005, Pepco completed the sale of the Pepco TPA Claim, plus the right to receive accrued interest thereon, to Deutsche Bank for a cash payment of $112.4 million. Additionally, Pepco received $0.5 million in proceeds from Mirant in settlement of an asbestos claim against the Mirant bankruptcy estate. Pepco Holdings and Pepco recognized a total gain of $70.5 million (pre-tax) related to the settlement of these claims. Based on the regulatory settlements entered into in connection with deregulation in Maryland and the District of Columbia, Pepco is obligated to share with its customers the profits it realizes from the provision of SOS during the rate cap periods. The proceeds of the sale of the Pepco TPA Claim will be included in the calculations of the amounts required to be shared with customers in both jurisdictions. Based on the applicable sharing formulas in the respective jurisdictions, Pepco anticipates that customers will receive (through billing credits) approximately $42.3 million of the proceeds over a 12-month period beginning in March 2006 (subject to DCPSC and MPSC approvals).

Power Purchase Agreements

Under agreements with FirstEnergy Corp., formerly Ohio Edison (FirstEnergy), and

Allegheny Energy, Inc., both entered into in 1987, Pepco was obligated to purchase 450 megawatts of capacity and energy from FirstEnergy annually through December 2005 (the FirstEnergy PPA). Under the Panda PPA, entered into in 1991, Pepco is obligated to purchase 230 megawatts of capacity and energy from Panda annually through 2021. At the time of the sale of Pepco's generation assets to Mirant, the purchase price of the energy and capacity under the PPAs was, and since that time has continued to be, substantially in excess of the market price. As a part of the Asset Purchase and Sale Agreement, Pepco entered into a "back-to-back" arrangement with Mirant. Under this arrangement, Mirant (i) was obligated, through December 2005, to purchase from Pepco the capacity and energy that Pepco was obligated to purchase under the FirstEnergy PPA at a price equal to Pepco's purchase price from FirstEnergy, and (ii) is obligated through 2021 to purchase from Pepco the capacity and energy that Pepco is obligated to purchase under the Panda PPA at a price equal to Pepco's purchase price from Panda (the PPA-Related Obligations). Mirant currently is making these required payments.

Pepco Pre-Petition Claims

At the time the Reorganization Plan was approved by the Bankruptcy Court, Pepco had pending pre-petition claims against Mirant totaling approximately $28.5 million (the Pre-Petition Claims), consisting of (i) approximately $26 million in payments due to Pepco in respect of the PPA-Related Obligations and (ii) approximately $2.5 million that Pepco has paid to Panda in settlement of certain billing disputes under the Panda PPA that related to periods after the sale of Pepco's generation assets to Mirant and prior to Mirant's bankruptcy filing, for which Pepco believes Mirant is obligated to reimburse it under the terms of the Asset Purchase and Sale Agreement. In the bankruptcy proceeding, Mirant filed an objection to the Pre-Petition Claims. The Pre-Petition Claims were not resolved in the Reorganization Plan and are the subject of ongoing litigation between Pepco and Mirant. To the extent Pepco is successful in its efforts to recover the Pre-Petition Claims, it would receive under the terms of the Reorganization Plan a number of shares of common stock of the new corporation created pursuant to the Reorganization Plan (the New Mirant Common Stock) equal to (i) the amount of the allowed claim (ii) divided by the market price of the New Mirant Common Stock on the Bankruptcy Emergence Date. Because the number of shares is based on the market price of the New Mirant Common Stock on the Bankruptcy Emergence Date, Pepco would receive the benefit, and bear the risk, of any change in the market price of the stock between the Bankruptcy Emergence Date and the date the stock is issued to Pepco.

As of December 31, 2005, Pepco maintained a receivable in the amount of $28.5 million, representing the Pre-Petition Claims, which was offset by a reserve of $14.5 million established by an expense recorded in 2003 to reflect the uncertainty as to whether the entire amount of the Pre-Petition Claims is recoverable. As of December 31, 2005, this reserve was reduced to $9.6 million to reflect the fact that there was no longer an objection to $15 million of Pepco's claim.

Mirant's Efforts to Reject the PPA-Related Obligations and Disgorgement Claims

In August 2003, Mirant filed with the Bankruptcy Court a motion seeking authorization to reject the PPA-Related Obligations (the First Motion to Reject). Upon motions filed with the U.S. District Court for the Northern District of Texas (the District Court) by Pepco and FERC, the District Court in October 2003 withdrew jurisdiction over this matter from the Bankruptcy Court. In December 2003, the District Court denied Mirant's motion to reject the PPA-Related Obligations on jurisdictional grounds. Mirant appealed the District Court's decision to the U.S. Court of Appeals for the Fifth Circuit (the Court of Appeals). In August 2004, the Court of

Appeals remanded the case to the District Court holding that the District Court had jurisdiction to rule on the merits of Mirant's rejection motion, suggesting that in doing so the court apply a "more rigorous standard" than the business judgment rule usually applied by bankruptcy courts in ruling on rejection motions.

In December 2004, the District Court issued an order again denying Mirant's motion to reject the PPA-Related Obligations. The District Court found that the PPA-Related Obligations are not severable from the Asset Purchase and Sale Agreement and that the Asset Purchase and Sale Agreement cannot be rejected in part, as Mirant was seeking to do. Mirant has appealed the District Court's order to the Court of Appeals.

In January 2005, Mirant filed in the Bankruptcy Court a motion seeking to reject certain of its ongoing obligations under the Asset Purchase and Sale Agreement, including the PPA-Related Obligations (the Second Motion to Reject). In March 2005, the District Court entered orders granting Pepco's motion to withdraw jurisdiction over these rejection proceedings from the Bankruptcy Court and ordering Mirant to continue to perform the PPA-Related Obligations (the March 2005 Orders). Mirant has appealed the March 2005 Orders to the Court of Appeals.

In March 2005, Pepco, FERC, the Office of People's Counsel of the District of Columbia (the District of Columbia OPC), the MPSC and the Office of People's Counsel of Maryland (Maryland OPC) filed in the District Court oppositions to the Second Motion to Reject. In August 2005, the District Court issued an order informally staying this matter, pending a decision by the Court of Appeals on the March 2005 Orders.

On February 9, 2006, oral arguments on Mirant's appeals of the District Court's order relating to the First Motion to Reject and the March 2005 Orders were held before the Court of Appeals; an opinion has not yet been issued.

On December 1, 2005, Mirant filed with the Bankruptcy Court a motion seeking to reject the executory parts of the Asset Purchase and Sale Agreement and its obligations under all other related agreements with Pepco, with the exception of Mirant's obligations relating to operation of the electric generating stations owned by Pepco Energy Services (the Third Motion to Reject). The Third Motion to Reject also seeks disgorgement of payments made by Mirant to Pepco in respect of the PPA-Related Obligations after filing of its bankruptcy petition in July 2003 to the extent the payments exceed the market value of the capacity and energy purchased. On December 21, 2005, Pepco filed an opposition to the Third Motion to Reject in the Bankruptcy Court.

On December 1, 2005, Mirant, in an attempt to "recharacterize" the PPA-Related Obligations, filed a complaint with the Bankruptcy Court seeking (i) a declaratory judgment that the payments due under the PPA-Related Obligations to Pepco are pre-petition debt obligations; and (ii) an order entitling Mirant to recover all payments that it made to Pepco on account of these pre-petition obligations after the petition date to the extent permitted under bankruptcy law (i.e., disgorgement).

On December 15, 2005, Pepco filed a motion with the District Court to withdraw jurisdiction over both of the December 1 filings from the Bankruptcy Court. The motion to withdraw and Mirant's underlying complaint have both been stayed pending a decision of the Court of Appeals in the appeals described above.

Each of the theories advanced by Mirant to recover funds paid to Pepco relating to the PPA-

Related Obligations as a practical matter seeks reimbursement for the above-market cost of the capacity and energy purchased from Pepco over a period beginning, at the earliest, from the date on which Mirant filed its bankruptcy petition and ending on the date of rejection or the date through which disgorgement is approved. Under these theories, Pepco's financial exposure is the amount paid by Mirant to Pepco in respect of the PPA-Related Obligations during the relevant period, less the amount realized by Mirant from the resale of the purchased energy and capacity. On this basis, Pepco estimates that if Mirant ultimately is successful in rejecting the PPA-Related Obligations or on its alternative claims to recover payments made to Pepco related to the PPA-Related Obligations, Pepco's maximum reimbursement obligation would be approximately $263 million as of March 1, 2006.

If Mirant were ultimately successful in its effort to reject its obligations relating to the Panda PPA, Pepco also would lose the benefit on a going-forward basis of the offsetting transaction that negates the financial risk to Pepco of the Panda PPA. Accordingly, if Pepco were required to purchase capacity and energy from Panda commencing as of March 1, 2006, at the rates provided in the PPA (with an average price per kilowatt hour of approximately 17.1 cents), and resold the capacity and energy at market rates projected, given the characteristics of the Panda PPA, to be approximately 11.0 cents per kilowatt hour, Pepco estimates that it would incur losses of approximately $24 million for the remainder of 2006, approximately $30 million in 2007, and approximately $27 million to $38 million annually thereafter through the 2021 contract termination date. These estimates are based in part on current market prices and forward price estimates for energy and capacity, and do not include financing costs, all of which could be subject to significant fluctuation.

Pepco is continuing to exercise all available legal remedies to vigorously oppose Mirant's efforts to reject or recharacterize the PPA-Related Obligations under the Asset Purchase and Sale Agreement in order to protect the interests of its customers and shareholders. While Pepco believes that it has substantial legal bases to oppose these efforts by Mirant, the ultimate legal outcome is uncertain. However, if Pepco is required to repay to Mirant any amounts received from Mirant in respect of the PPA-Related Obligations, Pepco believes it will be entitled to file a claim against the Mirant bankruptcy estate in an amount equal to the amount repaid. Likewise, if Mirant is successful in its efforts to reject its future obligations relating to the Panda PPA, Pepco will have a claim against Mirant in an amount corresponding to the increased costs that it would incur. In either case, Pepco anticipates that Mirant will contest the claim. To the extent Pepco is successful in its efforts to recover on these claims, it would receive, as in the case of the Pre-Petition Claims, a number of shares of New Mirant Common Stock that is calculated using the market price of the New Mirant Common Stock on the Bankruptcy Emergence Date and accordingly would receive the benefit, and bear the risk, of any change in the market price of the stock between the Bankruptcy Emergence Date and the date the stock is issued to Pepco.

Regulatory Recovery of Mirant Bankruptcy Losses

If Mirant were ultimately successful in rejecting the PPA-Related Obligations or on its alternative claims to recover payments made to Pepco related to the PPA-Related Obligations and Pepco's corresponding claims against the Mirant bankruptcy estate are not recovered in full, Pepco would seek authority from the MPSC and the DCPSC to recover its additional costs. Pepco is committed to working with its regulatory authorities to achieve a result that is appropriate for its shareholders and customers. Under the provisions of the settlement agreements approved by the MPSC and the DCPSC in the deregulation proceedings in which Pepco agreed to divest its generation assets under certain conditions, the PPAs were to become assets of Pepco's distribution business if they could not be sold. Pepco believes that these provisions would allow the stranded costs of the PPAs that are not recovered from the Mirant bankruptcy estate to be recovered from Pepco's customers through its distribution rates. If Pepco's interpretation of the settlement agreements is confirmed, Pepco expects to be able to establish the amount of its anticipated recovery from customers as a regulatory asset. However, there is no assurance that Pepco's interpretation of the settlement agreements would be confirmed by the respective public service commissions.

Pepco's Notice of Administrative Claims

On January 24, 2006, Pepco filed Notice of Administrative Claims in the Bankruptcy Court seeking to recover: (i) costs in excess of $70 million associated with the transmission upgrades necessitated by shut-down of the Potomac River Power Station; and (ii) costs in excess of $8 million due to Mirant's unjustified post-petition delay in executing the certificates needed to permit Pepco to refinance certain tax exempt pollution control bonds. Mirant is expected to oppose both of these claims, which must be approved by the Bankruptcy Court. There is no assurance that Pepco will be able to recover the amounts claimed.

Mirant's Fraudulent Transfer Claim

In July 2005, Mirant filed a complaint in the Bankruptcy Court against Pepco alleging that Mirant's $2.65 billion purchase of Pepco's generating assets in June 2000 constituted a fraudulent transfer for which it seeks compensatory and punitive damages. Mirant alleges in the complaint that the value of Pepco's generation assets was "not fair consideration or fair or reasonably equivalent value for the consideration paid to Pepco" and that the purchase of the assets rendered Mirant insolvent, or, alternatively, that Pepco and Southern Energy, Inc. (as predecessor to Mirant) intended that Mirant would incur debts beyond its ability to pay them.

Pepco believes this claim has no merit and is vigorously contesting the claim, which has been withdrawn to the District Court. On December 5, 2005, the District Court entered a stay pending a decision of the Court of Appeals in the appeals described above.

The SMECO Agreement

As a term of the Asset Purchase and Sale Agreement, Pepco assigned to Mirant a facility and capacity agreement with Southern Maryland Electric Cooperative (SMECO) under which Pepco was obligated to purchase the capacity of an 84-megawatt combustion turbine installed and owned by SMECO at a former Pepco generating facility (the SMECO Agreement). The SMECO Agreement expires in 2015 and contemplates a monthly payment to SMECO of approximately $.5 million. Pepco is responsible to SMECO for the performance of the SMECO Agreement if Mirant fails to perform its obligations thereunder. At this time, Mirant continues to make post-petition payments due to SMECO.

On March 15, 2004, Mirant filed a complaint with the Bankruptcy Court seeking a declaratory judgment that the SMECO Agreement is an unexpired lease of non-residential real property rather than an executory contract and that if Mirant were to successfully reject the agreement, any claim against the bankruptcy estate for damages made by SMECO (or by Pepco as subrogee) would be subject to the provisions of the Bankruptcy Code that limit the recovery of rejection damages by lessors.

On November 22, 2005, the Bankruptcy Court issued an order granting summary judgment in favor of Mirant, finding that the SMECO Agreement is an unexpired lease of nonresidential real property. On the basis of this ruling, any claim by SMECO (or by Pepco as subrogee) for damages arising from a successful rejection are limited to the greater of (i) the amount of future rental payments due over one year, or (ii) 15% of the future rental payments due over the remaining term of the lease, not to exceed three years.

On December 1, 2005, Mirant filed both a motion with the Bankruptcy Court seeking to reject the SMECO Agreement and a complaint against Pepco and SMECO seeking to recover payments made to SMECO after the entry of the Bankruptcy Court's November 22, 2005 order holding that the SMECO Agreement is a lease of real property. On December 15, 2005, Pepco filed a motion with the District Court to withdraw jurisdiction of this matter from the Bankruptcy Court. The motion to withdraw and Mirant's underlying motion and complaint have been stayed pending a decision of the Court of Appeals in the appeals described above.

If the SMECO Agreement is successfully rejected by Mirant, Pepco will become responsible for the performance of the SMECO Agreement. In addition, if the SMECO Agreement is ultimately determined to be an unexpired lease of nonresidential real property, Pepco's claim for recovery against the Mirant bankruptcy estate would be limited as described above. Pepco estimates that its rejection claim, assuming the SMECO Agreement is determined to be an unexpired lease of nonresidential real property, would be approximately $8 million, and that the amount it would be obligated to pay over the remaining nine years of the SMECO Agreement is approximately $44.3 million. While that amount would be offset by the sale of capacity, under current projections, the market value of the capacity is de minimis.

Rate Proceedings

Delaware

On October 3, 2005, DPL submitted its 2005 gas cost rate (GCR) filing to the DPSC, which permits DPL to recover gas procurement costs through customer rates. In its filing, DPL seeks to increase its GCR by approximately 38% in anticipation of increasing natural gas commodity costs. The proposed rate became effective November 1, 2005, subject to refund pending final DPSC approval after evidentiary hearings. A public input hearing was held on January 19, 2006. DPSC staff and the Division of the Public Advocate filed testimony on February 20, 2006.

As authorized by the April 16, 2002 settlement agreement in Delaware relating to the acquisition of Conectiv by Pepco (the Delaware Merger Settlement Agreement), on May 4, 2005, DPL filed with the DPSC a proposed increase of approximately $6.2 million in electric transmission service revenues, or about 1.1% of total Delaware retail electric revenues. This revenue increase covers the Delaware retail portion of the increase in the "Delmarva zonal" transmission rates on file with FERC under the PJM Open Access Transmission Tariff (OATT) and other transition PJM charges. This level of revenue increase will decrease to the extent that competitive suppliers provide the supply portion and its associated transmission service to retail customers. In that circumstance, PJM would charge the competitive retail supplier the PJM OATT rate for transmission service into the Delmarva zone and DPL's charges to the retail customer would exclude as a "shopping credit" an amount equal to the SOS supply charge and the transmission and ancillary charges that would otherwise be charged by DPL to the retail customer. DPL began collecting this rate change for service rendered on and after June 3, 2005, subject to refund pending final approval by the DPSC.

On September 1, 2005, DPL filed with the DPSC its first comprehensive base rate case in ten years. This application was filed as a result of increasing costs and is consistent with a provision in the Delaware Merger Settlement Agreement requiring DPL to file a base rate case by September 1, 2005 and permitting DPL to apply for an increase in rates to be effective no earlier than May 1, 2006. In the application, DPL sought approval of an annual increase of approximately $5.1 million in its electric rates, with an increase of approximately $1.6 million to its electric distribution base rates after proposing to assign approximately $3.5 million in costs to the supply component of rates to be collected as part of the SOS. Of the approximately $1.6 million in net increases to its electric distribution base rates, DPL proposed that approximately $1.2 million be recovered through changes in delivery charges and that the remaining approximately $0.4 million be recovered through changes in premise collection and reconnect fees. The full proposed revenue increase is approximately 0.9% of total annual electric utility revenues, while the proposed net increase to distribution rates is 0.2% of total annual electric utility revenues. DPL's distribution revenue requirement is based on a proposed return on common equity of 11%. DPL also has proposed revised depreciation rates and a number of tariff modifications.

On September 20, 2005, the DPSC issued an order approving DPL's request that the rate increase go into effect on May 1, 2006; subject to refund and pending evidentiary hearings. The order also suspends effectiveness of various proposed tariff rule changes until the case is concluded. The discovery process commenced on October 21, 2005. In its direct testimony, DPSC staff has proposed a variety of adjustments to rate base, operating expenses including depreciation and rate of return with an overall recommendation of a distribution base rate revenue decrease of $14.3 million. The DPSC staff's testimony also addresses issues such as rate design, allocation of any rate decrease and positions regarding the DPL's proposals on certain non-rate tariff modifications. The Delaware Division of Public Advocate has proposed many of the same adjustments and others with an overall recommendation of a distribution base rate revenue decrease of $18.9 million. DPL filed rebuttal testimony on January 17, 2006, which supports a distribution base rate revenue increase of $2 million. On January 30, 2006, the DPSC staff requested the Hearing Examiner approve a modification of the procedural schedule in the case to allow for inclusion of testimony regarding recalculation of DPSC staff's proposed depreciation rates to allow for a separate amortization of the cost of removal reserve. DPL objected to this modification of the procedural schedule. The Hearing Examiner issued a letter ruling on February 1, 2006, which denied DPSC staff's request for a modified procedural schedule. On February 2, 2006, DPSC staff filed an emergency motion requesting the DPSC to permit consideration of the issue by the Hearing Examiner in this docket. On February 6, 2006, the DPSC ruled to allow the issue in the case. A revised procedural schedule was established by the Hearing Examiner on February 10, 2006. On February 15, 2006, DPL filed an interlocutory appeal of the Hearing Examiner's ruling on the procedural schedule with the DPSC. On February 28, 2006, the DPSC upheld the Hearing Examiner's ruling and procedural schedule set on February 10, 2006. DPSC staff filed testimony related to this issue on February 17, 2006. DPSC staff's revised depreciation proposal reduces their recommended proposed rate decrease to $18.9 million, plus the amortization of the cost of removal of $58.4 million, which DPSC staff has recommended be returned to customers through either a 5, 7 or 10-year amortization. DPL continues to oppose the inclusion of this issue in the case for substantive and procedural grounds. Evidentiary hearings were held in early February. Hearings on the separate issue related to the depreciation of the cost of removal are scheduled to be held March 20, 2006. Briefs are due on March 31, 2006 and DPSC deliberation is scheduled to occur on April 25, 2006. DPL cannot predict the outcome of this proceeding.

District of Columbia and Maryland

On February 27, 2006, Pepco filed for the period February 8, 2002 through February 7, 2004 and for the period February 8, 2004 through February 7, 2005, an update to the District of Columbia Generation Procurement Credit (GPC), which provides for sharing of the profit from SOS sales; and on February 24, 2006, Pepco filed an update for the period July 1, 2003 through June 30, 2004 to the Maryland GPC. The updates to the GPC in both the District of Columbia and Maryland take into account the proceeds from the sale of the $105 million claim against the Mirant bankruptcy estate related to the TPA Settlement on December 13, 2005 for $112.4 million. The filings also incorporate true-ups to previous disbursements in the GPC for both states. In the filings, Pepco requests that $24.3 million be credited to District of Columbia customers and $17.7 million be credited to Maryland customers during the twelve-month-period beginning April 2006.

Federal Energy Regulatory Commission

On January 31, 2005, Pepco, DPL, and ACE filed at FERC to reset their rates for network transmission service using a formula methodology. The companies also sought a 12.4% return on common equity and a 50-basis-point return on equity adder that FERC had made available to transmission utilities who had joined Regional Transmission Organizations and thus turned over control of their assets to an independent entity. FERC issued an order on May 31, 2005, approving the rates to go into effect June 1, 2005, subject to refund, hearings, and further orders. The new rates reflect a decrease of 7.7% in Pepco's transmission rate, and increases of 6.5% and 3.3% in DPL's and ACE's transmission rates, respectively. The companies continue in settlement discussions under the supervision of a FERC administrative law judge and cannot predict the ultimate outcome of this proceeding.

Restructuring Deferral

Pursuant to orders issued by the NJBPU under New Jersey Electric Discount and Energy Competition Act (EDECA), beginning August 1, 1999, ACE was obligated to provide BGS to retail electricity customers in its service territory who did not choose a competitive energy supplier. For the period August 1, 1999 through July 31, 2003, ACE's aggregate costs that it was allowed to recover from customers exceeded its aggregate revenues from supplying BGS. These under-recovered costs were partially offset by a $59.3 million deferred energy cost liability existing as of July 31, 1999 (LEAC Liability) that was related to ACE's Levelized Energy Adjustment Clause and ACE's Demand Side Management Programs. ACE established a regulatory asset in an amount equal to the balance of under-recovered costs.

In August 2002, ACE filed a petition with the NJBPU for the recovery of approximately $176.4 million in actual and projected deferred costs relating to the provision of BGS and other restructuring related costs incurred by ACE over the four-year period August 1, 1999 through July 31, 2003, net of the $59.3 million offset for the LEAC Liability. The petition also requested that ACE's rates be reset as of August 1, 2003 so that there would be no under-recovery of costs embedded in the rates on or after that date. The increase sought represented an overall 8.4% annual increase in electric rates and was in addition to the base rate increase discussed above. ACE's recovery of the deferred costs is subject to review and approval by the NJBPU in accordance with EDECA.

In July 2004, the NJBPU issued a final order in the restructuring deferral proceeding confirming a July 2003 summary order, which (i) permitted ACE to begin collecting a portion of the deferred costs and reset rates to recover on-going costs incurred as a result of EDECA, (ii) approved the recovery of $125 million of the deferred balance over a ten-year amortization period beginning August 1, 2003, (iii) transferred to ACE's then pending base rate case for further consideration approximately $25.4 million of the deferred balance, and (iv) estimated the overall deferral balance as of July 31, 2003 at $195 million, of which $44.6 million was disallowed recovery by ACE. ACE believes the record does not justify the level of disallowance imposed by the NJBPU in the final order. In August 2004, ACE filed with the Appellate Division of the Superior Court of New Jersey, which hears appeals of New Jersey administrative agencies, including the NJBPU, a Notice of Appeal with respect to the July 2004 final order. ACE's initial brief was filed on August 17, 2005. Cross-appellant briefs on behalf of the Division of the New Jersey Ratepayer Advocate and Cogentrix Energy Inc., the co-owner of two cogeneration power plants with contracts to sell ACE approximately 397 megawatts of electricity, were filed on October 3, 2005. The NJBPU Staff filed briefs on December 12, 2005. ACE filed its reply briefs on January 30, 2006.

Divestiture Cases

District of Columbia

Final briefs on Pepco's District of Columbia divestiture proceeds sharing application were filed in July 2002 following an evidentiary hearing in June 2002. That application was filed to implement a provision of Pepco's DCPSC-approved divestiture settlement that provided for a sharing of any net proceeds from the sale of Pepco's generation-related assets. One of the principal issues in the case is whether Pepco should be required to share with customers the excess deferred income taxes (EDIT) and accumulated deferred investment tax credits (ADITC) associated with the sold assets and, if so, whether such sharing would violate the normalization provisions of the Internal Revenue Code and its implementing regulations. As of December 31, 2005, the District of Columbia allocated portions of EDIT and ADITC associated with the divested generation assets were approximately $6.5 million and $5.8 million, respectively.

Pepco believes that a sharing of EDIT and ADITC would violate the Internal Revenue Service (IRS) normalization rules. Under these rules, Pepco could not transfer the EDIT and the ADITC benefit to customers more quickly than on a straight line basis over the book life of the related assets. Since the assets are no longer owned there is no book life over which the EDIT and ADITC can be returned. If Pepco were required to share EDIT and ADITC and, as a result, the normalization rules were violated, Pepco would be unable to use accelerated depreciation on District of Columbia allocated or assigned property. In addition to sharing with customers the generation-related EDIT and ADITC balances, Pepco would have to pay to the IRS an amount equal to Pepco's District of Columbia jurisdictional generation-related ADITC balance ($5.8 million as of December 31, 2005), as well as its District of Columbia jurisdictional transmission and distribution-related ADITC balance ($5.3 million as of December 31, 2005) in each case as those balances exist as of the later of the date a DCPSC order is issued and all rights to appeal have been exhausted or lapsed, or the date the DCPSC order becomes operative.

In March 2003, the IRS issued a notice of proposed rulemaking (NOPR), which would allow for the sharing of EDIT and ADITC related to divested assets with utility customers on a prospective basis and at the election of the taxpayer on a retroactive basis. In December 2005 a revised NOPR was issued which, among other things, withdrew the March 2003 NOPR and eliminated the taxpayer's ability to elect to apply the regulation retroactively. Comments on the revised NOPR are due by March 21, 2006, and a public hearing will be held on April 5, 2006.

Pepco filed a letter with the DCPSC on January 12, 2006, in which it has reiterated that the DCPSC should continue to defer any decision on the ADITC and EDIT issues until the IRS issues final regulations or states that its regulations project will be terminated without the issuance of any regulations. Other issues in the divestiture proceeding deal with the treatment of internal costs and cost allocations as deductions from the gross proceeds of the divestiture.

Pepco believes that its calculation of the District of Columbia customers' share of divestiture proceeds is correct. However, depending on the ultimate outcome of this proceeding, Pepco could be required to make additional gain-sharing payments to District of Columbia customers, including the payments described above related to EDIT and ADITC. Such additional payments (which, other than the EDIT and ADITC related payments, cannot be estimated) would be charged to expense in the quarter and year in which a final decision is rendered and could have a material adverse effect on Pepco's and PHI's results of operations for those periods. However, neither PHI nor Pepco believes that additional gain-sharing payments, if any, or the ADITC-related payments to the IRS, if required, would have a material adverse impact on its financial position, results of operations or cash flows. It is uncertain when the DCPSC will issue a decision regarding Pepco's divestiture proceeds sharing application.

Maryland

Pepco filed its divestiture proceeds plan application in Maryland in April 2001. The principal issue in the Maryland case is the same EDIT and ADITC sharing issue that has been raised in the District of Columbia case. See the discussion above under "Divestiture Cases - District of Columbia." As of December 31, 2005, the MPSC allocated portions of EDIT and ADITC associated with the divested generation assets were approximately \$9.1 million and \$10.4 million, respectively. Other issues deal with the treatment of certain costs as deductions from the gross proceeds of the divestiture. In November 2003, the Hearing Examiner in the Maryland proceeding issued a proposed order with respect to the application that concluded that Pepco's Maryland divestiture settlement agreement provided for a sharing between Pepco and customers of the EDIT and ADITC associated with the sold assets. Pepco believes that such a sharing would violate the normalization rules (discussed above) and would result in Pepco's inability to use accelerated depreciation on Maryland allocated or assigned property. If the proposed order is affirmed, Pepco would have to share with its Maryland customers, on an approximately 50/50 basis, the Maryland allocated portion of the generation-related EDIT (\$9.1 million as of December 31, 2005), and the Maryland-allocated portion of generation-related ADITC. Furthermore, Pepco would have to pay to the IRS an amount equal to Pepco's Maryland jurisdictional generation-related ADITC balance (\$10.4 million as of December 31, 2005), as well as its Maryland retail jurisdictional ADITC transmission and distribution-related balance (\$9.5 million as of December 31, 2005), in each case as those balances exist as of the later of the date a MPSC order is issued and all rights to appeal have been exhausted or lapsed, or the date the MPSC order becomes operative. The Hearing Examiner decided all other issues in favor of Pepco, except for the determination that only one-half of the severance payments that Pepco included in its calculation of corporate reorganization costs should be deducted from the sales proceeds before sharing of the net gain between Pepco and customers. Pepco filed a letter with the MPSC on January 12, 2006, in which it has reiterated that the MPSC should continue to defer any decision on the ADITC and EDIT issues until the IRS issues final regulations or states that its regulations project will be terminated without the issuance of any regulations.

Pepco has appealed the Hearing Examiner's decision as it relates to the treatment of EDIT and ADITC and corporate reorganization costs to the MPSC. Consistent with Pepco's position in the District of Columbia, Pepco has argued that the only prudent course of action is for the MPSC to await the issuance of final regulations relating to the tax issues or a termination by the IRS of its regulation project without the issuance of any regulations, and then allow the parties to file supplemental briefs on the tax issues. Pepco believes that its calculation of the Maryland customers' share of divestiture proceeds is correct. However, depending on the ultimate outcome of this proceeding, Pepco could be required to share with its customers approximately 50 percent of the EDIT and ADITC balances described above and make additional gain-sharing payments related to the disallowed severance payments. Such additional payments would be charged to expense in the quarter and year in which a final decision is rendered and could have a material adverse effect on results of operations for those periods. However, neither PHI nor Pepco believes that additional gain-sharing payments, if any, or the ADITC-related payments to the IRS, if required, would have a material adverse impact on its financial position, results of operations or cash flows.

Default Electricity Supply Proceedings

District of Columbia

Under an order issued by the DCPSC in March 2004, as amended by a DCPSC order issued in July 2004, Pepco is obligated to provide SOS for small commercial and residential customers through May 31, 2011 and for large commercial customers through May 31, 2007. In August 2004, the DCPSC issued an order adopting administrative charges for residential, small and large commercial District of Columbia SOS customers that are intended to allow Pepco to recover the administrative costs incurred to provide the SOS supply. The approved administrative charges include an average margin for Pepco of approximately $.00248 per kilowatt hour, calculated based on total sales to residential, small and large commercial District of Columbia SOS customers over the twelve months ended December 31, 2003. Because margins vary by customer class, the actual average margin over any given time period will depend on the number of SOS customers from each customer class and the load taken by such customers over the time period. The administrative charges went into effect for Pepco's SOS sales on February 8, 2005.

The TPA with Mirant under which Pepco obtained the fixed-rate SOS supply ended on January 22, 2005, while the new SOS supply contracts with the winning bidders in the competitive procurement process began on February 1, 2005. Pepco procured power separately on the market for next-day deliveries to cover the period from January 23 through January 31, 2005, before the new SOS contracts began. Consequently, Pepco had to pay the difference between the procurement cost of power on the market for next-day deliveries and the current SOS rates charged to customers during the period from January 23 through January 31, 2005. In addition, because the new SOS rates did not go into effect until February 8, 2005, Pepco had to pay the difference between the procurement cost of power under the new SOS contracts and the SOS rates charged to customers for the period from February 1 to February 7, 2005. The total amount of the difference is estimated to be approximately $8.7 million. This difference, however, was included in the calculation of the GPC for the District of Columbia for the period February 8, 2004 through February 7, 2005, which was filed on July 12, 2005 with the DCPSC. The GPC provides for a sharing between Pepco's customers and shareholders, on an annual basis, of any margins, but not losses, that Pepco earned providing SOS in the District of Columbia during the four-year period from February 8, 2001 through February 7, 2005. At the time of the filing, based on the rates paid to Mirant by Pepco under the TPA Settlement, there was no customer sharing. On December 22, 2005 Pepco received $112.4 million in proceeds from the sale of the Pepco TPA Claim against the Mirant bankruptcy estate. A portion of this recovery related to the period February 8, 2004 through February 7, 2005 covered in the July 12 DCPSC filing. As a consequence, on February 27, 2006, Pepco filed with the DCPSC an updated calculation of the customer sharing for this period, which also takes into account the losses incurred during the January 22, 2005 through February 7, 2005 period. The updated filing shows that both residential and commercial customers will receive customer sharing that totals $17.5 million. Without the inclusion of the $8.7 million loss from the January 22, 2005 through February 7, 2005 period, the amount shared with customers would have been approximately $22.7 million, or $5.2 million greater, so that the net effect of the loss on the SOS sales during this period is approximately $3.5 million.

On February 3, 2006, Pepco announced proposed rates for its District of Columbia SOS customers to take effect on June 1, 2006. The new rate will raise the average monthly bill for residential customers by approximately 12%. The proposed rates must be approved by the DCPSC.

Delaware

Under a settlement approved by the DPSC, DPL is required to provide POLR to customers in Delaware through April 2006. DPL is paid for POLR to customers in Delaware at fixed rates established in the settlement. DPL obtains all of the energy needed to fulfill its POLR obligations in Delaware under a supply agreement with its affiliate Conectiv Energy, which terminates in May 2006. DPL does not make any profit or incur any loss on the supply component of the POLR supply that it delivers to its Delaware customers. DPL is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both POLR customers and customers who have selected another energy supplier. These delivery rates generally are frozen through April 2006, except that DPL is allowed to file for a one-time transmission rate change during this period. On March 22, 2005, the DPSC issued an order approving DPL as the SOS provider after May 1, 2006, when DPL's current fixed rate POLR obligation ends. DPL will retain the SOS obligation for an indefinite period until changed by the DPSC, and will purchase the power supply required to satisfy its SOS obligations from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure.

On October 11, 2005, the DPSC approved a settlement agreement, under which DPL will provide SOS to all customer classes, with no specified termination date for SOS. Two categories of SOS will exist: (i) a fixed price SOS available to all but the largest customers; and (ii) an Hourly Priced Service (HPS) for the largest customers. DPL will purchase the power supply required to satisfy its fixed-price SOS obligation from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure. Power to supply the HPS customers will be acquired on next-day and other short-term PJM markets. In addition to the costs of capacity, energy, transmission, and ancillary services associated with the fixed-price SOS and HPS, DPL's initial rates will include a component referred to as the Reasonable Allowance for Retail Margin (RARM). Components of the RARM include a fixed annual margin of $2.75 million, plus estimated incremental expenses, a cash working capital allowance, and recovery with a return over five years of the capitalized costs of a billing system to be used for billing HPS customers.

Bids for fixed-priced SOS supply for the May 1, 2006 through May 31, 2007 period were accepted and approved by the DPSC in December 2005 and January 2006. The new SOS rates are scheduled to be effective May 1, 2006.

On February 7, 2006, the Governor of Delaware issued an Executive Order directing the DPSC and other state agencies to examine ways to mitigate the electric rate increases that are expected in May 2006 as a result of rising energy prices. The Executive Order directed the DPSC to examine the feasibility of: (1) deferring or phasing-in the increases; (2) requiring DPL to build generation or enter into long-term supply contracts to meet all, or a portion of, the SOS supply requirements under a traditional regulatory paradigm; (3) directing DPL to conduct integrated resource planning to ensure fuel diversity and least-cost supply alternatives; and (4) requiring DPL to implement demand-side management, conservation and energy efficient programs.

In response to the Executive Order and to help facilitate discussion on several key issues facing the State of Delaware, particularly the issue of rising energy prices, DPL presented a proposed plan to the DPSC on February 28, 2006. A key feature of DPL's proposed plan is a phase-in of rate increases to assist DPL's residential and small commercial customers with the impact of rising energy prices. The proposed phase-in of the rate increase would be in three steps, with one third of the increase to be phased in on May 1, 2006, another one-third on January 1, 2007 and the remainder on June 1, 2007. The phase-in would create a deferral balance of approximately $60 million that would accrue interest and would be recovered through a surcharge imposed for a 24-month period beginning June 1, 2007. DPL believes that this proposal offers a fair and reasonable solution to the concerns identified in the Executive Order.

The Delaware Governor's Cabinet Committee on Energy filed its report with the Governor on March 8, 2006. The report outlines a proposal that recommends: (1) a phase-in of the SOS increase; (2) long-term steps to ensure more stabilized prices and supply; (3) aggregation of the state of Delaware's power needs; and (4) reduction of Delaware's dependence on traditional energy sources through conservation, energy efficiency, and innovation.

DPL intends to file with the DPSC, on or about March 15, 2006, an implementation plan with proposed tariffs based on its proposed phase-in plan as described above. DPL also anticipates that others may advance other legislative or regulatory proposals to address the concerns expressed in the Executive Order. Accordingly, the nature and impact of any changes precipitated by the Executive Order are uncertain and DPL cannot predict at this time whether this phase-in proposal will be implemented.

Maryland

Because of rising energy prices and the resultant expected increases in Pepco's and DPL's rates, on March 3, 2006 the MPSC issued an order initiating an investigation to consider a residential rate stabilization plan for Pepco and DPL. This investigation is driven by the unprecedented national and international events. The MPSC directed the MPSC staff, Pepco and DPL to file comments addressing whether or not the rate stabilization plan that the MPSC adopted for Baltimore Gas & Electric Company in a March 6, 2006 order also should be used for Pepco and DPL. Comments are to be filed by March 16, 2006.

On March 7, 2006, Pepco and DPL each announced the results of competitive bids to supply electricity to its Maryland SOS customers for one year beginning June 1, 2006. The proposed new rates must be approved formally by the MPSC. Due to significant increases in the cost of fuels used to generate electricity, the average monthly electric bill will increase by about 38.5% and 35% for Pepco's and DPL's Maryland residential customers, respectively.

Virginia

Under amendments to the Virginia Electric Utility Restructuring Act implemented in March 2004, DPL is obligated to offer Default Service to customers in Virginia for an indefinite period until relieved of that obligation by the VSCC. DPL currently obtains all of the energy and capacity needed to fulfill its Default Service obligations in Virginia under a supply agreement with Conectiv Energy that commenced on January 1, 2005 and expires in May 2006 (the 2005 Supply Agreement). A prior agreement, also with Conectiv Energy, terminated effective December 31, 2004. DPL entered into the 2005 Supply Agreement after conducting a competitive bid procedure in which Conectiv Energy was the lowest bidder.

In October 2004, DPL filed an application with the VSCC for approval to increase the rates that DPL charges its Default Service customers to allow it to recover its costs for power under the 2005 Supply Agreement plus an administrative charge and a margin. A VSCC order issued in November 2004 allowed DPL to put interim rates into effect on January 1, 2005, subject to refund if the VSCC subsequently determined the rate is excessive. The interim rates reflected an increase of 1.0247 cents per Kwh to the fuel rate, which provide for recovery of the entire amount being paid by DPL to Conectiv Energy, but did not include an administrative charge or margin, pending further consideration of this issue. In January 2005, the VSCC ruled that the administrative charge and margin are base rate items not recoverable through a fuel clause. In March 2005, the VSCC approved a settlement resolving all other issues and making the interim rates final.

On March 10, 2006, DPL filed a rate increase with the VSCC to reflect proposed rates for its Virginia Default Service customers to take effect on June 1, 2006. The new rates will raise the average monthly bill for residential customers by approximately 43%. The proposed rates must be approved by the VSCC.

New Jersey

On October 12, 2005, the NJBPU, following the evaluation of proposals submitted by ACE and the other three electric distribution companies located in New Jersey, issued an order reaffirming the current BGS auction process for the annual period from June 1, 2006 through May 2007. The NJBPU order maintains the current size and make up of the Commercial and Industrial Energy Pricing class (CIEP) and approved the electric distribution companies' recommended approach for the CIEP auction product, but deferred a decision on the level of the retail margin funds.

Proposed Shut Down of B.L. England Generating Facility

In April 2004, pursuant to a NJBPU order, ACE filed a report with the NJBPU recommending that ACE's B.L. England generating facility, a 447 megawatt plant, be shut down. The report stated that, while operation of the B.L. England generating facility was necessary at the time of the report to satisfy reliability standards, those reliability standards could also be satisfied in other ways. The report concluded that, based on B.L. England's current and projected operating costs resulting from compliance with more restrictive environmental requirements, the most cost-effective way in which to meet reliability standards is to shut down the B.L. England generating facility and construct additional transmission enhancements in southern New Jersey.

In December 2004, ACE filed a petition with the NJBPU requesting that the NJBPU establish a proceeding that will consist of a Phase I and Phase II and that the procedural process for the Phase I proceeding require intervention and participation by all persons interested in the prudence of the decision to shut down B.L. England generating facility and the categories of stranded costs associated with shutting down and dismantling the facility and remediation of the site. ACE contemplates that Phase II of this proceeding, which would be initiated by an ACE filing in 2008 or 2009, would establish the actual level of prudently incurred stranded costs to be recovered from customers in rates. The NJBPU has not acted on this petition.

In a January 24, 2006 Administrative Consent Order (ACO) among PHI, Conectiv, ACE, the New Jersey Department of Environmental Protection (NJDEP) and the Attorney General of New Jersey, ACE agreed to shut down and permanently cease operations at the B.L. England generating facility by December 15, 2007 if ACE does not sell the plant. The shut-down of the B.L. England generating facility will be subject to necessary approvals from the relevant agencies and the outcomes of the auction process, discussed under "ACE Auction of Generating Assets," below.

ACE Auction of Generation Assets

In May 2005, ACE announced that it would again auction its electric generation assets, consisting of its B.L. England generating facility and its ownership interests in the Keystone and Conemaugh generating stations. On November 15, 2005, ACE announced an agreement to sell its interests in the Keystone and Conemaugh generating stations to Duquesne Light Holdings Inc. for $173.1 million. The sale, subject to approval by the NJBPU as well as other regulatory agencies and certain other legal conditions, is expected to be completed mid-year 2006.

Based on the expressed need of the potential B.L. England bidders for the details of the ACO relating to the shut down of the plant that was being negotiated between ACE and the NJDEP, ACE elected to delay the final bid due date for B.L. England until such time as a final ACO was complete and available to bidders. With the January 24, 2006 execution of the ACO by all parties, ACE is proceeding with the auction process. Indicative bids were received on February 16, 2006 and final bids are scheduled to be submitted on or about April 19, 2006.

Under the terms of sale, any successful bid for B.L. England must include assumption of all environmental liabilities associated with the plant in accordance with the auction standards previously issued by the NJBPU.

Any sale of B.L. England will not affect the stranded costs associated with the plant that already have been securitized. If B.L. England is sold, ACE anticipates that, subject to regulatory approval in Phase II of the proceeding described above, approximately $9.1 million of additional assets may be eligible for recovery as stranded costs. The net gains on the sale of the Keystone and Conemaugh generating stations will be an offset to stranded costs associated with the shutdown of B.L. England or will be offset through other ratemaking adjustments. Testimony filed by ACE with the NJBPU in December 2005 estimated net gains of approximately $126.9 million; however, the net gains ultimately realized will be dependent upon the timing of the closing of the sale of Keystone and Conemaugh generating stations, transaction costs and other factors.

Federal Tax Treatment of Cross-Border Leases

PCI maintains a portfolio of cross-border energy sale-leaseback transactions, which, as of December 31, 2005, had a book value of approximately $1.3 billion, and from which PHI currently derives approximately $55 million per year in tax benefits in the form of interest and depreciation deductions.

On February 11, 2005, the Treasury Department and IRS issued Notice 2005-13 informing taxpayers that the IRS intends to challenge on various grounds the purported tax benefits claimed by taxpayers entering into certain sale-leaseback transactions with tax-indifferent parties (i.e., municipalities, tax-exempt and governmental entities), including those entered into on or prior to March 12, 2004 (the Notice). All of PCI's cross-border energy leases are with tax indifferent parties and were entered into prior to 2004. In addition, on June 29, 2005 the IRS published a Coordinated Issue Paper concerning the resolution of audit issues related to such transactions. PCI's cross-border energy leases are similar to those sale-leaseback transactions described in the Notice and the Coordinated Issue Paper.

PCI's leases have been under examination by the IRS as part of the normal PHI tax audit. On May 4, 2005, the IRS issued a Notice of Proposed Adjustment to PHI that challenges the tax benefits realized from interest and depreciation deductions claimed by PHI with respect to these leases for the tax years 2001 and 2002. The tax benefits claimed by PHI with respect to these leases from 2001 through December 31, 2005 were approximately $230 million. The ultimate outcome of this issue is uncertain; however, if the IRS prevails, PHI would be subject to additional taxes, along with interest and possibly penalties on the additional taxes, which could have a material adverse effect on PHI's financial condition, results of operations, and cash flows.

PHI believes that its tax position related to these transactions was proper based on applicable statutes, regulations and case law, and intends to contest the final adjustments proposed by the IRS; however, there is no assurance that PHI's position will prevail.

On November 18, 2005 the U.S. Senate passed The Tax Relief Act of 2005 (S.2020) which would apply passive loss limitation rules to leases with foreign tax indifferent parties effective for taxable years beginning after December 31, 2005, even if the leases were entered into on or prior to March 12, 2004. On December 8, 2005 the U.S. House of Representatives passed the Tax Relief Extension Reconciliation Act of 2005 (H.R. 4297), which does not contain any provision which would modify the current treatment of leases with tax indifferent parties. Enactment into law of a bill that is similar to S.2020 in its current form could result in a material delay of the income tax benefits that PCI would receive in connection with its cross-border energy leases and thereby adversely affect PHI's financial condition and cash flows. The U.S. House of Representatives and the U.S. Senate are expected to hold a conference in the near future to reconcile the differences in the two bills to determine the final legislation.

Under SFAS No. 13, as currently interpreted, a settlement with the IRS or a change in tax law that results in a deferral of tax benefits that does not change the total estimated net income from a lease does not require an adjustment to the book value of the lease. However, if the IRS were to disallow, rather than require the deferral of, certain tax deductions related to PHI's leases, PHI would be required to adjust the book value of the leases and record a charge to earnings equal to the repricing impact of the disallowed deductions. Such a charge to earnings, if required, is likely to have a material adverse effect on PHI's financial condition, results of operations, and cash flows for the period in which the charge is recorded.

In July 2005, the FASB released a Proposed Staff Position paper that would amend SFAS No. 13 and require a lease to be repriced and the book value adjusted when there is a change or probable change in the timing of tax benefits. Under this proposal, a material change in the timing of cash flows under PHI's cross-border leases as the result of a settlement with the IRS or a change in tax law also would require an adjustment to the book value. If adopted in its proposed form, the application of this guidance could result in a material adverse effect on PHI's financial condition, results of operations, and cash flows, even if a resolution with the IRS or a change in tax law is limited to a deferral of the tax benefits realized by PCI from its leases.

IRS Mixed Service Cost Issue

During 2001, Pepco, DPL, and ACE changed their methods of accounting with respect to capitalizable construction costs for income tax purposes, which allow the companies to accelerate the deduction of certain expenses that were previously capitalized and depreciated. Through December 31, 2005, these accelerated deductions have generated incremental tax cash flow benefits of approximately $205 million (consisting of $94 million for Pepco, $62 million for DPL, and $49 million for ACE) for the companies, primarily attributable to their 2001 tax returns. On August 2, 2005, the IRS issued Revenue Ruling 2005-53 (the Revenue Ruling) that will limit the ability of the companies to utilize this method of accounting for income tax purposes on their tax returns for 2004 and prior years. PHI intends to contest any IRS adjustment to its prior year income tax returns based on the Revenue Ruling. However, if the IRS is successful in applying this Revenue Ruling, Pepco, DPL, and ACE would be required to capitalize and depreciate a portion of the construction costs previously deducted and repay the associated income tax benefits, along with interest thereon. During 2005, PHI recorded a $10.9 million increase in income tax expense consisting of $6.0 million for Pepco, $2.9 million for DPL, and $2.0 million for ACE, to account for the accrued interest that would be paid on the portion of tax benefits that PHI estimates would be deferred to future years if the construction costs previously deducted are required to be capitalized and depreciated.

On the same day as the Revenue Ruling was issued, the Treasury Department released regulations that, if adopted in their current form, would require Pepco, DPL, and ACE to change their method of accounting with respect to capitalizable construction costs for income tax purposes for all future tax periods beginning in 2005. Under these regulations, Pepco, DPL, and ACE will have to capitalize and depreciate a portion of the construction costs that they have previously deducted and include the impact of this adjustment in taxable income over a two-year period beginning with tax year 2005. PHI is continuing to work with the industry to determine an alternative method of accounting for capitalizable construction costs acceptable to the IRS to replace the method disallowed by the proposed regulations.

In February 2006, PHI paid approximately $121 million of taxes to cover the amount of taxes management estimates will be payable once a new final method of tax accounting is adopted on its 2005 tax return, due to the proposed regulations. Although the increase in taxable income will be spread over the 2005 and 2006 tax return periods, the cash payments would have all occurred in 2006 with the filing of the 2005 tax return and the ongoing 2006 estimated tax payments. This $121 million tax payment was accelerated to eliminate the need to accrue additional Federal interest expense for the potential IRS adjustment related to the previous tax accounting method PHI used during the 2001-2004 tax years.

General Litigation

During 1993, Pepco was served with Amended Complaints filed in the state Circuit Courts of Prince George's County, Baltimore City and Baltimore County, Maryland in separate ongoing, consolidated proceedings known as "In re: Personal Injury Asbestos Case." Pepco and other corporate entities were brought into these cases on a theory of premises liability. Under this theory, the plaintiffs argued that Pepco was negligent in not providing a safe work environment for employees or its contractors, who allegedly were exposed to asbestos while working on Pepco's property. Initially, a total of approximately 448 individual plaintiffs added Pepco to their complaints. While the pleadings are not entirely clear, it appears that each plaintiff sought $2 million in compensatory damages and $4 million in punitive damages from each defendant.

Since the initial filings in 1993, additional individual suits have been filed against Pepco, and significant numbers of cases have been dismissed. As a result of two motions to dismiss, numerous hearings and meetings and one motion for summary judgment, Pepco has had approximately 400 of these cases successfully dismissed with prejudice, either voluntarily by the plaintiff or by the court. As of December 31, 2005, there are approximately 265 cases still pending against Pepco in the State Courts of Maryland; of those approximately 265 remaining asbestos cases, approximately 85 cases were filed after December 19, 2000, and have been tendered to Mirant Corporation for defense and indemnification pursuant to the terms of the Asset Purchase and Sale Agreement. Mirant's Plan of Reorganization, as approved by the Bankruptcy Court in connection with the Mirant bankruptcy, does not alter Mirant's indemnification obligations. However, litigation relating to Mirant's efforts to reject its contract obligations under the Asset Purchase and Sale Agreement is continuing. In the event Mirant's efforts to reject obligations under the Asset Purchase and Sale Agreement, including the indemnity obligations, were to be successful, Mirant would be relieved of these indemnity obligations and Pepco would have a pre-petition claim for the value of the damages incurred.

While the aggregate amount of monetary damages sought in the remaining suits (excluding those tendered to Mirant) exceeds $400 million, Pepco believes the amounts claimed by current plaintiffs are greatly exaggerated. The amount of total liability, if any, and any related insurance recovery cannot be determined at this time; however, based on information and relevant circumstances known at this time, Pepco does not believe these suits will have a material adverse effect on its financial position, results of operations or cash flows. However, if an unfavorable decision were rendered against Pepco, it could have a material adverse effect on Pepco's and PHI's financial position, results of operations or cash flows.

Environmental Litigation

PHI, through its subsidiaries, is subject to regulation by various federal, regional, state, and local authorities with respect to the environmental effects of its operations, including air and water quality control, solid and hazardous waste disposal, and limitations on land use. In addition, federal and state statutes authorize governmental agencies to compel responsible parties to clean up certain abandoned or unremediated hazardous waste sites. PHI's subsidiaries may incur costs to clean up currently or formerly owned facilities or sites found to be contaminated, as well as other facilities or sites that may have been contaminated due to past disposal practices. Although penalties assessed for violations of environmental laws and regulations are not recoverable from customers of the operating utilities, environmental clean-up costs incurred by Pepco, DPL and ACE would be included by each company in its respective cost of service for ratemaking purposes.

In July 2004, DPL entered into an ACO with the Maryland Department of the Environment (MDE) to perform a Remedial Investigation/Feasibility Study (RI/FS) to further identify the extent of soil, sediment and ground and surface water contamination related to former manufactured gas plant (MGP) operations at the Cambridge, Maryland site on DPL-owned property and to investigate the extent of MGP contamination on adjacent property. The MDE has approved the RI and DPL has completed and submitted the FS to MDE. The costs for completing the RI/FS for this site were approximately $150,000. The costs of cleanup resulting from the RI/FS will not be determinable until MDE identifies the appropriate remedy.

In the early 1970s, both Pepco and DPL sold scrap transformers, some of which may have contained some level of PCBs, to a metal reclaimer operating at the Metal Bank/Cottman Avenue site in Philadelphia, Pennsylvania, owned by a nonaffiliated company. In December 1987, Pepco and DPL were notified by EPA that they, along with a number of other utilities and non-utilities, were PRPs in connection with the PCB contamination at the site.

In 1994, an RI/FS including a number of possible remedies was submitted to the EPA. In 1997, the EPA issued a Record of Decision that set forth a selected remedial action plan with estimated implementation costs of approximately $17 million. In 1998, the EPA issued a unilateral administrative order to Pepco and 12 other PRPs directing them to conduct the design and actions called for in its decision. In May 2003, two of the potentially liable owner/operator entities filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. In October 2003, the bankruptcy court confirmed a reorganization plan that incorporates the terms of a settlement among the two debtor owner/operator entities, the United States and a group of utility PRPs including Pepco (the Utility PRPs). Under the bankruptcy settlement, the reorganized entity/site owner will pay a total of $13.25 million to remediate the site (the Bankruptcy Settlement).

On September 2, 2005 the United States lodged with the U.S. District Court for the Eastern District of Pennsylvania global consent decrees for the Metal Bank/Cottman Avenue site, entered into on August 23, 2005 involving the Utility PRPs, the U.S. Department of Justice, EPA, The City of Philadelphia and two owner/operators of the site. Under the terms of the settlement, the two owner/operators will make payments totaling $5.55 million to the U.S. and totaling $4.05 million to the Utility PRPs. The Utility PRPs will perform the remedy at the site and will be able to draw on the $13.25 million from the Bankruptcy Settlement to accomplish the remediation (the Bankruptcy Funds). The Utility PRPs will contribute funds to the extent remediation costs exceed the Bankruptcy Funds available. The Utility PRPs also will be liable for EPA costs associated with overseeing the monitoring and operation of the site remedy after the remedy construction is certified to be complete and also the cost of performing the "5 year" review of site conditions required by CERCLA. Any Bankruptcy Funds not spent on the remedy may be used to cover the Utility PRPs' liabilities for future costs. No parties are released from potential liability for damages to natural resources. The global settlement agreement is subject to approval by the court.

As of December 31, 2005, Pepco had accrued $1.7 million to meet its liability for a remedy at the Metal Bank/Cottman Avenue site. While final costs to Pepco of the settlement have not been determined, Pepco believes that its liability at this site will not have a material adverse effect on its financial position, results of operations or cash flows.

In 1999, DPL entered into a de minimis settlement with EPA and paid approximately $107,000 to resolve its liability for cleanup costs at the Metal Bank/Cottman Avenue site. The de minimis settlement did not resolve DPL's responsibility for natural resource damages, if any, at the site. DPL believes that any liability for natural resource damages at this site will not have a material adverse effect on its financial position, results of operations or cash flows.

In June 1992, EPA identified ACE as a PRP at the Bridgeport Rental and Oil Services Superfund site in Logan Township, New Jersey. In September 1996, ACE along with other PRPs signed a consent decree with EPA and NJDEP to address remediation of the site. ACE's liability is limited to .232 percent of the aggregate remediation liability and thus far ACE has made contributions of approximately $105,000. Based on information currently available, ACE anticipates that it may be required to contribute approximately an additional $52,000. ACE believes that its liability at this site will not have a material adverse effect on its financial position, results of operations or cash flows.

In November 1991, NJDEP identified ACE as a PRP at the Delilah Road Landfill site in Egg Harbor Township, New Jersey. In 1993, ACE, along with other PRPs, signed an ACO with NJDEP to remediate the site. The soil cap remedy for the site has been completed and the NJDEP conditionally approved the report submitted by the parties on the implementation of the remedy in January 2003. In March 2004, NJDEP approved a Ground Water Sampling and Analysis Plan. Positive results of groundwater monitoring events have resulted in a reduced level of groundwater monitoring. In March 2003, EPA demanded from the PRP group reimbursement for EPA's past costs at the site, totaling $168,789. The PRP group objected to the demand for certain costs, but agreed to reimburse EPA approximately $19,000. Based on information currently available, ACE anticipates that its share of additional cost associated with this site will be approximately $626,000. ACE believes that its liability for post-remedy operation and maintenance costs will not have a material adverse effect on its financial position, results of operations or cash flows.

On January 24, 2006, PHI, Conectiv and ACE entered into an ACO with NJDEP and the Attorney General of New Jersey. This ACO is the definitive agreement contemplated by the April 26, 2004 preliminary settlement agreement among the parties. The ACO resolves the NJDEP's concerns regarding ACE's compliance with NSR requirements with respect to the B.L. England generating facility and various other environmental issues relating to ACE and Conectiv Energy facilities in New Jersey. See Item 1 "Business -- Environmental Matters -- Air Quality Regulation."

Third Party Guarantees, Indemnifications, and Off-Balance Sheet Arrangements

Pepco Holdings and certain of its subsidiaries have various financial and performance guarantees and indemnification obligations which are entered into in the normal course of business to facilitate commercial transactions with third parties as discussed below.

As of December 31, 2005, Pepco Holdings and its subsidiaries were parties to a variety of agreements pursuant to which they were guarantors for standby letters of credit, performance residual value, and other commitments and obligations. The fair value of these commitments and obligations was not required to be recorded in Pepco Holdings' Consolidated Balance Sheets; however, certain energy marketing obligations of Conectiv Energy were recorded. The commitments and obligations, in millions of dollars, were as follows:

	Guarantor				
	PHI	DPL	ACE	Other	Total
Energy marketing obligations of Conectiv Energy (1)	$ 167.5	$ -	$ -	$ -	$ 167.5
Energy procurement obligations of Pepco Energy Services (1)	13.4	-	-	-	13.4
Guaranteed lease residual values (2)	.6	3.3	3.2	-	7.1
Other (3)	18.3	-	-	2.4	20.7
Total	$ 199.8	$ 3.3	$ 3.2	$ 2.4	$ 208.7

1. Pepco Holdings has contractual commitments for performance and related payments of Conectiv Energy and Pepco Energy Services to counterparties related to routine energy sales and procurement obligations, including requirements under BGS contracts entered into with ACE.

2. Subsidiaries of Pepco Holdings have guaranteed residual values in excess of fair value related to certain equipment and fleet vehicles held through lease agreements. As of December 31, 2005, obligations under the guarantees were approximately $7.1 million. Assets leased under agreements subject to residual value guarantees are typically for periods ranging from 2 years to 10 years. Historically, payments under the guarantees have not been made by the guarantor as, under normal conditions, the contract runs to full term at which time the residual value is minimal. As such, Pepco Holdings believes the likelihood of payment being required under the guarantee is remote.

3. Other guarantees consist of:

   - Pepco Holdings has guaranteed payment of a bond issued by a subsidiary of $14.9 million. Pepco Holdings does not expect to fund the full amount of the exposure under the guarantee.

   - Pepco Holdings has guaranteed a subsidiary building lease of $3.4 million. Pepco Holdings does not expect to fund the full amount of the exposure under the guarantee.

   - PCI has guaranteed facility rental obligations related to contracts entered into by Starpower. As of December 31, 2005, the guarantees cover the remaining $2.4 million in rental obligations.

Pepco Holdings and certain of its subsidiaries have entered into various indemnification agreements related to purchase and sale agreements and other types of contractual agreements with vendors and other third parties. These indemnification agreements typically cover environmental, tax, litigation and other matters, as well as breaches of representations, warranties and covenants set forth in these agreements. Typically, claims may be made by third parties under these indemnification agreements over various periods of time depending on the nature of the claim. The maximum potential exposure under these indemnification agreements can range from a specified dollar amount to an unlimited amount depending on the nature of the claim and the particular transaction. The total maximum potential amount of future payments under these indemnification agreements is not estimable due to several factors, including uncertainty as to whether or when claims may be made under these indemnities.

Contractual Obligations

As of December 31, 2005, Pepco Holdings' contractual obligations under non-derivative fuel and purchase power contracts, excluding the Panda PPA discussed above under "Relationship with Mirant Corporation" and BGS supplier load commitments, were $1,823.7 million in 2006, $1,705.0 million in 2007 to 2008, $754.3 million in 2009 to 2010, and $3,123.8 million in 2011 and thereafter.

(13) USE OF DERIVATIVES IN ENERGY AND INTEREST RATE HEDGING ACTIVITIES

PHI's Competitive Energy businesses use derivative instruments primarily to reduce their financial exposure to changes in the value of their assets and obligations due to commodity price fluctuations. The derivative instruments used by the Competitive Energy businesses include forward contracts, futures, swaps, and exchange-traded and over-the-counter options. In addition, the Competitive Energy businesses also manage commodity risk with contracts that are not classified as derivatives. The primary goal of these activities is to manage the spread between the cost of fuel used to operate electric generation plants and the revenue received from the sale of the power produced by those plants and manage the spread between retail sales commitments and the cost of supply used to service those commitments in order to ensure stable and known minimum cash flows and fix favorable prices and margins when they become available. To a lesser extent, Conectiv Energy also engages in market activities in an effort to profit from short-term geographical price differentials in electricity prices among markets. PHI collectively refers to these energy market activities, including its commodity risk management activities, as "other energy commodity" activities and identifies this activity separately from that of the discontinued proprietary trading activity described below.

Conectiv Energy's 2003 loss includes the unfavorable impact of net trading losses of $26.6 million that resulted from a dramatic rise in natural gas futures prices during February 2003, net of an after tax gain of $15 million on the sale of a purchase power contract in February 2003. As of March 2003, Conectiv Energy ceased all proprietary trading activities, which generally consisted of the entry into contracts to take a view of market direction, capture market price change, and put capital at risk. PHI's Competitive Energy businesses are no longer engaged in proprietary trading; however, the market exposure under certain contracts entered into prior to cessation of proprietary trading activities was not completely eliminated because perfectly offsetting contractual positions were not available in the market at that time. These contracts will remain in place until they are terminated and their values are realized.

On June 25, 2003, Conectiv Energy entered into an agreement consisting of a series of energy contracts with an international investment banking firm with a senior unsecured debt rating of A+ / Stable from Standard & Poor's (the Counterparty). The agreement was designed to more effectively hedge approximately 50% of Conectiv Energy's generation output and approximately 50% of its supply obligations, with the intention of providing Conectiv Energy with a more predictable earnings stream during the term of the agreement. The agreement consists of two major components: a fixed price energy supply hedge and a generation off-take agreement. The fixed price energy supply hedge is used to reduce Conectiv Energy's financial exposure under its current supply commitment to DPL. Under this commitment, which extends through April 2006, Conectiv Energy is obligated to supply to DPL the electric power necessary to enable DPL to meet its POLR load obligations. Under the energy supply hedge, the volume and price risks associated with 50% of the POLR load obligation are effectively transferred from Conectiv Energy to the Counterparty through a financial "contract-for-differences." The contract-for-differences (swap) establishes a fixed cost for the energy required by Conectiv Energy to satisfy 50% of the POLR load, and any deviations of the market price from the fixed price are paid by Conectiv Energy to, or are received by Conectiv Energy from, the Counterparty. The contract does not cover the cost of capacity or ancillary services. Under the generation off-take agreement, Conectiv Energy receives a fixed monthly payment from the Counterparty and the Counterparty receives the profit realized from the sale of approximately 50% of the electricity generated by Conectiv Energy's plants (excluding the Edge Moor facility) through May 2006. This portion of the agreement is designed to hedge sales of approximately 50% of Conectiv Energy's generation output, and under assumed operating parameters and market conditions should effectively transfer this portion of Conectiv Energy's wholesale energy market risk to the Counterparty, while providing a more stable stream of revenues to Conectiv Energy. The agreement also includes several standard energy price swaps under which Conectiv Energy has locked in a sales price for approximately 50% of the output from its Edge Moor facility and has financially hedged other on-peak and off-peak energy price exposures in its portfolio to further reduce market price exposure. In total, the transaction is expected to improve Conectiv Energy's risk profile by providing hedges that are tailored to the characteristics of its generation fleet and its POLR supply obligation.

PHI and its subsidiaries also use derivative instruments from time to time to mitigate the effects of fluctuating interest rates on debt incurred in connection with the operation of their businesses. In June 2002, PHI entered into several treasury lock transactions in anticipation of the issuance of several series of fixed rate debt commencing in July 2002. There remained a loss balance of $40.1 million in Accumulated Other Comprehensive Income (AOCI) at December 31, 2005 related to this transaction. The portion expected to be reclassified to earnings during the next 12 months is $7.1 million. In addition, interest rate swaps have been executed in support of PCI's medium-term note program.

The table below provides detail on effective cash flow hedges under SFAS No. 133 included in PHI's Consolidated Balance Sheet as of December 31, 2005. Under SFAS No. 133, cash flow hedges are marked-to-market on the balance sheet with corresponding adjustments to AOCI. The data in the table indicates the magnitude of the effective cash flow hedges by hedge type (i.e., other energy commodity and interest rate hedges), maximum term, and portion expected to be reclassified to earnings during the next 12 months.

Cash Flow Hedges Included in Accumulated Other Comprehensive Loss
As of December 31, 2005
(Millions of dollars)

Contracts	Accumulated OCI (Loss) After Tax (1)	Portion Expected to be Reclassified to Earnings during the Next 12 Months	Maximum Term
Other Energy Commodity	$ 24.6	$26.7	51 months
Interest Rate	(40.1)	(7.1)	320 months
Total	$(15.5)	$19.6	

(1) Accumulated Other Comprehensive Loss as of December 31, 2005, includes $(7.3) million for an adjustment for minimum pension liability. This adjustment is not included in this table as it is not a cash flow hedge.

The following table shows, in millions of dollars, the pre-tax gain (loss) recognized in earnings for cash flow hedge ineffectiveness for the years ended December 31, 2005, 2004, and 2003, and where they were reported in the Consolidated Statements of Earnings during the period.

	2005	2004	2003
Operating Revenue	$ 3.0	$ 2.5	$ 1.8
Fuel and Purchased Energy Expenses	(2.7)	(8.5)	(2.8)
Total	$ .3	$(6.0)	$(1.0)

For the years ended December 31, 2005 and 2004, there were no forecasted hedged transactions deemed to be no longer probable.

In connection with their other energy commodity activities, the Competitive Energy businesses hold certain derivatives that do not qualify as hedges. Under SFAS No. 133, these derivatives are marked-to-market through earnings with corresponding adjustments on the balance sheet. The pre-tax gains (losses) on these derivatives are included in "Competitive Energy Operating Revenues" and are summarized in the following table, in millions of dollars, for the years ended December 31, 2005, 2004, and 2003.

	2005	2004	2003
Proprietary Trading	$ .1	$ (.4)	$(67.3)
Other Energy Commodity	37.8	24.2	19.6
Total	$37.9	$23.8	$(47.7)

(14) EXTRAORDINARY ITEMS

On April 19, 2005, ACE, the staff of the New Jersey Board of Public Utilities (NJBPU), the New Jersey Ratepayer Advocate, and active intervenor parties agreed on a settlement in ACE's electric distribution rate case. As a result of this settlement, ACE reversed $15.2 million in accruals related to certain deferred costs that are now deemed recoverable. The after tax credit to income of $9.0 million is classified as an extraordinary gain in the 2005 financial statements since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.

In July 2003, the NJBPU approved the recovery of $149.5 million of stranded costs related to ACE's B.L. England generating facility. As a result of the order, ACE reversed $10.0 million of accruals for the possible disallowances related to these stranded costs. The after tax credit to income of $5.9 million is classified as an extraordinary gain in the 2003 financial statements, since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.

(15) RESTATEMENT

Pepco Holdings restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements. The restatement includes the correction of other errors for the same periods, primarily relating to unbilled revenue, taxes, and various accrual accounts, which were considered by management to be immaterial. These other errors would not themselves have required a restatement absent the restatement to correct the accounting for deferred compensation arrangements. This restatement was required solely because the cumulative impact of the correction, if recorded in the fourth quarter of 2005, would have been material to that period's reported net income. The impact of the restatement related to the deferred compensation arrangements on periods prior to 2003 has been reflected as a reduction of approximately $23 million to Pepco Holdings' retained earnings balance as of January 1, 2003. The following table sets forth for Pepco Holdings, for the years ended December 31, 2004 and 2003, the impact of the restatement to correct the accounting for the deferred compensation arrangements and the other errors noted above (millions of dollars):

	December 31, 2004		December 31, 2003	
	Previously Reported	Restated	Previously Reported	Restated
Consolidated Statements of Earnings				
Total Operating Revenue	$ 7,221.8	$ 7,223.1	$ 7,271.3	$ 7,268.7
Total Operating Expenses	6,446.1	6,451.0	6,654.9	6,658.0
Total Operating Income	775.7	772.1	616.4	610.7
Other Income (Expenses)	(341.0)	(341.4)	(429.0)	(433.3)
Income Before Income Tax Expense	431.9	427.9	173.5	163.5
Net Income	$ 258.7	$ 260.6	$ 113.5	$ 107.3
Earnings Per Share (Basic and Diluted)	$ 1.47	$ 1.48	$ .66	$ .63
Consolidated Balance Sheets				
Total Current Assets	$ 1,653.9	$ 1,672.5	$ 1,685.3	$ 1,702.2
Total Investments and Other Assets	4,607.5	4,587.7	4,721.1	4,701.1
Total Property, Plant and Equipment	7,088.0	7,090.6	6,964.9	6,965.7
Total Assets	13,349.4	13,350.8	13,371.3	13,369.0
Total Current Liabilities	1,942.8	1,940.3	2,179.7	2,198.9
Total Deferred Credits	2,912.6	2,943.8	2,672.3	2,680.0
Total Long-Term Liabilities	5,072.8	5,072.8	5,452.8	5,452.8
Total Shareholders' Equity	3,366.3	3,339.0	3,003.3	2,974.1
Total Liabilities and Shareholders' Equity	$13,349.4	$13,350.8	$13,371.3	$13,369.0
Consolidated Statements of Cash Flows				
Net Cash Provided by Operating Activities	$ 734.6	$ 715.7	$ 661.4	$ 662.4
Net Cash Used in Investing Activities	$ (422.1)	$ (417.3)	$ (254.8)	$ (252.7)
Net Cash Used in Financing Activities	$ (373.5)	$ (359.1)	$ (367.9)	$ (370.7)
Consolidated Statements of Shareholders' Equity				
Retained Earnings at December 31,	$ 863.7	$ 836.4	$ 781.0	$ 751.8

(16) QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The unaudited quarterly financial information for the three months ended March 31, 2005, June 30, 2005, and September 30, 2005 and all interim periods during the year ended December 31, 2004 have been restated to reflect the correction of the accounting for certain deferred compensation arrangements and other noted errors that would not themselves have required a restatement absent the restatement to correct the accounting for the deferred compensation arrangements as described in Note 15. The quarterly data presented below reflect all adjustments necessary in the opinion of management for a fair presentation of the interim results. Quarterly data normally vary seasonally because of temperature variations, differences between summer and winter rates, and the scheduled downtime and maintenance of electric generating units. The totals of the four quarterly basic and diluted earnings per common share may not equal the basic and diluted earnings per common share for the year due to changes in the number of common shares outstanding during the year.

	2005							
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated		Total
	(In millions, except per share data)							
Total Operating Revenue	$1,804.8	$1,798.8	$1,712.1	$1,720.2	$2,488.7	$2,483.6	$2,062.9	$ 8,065.5
Total Operating Expenses	1,656.7	1,654.1	1,533.3	1,535.8	2,118.2(c)	2,115.3(c)	1,854.9(d)(e)	7,160.1
Operating Income	148.1	144.7	178.8	184.4	370.5	368.3	208.0	905.4
Other Expenses	(66.9)	(67.8)	(73.9)	(74.8)	(71.6)	(72.4)	(70.5)	(285.5)
Preferred Stock Dividend Requirements of Subsidiaries	.6	.6	.7	.7	.6	.6	.6	2.5
Income Before Income Tax Expense	80.6	76.3	104.2	108.9	298.3	295.3	136.9	617.4
Income Tax Expense	34.1	30.6	40.2	42.5	128.2(b)	127.3(b)	54.8(f)	255.2
Income Before Extraordinary Item	46.5	45.7	64.0	66.4	170.1	168.0	82.1	362.2
Extraordinary Item	9.0(a)	9.0	-	-	-	-	-	9.0
Net Income	55.5	54.7	64.0	66.4	170.1	168.0	82.1	371.2
Basic and Diluted Earnings Per Share of Common Stock Before Extraordinary Item	.24	.24	.34	.35	.90	.89	.43	1.91
Extraordinary Item Per Share of Common Stock	.05	.05	-	-	-	-	-	.05
Basic and Diluted Earnings Per Share of Common Stock	.29	.29	.34	.35	.90	.89	.43	1.96
Cash Dividends Per Common Share	$ .25	$ .25	$ .25	$ .25	$ .25	$ .25	$ .25	$ 1.00

	2004								
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Total
	(In millions, except per share data)								
Total Operating Revenue	$ 1,764.1	$1,769.8	$ 1,691.5	$1,691.7	$ 2,046.5	$2,043.2	$ 1,719.7	$1,718.4	$ 7,223.1
Total Operating Expenses	1,613.6	1,616.0	1,461.0 (j)	1,469.7 (j)	1,767.0	1,769.3	1,604.5	1,596.0	6,451.0
Operating Income	150.5	153.8	230.5	222.0	279.5	273.9	115.2	122.4	772.1
Other Expenses	(87.2)	(87.6)	(80.6)(h)	(81.2) (h)	(96.3)(i)	(94.9)(i)	(76.9)	(77.7)	(341.4)
Preferred Stock Dividend Requirements of Subsidiaries	.7	.7	.8	.8	.7	.7	.6	.6	2.8
Income Before Income Tax Expense	62.6	65.5	149.1	140.0	182.5	178.3	37.7	44.1	427.9
Income Tax Expense	11.4(g)	13.0 (g)	58.7	55.5	71.5	68.6	31.6(k)	30.2 (k)	167.3
Net Income	51.2	52.5	90.4	84.5	111.0	109.7	6.1	13.9	260.6
Basic and Diluted Earnings Per Share of Common Stock	.30	.31	.53	.49	.64	.63	.03	.07	1.48
Cash Dividends Per Common Share	$ .25	$ .25	$ .25	$ .25	$ .25	$ .25	$ .25	$ .25	$ 1.00

(a) Relates to ACE's electric distribution rate case settlement that was accounted for in the first quarter of 2005. This resulted in ACE's reversal of $9.0 million in after tax accruals related to certain deferred costs that are now deemed recoverable. This amount is classified as an extraordinary gain since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.

(b) Includes $8.3 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(c) Includes $68.1 million gain ($40.7 million after tax) from sale of non-utility land owned by Pepco at Buzzard Point.

(d) Includes $70.5 million ($42.2 million after tax) gain (net of customer sharing) from the settlement of the Pepco TPA Claim and the Pepco asbestos claim against the Mirant bankruptcy estate.

(e) Includes $13.3 million gain ($8.9 million after tax) related to PCI's liquidation of a financial investment that was written off in 2001.

(f) Includes $2.6 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(g) Includes tax benefit of $13.2 million related to a local jurisdiction's final consolidated tax return regulations, which are retroactive to 2001.

(h) Includes an $11.2 million pre-tax impairment charge ($7.3 million after tax) to reduce the value of PHI's investment in Starpower Communications, LLC to $28 million. Also includes $11.2 million pre-tax gain ($6.6 million after tax) from the disposition of a joint venture associated with the Vineland co-generation facility.

(i) Includes $12.8 million pre-tax loss ($7.7 million after tax) associated with the prepayment of the debt incurred by Conectiv Bethlehem, LLC.

(j) Includes a $14.7 million pre-tax ($8.6 million after tax) gain from the condemnation settlement associated with the transfer of Vineland distribution assets.

(k) Includes a $19.7 million charge related to an IRS Settlement.

(17) SUBSEQUENT EVENTS

On February 9, 2006, certain institutional buyers tentatively agreed to purchase in a private placement $105 million of ACE's senior notes having an interest rate of 5.80% and a term of 30 years. The execution of a definitive purchase agreement and closing is expected on or about March 15, 2006. The proceeds from the notes would be used to repay outstanding commercial paper issued by ACE to fund the payment at maturity of $105 million in principal amount of various issues of medium-term notes.

On March 1, 2006, Pepco redeemed all outstanding shares of its Serial Preferred Stock of each series, at 102% of par, for an aggregate redemption amount of $21.9 million.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors
of Potomac Electric Power Company:

In our opinion, the financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Potomac Electric Power Company (a wholly owned subsidiary of Pepco Holdings, Inc.) at December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note 13 to the financial statements, the Company restated its financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003.

PricewaterhouseCoopers LLP
Washington, D.C.
March 13, 2006

POTOMAC ELECTRIC POWER COMPANY
STATEMENTS OF EARNINGS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
Operating Revenues	$ 1,845.3	$ 1,805.9	$ 1,548.0
Operating Expenses			
Fuel and purchased energy	913.7	898.2	684.8
Other operation and maintenance	280.3	273.2	239.3
Depreciation and amortization	161.8	166.3	169.8
Other taxes	276.1	249.0	206.5
Gain on settlement of claims with Mirant	(70.5)	-	-
Gain on sales of assets	(72.4)	(6.9)	-
Total Operating Expenses	1,489.0	1,579.8	1,300.4
Operating Income	356.3	226.1	247.6
Other Income (Expenses)			
Interest and dividend income	4.8	.9	3.5
Interest expense	(81.0)	(81.2)	(82.0)
Other income	13.8	8.3	12.3
Other expense	(1.3)	(1.9)	(6.3)
Total Other Expenses	(63.7)	(73.9)	(72.5)
Distributions on Preferred Securities of Subsidiary Trust	-	-	4.6
Income Before Income Tax Expense	292.6	152.2	170.5
Income Tax Expense	127.6	55.7	67.3
Net Income	165.0	96.5	103.2
Dividends on Serial Preferred Stock	1.3	1.0	3.3
Earnings Available for Common Stock	$ 163.7	$ 95.5	$ 99.9

The accompanying Notes are an integral part of these Financial Statements.

POTOMAC ELECTRIC POWER COMPANY
STATEMENTS OF COMPREHENSIVE EARNINGS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
Net income	$165.0	$96.5	$103.2
Minimum Pension Liability Adjustment, before income taxes	(4.5)	(1.2)	-
Income tax benefit	(1.8)	(.5)	-
Other comprehensive losses, net of income taxes	(2.7)	(.7)	-
Comprehensive earnings	$162.3	$95.8	$103.2

The accompanying Notes are an integral part of these Financial Statements.

POTOMAC ELECTRIC POWER COMPANY
BALANCE SHEETS

ASSETS	December 31, 2005	(Restated) December 31, 2004
(Millions of dollars)		
CURRENT ASSETS		
Cash and cash equivalents	$ 131.4	$ 1.5
Accounts receivable, less allowance for uncollectible accounts of $14.1 million and $20.1 million, respectively	339.0	312.7
Materials and supplies - at average cost	36.8	38.2
Prepaid expenses and other	11.7	8.6
Total Current Assets	518.9	361.0
INVESTMENTS AND OTHER ASSETS		
Regulatory assets	150.7	126.9
Prepaid pension expense	161.3	171.1
Investment in trust	53.1	52.9
Other	50.7	48.7
Total Investments and Other Assets	415.8	399.6
PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment	4,990.0	4,874.2
Accumulated depreciation	(2,068.0)	(1,937.8)
Net Property, Plant and Equipment	2,922.0	2,936.4
TOTAL ASSETS	$3,856.7	$3,697.0

The accompanying Notes are an integral part of these Financial Statements.

POTOMAC ELECTRIC POWER COMPANY
BALANCE SHEETS

LIABILITIES AND SHAREHOLDER'S EQUITY	December 31, 2005	(Restated) December 31, 2004
(In millions, except share data)		
CURRENT LIABILITIES		
Short-term debt	$ -	$ 14.0
Current maturities of long-term debt	50.0	100.0
Accounts payable and accrued liabilities	185.3	134.1
Accounts payable to associated companies	40.3	27.2
Capital lease obligations due within one year	5.1	4.7
Taxes accrued	154.9	50.3
Interest accrued	18.9	22.0
Other	81.2	75.5
Total Current Liabilities	535.7	427.8
DEFERRED CREDITS		
Regulatory liabilities	145.2	126.7
Income taxes	622.0	685.5
Investment tax credits	16.5	18.6
Other postretirement benefit obligations	46.7	43.8
Other	75.9	68.2
Total Deferred Credits	906.3	942.8
LONG-TERM LIABILITIES		
Long-term debt	1,198.9	1,198.3
Capital lease obligations	116.3	121.3
Total Long-Term Liabilities	1,315.2	1,319.6
COMMITMENTS AND CONTINGENCIES (NOTE 11)		
SERIAL PREFERRED STOCK	21.5	27.0
SHAREHOLDER'S EQUITY		
Common stock, $.01 par value, authorized 400,000,000 shares, issued 100 shares	-	-
Premium on stock and other capital contributions	507.1	507.0
Accumulated other comprehensive loss	(3.4)	(.7)
Retained earnings	574.3	473.5
Total Shareholder's Equity	1,078.0	979.8
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	$3,856.7	$3,697.0

The accompanying Notes are an integral part of these Financial Statements.

POTOMAC ELECTRIC POWER COMPANY
STATEMENTS OF CASH FLOWS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
OPERATING ACTIVITIES			
Net Income	$ 165.0	$ 96.5	$ 103.2
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	161.8	166.3	169.8
Gain on sale of assets	(72.4)	(6.9)	-
Gain on settlement of claims with Mirant	(70.5)	-	-
Proceeds from sale of claims with Mirant	112.9	-	-
Deferred income taxes	(49.8)	24.8	45.3
Investment tax credit adjustments, net	(2.0)	(2.0)	(2.0)
Prepaid pension expense	9.8	(2.9)	(14.6)
Other postretirement benefit obligation	2.9	(.5)	5.3
Other deferred charges	17.0	(8.9)	(8.8)
Other deferred credits	(3.6)	3.4	(4.6)
Changes in:			
Accounts receivable	(26.3)	(31.3)	(6.0)
Regulatory assets, net	(45.1)	(35.8)	(53.5)
Proceeds received on accounts receivable due from affiliate	-	-	31.2
Proceeds received on note receivable from affiliate	-	-	110.4
Prepaid expenses	(.9)	20.1	(15.5)
Accounts payable and accrued liabilities	59.8	(9.4)	(15.0)
Interest and taxes accrued	100.6	49.6	(14.7)
Materials and supplies	1.4	3.0	(7.1)
Net Cash Provided By Operating Activities	360.6	266.0	323.4
INVESTING ACTIVITIES			
Investment in property, plant and equipment	(177.7)	(204.1)	(197.5)
Proceeds from sale of assets	78.0	-	-
Proceeds from sale of other investments	-	22.4	-
Net other investing activity	(.2)	(.2)	-
Net Cash Used In Investing Activities	(99.9)	(181.9)	(197.5)
FINANCING ACTIVITIES			
Dividends to Pepco Holdings	(62.9)	(102.4)	(64.9)
Dividends paid on Pepco preferred stock	(1.3)	(1.0)	(3.3)
Redemption of preferred stock	(5.5)	(53.3)	(2.5)
Redemption of trust preferred stock	-	-	(125.0)
Issuances of long-term debt	175.0	375.0	199.3
Reacquisitions of long-term debt	(225.0)	(210.0)	(205.0)
Repayments of short-term debt, net	(14.0)	(93.5)	67.5
Net other financing activities	2.9	(4.2)	(3.4)
Net Cash Used In Financing Activities	(130.8)	(89.4)	(137.3)
Net Increase (Decrease) in Cash and Cash Equivalents	129.9	(5.3)	(11.4)
Cash and Cash Equivalents at Beginning of Year	1.5	6.8	18.2
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 131.4	$ 1.5	$ 6.8
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Cash paid for interest (net of capitalized interest of $1.6 million, $1.2 million and $1.8 million, respectively) and paid for income taxes:			
Interest	$ 77.8	$ 76.5	$ 82.8
Income taxes	$ 7.1	$ 6.2	$ 44.1

The accompanying Notes are an integral part of these Financial Statements.

POTOMAC ELECTRIC POWER COMPANY
STATEMENTS OF SHAREHOLDER'S EQUITY

(In millions, except share data)	Common Stock Shares	Common Stock Par Value	Premium on Stock	Capital Stock Expense	Accumulated Other Comprehensive Loss	Retained Earnings
BALANCE, DECEMBER 31, 2002 (AS REPORTED)	100	$ -	$ 507.6	$ (1.1)	$ -	$468.9
RESTATEMENT	-	-	-	-	-	(21.4)
BALANCE, DECEMBER 31, 2002 (RESTATED)	100	$ -	$ 507.6	$ (1.1)	$ -	$447.5
Net Income (RESTATED)	-	-	-	-	-	103.2
Dividends:						
Preferred stock	-	-	-	-	-	(3.3)
To Pepco Holdings	-	-	-	-	-	(64.9)
BALANCE, DECEMBER 31, 2003 (RESTATED)	100	$ -	$ 507.6	$ (1.1)	$ -	$482.5
Net Income (RESTATED)	-	-	-	-	-	96.5
Other comprehensive loss	-	-	-	-	(.7)	-
Dividends:						
Preferred stock	-	-	-	-	-	(1.0)
To Pepco Holdings	-	-	-	-	-	(102.4)
Of Investment to Pepco Holdings	-	-	-	-	-	(2.1)
Preferred stock repurchase	-	-	(.1)	.2	-	-
Preferred stock redemption	-	-	-	.4	-	-
BALANCE, DECEMBER 31, 2004 (RESTATED)	100	$ -	$ 507.5	$ (.5)	$ (.7)	$473.5
Net Income	-	-	-	-	-	165.0
Other comprehensive loss	-	-	-	-	(2.7)	-
Dividends:						
Preferred stock	-	-	-	-	-	(1.3)
To Pepco Holdings	-	-	-	-	-	(62.9)
Preferred stock redemption	-	-	-	.1	-	-
BALANCE, DECEMBER 31, 2005	100	$ -	$ 507.5	$ (.4)	$(3.4)	$574.3

The accompanying Notes are an integral part of these Financial Statements.

NOTES TO FINANCIAL STATEMENTS

POTOMAC ELECTRIC POWER COMPANY

(1) ORGANIZATION

Potomac Electric Power Company (Pepco) is engaged in the transmission and distribution of electricity in Washington, D.C. and major portions of Prince George's and Montgomery Counties in suburban Maryland. Pepco provides Default Electricity Supply, which is the supply of electricity at regulated rates to retail customers in its territories who do not elect to purchase electricity from a competitive supplier, in both the District of Columbia and Maryland. Default Electricity Supply is known as Standard Offer Service (SOS) in both the District of Columbia and Maryland. Pepco's service territory covers approximately 640 square miles and has a population of approximately 2 million. Pepco is a wholly owned subsidiary of Pepco Holdings, Inc. (Pepco Holdings or PHI). Because PHI is a public utility holding company subject to the Public Utility Holding Company Act of 2005 (PUHCA 2005), the relationship between PHI and Pepco and certain activities of Pepco are subject to the regulatory oversight of the Federal Energy Regulatory Commission (FERC) under PUHCA 2005.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, such as Statement of Position 94-6, "Disclosure of Certain Significant Risks and Uncertainties," requires management to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the financial statements and accompanying notes. Examples of significant estimates used by Pepco include the assessment of contingencies, the calculation of future cash flows and fair value amounts for use in asset impairment evaluations, pension and other postretirement benefits assumptions, unbilled revenue calculations, and judgment involved with assessing the probability of recovery of regulatory assets. Additionally, Pepco is subject to legal, regulatory, and other proceedings and claims that arise in the ordinary course of its business. Pepco records an estimated liability for these proceedings and claims based upon the probable and reasonably estimable criteria contained in SFAS No. 5, "Accounting for Contingencies." Although Pepco believes that its estimates and assumptions are reasonable, they are based upon information available to management at the time the estimates are made. Actual results may differ significantly from these estimates.

Change in Accounting Estimates

During 2005, Pepco recorded the impact of an increase in estimated unbilled revenue, primarily reflecting a change in Pepco's unbilled revenue estimation process. This modification in accounting estimate increased Pepco's net earnings for the year ended December 31, 2005 by approximately $2.2 million.

Regulation of Power Delivery Operations

Pepco is regulated by the Maryland Public Service Commission (MPSC) and the District of Columbia Public Service Commission (DCPSC), and its wholesale business is regulated by the Federal Energy Regulatory Commission (FERC).

Based on the regulatory framework in which it has operated, Pepco has historically applied, and in connection with its transmission and distribution business continues to apply, the provisions of Statement of Financial Accounting Standards No. 71 (SFAS No. 71), "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 allows regulated entities, in appropriate circumstances, to establish regulatory assets and to defer the income statement impact of certain costs that are expected to be recovered in future rates. Management's assessment of the probability of recovery of regulatory assets requires judgment and interpretation of laws, regulatory commission orders, and other factors. Should existing facts or circumstances change in the future to indicate that a regulatory asset is not probable of recovery, then the regulatory asset must be charged to earnings.

The components of Pepco's regulatory asset balances at December 31, 2005 and 2004, are as follows:

	2005	2004
	(Millions of dollars)	
Deferred recoverable income taxes	$ 53.7	$ 65.4
Deferred debt extinguishment costs	43.7	42.9
Other	53.3	18.6
Total regulatory assets	$150.7	$126.9

The components of Pepco's regulatory liability balances at December 31, 2005 and 2004, are as follows:

	2005	2004
	(Millions of dollars)	
Deferred income taxes due to customers	$33.4	$32.0
Generation Procurement Credit, customer sharing commitment, and other	46.8	17.5
Accrued asset removal costs	65.0	77.2
Total regulatory liabilities	$145.2	$126.7

A description of the regulatory assets and regulatory liabilities is as follows:

Deferred Recoverable Income Taxes: Represents deferred income tax assets recognized from the normalization of flow-through items as a result of amounts previously provided to customers. As temporary differences between the financial statement and tax basis of assets reverse, deferred recoverable income taxes are amortized. There is no return on these deferrals.

Deferred Debt Extinguishment Costs: Represents the costs of debt extinguishment for which recovery through regulated utility rates is considered probable and, if approved, will be amortized to interest expense during the authorized rate recovery period. A return is received on these deferrals.

Other: Represents miscellaneous regulatory assets that generally are being amortized over 1 to 20 years and generally do not receive a return.

Deferred Income Taxes Due to Customers: Represents the portion of deferred income tax liabilities applicable to Pepco's utility operations that has not been reflected in current customer rates for which future payment to customers is probable. As temporary differences between the financial statement and tax basis of assets reverse, deferred recoverable income taxes are amortized.

Generation Procurement Credit (GPC) and Customer Sharing Commitment: Pepco's generation divestiture settlement agreements, approved by both the DCPSC and MPSC, required the sharing between customers and shareholders of any profits earned during the four year transition period from February 8, 2001 through February 7, 2005 in each jurisdiction. The GPC represents the customers' share of profits that Pepco has realized on the procurement and resale of Standard Offer Service electricity supply to customers in Maryland and the District of Columbia that has not yet been distributed to customers. Pepco is currently distributing the customers' share of profits monthly to customers in a billing credit.

Accrued Asset Removal Costs: Represents Pepco's asset retirement obligation associated with removal costs accrued using public service commission approved depreciation rates for transmission, distribution, and general utility property. In accordance with the SEC interpretation of SFAS No. 143, accruals for removal costs were classified as a regulatory liability.

Revenue Recognition

Pepco recognizes revenue for the supply and delivery of electricity to customers, including amounts for services rendered, but not yet billed (unbilled revenue). Pepco recorded amounts for unbilled revenue of $92.6 million and $103.2 million as of December 31, 2005 and 2004, respectively. These amounts are included in the "accounts receivable" line item in the accompanying balance sheets. Pepco calculates unbilled revenue using an output based methodology. This methodology is based on the supply of electricity or gas distributed to customers. The unbilled revenue process requires management to make assumptions and judgments about input factors such as customer sales mix and estimated power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers), which are inherently uncertain and susceptible to change from period to period, the impact of which could be material.

The taxes related to the consumption of electricity by its customers, such as fuel, energy, or other similar taxes, are components of the Company's tariffs and, as such, are billed to customers and recorded in Operating Revenues. Accruals for these taxes by the Company are recorded in Other Taxes. Excise tax related generally to the consumption of gasoline by the Company in the normal course of business is charged to operations, maintenance or construction, and is de minimis.

Asset Retirement Obligations

Pepco adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," on January 1, 2003 and FIN 47 as of December 31, 2005. This statement and related interpretation establish the accounting and reporting standards for measuring and recording asset retirement obligations. Based on the implementation of SFAS No. 143, $65.0 million and $77.2 million at December 31, 2005 and 2004, respectively, are reflected as regulatory liabilities in the accompanying Balance Sheets. Additionally, in 2005, Pepco recorded immaterial conditional asset retirement obligations for underground storage tanks. Accretion expense for these asset retirement obligations has been recorded as a regulatory asset.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, money market funds, and commercial paper with original maturities of three months or less. Additionally, deposits in PHI's "money pool," which Pepco and certain other PHI subsidiaries use to manage short-term cash management requirements, are considered cash equivalents. Deposits in the money pool are guaranteed by PHI. PHI deposits funds in the money pool to the extent that the pool has insufficient funds to meet the needs of its participants, which may require PHI to borrow funds for deposit from external sources. Deposits in the money pool were $73.1 million at December 31, 2005.

Accounts Receivable and Allowance for Uncollectible Accounts

Pepco's accounts receivable balances primarily consist of customer accounts receivable, other accounts receivable, and accrued unbilled revenue. Accrued unbilled revenue represents revenue earned in the current period but not billed to the customer until a future date (usually within one month after the receivable is recorded). Pepco uses the allowance method to account for uncollectible accounts receivable.

Capitalized Interest and Allowance for Funds Used During Construction

In accordance with the provisions of SFAS No. 34, "Capitalization of Interest Cost," the cost of financing the construction of Pepco Holdings' subsidiaries electric generating plants is capitalized. Other non-utility construction projects also include financing costs in accordance with SFAS No. 34. In accordance with the provisions of SFAS No. 71, utilities can capitalize Allowance for Funds Used During Construction (AFUDC) as part of the cost of plant and equipment. AFUDC recognizes that utility construction is financed partially by debt and partially by equity.

Pepco recorded AFUDC for borrowed funds of $1.6 million, $1.2 million, and $1.8 million for the years ended December 31, 2005, 2004, and 2003, respectively. These amounts are recorded as a reduction of "interest expense" in the accompanying Statements of Earnings.

Pepco recorded amounts for the equity component of AFUDC of $2.6 million, $2.0 million, and $2.9 million for the years ended December 31, 2005, 2004, and 2003, respectively. The amounts are included in the "other income" caption of the accompanying Statements of Earnings.

Amortization Of Debt Issuance And Reacquisition Costs

Expenses incurred in connection with the issuance of long-term debt, including premiums and discounts associated with such debt, are deferred and amortized over the lives of the respective debt issues. Costs associated with the reacquisition of debt are also deferred and amortized over the lives of the new issues.

Severance Costs

In 2004, PHI's Power Delivery business reduced its work force through a combination of retirements and targeted reductions. This plan met the criteria for the accounting treatment provided under SFAS No. 88, "Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," and SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," as applicable. Additionally, during 2002, Pepco Holdings' management approved initiatives by Pepco and Conectiv to streamline its operating structure by reducing the number of employees at each company. These initiatives met the criteria for the accounting treatment provided under EITF No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." A roll forward of Pepco's severance accrual balance is as follows (Millions of dollars).

Balance, December 31, 2003	$ 3.3
Accrued during 2004	.9
Payments/reversals during 2004	(2.0)
Balance, December 31, 2004	2.2
Accrued during 2005	(.1)
Payments/reversals during 2005	(2.1)
Balance, December 31, 2005	$ -

Pension and Other Postretirement Benefit Plans

Pepco Holdings sponsors a retirement plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries (Retirement Plan). Following the consummation of the acquisition of Conectiv by Pepco on August 1, 2002, the Pepco General Retirement Plan and the Conectiv Retirement Plan were merged into the Retirement Plan on December 31, 2002. The provisions and benefits of the merged Retirement Plan for Pepco employees are identical to those of the original Pepco plan and for Conectiv employees are identical to the original Conectiv plan. Pepco Holdings also provides supplemental retirement benefits to certain eligible executives and key employees through nonqualified retirement plans and provides certain postretirement health care and life insurance benefits for eligible retired employees.

The Company accounts for the Retirement Plan in accordance with SFAS No. 87, "Employers' Accounting for Pensions," and its other postretirement benefits in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." PHI's financial statement disclosures were prepared in accordance with SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits."

Long-Lived Asset Impairment Evaluation

Pepco is required to evaluate certain assets that have long lives (for example, generating property and equipment and real estate) to determine if they are impaired when certain conditions exist. SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," provides the accounting for impairments of long-lived assets and indicates that companies are required to test long-lived assets for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. Examples of such events or changes include a significant decrease in the market price of a long-lived asset or a significant adverse change in the manner an asset is being used or its physical condition. For long-lived assets that are expected to be held and used, SFAS No. 144 requires that an impairment loss be recognized only if the carrying amount of an asset is not recoverable and exceeds its fair value.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. The carrying value of property, plant and equipment is evaluated for impairment whenever circumstances indicate the carrying value of those assets may not be recoverable under the provisions of SFAS No. 144. Upon retirement, the cost of regulated property, net of salvage, is charged to accumulated depreciation. For additional information regarding the treatment of removal obligations, see the "Asset Retirement Obligations" section included in this Note.

The annual provision for depreciation on electric and gas property, plant and equipment is computed on the straight-line basis using composite rates by classes of depreciable property. Accumulated depreciation is charged with the cost of depreciable property retired, less salvage and other recoveries. Property, plant and equipment other than electric and gas facilities is generally depreciated on a straight-line basis over the useful lives of the assets. The system-wide composite depreciation rates for 2005, 2004, and 2003 for Pepco's transmission and distribution system property were approximately 3.4%, 3.5%, and 3.5%, respectively.

Income Taxes

Pepco, as a direct subsidiary of Pepco Holdings, is included in the consolidated Federal income tax return of PHI. Federal income taxes are allocated to Pepco based upon the taxable income or loss amounts, determined on a separate return basis.

The Financial Statements include current and deferred income taxes. Current income taxes represent the amounts of tax expected to be reported on Pepco's state income tax returns and the amount of federal income tax allocated from Pepco Holdings. Deferred income taxes are discussed below.

Deferred income tax assets and liabilities represent the tax effects of temporary differences between the financial statement and tax basis of existing assets and liabilities and are measured using presently enacted tax rates. The portion of Pepco's deferred tax liability applicable to its utility operations that has not been recovered from utility customers represents income taxes recoverable in the future and is included in "regulatory assets" on the Balance Sheets. For additional information, see the discussion under "Regulation of Power Delivery Operations" above.

Deferred income tax expense generally represents the net change during the reporting period in the net deferred tax liability and deferred recoverable income taxes.

Investment tax credits from utility plants purchased in prior years are reported on the Balance Sheets as "Investment tax credits." These investment tax credits are being amortized to income over the useful lives of the related utility plant.

FIN 46R

Due to a variable element in the pricing structure of Pepco's purchase power agreement (Panda PPA) with Panda-Brandywine, L.P. (Panda), Pepco potentially assumes the variability in the operations of the plants related to this PPA and therefore has a variable interest in the entity. As required by FIN 46R, Pepco continued during 2005 to conduct exhaustive efforts to obtain information from this entity, but was unable to obtain sufficient information to conduct the analysis required under FIN 46R to determine whether the entity was a variable interest entity or if Pepco was the primary beneficiary. As a result, Pepco has applied the scope exemption from the application of FIN 46R for enterprises that have conducted exhaustive efforts to obtain the necessary information, but have not been able to obtain such information.

Power purchases related to the Panda PPA for the years ended December 31, 2005, 2004 and 2003, were approximately $91 million, $76 million and $80 million, respectively. Pepco's exposure to loss under the Panda PPA is discussed in Note (11), Commitments and Contingencies, under "Relationship with Mirant Corporation."

Other Non-Current Assets

The other assets balance principally consists of deferred compensation trust assets and unamortized debt expense.

Other Current Liabilities

The other current liability balance principally consists of customer deposits, accrued vacation liability, and the current portion of deferred income taxes.

Other Deferred Credits

The other deferred credits balance principally consists of miscellaneous deferred liabilities.

Dividend Restrictions

In addition to its future financial performance, the ability of Pepco to pay dividends is subject to limits imposed by: (i) state corporate and regulatory laws, which impose limitations on the funds that can be used to pay dividends and, in the case of regulatory laws, may require the prior approval of Pepco's utility regulatory commissions before dividends can be paid; (ii) the prior rights of holders of future preferred stock, if any, and existing and future mortgage bonds and other long-term debt issued by Pepco and any other restrictions imposed in connection with the incurrence of liabilities; and (iii) certain provisions of the charter of Pepco, which impose restrictions on payment of common stock dividends for the benefit of future preferred stockholders.

New Accounting Standards

SFAS No. 154

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections (SFAS No. 154), a replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. The reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS No. 154. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 (the year ended December 31, 2006 for Pepco). Early adoption is permitted.

EITF 04-13

In September 2005, the FASB ratified EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" (EITF 04-13), which addresses circumstances under which two or more exchange transactions involving inventory with the same counterparty should be viewed as a single exchange transaction for the purposes of evaluating the effect of APB Opinion 29. EITF 04-13 is effective for new arrangements entered into, or modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006 (April 1, 2006 for Pepco). EITF 04-13 would not affect Pepco's net income, overall financial condition, or cash flows, but rather could result in certain revenues and costs, including wholesale revenues and purchased power expenses, being presented on a net basis. Pepco is in the process of evaluating the impact of EITF 04-13 on its Statements of Earnings presentation of purchases and sales.

(3) SEGMENT INFORMATION

In accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," Pepco has one segment, its regulated utility business.

(4) LEASING ACTIVITIES

Lease Commitments

Pepco leases its consolidated control center, an integrated energy management center used by Pepco's power dispatchers to centrally control the operation of its transmission and distribution systems. The lease is accounted for as a capital lease and was initially recorded at the present value of future lease payments, which totaled $152 million. The lease requires semi-annual payments of $7.6 million over a 25-year period and provides for transfer of ownership of the system to Pepco for $1 at the end of the lease term. Under SFAS No. 71, the amortization of leased assets is modified so that the total of interest on the obligation and amortization of the leased asset is equal to the rental expense allowed for rate-making purposes. This lease has been treated as an operating lease for rate-making purposes.

Capital lease assets recorded within Property, Plant and Equipment at December 31, 2005 and 2004 are comprised of the following:

(Millions of dollars)			
At December 31, 2005	Original Cost	Accumulated Amortization	Net Book Value
Transmission	$ 76.0	$15.7	$ 60.3
Distribution	76.0	15.7	60.3
Other	2.6	1.8	.8
Total	$154.6	$33.2	$121.4
At December 31, 2004			
Transmission	$ 76.0	$13.6	$ 62.4
Distribution	76.0	13.6	62.4
Other	2.6	1.2	1.4
Total	$154.6	$28.4	$126.2

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is comprised of the following:

At December 31, 2005	Original Cost	Accumulated Depreciation	Net Book Value
		(Millions of dollars)	
Distribution	$3,659.5	$1,514.3	$2,145.2
Transmission	715.0	297.2	417.8
Construction work in progress	172.6	-	172.6
Non-operating and other property	442.9	256.5	186.4
Total	$4,990.0	$2,068.0	$2,922.0
At December 31, 2004			
Distribution	$3,501.3	$1,420.7	$2,080.6
Transmission	712.1	281.9	430.2
Construction work in progress	203.7	-	203.7
Non-operating and other property	457.1	235.2	221.9
Total	$4,874.2	$1,937.8	$2,936.4

The non-operating and other property amounts include balances for general plant, distribution and transmission plant held for future use, intangible plant and non-utility property. The system-wide composite depreciation rates for 2005, 2004, and 2003 for Pepco's transmission and distribution system property were approximately 3.4%, 3.5%, and 3.5%, respectively.

Gain on Sales of Assets

In August 2005, Pepco sold for $75 million in cash 384,051 square feet of excess non-utility land owned by Pepco located at Buzzard Point in the District of Columbia. The sale resulted in a pre-tax gain of $68.1 million which was recorded as a reduction of Operating Expenses in the Statements of Earnings.

(6) PENSIONS AND OTHER POSTRETIREMENT BENEFITS

Pension Benefits

Pepco Holdings sponsors a defined benefit Retirement Plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries. Pepco Holdings also provides supplemental retirement benefits to certain eligible executive and key employees through nonqualified retirement plans.

Other Postretirement Benefits

Pepco Holdings provides certain postretirement health care and life insurance benefits for eligible retired employees. Certain employees hired on January 1, 2005 or later will not have company subsidized retiree medical coverage; however, they will be able to purchase coverage at full cost through PHI.

During 2004, PHI amended its postretirement health care plans for certain groups of eligible employees effective January 1, 2005 or January 1, 2006. The amendments included changes to coverage and retiree cost-sharing, and are reflected as a reduction in PHI's 2004 net periodic benefit cost and a reduction of $42 million in the projected benefit obligation at December 31, 2004.

Pepco Holdings uses a December 31 measurement date for its plans. Plan assets are stated at their market value as of the measurement date, December 31. All dollar amounts in the following tables are in millions of dollars.

	Pension Benefits		Other Postretirement Benefits	
Change in Benefit Obligation	**2005**	**2004**	**2005**	**2004**
Benefit obligation at beginning of year	$1,648.0	$1,579.2	$593.5	$511.9
Service cost	37.9	35.9	8.5	8.6
Interest cost	96.1	94.7	33.6	35.4
Amendments	-	-	-	(42.4)
Actuarial loss	81.1	51.4	12.8	117.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Benefit obligation at end of year	$1,746.0	$1,648.0	$610.2	$593.5
Change in Plan Assets				
Fair value of plan assets at beginning of year	$1,523.5	$1,462.8	$164.9	$145.2
Actual return on plan assets	106.4	161.1	10.0	15.7
Company contributions	65.6	12.8	37.0	41.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$173.7	$164.9

The following table provides a reconciliation of the projected benefit obligation, plan assets and funded status of the plans.

	Pension Benefits		Other Postretirement Benefits	
	2005	**2004**	**2005**	**2004**
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$ 173.7	$164.9
Benefit obligation at end of year	1,746.0	1,648.0	610.2	593.5
Funded status (plan assets less than plan obligations)	(167.6)	(124.5)	(436.5)	(428.6)
Amounts not recognized:				
Unrecognized net actuarial loss	350.5	261.2	188.6	188.5
Unrecognized prior service cost	1.9	3.0	(26.2)	(29.5)
Net amount recognized	$ 184.8	$ 139.7	$(274.1)	$(269.6)

The following table provides a reconciliation of the amounts recognized in PHI's Consolidated Balance Sheet as of December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Prepaid benefit cost	$208.9	$165.7	$ -	$ -
Accrued benefit cost	(24.1)	(26.0)	(274.1)	(269.6)
Additional minimum liability for nonqualified plan	(12.2)	(7.0)	-	-
Intangible assets for nonqualified plan	.1	.1	-	-
Accumulated other comprehensive income for nonqualified plan	12.1	6.9	-	-
Net amount recognized	$184.8	$139.7	$(274.1)	$(269.6)

The accumulated benefit obligation for the Retirement Plan (the qualified defined benefit pension plan) was $1,556.2 million and $1,462.9 million at December 31, 2005, and 2004, respectively. The table below provides the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for the PHI nonqualified pension plan with an accumulated benefit obligation in excess of plan assets at December 31, 2005 and 2004.

	Pension Benefits	
	2005	2004
Projected benefit obligation for nonqualified plan	$38.6	$35.3
Accumulated benefit obligation for nonqualified plan	$36.3	$32.9
Fair value of plan assets for nonqualified plan	-	-

In 2005 and 2004, PHI was required to recognize an additional minimum liability and an intangible asset related to its nonqualified pension plan as prescribed by SFAS No. 87. The liability was recorded as a reduction to shareholders' equity (other comprehensive income), and the equity will be restored to the balance sheet in future periods when the accrued benefit liability exceeds the accumulated benefit obligation at future measurement dates. The amount of reduction to shareholders' equity (net of income taxes) in 2005 was $7.3 million and in 2004 was $4.1 million. The recording of this reduction did not affect net income or cash flows in 2005 or 2004 or compliance with debt covenants.

The table below provides the components of net periodic benefit costs recognized for the years ended December 31.

	Pension Benefits			Other Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Service cost	$ 37.9	$ 35.9	$ 33.0	$ 8.5	$ 8.6	$ 9.5
Interest cost	96.1	94.7	93.7	33.6	35.4	32.9
Expected return on plan assets	(125.5)	(124.2)	(106.2)	(10.9)	(9.9)	(8.3)
Amortization of prior service cost	1.1	1.1	1.0	-	-	-
Amortization of net loss	10.9	6.5	13.9	8.0	9.5	8.0
Net periodic benefit cost	$ 20.5	$ 14.0	$ 35.4	$39.2	$43.6	$42.1

Approximately $28.9 million, $24.1 million and $33.7 million were included in capital and operating and maintenance expense, in 2005, 2004 and 2003, respectively, for Pepco's allocated portion of PHI's combined pension and other postretirement benefit expense.

The following weighted average assumptions were used to determine the benefit obligations at December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Discount rate	5.625%	5.875%	5.625%	5.875%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%
Health care cost trend rate assumed for next year	n/a	n/a	8.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)			5.00%	5.00%
Year that the rate reaches the ultimate trend rate			2009	2009

Assumed health care cost trend rates may have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects (millions of dollars):

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on total of service and interest cost	$ 1.8	$ (1.7)
Effect on postretirement benefit obligation	27.0	(25.1)

The following weighted average assumptions were used to determine the net periodic benefit cost for years ended December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	**2004**	**2005**	**2004**
Discount rate	5.875%	6.250%	5.875%	6.250%
Expected long-term return on plan assets	8.500%	8.750%	8.500%	8.750%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%

A cash flow matched bond portfolio approach to developing a discount rate is used to value FAS 87 and FAS 106 liabilities. The hypothetical portfolio includes high quality instruments with maturities that mirror the benefit obligations.

In selecting an expected rate of return on plan assets, PHI considers actual historical returns, economic forecasts and the judgment of its investment consultants on expected long-term performance for the types of investments held by the plan. The plan assets consist of equity and fixed income investments, and when viewed over a long time horizon, are expected to yield a return on assets of 8.50%.

Plan Assets

Pepco Holdings' Retirement Plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

	Plan Assets at December 31		Target Plan Asset	Minimum/
Asset Category	**2005**	**2004**	**Allocation**	**Maximum**
Equity securities	62%	66%	60%	55% - 65%
Debt securities	37%	33%	35%	30% - 50%
Other	1%	1%	5%	0% - 10%
Total	100%	100%	100%	

Pepco Holdings' other postretirement plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

	Plan Assets at December 31		Target Plan Asset	Minimum/
Asset Category	**2005**	**2004**	**Allocation**	**Maximum**
Equity securities	67%	65%	60%	55% - 65%
Debt securities	24%	32%	35%	20% - 50%
Cash	9%	3%	5%	0% - 10%
Total	100%	100%	100%	

In developing an asset allocation policy for its Retirement Plan and Other Postretirement Plan, PHI examined projections of asset returns and volatility over a long-term horizon. In connection with this analysis, PHI examined the risk/return tradeoffs of alternative asset classes and asset mixes given long-term historical relationships, as well as prospective capital market returns. PHI also conducted an asset/liability study to match projected asset growth with projected liability growth and provide sufficient liquidity for projected benefit payments. By incorporating the results of these analyses with an assessment of its risk posture, and taking into account industry practices, PHI developed its asset mix guidelines. Under these guidelines, PHI diversifies assets in order to protect against large investment losses and to reduce the probability of excessive performance volatility while maximizing return at an acceptable risk level. Diversification of assets is implemented by allocating monies to various asset classes and investment styles within asset classes, and by retaining investment management firm(s) with complementary investment philosophies, styles and approaches. Based on the assessment of demographics, actuarial/funding, and business and financial characteristics, PHI believes that its risk posture is slightly below average relative to other pension plans. Consequently, Pepco Holdings believes that a slightly below average equity exposure (i.e., a target equity asset allocation of 60%) is appropriate for the Retirement Plan and the Other Postretirement Plan.

On a periodic basis, Pepco Holdings reviews its asset mix and rebalances assets back to the target allocation over a reasonable period of time.

No Pepco Holdings common stock is included in pension or postretirement program assets.

Cash Flows

Contributions - Retirement Plan

Pepco Holdings' funding policy with regard to the Retirement Plan is to maintain a funding level in excess of 100% with respect to its accumulated benefit obligation (ABO). PHI's Retirement Plan currently meets the minimum funding requirements of ERISA without any additional funding. In 2005 and 2004, PHI made discretionary tax-deductible cash contributions to the plan of $60.0 million and $10.0 million, respectively, in line with its funding policy. Assuming no changes to the current pension plan assumptions, PHI projects no funding will be required under ERISA in 2006; however, PHI may elect to make a discretionary tax-deductible contribution, if required to maintain its plan assets in excess of its ABO.

Contributions - Other Postretirement Benefits

In 2005, PHI combined its health and welfare plans and the existing IRC 501 (c) (9) Voluntary Employee Beneficiary Association (VEBA) trusts for Pepco, DPL and ACE to fund a portion of their estimated postretirement liabilities. Pepco contributed \$3.1 million and \$4.7 million to the PHI-sponsored plan in 2005 and 2004, respectively. Assuming no changes to the current plan assumptions, Pepco expects to contribute amounts similar to its allocated portion of PHI's other postretirement benefit expense to the other postretirement welfare benefit plan in 2006.

Expected Benefit Payments

Estimated future benefit payments to participants in PHI's qualified pension and postretirement welfare benefit plans, which reflect expected future service as appropriate, as of December 31, 2005 are in millions of dollars:

Years	Pension Benefits	Other Postretirement Benefits
2006	$ 91.6	$ 37.2
2007	99.7	39.5
2008	102.2	41.7
2009	104.7	43.1
2010	106.1	44.3
2011 through 2015	553.0	229.7

(7) LONG-TERM DEBT

The components of long-term debt are shown below.

Interest Rate	Maturity	At December 31, 2005	2004
		(Millions of dollars)	
First Mortgage Bonds			
6.50%	2005	$ -	$ 100.0
6.25%	2007	175.0	175.0
6.50%	2008	78.0	78.0
5.875%	2008	50.0	50.0
5.75% (a)	2010	16.0	16.0
4.95% (a)	2013	200.0	200.0
4.65% (a)	2014	175.0	175.0
6.00% (a)	2022	30.0	30.0
6.375% (a)	2023	37.0	37.0
5.375% (a)	2024	42.5	42.5
5.375% (a)	2024	38.3	38.3
7.375%	2025	-	75.0
5.75% (a)	2034	100.0	100.0
5.40% (a)	2035	175.0	-
Total First Mortgage Bonds		1,116.8	1,116.8
Medium-Term Notes			
7.64%	2007	35.0	35.0
6.25%	2009	50.0	50.0
Notes (Unsecured)			
Variable	2006	50.0	100.0
Net unamortized discount		(2.9)	(3.5)
Current maturities of long-term debt		(50.0)	(100.0)
Total net long-term debt		$ 1,198.9	$ 1,198.3

(a) Represents a series of First Mortgage Bonds issued by Pepco as collateral for an outstanding series of senior notes or tax-exempt bonds issued by Pepco. The maturity date, optional and mandatory prepayment provisions, if any, interest rate, and interest payment dates on each series of senior notes or tax-exempt bonds are identical to the terms of the collateral First Mortgage Bonds by which it is secured. Payments of principal and interest on a series of senior notes or tax-exempt bonds satisfy the corresponding payment obligations on the related series of collateral First Mortgage Bonds. At such time as there are no First Mortgage Bonds of an issuing company outstanding, other than collateral First Mortgage Bonds securing payment of senior notes and tax-exempt bonds, each outstanding series of senior notes and tax-exempt bonds of the company will automatically cease to be secured by the corresponding series of collateral First Mortgage Bonds and all of the outstanding collateral First Mortgage Bonds of the company will be cancelled. Because each series of senior notes and tax-exempt bonds and the series of collateral First Mortgage Bonds securing that series of senior notes or tax-exempt bonds effectively represents a single financial obligation, the senior notes and the tax-exempt bonds are not separately shown on the table.

The outstanding First Mortgage Bonds are secured by a lien on substantially all of Pepco's property, plant and equipment.

The aggregate principal amount of long-term debt outstanding at December 31, 2005, that will mature in each of 2006 through 2010 and thereafter is as follows: $50 million in 2006, $210 million in 2007, $128 million in 2008, $50 million in 2009, $16 million in 2010, and $797.8 million thereafter.

SHORT-TERM DEBT

Pepco, a regulated utility, has traditionally used a number of sources to fulfill short-term funding needs, such as commercial paper, short-term notes, and bank lines of credit. Proceeds from short-term borrowings are used primarily to meet working capital needs, but may also be used to temporarily fund long-term capital requirements. Pepco had no short-term debt outstanding at December 31, 2005 and $14.0 million in inter-company borrowings outstanding at December 31, 2004.

Commercial Paper

Pepco maintains an ongoing commercial paper program of up to $300 million. The commercial paper notes can be issued with maturities up to 270 days from the date of issue. The commercial paper program is backed by a $500 million credit facility, described below under the heading "Credit Facility," shared with DPL and ACE.

Pepco had no commercial paper outstanding at December 31, 2005 and December 31, 2004. No commercial paper was issued during 2005. The interest rate for commercial paper issued during 2004 was 1.07%.

Credit Facility

In May 2005, Pepco Holdings, Pepco, DPL and ACE entered into a five-year credit agreement with an aggregate borrowing limit of $1.2 billion. This agreement replaces a $650 million five-year credit agreement that was entered into in July 2004 and a $550 million three-year credit agreement entered into in July 2003. Pepco Holdings' credit limit under this agreement is $700 million. The credit limit of each of Pepco, DPL and ACE is the lower of $300 million and the maximum amount of debt the company is permitted to have outstanding by its regulatory authorities, except that the aggregate amount of credit used by Pepco, DPL and ACE at any given time under the agreement may not exceed $500 million. Under the terms of the credit agreement, the companies are entitled to request increases in the principal amount of available credit up to an aggregate increase of $300 million, with any such increase proportionately increasing the credit limit of each of the respective borrowers and the $300 million sublimits for each of Pepco, DPL and ACE. The interest rate payable by the respective companies on utilized funds is determined by a pricing schedule with rates corresponding to the credit rating of the borrower. Any indebtedness incurred under the credit agreement would be unsecured.

The credit agreement is intended to serve primarily as a source of liquidity to support the commercial paper programs of the respective companies. The companies also are permitted to use the facility to borrow funds for general corporate purposes and issue letters of credit. In order for a borrower to use the facility, certain representations and warranties made by the borrower at the time the credit agreement was entered into also must be true at the time the facility is utilized, and the borrower must be in compliance with specified covenants, including the financial covenant described below. However, a material adverse change in the borrower's business, property, and results of operations or financial condition subsequent to the entry into the credit agreement is not a condition to the availability of credit under the facility. Among the covenants contained in the credit agreement are (i) the requirement that each borrowing company maintain a ratio of total indebtedness to total capitalization of 65% or less, computed in accordance with the terms of the credit agreement, (ii) a restriction on sales or other dispositions of assets, other than sales and dispositions permitted by the credit agreement, and (iii) a restriction on the incurrence of liens on the assets of a borrower or any of its significant subsidiaries other than liens permitted by the credit agreement. The failure to satisfy any of the covenants or the occurrence of specified events that constitute an event of default could result in the acceleration of the repayment obligations of the borrower. The events of default include (i) the failure of any borrowing company or any of its significant subsidiaries to pay when due, or the acceleration of, certain indebtedness under other borrowing arrangements, (ii) certain bankruptcy events, judgments or decrees against any borrowing company or its significant subsidiaries, and (iii) a change in control (as defined in the credit agreement) of Pepco Holdings or the failure of Pepco Holdings to own all of the voting stock of Pepco, DPL and ACE. The agreement does not include any ratings triggers. There were no balances outstanding at December 31, 2005 and 2004.

(8) INCOME TAXES

Pepco, as a direct subsidiary of PHI, is included in the consolidated Federal income tax return of PHI. Federal income taxes are allocated to Pepco pursuant to a written tax sharing agreement which was approved by the Securities and Exchange Commission pursuant to regulations under the Public Utility Holding Company Act of 1935 in connection with the establishment of PHI as a holding company as part of Pepco's acquisition of Conectiv on August 1, 2002. Under this tax sharing agreement, PHI's consolidated Federal income tax liability is allocated based upon PHI's and its subsidiaries' separate taxable income or loss, with the exception of the tax benefits applicable to non-acquisition debt expenses of PHI. Such tax benefits are allocated to subsidiaries with taxable income.

The provision for income taxes, reconciliation of consolidated income tax expense, and components of consolidated deferred income tax liabilities (assets) are shown below.

Provision for Income Taxes

	For the Year Ended December 31, 2005	2004	2003
	(Millions of dollars)		
Current Tax Expense			
Federal	$ 142.1	$ 19.2	$ 8.8
State and local	36.7	12.6	14.0
Total Current Tax Expense	178.8	31.8	22.8
Deferred Tax (Benefit) Expense			
Federal	(36.4)	27.5	45.4
State and local	(12.8)	(1.6)	1.1
Investment tax credits	(2.0)	(2.0)	(2.0)
Total Deferred Tax (Benefit) Expense	(51.2)	23.9	44.5
Total Income Tax Expense	$ 127.6	$ 55.7	$ 67.3

Reconciliation of Income Tax Expense

	For the Year Ended December 31, 2005		2004		2003	
	(Millions of dollars)					
	Amount	Rate	Amount	Rate	Amount	Rate
Income Before Income Taxes	$ 292.6		$ 152.2		$ 170.5	
Income tax at federal statutory rate	$ 102.4	.35	$ 53.3	.35	$ 59.7	.35
Increases (decreases) resulting from						
Depreciation	5.3	.02	5.9	.04	8.2	.05
Accrued asset removal costs	(3.3)	(.01)	(1.7)	(.01)	(4.6)	(.03)
State income taxes, net of federal effect	15.6	.05	8.0	.05	9.6	.06
Software amortization	5.2	.02	(3.6)	(.02)	(4.7)	(.03)
Tax credits	(2.3)	(.01)	(2.7)	(.02)	(1.9)	(.01)
Change in estimates related to tax liabilities of prior years	6.1	.02	(3.8)	(.02)	-	-
Other	(1.4)	-	.3	-	1.0	-
Total Income Tax Expense	$ 127.6	.44	$ 55.7	.37	$ 67.3	.39

Components of Deferred Income Tax Liabilities (Assets)

	At December 31 2005	At December 31 2004
	(Millions of dollars)	
Deferred Tax Liabilities (Assets)		
Depreciation and other book to tax basis differences	$ 673.7	$ 725.1
Pension plan contribution	73.5	72.5
Other Post Employment Benefits	(24.3)	(18.1)
Deferred taxes on amounts to be collected through future rates	8.1	13.4
Deferred investment tax credit	(17.3)	(17.3)
Contributions in aid of construction	(57.9)	(56.9)
Customer sharing	(.4)	(.4)
Transition costs	(14.3)	(14.3)
Property taxes and other	(22.3)	(19.0)
Total Deferred Tax Liabilities, Net	618.8	685.0
Deferred tax assets included in Other Current Assets	3.2	.5
Total Deferred Tax Liabilities, Net - Non-Current	$ 622.0	$ 685.5

The net deferred tax liability represents the tax effect, at presently enacted tax rates, of temporary differences between the financial statement and tax basis of assets and liabilities. The portion of the net deferred tax liability applicable to Pepco's operations, which has not been reflected in current service rates, represents income taxes recoverable through future rates, net and is recorded as a regulatory asset on the balance sheet. No valuation allowance for deferred tax assets was required or recorded at December 31, 2005 and 2004.

The Tax Reform Act of 1986 repealed the Investment Tax Credit (ITC) for property placed in service after December 31, 1985, except for certain transition property. ITC previously earned on Pepco's property continues to be normalized over the remaining service lives of the related assets.

Pepco's federal income tax liabilities for all years through 2000 have been determined, subject to adjustment to the extent of any net operating loss or credit carrybacks from subsequent years.

Taxes Other Than Income Taxes

Taxes other than income taxes for each year are shown below.

	2005	2004	2003
	(Millions of dollars)		
Gross Receipts/Delivery	$107.8	$103.6	$ 99.7
Property	36.4	37.0	36.7
County Fuel and Energy	89.0	70.6	36.7
Environmental, Use and Other	42.9	37.8	33.4
Total	$276.1	$249.0	$206.5

(9) PREFERRED STOCK

The preferred stock amounts outstanding as of December 31, 2005 and 2004 are as follows.

Series	Redemption Price	Shares Outstanding 2005	Shares Outstanding 2004	December 31, 2005 (Millions of dollars)	December 31, 2004 (Millions of dollars)
Serial Preferred (1)					
$2.44 Series of 1957	$51.00	216,846	239,641	$10.9	$12.0
$2.46 Series of 1958	$51.00	99,789	173,892	5.0	8.7
$2.28 Series of 1965	$51.00	112,709	125,857	5.6	6.3
				$21.5	$27.0

(1) In September and October of 2004, Pepco redeemed 81,400 and 84,502 shares, respectively, of its $2.28 Series 1965 Serial Preferred Stock for aggregate redemption amounts of $4.1 million and $4.2 million, respectively. In October 2005, Pepco redeemed 74,103 shares of its $2.46 Series 1958 Serial Preferred Stock, 13,148 shares of its $2.28 Series 1965 Serial Preferred Stock and 22,795 shares of its $2.44 Series 1957 Serial Preferred Stock for an aggregate redemption amount of $3.7 million, $.7 million and $1.1 million, respectively. On March 1, 2006, Pepco redeemed all outstanding shares of its Serial Preferred Stock of each series, at 102% of par, for an aggregate redemption amount of $21.9 million.

(10) FAIR VALUES OF FINANCIAL INSTRUMENTS

The estimated fair values of Pepco's financial instruments at December 31, 2005 and 2004 are shown below.

	At December 31, 2005 (Millions of dollars)		At December 31, 2004 (Millions of dollars)	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Liabilities and Capitalization				
Long-Term Debt	$1,198.9	$1,198.2	$1,198.3	$1,221.2
Serial Preferred Stock	$ 21.5	$ 18.2	$ 27.0	$ 21.7

The methods and assumptions described below were used to estimate, at December 31, 2005 and 2004, the fair value of each class of financial instrument shown above for which it is practicable to estimate a value.

The fair values of the Long-term Debt, which include First Mortgage Bonds, Medium-Term Notes, and Unsecured Notes, excluding amounts due within one year, were based on the current market prices, or for issues with no market price available, were based on discounted cash flows using current rates for similar issues with similar terms and remaining maturities.

The fair value of the Serial Preferred Stock, excluding amounts due within one year, was based on quoted market prices or discounted cash flows using current rates of preferred stock with similar terms.

The carrying amounts of all other financial instruments in Pepco's accompanying financial statements approximate fair value.

(11) COMMITMENTS AND CONTINGENCIES

REGULATORY AND OTHER MATTERS

Relationship with Mirant Corporation

In 2000, Pepco sold substantially all of its electricity generation assets to Mirant Corporation, formerly Southern Energy, Inc. As part of the Asset Purchase and Sale Agreement, Pepco entered into several ongoing contractual arrangements with Mirant Corporation and certain of its subsidiaries. In July 2003, Mirant Corporation and most of its subsidiaries filed a voluntary petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the Northern District of Texas (the Bankruptcy Court). On December 9, 2005, the Bankruptcy Court approved Mirant's Plan of Reorganization (the Reorganization Plan) and the Mirant business emerged from bankruptcy on January 3, 2006 (the Bankruptcy Emergence Date), in the form of a new corporation of the same name (together with its predecessors, Mirant). However, as discussed below, the Reorganization Plan did not resolve all of the outstanding matters between Pepco and Mirant relating to the Mirant bankruptcy and the litigation between Pepco and Mirant over these matters is ongoing.

Depending on the outcome of ongoing litigation, the Mirant bankruptcy could have a material adverse effect on the results of operations and cash flows of Pepco Holdings and Pepco. However, management believes that Pepco Holdings and Pepco currently have sufficient cash, cash flow and borrowing capacity under their credit facilities and in the capital markets to be able to satisfy any additional cash requirements that may arise due to the Mirant bankruptcy. Accordingly, management does not anticipate that the Mirant bankruptcy will impair the ability of either Pepco Holdings or Pepco to fulfill its contractual obligations or to fund projected capital expenditures. On this basis, management currently does not believe that the Mirant bankruptcy will have a material adverse effect on the financial condition of either company.

Transition Power Agreements

As part of the Asset Purchase and Sale Agreement, Pepco and Mirant entered into Transition Power Agreements for Maryland and the District of Columbia, respectively (collectively, the TPAs). Under the TPAs, Mirant was obligated to supply Pepco with all of the capacity and energy needed to fulfill Pepco's SOS obligations during the rate cap periods in each jurisdiction immediately following deregulation, which in Maryland extended through June 2004 and in the District of Columbia extended until January 22, 2005.

To avoid the potential rejection of the TPAs by Mirant in the bankruptcy proceeding, Pepco and Mirant in October 2003 entered into an Amended Settlement Agreement and Release (the Settlement Agreement) pursuant to which the terms of the TPAs were modified to increase the purchase price of the capacity and energy supplied by Mirant. In exchange, the Settlement Agreement provided Pepco with an allowed, pre-petition general unsecured claim against Mirant Corporation in the amount of $105 million (the Pepco TPA Claim).

On December 22, 2005, Pepco completed the sale of the Pepco TPA Claim, plus the right to receive accrued interest thereon, to Deutsche Bank for a cash payment of $112.4 million. Additionally, Pepco received $0.5 million in proceeds from Mirant in settlement of an asbestos claim against the Mirant bankruptcy estate. Pepco Holdings and Pepco recognized a total gain of $70.5 million (pre-tax) related to the settlement of these claims. Based on the regulatory settlements entered into in connection with deregulation in Maryland and the District of Columbia, Pepco is obligated to share with its customers the profits it realizes from the provision of SOS during the rate cap periods. The proceeds of the sale of the Pepco TPA Claim will be included in the calculations of the amounts required to be shared with customers in both jurisdictions. Based on the applicable sharing formulas in the respective jurisdictions, Pepco anticipates that customers will receive (through billing credits) approximately $42.3 million of the proceeds over a 12-month period beginning in March 2006 (subject to DCPSC and MPSC approvals).

Power Purchase Agreements

Under agreements with FirstEnergy Corp., formerly Ohio Edison (FirstEnergy), and Allegheny Energy, Inc., both entered into in 1987, Pepco was obligated to purchase 450 megawatts of capacity and energy from FirstEnergy annually through December 2005 (the FirstEnergy PPA). Under the Panda PPA, entered into in 1991, Pepco is obligated to purchase 230 megawatts of capacity and energy from Panda annually through 2021. At the time of the sale of Pepco's generation assets to Mirant, the purchase price of the energy and capacity under the PPAs was, and since that time has continued to be, substantially in excess of the market price. As a part of the Asset Purchase and Sale Agreement, Pepco entered into a "back-to-back" arrangement with Mirant. Under this arrangement, Mirant (i) was obligated, through December 2005, to purchase from Pepco the capacity and energy that Pepco was obligated to purchase under the FirstEnergy PPA at a price equal to Pepco's purchase price from FirstEnergy, and (ii) is obligated through 2021 to purchase from Pepco the capacity and energy that Pepco is obligated to purchase under the Panda PPA at a price equal to Pepco's purchase price from Panda (the PPA-Related Obligations). Mirant currently is making these required payments.

Pepco Pre-Petition Claims

At the time the Reorganization Plan was approved by the Bankruptcy Court, Pepco had pending pre-petition claims against Mirant totaling approximately $28.5 million (the Pre-Petition Claims), consisting of (i) approximately $26 million in payments due to Pepco in respect of the PPA-Related Obligations and (ii) approximately $2.5 million that Pepco has paid to Panda in settlement of certain billing disputes under the Panda PPA that related to periods after the sale of Pepco's generation assets to Mirant and prior to Mirant's bankruptcy filing, for which Pepco believes Mirant is obligated to reimburse it under the terms of the Asset Purchase and Sale Agreement. In the bankruptcy proceeding, Mirant filed an objection to the Pre-Petition Claims. The Pre-Petition Claims were not resolved in the Reorganization Plan and are the subject of ongoing litigation between Pepco and Mirant. To the extent Pepco is successful in its efforts to recover the Pre-Petition Claims, it would receive under the terms of the Reorganization Plan a number of shares of common stock of the new corporation created pursuant to the Reorganization Plan (the New Mirant Common Stock) equal to (i) the amount of the allowed claim (ii) divided by the market price of the New Mirant Common Stock on the Bankruptcy Emergence Date. Because the number of shares is based on the market price of the New Mirant Common Stock on the Bankruptcy Emergence Date, Pepco would receive the benefit, and bear the risk, of any change in the market price of the stock between the Bankruptcy Emergence Date and the date the stock is issued to Pepco.

As of December 31, 2005, Pepco maintained a receivable in the amount of $28.5 million, representing the Pre-Petition Claims, which was offset by a reserve of $14.5 million established by an expense recorded in 2003 to reflect the uncertainty as to whether the entire amount of the Pre-Petition Claims is recoverable. As of December 31, 2005, this reserve was reduced to $9.6 million to reflect the fact that there was no longer an objection to $15 million of Pepco's claim.

Mirant's Efforts to Reject the PPA-Related Obligations and Disgorgement Claims

In August 2003, Mirant filed with the Bankruptcy Court a motion seeking authorization to reject the PPA-Related Obligations (the First Motion to Reject). Upon motions filed with the U.S. District Court for the Northern District of Texas (the District Court) by Pepco and FERC, the District Court in October 2003 withdrew jurisdiction over this matter from the Bankruptcy Court. In December 2003, the District Court denied Mirant's motion to reject the PPA-Related Obligations on jurisdictional grounds. Mirant appealed the District Court's decision to the U.S. Court of Appeals for the Fifth Circuit (the Court of Appeals). In August 2004, the Court of Appeals remanded the case to the District Court holding that the District Court had jurisdiction to rule on the merits of Mirant's rejection motion, suggesting that in doing so the court apply a "more rigorous standard" than the business judgment rule usually applied by bankruptcy courts in ruling on rejection motions.

In December 2004, the District Court issued an order again denying Mirant's motion to reject the PPA-Related Obligations. The District Court found that the PPA-Related Obligations are not severable from the Asset Purchase and Sale Agreement and that the Asset Purchase and Sale Agreement cannot be rejected in part, as Mirant was seeking to do. Mirant has appealed the District Court's order to the Court of Appeals.

In January 2005, Mirant filed in the Bankruptcy Court a motion seeking to reject certain of its ongoing obligations under the Asset Purchase and Sale Agreement, including the PPA-Related Obligations (the Second Motion to Reject). In March 2005, the District Court entered orders granting Pepco's motion to withdraw jurisdiction over these rejection proceedings from the Bankruptcy Court and ordering Mirant to continue to perform the PPA-Related Obligations (the March 2005 Orders). Mirant has appealed the March 2005 Orders to the Court of Appeals.

In March 2005, Pepco, FERC, the Office of People's Counsel of the District of Columbia (the District of Columbia OPC), the MPSC and the Office of People's Counsel of Maryland (Maryland OPC) filed in the District Court oppositions to the Second Motion to Reject. In August 2005, the District Court issued an order informally staying this matter, pending a decision by the Court of Appeals on the March 2005 Orders.

On February 9, 2006, oral arguments on Mirant's appeals of the District Court's order relating to the First Motion to Reject and the March 2005 Orders were held before the Court of Appeals;

an opinion has not yet been issued.

On December 1, 2005, Mirant filed with the Bankruptcy Court a motion seeking to reject the executory parts of the Asset Purchase and Sale Agreement and its obligations under all other related agreements with Pepco, with the exception of Mirant's obligations relating to operation of the electric generating stations owned by Pepco Energy Services (the Third Motion to Reject). The Third Motion to Reject also seeks disgorgement of payments made by Mirant to Pepco in respect of the PPA-Related Obligations after filing of its bankruptcy petition in July 2003 to the extent the payments exceed the market value of the capacity and energy purchased. On December 21, 2005, Pepco filed an opposition to the Third Motion to Reject in the Bankruptcy Court.

On December 1, 2005, Mirant, in an attempt to "recharacterize" the PPA-Related Obligations, filed a complaint with the Bankruptcy Court seeking (i) a declaratory judgment that the payments due under the PPA-Related Obligations to Pepco are pre-petition debt obligations; and (ii) an order entitling Mirant to recover all payments that it made to Pepco on account of these pre-petition obligations after the petition date to the extent permitted under bankruptcy law (i.e., disgorgement).

On December 15, 2005, Pepco filed a motion with the District Court to withdraw jurisdiction over both of the December 1 filings from the Bankruptcy Court. The motion to withdraw and Mirant's underlying complaint have both been stayed pending a decision of the Court of Appeals in the appeals described above.

Each of the theories advanced by Mirant to recover funds paid to Pepco relating to the PPA-Related Obligations as a practical matter seeks reimbursement for the above-market cost of the capacity and energy purchased from Pepco over a period beginning, at the earliest, from the date on which Mirant filed its bankruptcy petition and ending on the date of rejection or the date through which disgorgement is approved. Under these theories, Pepco's financial exposure is the amount paid by Mirant to Pepco in respect of the PPA-Related Obligations during the relevant period, less the amount realized by Mirant from the resale of the purchased energy and capacity. On this basis, Pepco estimates that if Mirant ultimately is successful in rejecting the PPA-Related Obligations or on its alternative claims to recover payments made to Pepco related to the PPA-Related Obligations, Pepco's maximum reimbursement obligation would be approximately $263 million as of March 1, 2006.

If Mirant were ultimately successful in its effort to reject its obligations relating to the Panda PPA, Pepco also would lose the benefit on a going-forward basis of the offsetting transaction that negates the financial risk to Pepco of the Panda PPA. Accordingly, if Pepco were required to purchase capacity and energy from Panda commencing as of March 1, 2006, at the rates provided in the PPA (with an average price per kilowatt hour of approximately 17.1 cents), and resold the capacity and energy at market rates projected, given the characteristics of the Panda PPA, to be approximately 11.0 cents per kilowatt hour, Pepco estimates that it would incur losses of approximately $24 million for the remainder of 2006, approximately $30 million in 2007, and approximately $27 million to $38 million annually thereafter through the 2021 contract termination date. These estimates are based in part on current market prices and forward price estimates for energy and capacity, and do not include financing costs, all of which could be subject to significant fluctuation.

Pepco is continuing to exercise all available legal remedies to vigorously oppose Mirant's efforts to reject or recharacterize the PPA-Related Obligations under the Asset Purchase and Sale Agreement in order to protect the interests of its customers and shareholders. While Pepco believes that it has substantial legal bases to oppose these efforts by Mirant, the ultimate legal outcome is uncertain. However, if Pepco is required to repay to Mirant any amounts received from Mirant in respect of the PPA-Related Obligations, Pepco believes it will be entitled to file a claim against the Mirant bankruptcy estate in an amount equal to the amount repaid. Likewise, if Mirant is successful in its efforts to reject its future obligations relating to the Panda PPA, Pepco will have a claim against Mirant in an amount corresponding to the increased costs that it would incur. In either case, Pepco anticipates that Mirant will contest the claim. To the extent Pepco is successful in its efforts to recover on these claims, it would receive, as in the case of the Pre-Petition Claims, a number of shares of New Mirant Common Stock that is calculated using the market price of the New Mirant Common Stock on the Bankruptcy Emergence Date and accordingly would receive the benefit, and bear the risk, of any change in the market price of the stock between the Bankruptcy Emergence Date and the date the stock is issued to Pepco.

Regulatory Recovery of Mirant Bankruptcy Losses

If Mirant were ultimately successful in rejecting the PPA-Related Obligations or on its alternative claims to recover payments made to Pepco related to the PPA-Related Obligations and Pepco's corresponding claims against the Mirant bankruptcy estate are not recovered in full, Pepco would seek authority from the MPSC and the DCPSC to recover its additional costs. Pepco is committed to working with its regulatory authorities to achieve a result that is appropriate for its shareholders and customers. Under the provisions of the settlement agreements approved by the MPSC and the DCPSC in the deregulation proceedings in which Pepco agreed to divest its generation assets under certain conditions, the PPAs were to become assets of Pepco's distribution business if they could not be sold. Pepco believes that these provisions would allow the stranded costs of the PPAs that are not recovered from the Mirant bankruptcy estate to be recovered from Pepco's customers through its distribution rates. If Pepco's interpretation of the settlement agreements is confirmed, Pepco expects to be able to establish the amount of its anticipated recovery from customers as a regulatory asset. However, there is no assurance that Pepco's interpretation of the settlement agreements would be confirmed by the respective public service commissions.

Pepco's Notice of Administrative Claims

On January 24, 2006, Pepco filed Notice of Administrative Claims in the Bankruptcy Court seeking to recover: (i) costs in excess of $70 million associated with the transmission upgrades necessitated by shut-down of the Potomac River Power Station; and (ii) costs in excess of $8 million due to Mirant's unjustified post-petition delay in executing the certificates needed to permit Pepco to refinance certain tax exempt pollution control bonds. Mirant is expected to oppose both of these claims, which must be approved by the Bankruptcy Court. There is no assurance that Pepco will be able to recover the amounts claimed.

Mirant's Fraudulent Transfer Claim

In July 2005, Mirant filed a complaint in the Bankruptcy Court against Pepco alleging that Mirant's $2.65 billion purchase of Pepco's generating assets in June 2000 constituted a fraudulent transfer for which it seeks compensatory and punitive damages. Mirant alleges in the complaint that the value of Pepco's generation assets was "not fair consideration or fair or reasonably equivalent value for the consideration paid to Pepco" and that the purchase of the assets rendered Mirant insolvent, or, alternatively, that Pepco and Southern Energy, Inc. (as predecessor to Mirant) intended that Mirant would incur debts beyond its ability to pay them.

Pepco believes this claim has no merit and is vigorously contesting the claim, which has been withdrawn to the District Court. On December 5, 2005, the District Court entered a stay pending a decision of the Court of Appeals in the appeals described above.

The SMECO Agreement

As a term of the Asset Purchase and Sale Agreement, Pepco assigned to Mirant a facility and capacity agreement with Southern Maryland Electric Cooperative (SMECO) under which Pepco was obligated to purchase the capacity of an 84-megawatt combustion turbine installed and owned by SMECO at a former Pepco generating facility (the SMECO Agreement). The SMECO Agreement expires in 2015 and contemplates a monthly payment to SMECO of approximately $.5 million. Pepco is responsible to SMECO for the performance of the SMECO Agreement if Mirant fails to perform its obligations thereunder. At this time, Mirant continues to make post-petition payments due to SMECO.

On March 15, 2004, Mirant filed a complaint with the Bankruptcy Court seeking a declaratory judgment that the SMECO Agreement is an unexpired lease of non-residential real property rather than an executory contract and that if Mirant were to successfully reject the agreement, any claim against the bankruptcy estate for damages made by SMECO (or by Pepco as subrogee) would be subject to the provisions of the Bankruptcy Code that limit the recovery of rejection damages by lessors.

On November 22, 2005, the Bankruptcy Court issued an order granting summary judgment in favor of Mirant, finding that the SMECO Agreement is an unexpired lease of nonresidential real property. On the basis of this ruling, any claim by SMECO (or by Pepco as subrogee) for damages arising from a successful rejection are limited to the greater of (i) the amount of future rental payments due over one year, or (ii) 15% of the future rental payments due over the remaining term of the lease, not to exceed three years.

On December 1, 2005, Mirant filed both a motion with the Bankruptcy Court seeking to reject the SMECO Agreement and a complaint against Pepco and SMECO seeking to recover payments made to SMECO after the entry of the Bankruptcy Court's November 22, 2005 order holding that the SMECO Agreement is a lease of real property. On December 15, 2005, Pepco filed a motion with the District Court to withdraw jurisdiction of this matter from the Bankruptcy Court. The motion to withdraw and Mirant's underlying motion and complaint have been stayed pending a decision of the Court of Appeals in the appeals described above.

If the SMECO Agreement is successfully rejected by Mirant, Pepco will become responsible for the performance of the SMECO Agreement. In addition, if the SMECO Agreement is ultimately determined to be an unexpired lease of nonresidential real property, Pepco's claim for recovery against the Mirant bankruptcy estate would be limited as described above. Pepco estimates that its rejection claim, assuming the SMECO Agreement is determined to be an unexpired lease of nonresidential real property, would be approximately $8 million, and that the amount it would be obligated to pay over the remaining nine years of the SMECO Agreement is approximately $44.3 million. While that amount would be offset by the sale of capacity, under current projections, the market value of the capacity is de minimis.

Rate Proceedings

District of Columbia and Maryland

On February 27, 2006, Pepco filed for the period February 8, 2002 through February 7, 2004 and for the period February 8, 2004 through February 7, 2005, an update to the District of Columbia Generation Procurement Credit (GPC), which provides for sharing of the profit from SOS sales; and on February 24, 2006, Pepco filed an update for the period July1, 2003 through June 30, 2004 to the Maryland GPC. The updates to the GPC in both the District of Columbia and Maryland take into account the proceeds from the sale of the $105 million claim against the Mirant bankruptcy estate related to the TPA Settlement on December 13, 2005 for $112.4 million. The filings also incorporate true-ups to previous disbursements in the GPC for both states. In the filings, Pepco requests that $24.3 million be credited to District of Columbia customers and $17.7 million be credited to Maryland customers during the twelve-month-period beginning April 2006.

Federal Energy Regulatory Commission

On January 31, 2005, Pepco filed at FERC to reset its rates for network transmission service using a formula methodology. Pepco also sought a 12.4% return on common equity and a 50-basis-point return on equity adder that FERC had made available to transmission utilities who had joined Regional Transmission Organizations and thus turned over control of their assets to an independent entity. FERC issued an order on May 31, 2005, approving the rates to go into effect June 1, 2005, subject to refund, hearings, and further orders. The new rates reflect a decrease of 7.7% in Pepco's transmission rate. Pepco continues in settlement discussions under the supervision of a FERC administrative law judge and cannot predict the ultimate outcome of this proceeding.

Divestiture Cases

District of Columbia

Final briefs on Pepco's District of Columbia divestiture proceeds sharing application were filed in July 2002 following an evidentiary hearing in June 2002. That application was filed to implement a provision of Pepco's DCPSC-approved divestiture settlement that provided for a sharing of any net proceeds from the sale of Pepco's generation-related assets. One of the principal issues in the case is whether Pepco should be required to share with customers the excess deferred income taxes (EDIT) and accumulated deferred investment tax credits (ADITC) associated with the sold assets and, if so, whether such sharing would violate the normalization provisions of the Internal Revenue Code and its implementing regulations. As of December 31, 2005, the District of Columbia allocated portions of EDIT and ADITC associated with the divested generation assets were approximately $6.5 million and $5.8 million, respectively.

Pepco believes that a sharing of EDIT and ADITC would violate the Internal Revenue

Service (IRS) normalization rules. Under these rules, Pepco could not transfer the EDIT and the ADITC benefit to customers more quickly than on a straight line basis over the book life of the related assets. Since the assets are no longer owned there is no book life over which the EDIT and ADITC can be returned. If Pepco were required to share EDIT and ADITC and, as a result, the normalization rules were violated, Pepco would be unable to use accelerated depreciation on District of Columbia allocated or assigned property. In addition to sharing with customers the generation-related EDIT and ADITC balances, Pepco would have to pay to the IRS an amount equal to Pepco's District of Columbia jurisdictional generation-related ADITC balance ($5.8 million as of December 31, 2005), as well as its District of Columbia jurisdictional transmission and distribution-related ADITC balance ($5.3 million as of December 31, 2005) in each case as those balances exist as of the later of the date a DCPSC order is issued and all rights to appeal have been exhausted or lapsed, or the date the DCPSC order becomes operative.

In March 2003, the IRS issued a notice of proposed rulemaking (NOPR), which would allow for the sharing of EDIT and ADITC related to divested assets with utility customers on a prospective basis and at the election of the taxpayer on a retroactive basis. In December 2005 a revised NOPR was issued which, among other things, withdrew the March 2003 NOPR and eliminated the taxpayer's ability to elect to apply the regulation retroactively. Comments on the revised NOPR are due by March 21, 2006, and a public hearing will be held on April 5, 2006. Pepco filed a letter with the DCPSC on January 12, 2006, in which it has reiterated that the DCPSC should continue to defer any decision on the ADITC and EDIT issues until the IRS issues final regulations or states that its regulations project will be terminated without the issuance of any regulations. Other issues in the divestiture proceeding deal with the treatment of internal costs and cost allocations as deductions from the gross proceeds of the divestiture.

Pepco believes that its calculation of the District of Columbia customers' share of divestiture proceeds is correct. However, depending on the ultimate outcome of this proceeding, Pepco could be required to make additional gain-sharing payments to District of Columbia customers, including the payments described above related to EDIT and ADITC. Such additional payments (which, other than the EDIT and ADITC related payments, cannot be estimated) would be charged to expense in the quarter and year in which a final decision is rendered and could have a material adverse effect on Pepco's and PHI's results of operations for those periods. However, neither PHI nor Pepco believes that additional gain-sharing payments, if any, or the ADITC-related payments to the IRS, if required, would have a material adverse impact on its financial position, results of operations or cash flows. It is uncertain when the DCPSC will issue a decision regarding Pepco's divestiture proceeds sharing application.

Maryland

Pepco filed its divestiture proceeds plan application in Maryland in April 2001. The principal issue in the Maryland case is the same EDIT and ADITC sharing issue that has been raised in the District of Columbia case. See the discussion above under "Divestiture Cases - District of Columbia." As of December 31, 2005, the MPSC allocated portions of EDIT and ADITC associated with the divested generation assets were approximately $9.1 million and $10.4 million, respectively. Other issues deal with the treatment of certain costs as deductions from the gross proceeds of the divestiture. In November 2003, the Hearing Examiner in the Maryland proceeding issued a proposed order with respect to the application that concluded that Pepco's Maryland divestiture settlement agreement provided for a sharing between Pepco and customers of the EDIT and ADITC associated with the sold assets. Pepco believes that such a sharing would violate the normalization rules (discussed above) and would result in Pepco's inability to use accelerated depreciation on Maryland allocated or assigned property. If the proposed order is affirmed, Pepco would have to share with its Maryland customers, on an approximately 50/50 basis, the Maryland allocated portion of the generation-related EDIT ($9.1 million as of December 31, 2005), and the Maryland-allocated portion of generation-related ADITC. Furthermore, Pepco would have to pay to the IRS an amount equal to Pepco's Maryland jurisdictional generation-related ADITC balance ($10.4 million as of December 31, 2005), as well as its Maryland retail jurisdictional ADITC transmission and distribution-related balance ($9.5 million as of December 31, 2005), in each case as those balances exist as of the later of the date a MPSC order is issued and all rights to appeal have been exhausted or lapsed, or the date the MPSC order becomes operative. The Hearing Examiner decided all other issues in favor of Pepco, except for the determination that only one-half of the severance payments that Pepco included in its calculation of corporate reorganization costs should be deducted from the sales proceeds before sharing of the net gain between Pepco and customers. Pepco filed a letter with the MPSC on January 12, 2006, in which it has reiterated that the MPSC should continue to defer any decision on the ADITC and EDIT issues until the IRS issues final regulations or states that its regulations project will be terminated without the issuance of any regulations.

Pepco has appealed the Hearing Examiner's decision as it relates to the treatment of EDIT and ADITC and corporate reorganization costs to the MPSC. Consistent with Pepco's position in the District of Columbia, Pepco has argued that the only prudent course of action is for the MPSC to await the issuance of final regulations relating to the tax issues or a termination by the IRS of its regulation project without the issuance of any regulations, and then allow the parties to file supplemental briefs on the tax issues. Pepco believes that its calculation of the Maryland customers' share of divestiture proceeds is correct. However, depending on the ultimate outcome of this proceeding, Pepco could be required to share with its customers approximately 50 percent of the EDIT and ADITC balances described above and make additional gain-sharing payments related to the disallowed severance payments. Such additional payments would be charged to expense in the quarter and year in which a final decision is rendered and could have a material adverse effect on results of operations for those periods. However, neither PHI nor Pepco believes that additional gain-sharing payments, if any, or the ADITC-related payments to the IRS, if required, would have a material adverse impact on its financial position, results of operations or cash flows.

Default Electricity Supply Proceedings

District of Columbia

Under an order issued by the DCPSC in March 2004, as amended by a DCPSC order issued in July 2004, Pepco is obligated to provide SOS for small commercial and residential customers through May 31, 2011 and for large commercial customers through May 31, 2007. In August 2004, the DCPSC issued an order adopting administrative charges for residential, small and large commercial District of Columbia SOS customers that are intended to allow Pepco to recover the administrative costs incurred to provide the SOS supply. The approved administrative charges include an average margin for Pepco of approximately $.00248 per kilowatt hour, calculated based on total sales to residential, small and large commercial District of Columbia SOS customers over the twelve months ended December 31, 2003. Because margins vary by customer class, the actual average margin over any given time period will depend on the number of SOS customers from each customer class and the load taken by such customers over the time period. The administrative charges went into effect for Pepco's SOS sales on February 8, 2005.

The TPA with Mirant under which Pepco obtained the fixed-rate SOS supply ended on January 22, 2005, while the new SOS supply contracts with the winning bidders in the competitive procurement process began on February 1, 2005. Pepco procured power separately on the market for next-day deliveries to cover the period from January 23 through January 31, 2005, before the new SOS contracts began. Consequently, Pepco had to pay the difference between the procurement cost of power on the market for next-day deliveries and the current SOS rates charged to customers during the period from January 23 through January 31, 2005. In addition, because the new SOS rates did not go into effect until February 8, 2005, Pepco had to pay the difference between the procurement cost of power under the new SOS contracts and the SOS rates charged to customers for the period from February 1 to February 7, 2005. The total amount of the difference is estimated to be approximately $8.7 million. This difference, however, was included in the calculation of the GPC for the District of Columbia for the period February 8, 2004 through February 7, 2005, which was filed on July 12, 2005 with the DCPSC. The GPC provides for a sharing between Pepco's customers and shareholders, on an annual basis, of any margins, but not losses, that Pepco earned providing SOS in the District of Columbia during the four-year period from February 8, 2001 through February 7, 2005. At the time of the filing, based on the rates paid to Mirant by Pepco under the TPA Settlement, there was no customer sharing. On December 22, 2005 Pepco received $112.4 million in proceeds from the sale of the Pepco TPA Claim against the Mirant bankruptcy estate. A portion of this recovery related to the period February 8, 2004 through February 7, 2005 covered in the July 12 DCPSC filing. As a consequence, on February 27, 2006, Pepco filed with the DCPSC an updated calculation of the customer sharing for this period, which also takes into account the losses incurred during the January 22, 2005 through February 7, 2005 period. The updated filing shows that both residential and commercial customers will receive customer sharing that totals $17.5 million. Without the inclusion of the $8.7 million loss from the January 22, 2005 through February 7, 2005 period, the amount shared with customers would have been approximately $22.7 million, or $5.2 million greater, so that the net effect of the loss on the SOS sales during this period is approximately $3.5 million.

On February 3, 2006, Pepco announced proposed rates for its District of Columbia SOS customers to take effect on June 1, 2006. The new rate will raise the average monthly bill for residential customers by approximately 12%. The proposed rates must be approved by the DCPSC.

Maryland

Because of rising energy prices and the resultant expected increases in Pepco's rates, on March 3, 2006 the MPSC issued an order initiating an investigation to consider a residential rate stabilization plan for Pepco. This investigation is driven by the unprecedented national and international events. The MPSC directed the MPSC staff and Pepco to file comments addressing whether or not the rate stabilization plan that the MPSC adopted for Baltimore Gas & Electric Company in a March 6, 2006 order also should be used for Pepco. Comments are to be filed by March 16, 2006.

On March 7, 2006, Pepco announced the results of competitive bids to supply electricity to its Maryland SOS customers for one year beginning June 1, 2006. The proposed new rates must be approved formally by the MPSC. Due to significant increases in the cost of fuels used to generate electricity, the average monthly electric bill for Pepco's Maryland residential customers will increase by about 38.5%.

IRS Mixed Service Cost Issue

During 2001, Pepco changed its methods of accounting with respect to capitalizable construction costs for income tax purposes, which allow Pepco to accelerate the deduction of certain expenses that were previously capitalized and depreciated. Through December 31, 2005, these accelerated deductions have generated incremental tax cash flow benefits of approximately $94 million for Pepco, primarily attributable to its 2001 tax returns. On August 2, 2005, the IRS issued Revenue Ruling 2005-53 (the Revenue Ruling) that will limit the ability of Pepco to utilize this method of accounting for income tax purposes on its tax returns for 2004 and prior years. Pepco intends to contest any IRS adjustment to its prior year income tax returns based on the Revenue Ruling. However, if the IRS is successful in applying this Revenue Ruling Pepco would be required to capitalize and depreciate a portion of the construction costs previously deducted and repay the associated income tax benefits, along with interest thereon. During 2005, Pepco recorded a $6.0 million increase in income tax expense to account for the accrued interest that would be paid on the portion of tax benefits that Pepco estimates would be deferred to future years if the construction costs previously deducted are required to be capitalized and depreciated.

On the same day as the Revenue Ruling was issued, the Treasury Department released regulations that, if adopted in their current form, would require Pepco to change its method of accounting with respect to capitalizable construction costs for income tax purposes for all future tax periods beginning in 2005. Under these regulations, Pepco will have to capitalize and depreciate a portion of the construction costs that it has previously deducted and include the impact of this adjustment in taxable income over a two-year period beginning with tax year 2005. Pepco is continuing to work with the industry to determine an alternative method of accounting for capitalizable construction costs acceptable to the IRS to replace the method disallowed by the proposed regulations.

In February 2006, PHI paid approximately $121 million, a portion of which is attributable to Pepco, of taxes to cover the amount of taxes management estimates will be payable once a new final method of tax accounting is adopted on its 2005 tax return, due to the proposed regulations. Although the increase in taxable income will be spread over the 2005 and 2006 tax return periods, the cash payments would have all occurred in 2006 with the filing of the 2005 tax return and the ongoing 2006 estimated tax payments. This $121 million tax payment was accelerated to eliminate the need to accrue additional federal interest expense for the potential IRS adjustment related to the previous tax accounting method PHI used during the 2001-2004 tax years.

Contractual Obligations

As of December 31, 2005, Pepco's contractual obligations under non-derivative fuel and power purchase contracts (excluding PPA related obligations that are part of the back-to-back agreement with Mirant) were $248.6 million in 2006, $428.2 million in 2007 to 2008, zero in 2009 to 2010, and zero in 2011 and thereafter.

(12) RELATED PARTY TRANSACTIONS

PHI Service Company provides various administrative and professional services to PHI and its regulated and unregulated subsidiaries including Pepco. The cost of these services is allocated in accordance with cost allocation methodologies set forth in the service agreement using a variety of factors, including the subsidiaries' share of employees, operating expenses, assets, and other cost causal methods. These intercompany transactions are eliminated in consolidation and no profit results from these transactions. PHI Service Company costs directly charged or allocated to Pepco for the years ended December 31, 2005, 2004 and 2003 were approximately $114.6 million, $91.1 million and $82.8 million, respectively.

Certain subsidiaries of Pepco Energy Services perform utility maintenance services, including services that are treated as capital costs, for Pepco. Amounts paid by Pepco to these companies for the years ended December 31, 2005, 2004 and 2003 were approximately $11.6 million, $14.1 million and $11.3 million, respectively.

In addition to the transactions described above, Pepco's financial statements include the following related party transactions in its Statements of Earnings:

	For the Year Ended December 31,		
	2005	2004	2003
Income (Expense)	(Millions of dollars)		
Inter-company lease transactions related to computer services (c)	$ .8	$ .9	$ -
Inter-company lease transactions related to facility and building maintenance (c)	(5.2)	(6.5)	(1.4)
Inter-company use revenue (b)	.2	.3	-
Money pool interest income (d)	.3	.1	.1
Money pool interest expense (d)	$ (.2)	$ (.6)	$ -

As of December 31, 2005 and 2004, Pepco had the following balances on its Balance Sheets due (to)/from related parties:

Asset (Liability)	2005	2004
	(Millions of dollars)	
Payable to Related Party (current)		
PHI Service Company	$(15.3)	$(14.6)
Pepco Energy Services (a)	(25.0)	(12.5)
Other Related Party Activity	-	(.1)
Total Payable to Related Parties	$(40.3)	$(27.2)
Money Pool Balance with Pepco Holdings (included in cash and cash equivalents in 2005 and in short-term debt in 2004 on the Balance Sheet)	$ 73.1	$(14.0)

(a) Pepco bills customers on behalf of Pepco Energy Services where customers have selected Pepco Energy Services as their alternative supplier or where Pepco Energy Services has performed work for certain government agencies under a General Services Administration area-wide agreement.

(b) Included in operating revenue.

(c) Included in other operation and maintenance.

(d) Included in interest expense.

(13) RESTATEMENT

Pepco restated its previously reported financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements. The restatement includes the correction of other errors for the same periods, primarily relating to unbilled revenue, taxes, and various accrual accounts, which were considered by management to be immaterial. These other errors would not themselves have required a restatement absent the restatement to correct the accounting for deferred compensation arrangements. This restatement was required solely because the cumulative impact of the correction, if recorded in the fourth quarter of 2005, would have been material to that period's reported net income. The impact of the restatement related to the deferred compensation arrangements on periods prior to 2003 has been reflected as a reduction of approximately $21.4 million to Pepco's retained earnings balance as of January 1, 2003. The following table sets forth for Pepco, for the years ended December 31, 2004 and 2003, the impact of the restatement to correct the accounting for the deferred compensation arrangements and the other errors noted above (millions of dollars):

	December 31, 2004		December 31, 2003	
	Previously Reported	Restated	Previously Reported	Restated
Consolidated Statements of Earnings				
Total Operating Revenue	$ 1,805.9	$ 1,805.9	$ 1,548.0	$ 1,548.0
Total Operating Expenses	1,579.7	1,579.8	1,298.9	1,300.4
Total Operating Income	226.2	226.1	249.1	247.6
Other Income (Expenses)	(72.9)	(73.9)	(70.8)	(72.5)
Income Before Income Tax Expense	153.3	152.2	173.7	170.5
Net Income	$ 96.6	$ 96.5	$ 104.6	$ 103.2
Consolidated Balance Sheets				
Total Current Assets	$ 354.4	$ 361.0	$ 347.2	$ 358.9
Total Investments and Other Assets	417.8	399.6	397.9	376.1
Net Property, Plant and Equipment	2,931.6	2,936.4	2,924.9	2,927.9
Total Assets	3,703.8	3,697.0	3,670.0	3,662.9
Total Current Liabilities	416.1	427.8	418.6	434.1
Total Deferred Credits	938.4	942.8	902.8	903.0
Total Long-Term Liabilities	1,319.6	1,319.6	1,301.5	1,301.5
Total Shareholder's Equity	1,002.7	979.8	1,011.8	989.0
Total Liabilities and Shareholder's Equity	$ 3,703.8	$ 3,697.0	$ 3,670.0	$ 3,662.9
Consolidated Statements of Cash Flows				
Net Cash Provided by Operating Activities	$ 274.5	$ 266.0	$ 325.9	$ 323.4
Net Cash Used in Investing Activities	$ (181.7)	$ (181.9)	$ (197.5)	$ (197.5)
Net Cash Used in Financing Activities	$ (98.1)	$ (89.4)	$ (139.8)	$ (137.3)
Consolidated Statements of Shareholder's Equity				
Retained Earnings at December 31,	$ 496.4	$ 473.5	$ 505.3	$ 482.5

(14) QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The unaudited quarterly financial information for the three months ended March 31, 2005, June 30, 2005, and September 30, 2005 and all interim periods during the year ended December 31, 2004 have been restated to reflect the correction of the accounting for certain deferred compensation arrangements and other noted errors that would not themselves have required a restatement absent the restatement to correct the accounting for the deferred compensation arrangements as described in Note 13. The quarterly data presented below reflect all adjustments necessary in the opinion of management for a fair presentation of the interim results. Quarterly data normally vary seasonally because of temperature variations and differences between summer and winter rates.

	2005							
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated		Total
	(Millions of dollars)							
Total Operating Revenue	$425.5	$419.9	$396.1	$403.5	$582.9	$581.1	$440.8	$1,845.3
Total Operating Expenses	388.4	386.3	341.1	341.7	418.8 (a)	419.2 (a)	341.8 (b)	1,489.0
Operating Income	37.1	33.6	55.0	61.8	164.1	161.9	99.0	356.3
Other Expenses	(16.5)	(16.8)	(13.5)	(13.8)	(16.9)	(17.0)	(16.1)	(63.7)
Income Before Income Tax Expense	20.6	16.8	41.5	48.0	147.2	144.9	82.9	292.6
Income Tax Expense	9.1	7.7	17.6	20.3	64.9 (c)	64.1 (c)	35.5 (d)	127.6
Net Income	11.5	9.1	23.9	27.7	82.3	80.8	47.4	165.0
Dividends on Preferred Stock	.3	.3	.3	.3	.3	.3	.4	1.3
Earnings Available for Common Stock	$ 11.2	$ 8.8	$ 23.6	$ 27.4	$ 82.0	$ 80.5	$ 47.0	$ 163.7

	2004								
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Total
	(Millions of dollars)								
Total Operating Revenue	$369.6	$369.6	$461.2	$461.2	$575.5	$575.5	$399.6	$399.6	$1,805.9
Total Operating Expenses	334.6	333.5	397.6	397.9	468.9	469.2	378.6	379.2	1,579.8
Operating Income	35.0	36.1	63.6	63.3	106.6	106.3	21.0	20.4	226.1
Other Expenses	(19.3)	(19.4)	(18.7)	(19.0)	(17.4)	(17.7)	(17.5)	(17.8)	(73.9)
Income Before Income Tax Expense	15.7	16.7	44.9	44.3	89.2	88.6	3.5	2.6	152.2
Income Tax Expense (Benefit)	6.2	6.7	18.8	18.7	33.2	33.1	(1.5)	(2.8)	55.7
Net Income	9.5	10.0	26.1	25.6	56.0	55.5	5.0	5.4	96.5
Dividends on Preferred Stock	.4	.4	.4	.4	.1	.1	.1	.1	1.0
Earnings Available for Common Stock	$ 9.1	$ 9.6	$ 25.7	$ 25.2	$ 55.9	$ 55.4	$ 4.9	$ 5.3	$ 95.5

NOTE: Sales of electric energy are seasonal and, accordingly, comparisons by quarter within a year are not meaningful.

(a) Includes $68.1 million gain ($40.7 million after tax) from sale of non-utility land owned by Pepco at Buzzard Point.

(b) Includes $70.5 million gain ($42.2 million after tax) from the settlement of the TPA claim with Mirant.

(c) Includes $4.6 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(d) Includes $1.4 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(15) SUBSEQUENT EVENT

On March 1, 2006, Pepco redeemed all outstanding shares of its Serial Preferred Stock of each series, at 102% of par, for an aggregate redemption amount of $21.9 million.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors
of Delmarva Power & Light Company:

In our opinion, the financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Delmarva Power & Light Company (a wholly owned subsidiary of Pepco Holdings, Inc.) at December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note 13 to the financial statements, the Company restated its financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003.

PricewaterhouseCoopers LLP
Washington, D.C.
March 13, 2006

DELMARVA POWER & LIGHT COMPANY
STATEMENTS OF EARNINGS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
Operating Revenue			
Electric	$1,082.3	$1,017.4	$1,061.5
Natural Gas	261.5	228.6	191.1
Total Operating Revenue	1,343.8	1,246.0	1,252.6
Operating Expenses			
Fuel and purchased energy	698.0	655.6	699.1
Gas purchased	196.8	163.7	132.7
Other operation and maintenance	180.1	177.0	187.1
Depreciation and amortization	75.7	73.9	73.7
Other taxes	34.4	35.3	34.8
Gain on sales of assets	(3.6)	-	-
Total Operating Expenses	1,181.4	1,105.5	1,127.4
Operating Income	162.4	140.5	125.2
Other Income (Expenses)			
Interest and dividend income	.9	.4	.8
Interest expense	(34.7)	(33.0)	(37.0)
Other income	8.3	7.6	8.0
Other expenses	(4.6)	(4.4)	(4.8)
Total Other Expenses	(30.1)	(29.4)	(33.0)
Distributions on Preferred Securities of Subsidiary Trust	-	-	2.8
Income Before Income Tax Expense	132.3	111.1	89.4
Income Tax Expense	57.6	48.1	37.0
Net Income	74.7	63.0	52.4
Dividends on Redeemable Serial Preferred Stock	1.0	1.0	1.0
Earnings Available for Common Stock	$ 73.7	$ 62.0	$ 51.4

The accompanying Notes are an integral part of these Financial Statements.

DELMARVA POWER & LIGHT COMPANY
BALANCE SHEETS

ASSETS	December 31, 2005	(Restated) December 31, 2004
(Millions of dollars)		
CURRENT ASSETS		
Cash and cash equivalents	$ 7.4	$ 3.6
Restricted cash	-	4.8
Accounts receivable, less allowance for uncollectible accounts of $9.2 million and $8.7 million, respectively	181.4	175.4
Fuel, materials and supplies - at average cost	41.8	38.4
Prepaid expenses and other	28.4	11.6
Total Current Assets	259.0	233.8
INVESTMENTS AND OTHER ASSETS		
Goodwill	48.5	48.5
Regulatory assets	140.9	140.3
Prepaid pension expense	213.3	204.7
Other	32.7	29.8
Total Investments and Other Assets	435.4	423.3
PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment	2,409.5	2,303.1
Accumulated depreciation	(800.3)	(755.0)
Net Property, Plant and Equipment	1,609.2	1,548.1
TOTAL ASSETS	$2,303.6	$2,205.2

The accompanying Notes are an integral part of these Financial Statements.

DELMARVA POWER & LIGHT COMPANY
BALANCE SHEETS

LIABILITIES AND SHAREHOLDER'S EQUITY	December 31, 2005	(Restated) December 31, 2004
(In millions, except share data)		
CURRENT LIABILITIES		
Short-term debt	$ 165.5	$ 134.3
Current maturities of long-term debt	22.9	2.7
Accounts payable and accrued liabilities	74.0	59.6
Accounts payable due to associated companies	57.3	48.1
Capital lease obligations due within one year	.2	.2
Taxes accrued	33.7	8.8
Interest accrued	6.4	6.3
Other	48.2	60.4
Total Current Liabilities	408.2	320.4
DEFERRED CREDITS		
Regulatory liabilities	242.5	220.6
Income taxes	413.7	430.9
Investment tax credits	10.7	11.7
Above-market purchased energy contracts and other electric restructuring liabilities	25.8	30.6
Other	33.0	31.7
Total Deferred Credits	725.7	725.5
LONG-TERM LIABILITIES		
Long-term debt	516.4	539.6
Capital lease obligations	-	.2
Total Long-Term Liabilities	516.4	539.8
COMMITMENTS AND CONTINGENCIES (NOTE 11)		
REDEEMABLE SERIAL PREFERRED STOCK	18.2	21.7
SHAREHOLDER'S EQUITY		
Common stock, $2.25 par value, authorized 1,000,000 shares - issued 1,000 shares	-	-
Premium on stock and other capital contributions	235.4	235.4
Retained earnings	399.7	362.4
Total Shareholder's Equity	635.1	597.8
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	$2,303.6	$2,205.2

The accompanying Notes are an integral part of these Financial Statements.

DELMARVA POWER & LIGHT COMPANY
STATEMENTS OF CASH FLOWS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
OPERATING ACTIVITIES			
Net income	$ 74.7	$ 63.0	$ 52.4
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	75.7	73.9	73.7
Gain on sale of assets	(3.6)	-	-
Deferred income taxes	(22.7)	66.5	28.3
Investment tax credit adjustments, net	(.9)	(.9)	(1.0)
Prepaid pension expense	(8.6)	(9.3)	(2.6)
Energy supply contracts	(8.2)	(3.9)	(14.4)
Other deferred credits	1.1	.3	2.5
Other deferred charges	1.7	(.3)	2.9
Changes in:			
Accounts receivable	(7.8)	(4.8)	6.7
Regulatory assets and liabilities	(1.1)	(9.1)	(10.4)
Fuel, materials and supplies	(3.4)	(4.2)	(8.8)
Accounts payable and accrued liabilities	28.3	9.8	1.3
Interest and taxes accrued	21.1	17.9	(26.4)
Prepaid expenses and other	(2.2)	1.0	(.1)
Net Cash Provided By Operating Activities	144.1	199.9	104.1
INVESTING ACTIVITIES			
Investment in property, plant and equipment	(137.2)	(115.2)	(98.7)
Proceeds from/changes in:			
Sale of other assets	4.4	-	-
Restricted cash	4.8	(4.8)	-
Net other investing activities	-	(1.1)	.2
Net Cash Used In Investing Activities	(128.0)	(121.1)	(98.5)
FINANCING ACTIVITIES			
Common dividends paid	(36.4)	(68.0)	(49.1)
Preferred dividends paid	(1.0)	(1.0)	(1.0)
Redemption of preferred stock	(3.5)	-	-
Redemption of debentures issued to financing trust	-	(70.0)	-
Long-term debt issued	100.0	100.0	33.2
Long-term debt redeemed	(102.7)	(7.0)	(153.4)
Net change in short-term debt	31.2	(33.2)	62.6
Net other financing activities	.1	(.8)	(2.7)
Net Cash Used In Financing Activities	(12.3)	(80.0)	(110.4)
Net Increase (Decrease) In Cash and Cash Equivalents	3.8	(1.2)	(104.8)
Cash and Cash Equivalents at Beginning of Year	3.6	4.8	109.6
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 7.4	$ 3.6	$ 4.8
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Cash paid for interest (net of capitalized interest of $.9 million, $.3 million, and $.3 million, respectively), and paid (received) for income taxes:			
Interest	$ 32.2	$ 29.3	$ 37.1
Income taxes	$ 8.4	$ (3.4)	$ 22.1
NONCASH ACTIVITIES			
Capital contribution in respect of certain intercompany transactions	$ -	$ 21.9	$ -

The accompanying Notes are an integral part of these Financial Statements.

DELMARVA POWER & LIGHT COMPANY
STATEMENTS OF SHAREHOLDER'S EQUITY

	Common Stock		Premium	Capital Stock	Retained
	Shares	Par Value	on Stock	Expense	Earnings
(In millions, except share data)					
BALANCE, DECEMBER 31, 2002 (AS REPORTED)	1,000	$-	$223.5	$(10.1)	$364.4
RESTATEMENT	-	-	-	-	1.8
BALANCE, DECEMBER 31, 2002 (RESTATED)	1,000	$-	$223.5	$(10.1)	$366.2
Net Income (RESTATED)	-	-	-	-	52.4
Dividends:					
Preferred stock	-	-	-	-	(1.0)
Common stock	-	-	-	-	(49.1)
Redemption of preferred stock	-	-	-	.1	(.1)
BALANCE, DECEMBER 31, 2003 (RESTATED)	1,000	$-	$223.5	$(10.0)	$368.4
Net Income (RESTATED)	-	-	-	-	63.0
Capital contribution	-	-	21.9	-	-
Dividends:					
Preferred stock	-	-	-	-	(1.0)
Common stock	-	-	-	-	(68.0)
BALANCE, DECEMBER 31, 2004 (RESTATED)	1,000	$-	$245.4	$(10.0)	$362.4
Net Income	-	-	-	-	74.7
Dividends:					
Preferred stock	-	-	-	-	(1.0)
Common stock	-	-	-	-	(36.4)
BALANCE, DECEMBER 31, 2005	1,000	$-	$245.4	$(10.0)	$399.7

The accompanying Notes are an integral part of these Financial Statements.

NOTES TO FINANCIAL STATEMENTS

DELMARVA POWER & LIGHT COMPANY

(1) ORGANIZATION

Delmarva Power & Light Company (DPL) is engaged in the transmission and distribution of electricity in Delaware and portions of Maryland and Virginia, and provides gas distribution service in northern Delaware. Additionally, DPL supplies electricity at regulated rates to retail customers in its territories who do not elect to purchase electricity from a competitive supplier. The regulatory term for this service varies by jurisdiction as follows:

Delaware	Provider of Last Resort service (POLR) -- before May 1, 2006 Standard Offer Service (SOS) -- on and after May 1, 2006
Maryland	SOS
Virginia	Default Service

DPL also refers to this supply service in each of its jurisdictions generally as Default Electricity Supply.

DPL's electricity distribution service territory covers approximately 6,000 square miles and has a population of approximately 1.28 million. DPL's natural gas distribution service territory covers approximately 275 square miles and has a population of approximately 523,000. DPL is a wholly owned subsidiary of Conectiv, which is wholly owned by Pepco Holdings, Inc. (Pepco Holdings or PHI). Because PHI is a public utility holding company subject to the Public Utility Holding Company Act of 2005 (PUHCA 2005), the relationship between PHI and DPL and certain activities of DPL are subject to the regulatory oversight of the Federal Energy Regulatory Commission (FERC) under PUHCA 2005.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, such as compliance with Statement of Position 94-6, "Disclosure of Certain Significant Risks and Uncertainties," requires management to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the financial statements and accompanying notes. Examples of significant estimates used by DPL include the assessment of contingencies, the calculation of future cash flows and fair value amounts for use in asset impairment evaluations, fair value calculations (based on estimated market pricing) associated with derivative instruments, pension and other postretirement benefits assumptions, unbilled revenue calculations, and judgment involved with assessing the probability of recovery of regulatory assets. Additionally, DPL is subject to legal, regulatory, and other proceedings and claims that arise in the ordinary course of its business. DPL records an estimated liability for these proceedings and claims based upon the probable and reasonably estimable criteria contained in SFAS No. 5, "Accounting for Contingencies." Although DPL believes that its estimates and assumptions are reasonable, they are based upon information available to management at the time the estimates are made. Actual results may differ significantly from these estimates.

Change in Accounting Estimates

During 2005, DPL recorded the impact of a reduction in estimated unbilled revenue, primarily reflecting an increase in the estimated amount of power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers). This change in accounting estimate reduced net earnings for the year ended December 31, 2005 by approximately $1.0 million.

Revenue Recognition

DPL recognizes revenues for the supply and delivery of electricity and gas upon delivery to the customers, including amounts for services rendered, but not yet billed (unbilled revenue). DPL recorded amounts for unbilled revenue of $63.5 million and $66.9 million as of December 31, 2005 and 2004, respectively. These amounts are included in the "accounts receivable" line item in the accompanying Balance Sheets. DPL calculates unbilled revenue using an output based methodology. This methodology is based on the supply of electricity or gas distributed to customers. The unbilled revenue process requires management to make assumptions and judgments about input factors such as customer sales mix and estimated power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers), which are inherently uncertain and susceptible to change from period to period, the impact of which could be material. Similarly, revenues from other services are recognized when services are performed or products are delivered.

Revenues from non-regulated electricity and gas sales are included in "Electric" revenues and "Natural Gas" revenues, respectively. The taxes related to the consumption of electricity and gas by its customers, such as fuel, energy, or other similar taxes, are components of the Company's tariffs and, as such, are billed to customers and recorded in Operating Revenues. Accruals for these taxes by the Company are recorded in Other Taxes. Excise tax related generally to the consumption of gasoline by the Company in the normal course of business is charged to operations, maintenance or construction, and is de minimis.

Regulation of Power Delivery Operations

Certain aspects of DPL's utility businesses are subject to regulation by DPSC and MPSC, and the Virginia State Corporation Commission (VSCC), and its wholesale operations are subject to regulation by the Federal Energy Regulatory Commission (FERC).

Based on the regulatory framework in which it has operated, DPL has historically applied, and in connection with its transmission and distribution business continues to apply, the provisions of Statement of Financial Accounting Standards No. 71 (SFAS No. 71), "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 allows regulated entities, in appropriate circumstances, to establish regulatory assets and to defer the income statement impact of certain costs that are expected to be recovered in future rates. Management's assessment of the probability of recovery of regulatory assets requires judgment and interpretation of laws, regulatory commission orders, and other factors. Should existing facts or circumstances change in the future to indicate that a regulatory asset is not probable of recovery, then the regulatory asset must be charged to earnings.

The components of DPL's regulatory asset balances at December 31, 2005 and 2004, are as follows:

	2005	2004
	(Millions of dollars)	
Deferred energy supply costs	$ 18.3	$ 17.7
Deferred recoverable income taxes	80.7	83.5
Deferred debt extinguishment costs	20.6	17.6
Unrecovered purchased power contract costs	6.0	9.4
Other	15.3	12.1
Total regulatory assets	$140.9	$140.3

The components of DPL's regulatory liability balances at December 31, 2005 and 2004, are as follows:

	2005	2004
	(Millions of dollars)	
Deferred income taxes due to customers	$ 39.7	$ 39.0
Accrued asset removal costs	179.2	176.8
Other	23.6	4.8
Total regulatory liabilities	$242.5	$220.6

A description for each category of regulatory assets and regulatory liabilities follows:

Deferred Energy Supply Costs: Primarily represents deferred fuel costs for DPL's gas business. All deferrals receive a return. The deferred fuel costs are recovered annually.

Deferred Recoverable Income Taxes: Represents deferred income tax assets recognized from the normalization of flow-through items as a result of amounts previously provided to customers. As temporary differences between the financial statement and tax basis of assets reverse, deferred recoverable income taxes are amortized. There is no return on these deferrals.

Deferred Debt Extinguishment Costs: Represents the costs of debt extinguishment for which recovery through regulated utility rates is considered probable and, if approved, will be amortized to interest expense during the authorized rate recovery period. A return is received on these deferrals.

Unrecovered Purchased Power Contract Costs: Represents deferred costs related to purchase power contracts at DPL, which are being recovered from February 1996 through October 2007 and which earn a return.

Other: Represents miscellaneous regulatory assets that generally are being amortized over 1 to 2 years and generally do not receive a return.

Deferred Income Taxes Due to Customers: Represents the portion of deferred income tax liabilities applicable to DPL's utility operations that has not been reflected in current customer rates, for which future payment to customers is probable. As temporary differences between the financial statement and tax basis of assets reverse, deferred recoverable income taxes are amortized.

Accrued Asset Removal Costs: Represents DPL's asset retirement obligation associated with removal costs accrued using public service commission approved depreciation rates for transmission, distribution and general utility property. In accordance with the SEC interpretation of SFAS No. 143, accruals for removal costs were classified as a regulatory liability.

Other: Includes costs associated with DPL's natural gas hedging activity and Maryland SOS.

Income Taxes

DPL, as an indirect subsidiary of Pepco Holdings, is included in the consolidated Federal income tax return of PHI. Federal income taxes are allocated to DPL based upon the taxable income or loss amounts, determined on a separate return basis.

The Financial Statements include current and deferred income taxes. Current income taxes represent the amounts of tax expected to be reported on DPL's state income tax returns and the amount of federal income tax allocated from Pepco Holdings. Deferred income taxes are discussed below.

Deferred income tax assets and liabilities represent the tax effects of temporary differences between the financial statement and tax basis of existing assets and liabilities and are measured using presently enacted tax rates. The portion of DPL's deferred tax liability applicable to its utility operations that has not been recovered from utility customers represents income taxes recoverable in the future and is included in "regulatory assets" on the Balance Sheets. For additional information, see the discussion under "Regulation of Power Delivery Operations," above.

Deferred income tax expense generally represents the net change during the reporting period in the net deferred tax liability and deferred recoverable income taxes.

Investment tax credits from utility plant purchased in prior years are reported on the Balance Sheets as "Investment tax credits." These investment tax credits are being amortized to income over the useful lives of the related utility plant.

Accounting for Derivatives

DPL uses derivative instruments (forward contracts, futures, swaps, and exchange-traded and over-the-counter options) primarily to reduce gas commodity price volatility while limiting its firm customers' exposure to increases in the market price of gas. DPL also manages commodity risk with physical natural gas and capacity contracts that are not classified as derivatives. The primary goal of these activities is to reduce the exposure of its regulated retail gas customers to natural gas price fluctuations. All premiums paid and other transaction costs incurred as part of DPL's natural gas hedging activity, in addition to all gains and losses related to hedging activities, are fully recoverable through the fuel adjustment clause approved by the DPSC, and are deferred under SFAS No. 71 until recovered. At December 31, 2005, there was a deferred derivative receivable on DPL's balance sheet of $21.6 million, offset by a $21.6 million regulatory liability.

Accounts Receivable and Allowance for Uncollectible Accounts

DPL's accounts receivable balances primarily consist of customer accounts receivable, other accounts receivable, and accrued unbilled revenue. Accrued unbilled revenue represents revenue earned in the current period, but not billed to the customer until a future date (usually within one month after the receivable is recorded). DPL uses the allowance method to account for uncollectible accounts receivable.

Capitalized Interest and Allowance for Funds Used During Construction

In accordance with the provisions of SFAS No. 34, "Capitalization of Interest Cost," the cost of financing the construction of DPL's electric generating plants is capitalized. Other non-utility construction projects also include financing costs in accordance with SFAS No. 34. In accordance with the provisions of SFAS No. 71, utilities can capitalize Allowance for Funds Used During Construction (AFUDC) as part of the cost of plant and equipment. AFUDC recognizes that utility construction is financed partially by debt and partially by equity.

DPL recorded AFUDC for borrowed funds of $.9 million, $.3 million, and $.3 million for the years ended December 31, 2005, 2004, and 2003, respectively. These amounts are recorded as a reduction of "interest expense" in the accompanying Statements of Earnings.

DPL recorded amounts for the equity component of AFUDC of $.5 million, $.4 million and $.5 million for the years ended December 31, 2005, 2004 and 2003, respectively. The amounts are included in the "other income" caption of the accompanying Statements of Earnings.

Amortization of Debt Issuance and Reacquisition Costs

The amortization of debt discount, premium, and expense, including deferred debt extinguishment costs associated with the regulated electric and gas transmission and distribution businesses, is included in interest expense.

Accounting for Goodwill

Goodwill represents the excess of the purchase price of an acquisition over the fair value of the net assets acquired. DPL's goodwill balance at December 31, 2005 and 2004 of $48.5 million was derived from DPL's acquisition of Conowingo Power Company in 1995. The accounting for goodwill is governed by SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting and broadens the criteria for recording intangible assets apart from goodwill. SFAS No. 142 requires that purchased goodwill and certain indefinite-lived intangibles no longer be amortized, but instead be tested for impairment at least annually.

Goodwill Impairment Evaluation

The provisions of SFAS No. 142 require the evaluation of goodwill for impairment at least annually or more frequently if events and circumstances indicate that the asset might be impaired. Examples of such events and circumstances include an adverse action or assessment by a regulator, a significant adverse change in legal factors or in the business climate, and unanticipated competition. SFAS No. 142 indicates that if the fair value of a reporting unit is less than its carrying value, including goodwill, an impairment charge may be necessary. During

2005, DPL tested its goodwill for impairment as of July 1, 2005. This test concluded that none of DPL's goodwill balance was impaired.

Long-Lived Asset Impairment Evaluation

DPL is required to evaluate certain long-lived assets (for example, generating property and equipment and real estate) to determine if they are impaired when certain conditions exist. SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," provides the accounting for impairments of long-lived assets and indicates that companies are required to test long-lived assets for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. Examples of such events or changes include a significant decrease in the market price of a long-lived asset or a significant adverse change in the manner an asset is being used or its physical condition.

For long-lived assets that are expected to be held and used, SFAS No. 144 requires that an impairment loss be recognized only if the carrying amount of an asset is not recoverable and exceeds its fair value. For long-lived assets that can be classified as assets to be disposed of by sale under SFAS No. 144, an impairment loss shall be recognized to the extent their carrying amount exceeds their fair value, including costs to sell.

Pension and Other Postretirement Plans

Pepco Holdings sponsors a retirement plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries (Retirement Plan). Following the consummation of the acquisition of Conectiv by Pepco on August 1, 2002, the Pepco General Retirement Plan and the Conectiv Retirement Plan were merged into the Retirement Plan on December 31, 2002. The provisions and benefits of the merged Retirement Plan for Pepco employees are identical to those of the original Pepco plan and for Conectiv employees are identical to the original Conectiv plan. Pepco Holdings also provides supplemental retirement benefits to certain eligible executives and key employees through nonqualified retirement plans and provides certain postretirement health care and life insurance benefits for eligible retired employees.

The Company accounts for the Retirement Plan in accordance with SFAS No. 87, "Employers' Accounting for Pensions," and its other postretirement benefits in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." DPL's financial statement disclosures were prepared in accordance with SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits."

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. The carrying value of property, plant and equipment is evaluated for impairment whenever circumstances indicate the carrying value of those assets may not be recoverable under the provisions of SFAS No. 144. Upon retirement, the cost of regulated property, net of salvage, is charged to accumulated depreciation. For additional information regarding the treatment of retirement obligations, see the "Asset Retirement Obligations" section included in this Note.

The annual provision for depreciation on electric and gas property, plant and equipment is computed on the straight-line basis using composite rates by classes of depreciable property. Accumulated depreciation is charged with the cost of depreciable property retired, less salvage and other recoveries. The system-wide composite depreciation rate for 2005, 2004 and 2003 for DPL's transmission and distribution system property was approximately 3.1%. Property, plant and equipment other than electric and gas facilities is generally depreciated on a straight-line basis over the useful lives of the assets.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, money market funds, and commercial paper with original maturities of three months or less. Additionally, deposits in PHI's "money pool," which DPL and certain other PHI subsidiaries use to manage short-term cash management requirements, are considered cash equivalents. Deposits in the money pool are guaranteed by PHI. PHI deposits funds in the money pool to the extent that the pool has insufficient funds to meet the needs of its participants, which may require PHI to borrow funds for deposit from external sources.

Restricted Cash

Restricted cash represents cash either held as collateral or pledged as collateral, and is restricted from use for general corporate purposes.

Asset Retirement Obligations

DPL adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," on January 1, 2003 and FIN 47 as of December 31, 2005. This statement and related interpretation establish the accounting and reporting standards for measuring and recording asset retirement obligations. Based on the implementation of SFAS No. 143, $179.2 million and $176.8 million at December 31, 2005 and 2004 are reflected as regulatory liabilities in the accompanying Balance Sheets. Additionally, in 2005, DPL recorded immaterial conditional asset retirement obligations for underground storage tanks. Accretion expense for these asset retirement obligations has been recorded as a regulatory asset.

FIN 46R

On December 31, 2003, FIN 46 was implemented by DPL. FIN 46 was revised and superseded by FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities" (FIN 46R), which clarified some of the provisions of FIN 46 and exempted certain entities from its requirements. The implementation of FIN 46R did not impact DPL's financial condition or results of operations for the years ended December 31, 2005, 2004 and 2003.

Other Non-Current Assets

The other assets balance principally consists of real estate under development, equity and other investments, and deferred compensation trust assets.

Other Current Liabilities

The other current liabilities balance principally consists of customer deposits, accrued vacation liability, and the current portion of deferred income taxes.

Other Deferred Credits

The other deferred credits balance principally consists of miscellaneous deferred liabilities.

Dividend Restrictions

In addition to its future financial performance, the ability of DPL to pay dividends is subject to limits imposed by: (i) state corporate and regulatory laws, which impose limitations on the funds that can be used to pay dividends and, in the case of regulatory laws, may require the prior approval of DPL's utility regulatory commissions before dividends can be paid; (ii) the prior rights of holders of existing and future preferred stock, mortgage bonds and other long-term debt issued by DPL and any other restrictions imposed in connection with the incurrence of liabilities; and (iii) certain provisions of the charter of DPL, which impose restrictions on payment of common stock dividends for the benefit of preferred stockholders.

New Accounting Standards

SFAS No. 154

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections (SFAS No. 154), a replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. The reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS No. 154. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 (the year ended December 31, 2006 for Pepco Holdings). Early adoption is permitted.

EITF 04-13

In September 2005, the FASB ratified EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" (EITF 04-13), which addresses circumstances under which two or more exchange transactions involving inventory with the same counterparty should be viewed as a single exchange transaction for the purposes of evaluating the effect of APB Opinion 29. EITF 04-13 is effective for new arrangements entered into, or modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006 (April 1, 2006 for DPL). EITF 04-13 would not affect DPL's net income, overall financial condition, or cash flows, but rather could result in certain revenues and costs, including wholesale revenues and purchased power expenses, being presented on a net basis. DPL is in the process of evaluating the impact of EITF 04-13 on its Statements of Earnings presentation of purchases and sales.

(3) SEGMENT INFORMATION

In accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," DPL has one segment, its regulated utility business.

(4) LEASING ACTIVITIES

DPL leases an 11.9% interest in the Merrill Creek Reservoir. The lease is an operating lease and payments over the remaining lease term, which ends in 2032, are $118.6 million in the aggregate. DPL also has long-term leases for certain other facilities and equipment. Minimum commitments as of December 31, 2005, under the Merrill Creek Reservoir lease and other lease agreements, are as follows: 2006-$8.5 million; 2007-$8.4 million; 2008-$9.2 million; 2009-$9.2 million; 2010-$9.2 million; beyond 2010-$102.1 million; total-$146.6 million.

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is comprised of the following:

At December 31, 2005	Original Cost	Accumulated Depreciation	Net Book Value
		(Millions of dollars)	
Distribution	$1,236.0	$392.1	$ 843.9
Transmission	524.1	194.9	329.2
Gas	339.5	100.7	238.8
Construction work in progress	101.1	-	101.1
Non-operating and other property	208.8	112.6	96.2
Total	$2,409.5	$800.3	$1,609.2
At December 31, 2004			
Distribution	$1,172.1	$356.2	$ 815.9
Transmission	512.4	186.2	326.2
Gas	326.7	93.8	232.9
Construction work in progress	71.4	-	71.4
Non-operating and other property	220.5	118.8	101.7
Total	$2,303.1	$755.0	$1,548.1

The balances of all property, plant and equipment, which are primarily electric transmission and distribution property, are stated at original cost. Utility plant is generally subject to a first mortgage lien. The system-wide composite depreciation rate in 2005 and 2004 for DPL's transmission and distribution system property was approximately 3.1%.

(6) PENSIONS AND OTHER POSTRETIREMENT BENEFITS

Pension Benefits

Pepco Holdings sponsors a defined benefit Retirement Plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries. Pepco Holdings also provides supplemental retirement benefits to certain eligible executive and key employees through nonqualified retirement plans.

Other Postretirement Benefits

Pepco Holdings provides certain postretirement health care and life insurance benefits for eligible retired employees. Certain employees hired on January 1, 2005 or later will not have company subsidized retiree medical coverage; however, they will be able to purchase coverage at full cost through PHI.

During 2004, PHI amended its postretirement health care plans for certain groups of eligible employees effective January 1, 2005 or January 1, 2006. The amendments included changes to coverage and retiree cost-sharing, and are reflected as a reduction in PHI's 2004 net periodic benefit cost and a reduction of $42 million in the projected benefit obligation at December 31, 2004.

Pepco Holdings uses a December 31 measurement date for its plans. Plan assets are stated at their market value as of the measurement date, December 31. All dollar amounts in the following tables are in millions of dollars.

	Pension Benefits		Other Postretirement Benefits	
Change in Benefit Obligation	**2005**	**2004**	**2005**	**2004**
Benefit obligation at beginning of year	$1,648.0	$1,579.2	$593.5	$511.9
Service cost	37.9	35.9	8.5	8.6
Interest cost	96.1	94.7	33.6	35.4
Amendments	-	-	-	(42.4)
Actuarial loss	81.1	51.4	12.8	117.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Benefit obligation at end of year	$1,746.0	$1,648.0	$610.2	$593.5
Change in Plan Assets				
Fair value of plan assets at beginning of year	$1,523.5	$1,462.8	$164.9	$145.2
Actual return on plan assets	106.4	161.1	10.0	15.7
Company contributions	65.6	12.8	37.0	41.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$173.7	$164.9

The following table provides a reconciliation of the projected benefit obligation, plan assets and funded status of the plans.

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$ 173.7	$164.9
Benefit obligation at end of year	1,746.0	1,648.0	610.2	593.5
Funded status (plan assets less than plan obligations)	(167.6)	(124.5)	(436.5)	(428.6)
Amounts not recognized:				
Unrecognized net actuarial loss	350.5	261.2	188.6	188.5
Unrecognized prior service cost	1.9	3.0	(26.2)	(29.5)
Net amount recognized	$ 184.8	$ 139.7	$(274.1)	$(269.6)

The following table provides a reconciliation of the amounts recognized in PHI's Consolidated Balance Sheet as of December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Prepaid benefit cost	$208.9	$165.7	$ -	$ -
Accrued benefit cost	(24.1)	(26.0)	(274.1)	(269.6)
Additional minimum liability for nonqualified plan	(12.2)	(7.0)	-	-
Intangible assets for nonqualified plan	.1	.1	-	-
Accumulated other comprehensive income for nonqualified plan	12.1	6.9	-	-
Net amount recognized	$184.8	$139.7	$(274.1)	$(269.6)

The accumulated benefit obligation for the Retirement Plan (the qualified defined benefit pension plan) was $1,556.2 million and $1,462.9 million at December 31, 2005, and 2004, respectively. The table below provides the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for the PHI nonqualified pension plan with an accumulated benefit obligation in excess of plan assets at December 31, 2005 and 2004.

	Pension Benefits	
	2005	2004
Projected benefit obligation for nonqualified plan	$38.6	$35.3
Accumulated benefit obligation for nonqualified plan	$36.3	$32.9
Fair value of plan assets for nonqualified plan	-	-

In 2005 and 2004, PHI was required to recognize an additional minimum liability and an intangible asset related to its nonqualified pension plan as prescribed by SFAS No. 87. The liability was recorded as a reduction to shareholders' equity (other comprehensive income), and the equity will be restored to the balance sheet in future periods when the accrued benefit liability exceeds the accumulated benefit obligation at future measurement dates. The amount of reduction to shareholders' equity (net of income taxes) in 2005 was $7.3 million and in 2004 was $4.1 million. The recording of this reduction did not affect net income or cash flows in 2005 or 2004 or compliance with debt covenants.

The table below provides the components of net periodic benefit costs recognized for the years ended December 31.

	Pension Benefits			Other Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Service cost	$ 37.9	$ 35.9	$ 33.0	$ 8.5	$ 8.6	$ 9.5
Interest cost	96.1	94.7	93.7	33.6	35.4	32.9
Expected return on plan assets	(125.5)	(124.2)	(106.2)	(10.9)	(9.9)	(8.3)
Amortization of prior service cost	1.1	1.1	1.0	-	-	-
Amortization of net loss	10.9	6.5	13.9	8.0	9.5	8.0
Net periodic benefit cost	$ 20.5	$ 14.0	$ 35.4	$39.2	$43.6	$42.1

Approximately $(2.0) million, $1.0 million and $7.1 million were included in capital and operating and maintenance expense, in 2005, 2004 and 2003, respectively, for DPL's allocated portion of PHI's combined pension and other postretirement benefit expense.

The following weighted average assumptions were used to determine the benefit obligations at December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Discount rate	5.625%	5.875%	5.625%	5.875%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%
Health care cost trend rate assumed for next year	n/a	n/a	8.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)			5.00%	5.00%
Year that the rate reaches the ultimate trend rate			2009	2009

Assumed health care cost trend rates may have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects (millions of dollars):

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on total of service and interest cost	$ 1.8	$ (1.7)
Effect on postretirement benefit obligation	27.0	(25.1)

The following weighted average assumptions were used to determine the net periodic benefit cost for years ended December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Discount rate	5.875%	6.250%	5.875%	6.250%
Expected long-term return on plan assets	8.500%	8.750%	8.500%	8.750%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%

A cash flow matched bond portfolio approach to developing a discount rate is used to value FAS 87 and FAS 106 liabilities. The hypothetical portfolio includes high quality instruments with maturities that mirror the benefit obligations.

In selecting an expected rate of return on plan assets, PHI considers actual historical returns, economic forecasts and the judgment of its investment consultants on expected long-term performance for the types of investments held by the plan. The plan assets consist of equity and fixed income investments, and when viewed over a long time horizon, are expected to yield a return on assets of 8.50%.

Plan Assets

Pepco Holdings' Retirement Plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

	Plan Assets at December 31		Target Plan Asset	Minimum/
Asset Category	2005	2004	Allocation	Maximum
Equity securities	62%	66%	60%	55% - 65%
Debt securities	37%	33%	35%	30% - 50%
Other	1%	1%	5%	0% - 10%
Total	100%	100%	100%	

Pepco Holdings' other postretirement plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

	Plan Assets at December 31		Target Plan Asset	Minimum/
Asset Category	2005	2004	Allocation	Maximum
Equity securities	67%	65%	60%	55% - 65%
Debt securities	24%	32%	35%	20% - 50%
Cash	9%	3%	5%	0% - 10%
Total	100%	100%	100%	

In developing an asset allocation policy for its Retirement Plan and Other Postretirement Plan, PHI examined projections of asset returns and volatility over a long-term horizon. In connection with this analysis, PHI examined the risk/return tradeoffs of alternative asset classes and asset mixes given long-term historical relationships, as well as prospective capital market returns. PHI also conducted an asset/liability study to match projected asset growth with projected liability growth and provide sufficient liquidity for projected benefit payments. By incorporating the results of these analyses with an assessment of its risk posture, and taking into account industry practices, PHI developed its asset mix guidelines. Under these guidelines, PHI diversifies assets in order to protect against large investment losses and to reduce the probability of excessive performance volatility while maximizing return at an acceptable risk level. Diversification of assets is implemented by allocating monies to various asset classes and investment styles within asset classes, and by retaining investment management firm(s) with complementary investment philosophies, styles and approaches. Based on the assessment of demographics, actuarial/funding, and business and financial characteristics, PHI believes that its risk posture is slightly below average relative to other pension plans. Consequently, Pepco Holdings believes that a slightly below average equity exposure (i.e., a target equity asset allocation of 60%) is appropriate for the Retirement Plan and the Other Postretirement Plan.

On a periodic basis, Pepco Holdings reviews its asset mix and rebalances assets back to the target allocation over a reasonable period of time.

No Pepco Holdings common stock is included in pension or postretirement program assets.

Cash Flows

Contributions - Retirement Plan

Pepco Holdings' funding policy with regard to the Retirement Plan is to maintain a funding level in excess of 100% with respect to its accumulated benefit obligation (ABO). PHI's Retirement Plan currently meets the minimum funding requirements of ERISA without any additional funding. In 2005 and 2004, PHI made discretionary tax-deductible cash contributions to the plan of $60.0 million and $10.0 million, respectively, in line with its funding policy. Assuming no changes to the current pension plan assumptions, PHI projects no funding will be required under ERISA in 2006; however, PHI may elect to make a discretionary tax-deductible contribution, if required to maintain its plan assets in excess of its ABO.

Contributions - Other Postretirement Benefits

In 2005, PHI combined its health and welfare plans and the existing IRC 501 (C) (9) Voluntary Employee Beneficiary Association (VEBA) trusts for Pepco, DPL and ACE to fund a portion of their estimated postretirement liabilities. DPL contributed $6.0 million and $9.5 million to the PHI-sponsored plan in 2005 and 2004, respectively. Assuming no changes to the current plan assumptions, DPL expects to contribute amounts similar to its allocated portion of PHI's other postretirement benefit expense to the other postretirement welfare benefit plan in 2006.

Expected Benefit Payments

Estimated future benefit payments to participants in PHI's qualified pension and postretirement welfare benefit plans, which reflect expected future service as appropriate, as of December 31, 2005 are in millions of dollars:

Years	Pension Benefits	Other Postretirement Benefits
2006	$ 91.6	$ 37.2
2007	99.7	39.5
2008	102.2	41.7
2009	104.7	43.1
2010	106.1	44.3
2011 through 2015	553.0	229.7

(7) LONG-TERM DEBT

Long-term debt outstanding as of December 31, 2005 and 2004 is presented below:

Type of Debt	Interest Rates	Maturity	2005	2004
			(Millions of dollars)	
First Mortgage Bonds	7.71%	2025	$ -	$100.0
Amortizing First Mortgage Bonds	6.95%	2005-2008	10.5	13.2
			10.5	113.2
Unsecured Tax-Exempt Bonds:				
	5.20%	2019	31.0	31.0
	3.15%	2023 (c)	18.2	18.2
	5.50%	2025 (a)	15.0	15.0
	4.90%	2026 (b)	34.5	34.5
	5.65%	2028 (a)	16.2	16.2
	Variable	2030-2038	93.4	93.4
			208.3	208.3
Medium-Term Notes (unsecured):				
	6.75%	2006	20.0	20.0
	7.06%-8.13%	2007	61.5	61.5
	7.56%-7.58%	2017	14.0	14.0
	6.81%	2018	4.0	4.0
	7.61%	2019	12.0	12.0
	7.72%	2027	10.0	10.0
			121.5	121.5
Notes (unsecured):				
	5.0%	2014	100.0	100.0
	5.0%	2015	100.0	-
			200.0	100.0
Total long-term debt			540.3	543.0
Unamortized premium and discount, net			(1.0)	(.7)
Current maturities of long-term debt			(22.9)	(2.7)
Total net long-term debt			$516.4	$539.6

(a) The bonds are subject to mandatory tender on July 1, 2010.
(b) The bonds are subject to mandatory tender on May 1, 2011.
(c) The bonds are subject to mandatory tender on August 1, 2008.

The outstanding First Mortgage Bonds issued by DPL are secured by a lien on substantially all of DPL's property, plant and equipment.

Maturities of long-term debt and sinking fund requirements during the next five years are as follows: 2006-$22.9 million; 2007-$64.7 million; 2008-$22.6 million; 2009-zero; 2010-$31.2 million; and $398.9 million thereafter.

SHORT-TERM DEBT

DPL, a regulated utility, has traditionally used a number of sources to fulfill short-term funding needs, such as commercial paper, short-term notes, and bank lines of credit. Proceeds from short-term borrowings are used primarily to meet working capital needs, but may also be used to temporarily fund long-term capital requirements. A detail of the components of DPL's short-term debt at December 31, 2005 and 2004 is as follows.

	2005	2004
	(Millions of dollars)	
Commercial paper	$ -	$ -
Inter-Company borrowings	60.7	29.5
Variable rate demand bonds	104.8	104.8
Total	$165.5	$134.3

Commercial Paper

DPL maintains an ongoing commercial paper program of up to $275 million. The commercial paper notes can be issued with maturities up to 270 days from the date of issue. The commercial paper program is backed by a $500 million credit facility, described below under the heading "Credit Facility," shared with Pepco and ACE.

DPL had no commercial paper outstanding at December 31, 2005 and December 31, 2004. The interest rate for commercial paper issued during 2004 was 1.10%.

Variable Rate Demand Bonds

Variable Rate Demand Bonds ("VRDB") are subject to repayment on the demand of the holders and for this reason are accounted for as short-term debt in accordance with GAAP. However, bonds submitted for purchase are remarketed by a remarketing agent on a best efforts basis. DPL expects the bonds submitted for purchase will continue to be remarketed successfully due to the credit worthiness of the company and because the remarketing agent resets the interest rate to the then-current market rate. The company also may utilize one of the fixed rate/fixed term conversion options of the bonds to establish a maturity which corresponds to the date of final maturity of the bonds. On this basis, DPL views VRDBs as a source of long-term financing. The VRDB outstanding in 2005 and 2004 mature in 2017 ($26.0 million), 2024 ($33.3 million), 2028 ($15.5 million), and 2029 ($30.0 million). The weighted average interest rate for VRDB was 2.63% during 2005 and ranged from 1.04% to 2.47% in 2004.

Credit Facility

In May 2005, Pepco Holdings, Pepco, DPL and ACE entered into a five-year credit agreement with an aggregate borrowing limit of $1.2 billion. This agreement replaces a $650 million five-year credit agreement that was entered into in July 2004 and a $550 million three-year credit agreement entered into in July 2003. Pepco Holdings' credit limit under this agreement is $700 million. The credit limit of each of Pepco, DPL and ACE is the lower of $300 million and the maximum amount of debt the company is permitted to have outstanding by its regulatory authorities, except that the aggregate amount of credit used by Pepco, DPL and ACE at any given time under the agreement may not exceed $500 million. Under the terms of the credit agreement, the companies are entitled to request increases in the principal amount of available credit up to an aggregate increase of $300 million, with any such increase proportionately increasing the credit limit of each of the respective borrowers and the $300 million sublimits for each of Pepco, DPL and ACE. The interest rate payable by the respective companies on utilized funds is determined by a pricing schedule with rates corresponding to the credit rating of the borrower. Any indebtedness incurred under the credit agreement would be unsecured.

The credit agreement is intended to serve primarily as a source of liquidity to support the commercial paper programs of the respective companies. The companies also are permitted to use the facility to borrow funds for general corporate purposes and issue letters of credit. In order for a borrower to use the facility, certain representations and warranties made by the borrower at the time the credit agreement was entered into also must be true at the time the facility is utilized, and the borrower must be in compliance with specified covenants, including the financial covenant described below. However, a material adverse change in the borrower's business, property, and results of operations or financial condition subsequent to the entry into the credit agreement is not a condition to the availability of credit under the facility. Among the covenants contained in the credit agreement are (i) the requirement that each borrowing company maintain a ratio of total indebtedness to total capitalization of 65% or less, computed in accordance with the terms of the credit agreement, (ii) a restriction on sales or other dispositions of assets, other than sales and dispositions permitted by the credit agreement, and (iii) a restriction on the incurrence of liens on the assets of a borrower or any of its significant subsidiaries other than liens permitted by the credit agreement. The failure to satisfy any of the covenants or the occurrence of specified events that constitute an event of default could result in the acceleration of the repayment obligations of the borrower. The events of default include (i) the failure of any borrowing company or any of its significant subsidiaries to pay when due, or the acceleration of, certain indebtedness under other borrowing arrangements, (ii) certain bankruptcy events, judgments or decrees against any borrowing company or its significant subsidiaries, and (iii) a change in control (as defined in the credit agreement) of Pepco Holdings or the failure of Pepco Holdings to own all of the voting stock of Pepco, DPL and ACE. The agreement does not include any ratings triggers. There were no balances outstanding at December 31, 2005 and 2004.

(8) INCOME TAXES

DPL, as an indirect subsidiary of PHI, is included in the Federal income tax return of PHI. Federal income taxes are allocated to DPL pursuant to a written tax sharing agreement which was approved by the Securities and Exchange Commission pursuant to regulations under the Public Utility Holding Company Act of 1935 in connection with the establishment of PHI as a holding company as part of Pepco's acquisition of Conectiv on August 1, 2002. Under this tax sharing agreement, PHI's consolidated Federal income tax liability is allocated based upon PHI's and its subsidiaries' separate taxable income or loss, with the exception of the tax benefits applicable to non-acquisition debt expenses of PHI. Such tax benefits are allocated only to subsidiaries with taxable income.

The provision for income taxes, reconciliation of income tax expense, and components of deferred income tax liabilities (assets) are shown below.

Provision for Income Taxes

		For the Year Ended December 31,		
		2005	2004	2003
		(Millions of dollars)		
Federal:	Current	$64.3	$(16.0)	$10.8
	Deferred	(16.3)	54.7	19.3
State:	Current	16.4	(1.4)	(1.2)
	Deferred	(5.9)	11.7	9.0
Investment tax credit amortization		(.9)	(.9)	(.9)
Total Income Tax Expense		$57.6	$48.1	$37.0

Reconciliation of Income Tax Expense

	For the Year Ended December 31,					
	2005		2004		2003	
	Amount	Rate	Amount	Rate	Amount	Rate
			(Millions of dollars)			
Statutory federal income tax expense	$46.3	.35	$38.9	.35	$31.3	.35
State income taxes, net of federal benefit	6.0	.05	6.5	.06	5.0	.06
Plant basis difference	2.0	.01	1.5	.01	-	-
Investment tax credit amortization	(.9)	(.01)	(.9)	(.01)	(.9)	(.01)
Change in estimates related to prior year tax liabilities	4.3	.03	5.0	.04	1.0	.01
Other, net	(.1)	-	(2.9)	(.02)	.6	-
Total Income Tax Expense	$57.6	.43	$48.1	.43	$37.0	.41

Components of Deferred Income Tax Liabilities (Assets)

The tax effects of temporary differences that give rise to DPL's net deferred tax liability are shown below. There were no valuation allowances for deferred tax assets as of December 31, 2005 and December 31, 2004.

	As of December 31,	
	2005	2004
	(Millions of dollars)	
Deferred Tax Liabilities		
Depreciation and other book to tax basis differences	$298.8	$326.8
Deferred recoverable income taxes	39.7	39.0
Prepaid pension expense	83.8	80.7
Other	28.3	26.7
Total deferred tax liabilities	450.6	473.2
Deferred Tax Assets		
Deferred investment tax credits	(4.1)	(4.6)
Above-market purchased energy contracts and other Electric restructuring liabilities	(12.7)	(17.1)
Other	(26.5)	(18.0)
Total deferred tax assets	(43.3)	(39.7)
Total net deferred tax liability	407.3	433.5
Deferred tax asset (liability) included in Other Current Assets (Liabilities)	6.4	(2.6)
Total net deferred tax liability, non-current	$413.7	$430.9

Taxes Other Than Income Taxes

Taxes other than income taxes for each year are shown below.

	2005	2004	2003
	(Millions of dollars)		
Gross Receipts/Delivery	$18.9	$15.5	$16.3
Property	15.1	16.0	16.8
Environmental, Use and Other	.4	3.8	1.7
Total	$34.4	$35.3	$34.8

(9) PREFERRED STOCK

The preferred stock amounts outstanding as of December 31, 2005 and 2004 are as follows:

Series	Redemption Price	Shares Outstanding 2005	Shares Outstanding 2004	December 31, 2005 (Millions of dollars)	December 31, 2004 (Millions of dollars)
Redeemable Serial Preferred					
$100 per share par value:					
3.70%-5.00%	$103-$105	181,698	181,698	$18.2	$18.2
6.75% (1)	$100	-	35,000	-	3.5
				$18.2	$21.7

(1) In December 2005, DPL redeemed all outstanding shares of its 6.75% Serial Preferred Stock, at par, for an aggregate redemption amount of $3.5 million.

(10) FAIR VALUES OF FINANCIAL INSTRUMENTS

The estimated fair values of DPL's financial instruments at December 31, 2005 and 2004 are shown below.

	2005 Carrying Amount	2005 Fair Value	2004 Carrying Amount	2004 Fair Value
	(Millions of dollars)			
Assets				
Derivative instruments	$ 21.6	$ 21.6	$ 4.1	$ 4.1
Liabilities and Capitalization				
Long-term debt	$516.4	$524.1	$539.6	$568.6
Redeemable serial preferred stock	$ 18.2	$ 12.8	$ 21.7	$ 14.4
Derivative instruments	$ 21.6	$ 21.6	$ 2.6	$ 2.6

The methods and assumptions below were used to estimate, at December 31, 2005 and 2004, the fair value of each class of financial instruments shown above for which it is practicable to estimate a value.

The fair values of derivative instruments were derived based on quoted market prices.

The fair values of the Long-term debt, which includes First Mortgage Bonds, Amortizing First Mortgage Bonds, Unsecured Tax-Exempt Bonds, Medium-Term Notes, and Unsecured Notes, excluding amounts due within one year, were derived based on current market prices, or for issues with no market price available, were based on discounted cash flows using current rates for similar issues with similar terms and remaining maturities.

The fair value of the Redeemable serial preferred stock, excluding amounts due within one year, were derived based on quoted market prices or discounted cash flows using current rates of preferred stock with similar terms.

The carrying amounts of all other financial instruments in DPL's accompanying financial statements approximate fair value.

(11) COMMITMENTS AND CONTINGENCIES

REGULATORY AND OTHER MATTERS

Rate Proceedings

Delaware

On October 3, 2005, DPL submitted its 2005 gas cost rate (GCR) filing to the DPSC, which permits DPL to recover gas procurement costs through customer rates. In its filing, DPL seeks to increase its GCR by approximately 38% in anticipation of increasing natural gas commodity costs. The proposed rate became effective November 1, 2005, subject to refund pending final DPSC approval after evidentiary hearings. A public input hearing was held on January 19, 2006. DPSC staff and the Division of the Public Advocate filed testimony on February 20, 2006.

As authorized by the April 16, 2002 settlement agreement in Delaware relating to the acquisition of Conectiv by Pepco (the Delaware Merger Settlement Agreement), on May 4, 2005, DPL filed with the DPSC a proposed increase of approximately $6.2 million in electric transmission service revenues, or about 1.1% of total Delaware retail electric revenues. This revenue increase covers the Delaware retail portion of the increase in the "Delmarva zonal" transmission rates on file with FERC under the PJM Interconnection, LLC (PJM) Open Access Transmission Tariff (OATT) and other transition of PJM charges. This level of revenue increase will decrease to the extent that competitive suppliers provide the supply portion and its associated transmission service to retail customers. In that circumstance, PJM would charge the competitive retail supplier the PJM OATT rate for transmission service into the Delmarva zone and DPL's charges to the retail customer would exclude as a "shopping credit" an amount equal to the SOS supply charge and the transmission and ancillary charges that would otherwise be charged by DPL to the retail customer. DPL began collecting this rate change for service rendered on and after June 3, 2005, subject to refund pending final approval by the DPSC.

On September 1, 2005, DPL filed with the DPSC its first comprehensive base rate case in ten years. This application was filed as a result of increasing costs and is consistent with a provision in the Delaware Merger Settlement Agreement requiring DPL to file a base rate case by September 1, 2005 and permitting DPL to apply for an increase in rates to be effective no earlier than May 1, 2006. In the application, DPL sought approval of an annual increase of approximately $5.1 million in its electric rates, with an increase of approximately $1.6 million to its electric distribution base rates after proposing to assign approximately $3.5 million in costs to the supply component of rates to be collected as part of the SOS. Of the approximately $1.6 million in net increases to its electric distribution base rates, DPL proposed that approximately $1.2 million be recovered through changes in delivery charges and that the remaining approximately $0.4 million be recovered through changes in premise collection and reconnect fees. The full proposed revenue increase is approximately 0.9% of total annual electric utility revenues, while the proposed net increase to distribution rates is 0.2% of total annual electric utility revenues. DPL's distribution revenue requirement is based on a proposed return on common equity of 11%. DPL also has proposed revised depreciation rates and a number of tariff modifications.

On September 20, 2005, the DPSC issued an order approving DPL's request that the rate increase go into effect on May 1, 2006; subject to refund and pending evidentiary hearings. The order also suspends effectiveness of various proposed tariff rule changes until the case is concluded. The discovery process commenced on October 21, 2005. In its direct testimony, DPSC staff has proposed a variety of adjustments to rate base, operating expenses including depreciation and rate of return with an overall recommendation of a distribution base rate revenue decrease of $14.3 million. The DPSC staff's testimony also addresses issues such as rate design, allocation of any rate decrease and positions regarding the DPL's proposals on certain non-rate tariff modifications. The Delaware Division of Public Advocate has proposed many of the same adjustments and others with an overall recommendation of a distribution base rate revenue decrease of $18.9 million. DPL filed rebuttal testimony on January 17, 2006, which supports a distribution base rate revenue increase of $2 million. On January 30, 2006, the DPSC staff requested the Hearing Examiner approve a modification of the procedural schedule in the case to allow for inclusion of testimony regarding recalculation of DPSC staff's proposed depreciation rates to allow for a separate amortization of the cost of removal reserve. DPL objected to this modification of the procedural schedule. The Hearing Examiner issued a letter ruling on February 1, 2006, which denied DPSC staff's request for a modified procedural schedule. On February 2, 2006, DPSC staff filed an emergency motion requesting the DPSC to permit consideration of the issue by the Hearing Examiner in this docket. On February 6, 2006, the DPSC ruled to allow the issue in the case. A revised procedural schedule was established by the Hearing Examiner on February 10, 2006. On February 15, 2006, DPL filed an interlocutory appeal of the Hearing Examiner's ruling on the procedural schedule with the DPSC. On February 28, 2006, the DPSC upheld the Hearing Examiner's ruling and procedural schedule set on February 10, 2006. DPSC staff filed testimony related to this issue on February 17, 2006. DPSC staff's revised depreciation proposal reduces their recommended proposed rate decrease to $18.9 million, plus the amortization of the cost of removal of $58.4 million, which DPSC staff has recommended be returned to customers through either a 5-, 7- or 10-year amortization. DPL continues to oppose the inclusion of this issue in the case for substantive and procedural grounds. Evidentiary hearings were held in early February. Hearings on the separate issue related to the depreciation of the cost of removal are scheduled to be held March 20, 2006. Briefs are due on March 31, 2006 and DPSC deliberation is scheduled to occur on April 25, 2006. DPL cannot predict the outcome of this proceeding.

Federal Energy Regulatory Commission

On January 31, 2005, DPL filed at FERC to reset its rates for network transmission service using a formula methodology. DPL also sought a 12.4% return on common equity and a 50-basis-point return on equity adder that FERC had made available to transmission utilities who had joined Regional Transmission Organizations and thus turned over control of their assets to an independent entity. FERC issued an order on May 31, 2005, approving the rates to go into effect June 1, 2005, subject to refund, hearings, and further orders. The new rates reflect an increase of 6.5% in DPL's transmission rates. DPL continues in settlement discussions under the supervision of a FERC administrative law judge and cannot predict the ultimate outcome of this proceeding.

Default Electricity Supply Proceedings

Delaware

Under a settlement approved by the DPSC, DPL is required to provide POLR to customers in Delaware through April 2006. DPL is paid for POLR to customers in Delaware at fixed rates established in the settlement. DPL obtains all of the energy needed to fulfill its POLR obligations in Delaware under a supply agreement with its affiliate Conectiv Energy, which terminates in May 2006. DPL does not make any profit or incur any loss on the supply component of the POLR supply that it delivers to its Delaware customers. DPL is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both POLR customers and customers who have selected another energy supplier. These delivery rates generally are frozen through April 2006, except that DPL is allowed to file for a one-time transmission rate change during this period. On March 22, 2005, the DPSC issued an order approving DPL as the SOS provider after May 1, 2006, when DPL's current fixed rate POLR obligation ends. DPL will retain the SOS obligation for an indefinite period until changed by the DPSC, and will purchase the power supply required to satisfy its SOS obligations from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure.

On October 11, 2005, the DPSC approved a settlement agreement, under which DPL will provide SOS to all customer classes, with no specified termination date for SOS. Two categories of SOS will exist: (i) a fixed price SOS available to all but the largest customers; and (ii) an Hourly Priced Service (HPS) for the largest customers. DPL will purchase the power supply required to satisfy its fixed-price SOS obligation from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure. Power to supply the HPS customers will be acquired on next-day and other short-term PJM markets. In addition to the costs of capacity, energy, transmission, and ancillary services associated with the fixed-price SOS and HPS, DPL's initial rates will include a component referred to as the Reasonable Allowance for Retail Margin (RARM). Components of the RARM include a fixed annual margin of $2.75 million, plus estimated incremental expenses, a cash working capital allowance, and recovery with a return over five years of the capitalized costs of a billing system to be used for billing HPS customers.

Bids for fixed-priced SOS supply for the May 1, 2006 through May 31, 2007 period were accepted and approved by the DPSC in December 2005 and January 2006. The new SOS rates are scheduled to be effective May 1, 2006.

On February 7, 2006, the Governor of Delaware issued an Executive Order directing the DPSC and other state agencies to examine ways to mitigate the electric rate increases that are expected in May 2006 as a result of rising energy prices. The Executive Order directed the DPSC to examine the feasibility of: (1) deferring or phasing-in the increases; (2) requiring DPL to build generation or enter into long-term supply contracts to meet all, or a portion of, the SOS supply requirements under a traditional regulatory paradigm; (3) directing DPL to conduct integrated resource planning to ensure fuel diversity and least-cost supply alternatives; and (4) requiring DPL to implement demand-side management, conservation and energy efficient programs.

In response to the Executive Order and to help facilitate discussion on several key issues facing the State of Delaware, particularly the issue of rising energy prices, DPL presented a proposed plan to the DPSC on February 28, 2006. A key feature of DPL's proposed plan is a phase-in of rate increases to assist DPL's residential and small commercial customers with the impact of rising energy prices. The proposed phase-in of the rate increase would be in three steps, with one third of the increase to be phased in on May 1, 2006, another one-third on January 1, 2007 and the remainder on June 1, 2007. The phase-in would create a deferral balance of approximately $60 million dollars that would accrue interest and would be recovered through a surcharge imposed for a 24-month period beginning June 1, 2007. DPL believes that this proposal offers a fair and reasonable solution to the concerns identified in the Executive Order.

The Delaware Governor's Cabinet Committee on Energy filed its report with the Governor on March 8, 2006. The report outlines a proposal that recommends: (1) a phase-in of the SOS increase; (2) long-term steps to ensure more stabilized prices and supply; (3) aggregation of the state of Delaware's power needs; and (4) reduction of Delaware's dependence on traditional energy sources through conservation, energy efficiency, and innovation.

DPL intends to file with the DPSC, on or about March 15, 2006, an implementation plan with proposed tariffs based on its proposed phase-in plan as described above. DPL also anticipates that others may advance other legislative or regulatory proposals to address the concerns expressed in the Executive Order. Accordingly, the nature and impact of any changes precipitated by the Executive Order are uncertain and DPL cannot predict at this time whether this phase-in proposal will be implemented.

Maryland

Because of rising energy prices and the resultant expected increases in DPL's rates, on March 3, 2006 the MPSC issued an order initiating an investigation to consider a residential rate stabilization plan for DPL. This investigation is driven by the unprecedented national and international events. The MPSC directed the MPSC staff and DPL to file comments addressing whether or not the rate stabilization plan that the MPSC adopted for Baltimore Gas & Electric Company in a March 6, 2006 order also should be used for DPL. Comments are to be filed by March 16, 2006.

On March 7, 2006, DPL announced the results of competitive bids to supply electricity to its Maryland SOS customers for one year beginning June 1, 2006. The proposed new rates must be approved formally by the MPSC. Due to significant increases in the cost of fuels used to generate electricity, the average monthly electric bill for and DPL's Maryland residential customers will increase by about 35%.

Virginia

Under amendments to the Virginia Electric Utility Restructuring Act implemented in March 2004, DPL is obligated to offer Default Service to customers in Virginia for an indefinite period until relieved of that obligation by the VSCC. DPL currently obtains all of the energy and capacity needed to fulfill its Default Service obligations in Virginia under a supply agreement with Conectiv Energy that commenced on January 1, 2005 and expires in May 2006 (the 2005 Supply Agreement). A prior agreement, also with Conectiv Energy, terminated effective December 31, 2004. DPL entered into the 2005 Supply Agreement after conducting a competitive bid procedure in which Conectiv Energy was the lowest bidder.

In October 2004, DPL filed an application with the VSCC for approval to increase the rates that DPL charges its Default Service customers to allow it to recover its costs for power under the 2005 Supply Agreement plus an administrative charge and a margin. A VSCC order issued in November 2004 allowed DPL to put interim rates into effect on January 1, 2005, subject to refund if the VSCC subsequently determined the rate is excessive. The interim rates reflected an increase of 1.0247 cents per Kwh to the fuel rate, which provide for recovery of the entire amount being paid by DPL to Conectiv Energy, but did not include an administrative charge or margin, pending further consideration of this issue. In January 2005, the VSCC ruled that the administrative charge and margin are base rate items not recoverable through a fuel clause. In March 2005, the VSCC approved a settlement resolving all other issues and making the interim rates final.

On March 10, 2006, DPL filed a rate increase with the VSCC to reflect proposed rates for its Virginia Default Service customers to take effect on June 1, 2006. The new rates will raise the average monthly bill for residential customers by approximately 43%. The proposed rates must be approved by the VSCC.

IRS Mixed Service Cost Issue

During 2001, DPL changed its methods of accounting with respect to capitalizable construction costs for income tax purposes, which allow DPL to accelerate the deduction of certain expenses that were previously capitalized and depreciated. Through December 31, 2005, these accelerated deductions have generated incremental tax cash flow benefits of approximately $62 million for DPL, primarily attributable to its 2001 tax returns. On August 2, 2005, the IRS issued Revenue Ruling 2005-53 (the Revenue Ruling) that will limit the ability of DPL to utilize this method of accounting for income tax purposes on its tax returns for 2004 and prior years. DPL intends to contest any IRS adjustment to its prior year income tax returns based on the Revenue Ruling. However, if the IRS is successful in applying this Revenue Ruling DPL would be required to capitalize and depreciate a portion of the construction costs previously deducted and repay the associated income tax benefits, along with interest thereon. During 2005, DPL recorded a $2.9 million increase in income tax expense to account for the accrued interest that would be paid on the portion of tax benefits that DPL estimates would be deferred to future years if the construction costs previously deducted are required to be capitalized and depreciated.

On the same day as the Revenue Ruling was issued, the Treasury Department released regulations that, if adopted in their current form, would require DPL to change its method of accounting with respect to capitalizable construction costs for income tax purposes for all future tax periods beginning in 2005. Under these regulations, DPL will have to capitalize and depreciate a portion of the construction costs that it has previously deducted and include the impact of this adjustment in taxable income over a two-year period beginning with tax year 2005. DPL is continuing to work with the industry to determine an alternative method of accounting for capitalizable construction costs acceptable to the IRS to replace the method disallowed by the proposed regulations.

In February 2006, PHI paid approximately $121 million, a portion of which is attributable to DPL, of taxes to cover the amount of taxes management estimates will be payable once a new final method of tax accounting is adopted on its 2005 tax return, due to the proposed regulations. Although the increase in taxable income will be spread over the 2005 and 2006 tax return periods, the cash payments would have all occurred in 2006 with the filing of the 2005 tax return and the ongoing 2006 estimated tax payments. This $121 million tax payment was accelerated to eliminate the need to accrue additional federal interest expense for the potential IRS adjustment related to the previous tax accounting method PHI used during the 2001-2004 tax years.

Contractual Obligations

As of December 31, 2005, DPL's contractual obligations under non-derivative fuel and power purchase contracts were $501 million in 2006, $377.8 million in 2007 to 2008, $38.4 million in 2009 to 2010, and $19.1 million in 2011 and thereafter.

(12) RELATED PARTY TRANSACTIONS

PHI Service Company provides various administrative and professional services to PHI and its regulated and unregulated subsidiaries including DPL. The cost of these services is allocated in accordance with cost allocation methodologies set forth in the service agreement using a variety of factors, including the subsidiaries' share of employees, operating expenses, assets, and other cost causal methods. These intercompany transactions are eliminated in consolidation and no profit results from these transactions. PHI Service Company costs directly charged or allocated to DPL for the years ended December 31, 2005, 2004 and 2003 were $98.4 million, $99.5 million and $100.3 million, respectively.

In addition to the PHI Service Company charges described above, DPL's financial statements include the following related party transactions in its Statements of Earnings:

	For the Year Ended December 31,		
	2005	2004	2003
(Expense) Income		(Millions of dollars)	
Full Requirements Contract with Conectiv Energy Supply for power, capacity and ancillary services to service Provider of Last Resort Load (a)	$(426.1)	$(510.5)	$(607.7)
Standard Offer Service agreement with Conectiv Energy Supply (a)	(53.4)	(11.3)	-
Standard Offer Service agreement with Conectiv Energy (a)	-	-	$44.3
Inter-company lease transactions related to facilities (b)	3.5	3.9	6.0
Inter-company lease transactions related to computer services (b)	2.2	2.2	2.4
Sublease of Merrill Creek Water Rights to Conectiv Delmarva Generation (b)	2.6	2.5	2.8
Inter-company labor charges for facility work (b)	.5	.4	.1
Inter-company use revenue (b)	.7	.9	1.1
Inter-company use expense (b)	(.6)	(.8)	(1.0)
Transcompany pipeline gas sales with Conectiv Energy Supply (e)	7.5	-	-
Transcompany pipeline gas purchase with Conectiv Energy Supply (d)	(5.4)	(1.2)	(.4)
Money pool interest income (c)	.1	-	.8
Money pool interest expense (c)	$ (.6)	$ (1.1)	$ -

(a) Included in fuel and purchased energy.
(b) Included in electric revenue.
(c) Included in interest expense.
(d) Included in gas purchased.
(e) Included in gas revenue.

As of December 31, 2005 and 2004, DPL had the following balances on its balance sheets due (to)/from related parties:

Asset (Liability)	2005	2004
	(Millions of dollars)	
Receivable from Related Party		
King Street Assurance	$ -	$ 6.7
Payable to Related Party (current)		
PHI Service Company	(12.2)	(14.4)
Conectiv Energy Supply	(45.3)	(38.5)
Delmarva Operating Service Company	-	(2.4)
Other Related Party Activity	.2	.5
Total Net Payable to Related Parties	$(57.3)	$(48.1)
Money Pool Balance with Pepco Holdings (included in short-term debt)	$(60.7)	$(29.5)
Money Pool Interest Accrued (included in interest accrued)	$ (.2)	$ -

(13) RESTATEMENT

Our parent company, Pepco Holdings, restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements. The restatement includes the correction of other errors for the same periods, primarily relating to unbilled revenue, taxes, and various accrual accounts, which were considered by management to be immaterial. These other errors would not themselves have required a restatement absent the restatement to correct the accounting for deferred compensation arrangements. The restatement of Pepco Holdings consolidated financial statements was required solely because the cumulative impact of the correction, if recorded in the fourth quarter of 2005, would have been material to that period's reported net income. The restatement to correct the accounting for the deferred compensation arrangements had no impact on DPL; however, DPL restated its previously reported financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, and the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to reflect the correction of other errors. The correction of these other errors, primarily relating to unbilled revenue, taxes, and various accrual accounts, was considered by management to be immaterial. See Note 13 "Restatement" for further discussion.

	December 31, 2004		December 31, 2003	
	Previously Reported	Restated	Previously Reported	Restated
Consolidated Statements of Earnings				
Total Operating Revenue	$1,245.3	$1,246.0	$1,253.7	$1,252.6
Total Operating Expenses	1,099.9	1,105.5	1,128.3	1,127.4
Total Operating Income	145.4	140.5	125.4	125.2
Other Income (Expenses)	(29.4)	(29.4)	(33.0)	(33.0)
Income Before Income Tax Expense	116.0	111.1	89.6	89.4
Net Income	$ 66.3	$ 63.0	$ 53.2	$ 52.4
Consolidated Balance Sheets				
Total Current Assets	$ 228.2	$ 233.8	$ 216.7	$ 220.0
Total Investments and Other Assets	423.3	423.3	412.4	412.4
Total Property, Plant and Equipment	1,548.4	1,548.1	1,508.0	1,508.0
Total Assets	2,199.9	2,205.2	2,137.1	2,140.4
Total Current Liabilities	312.0	320.4	330.4	329.0
Total Deferred Credits	726.3	725.5	688.8	692.5
Total Long-Term Liabilities	539.8	539.8	515.3	515.3
Total Shareholder's Equity	600.1	597.8	580.9	581.9
Total Liabilities and Shareholder's Equity	$2,199.9	$2,205.2	$2,137.1	$2,140.4
Consolidated Statements of Cash Flows				
Net Cash Provided by Operating Activities	$ 200.3	$ 199.9	$ 104.3	$ 104.1
Net Cash Used in Investing Activities	$(121.1)	$(121.1)	$ (98.5)	$ (98.5)
Net Cash Used in Financing Activities	$ (80.4)	$ (80.0)	$(110.6)	$(110.4)
Consolidated Statements of Shareholder's Equity				
Retained Earnings at December 31,	$ 364.7	$ 362.4	$367.4	$ 368.4

(14) QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The unaudited quarterly financial information for the three months ended March 31, 2005, June 30, 2005 and September 30, 2005 and all interim periods during the year ended December 31, 2004 have been restated to reflect the correction of certain immaterial errors. See Note 13 for further discussion. The quarterly data presented below reflect all adjustments necessary in the opinion of management for a fair presentation of the interim results. Quarterly data normally vary seasonally because of temperature variations and differences between summer and winter rates.

	2005							
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated		Total
	(Millions of dollars)							
Total Operating Revenue	$370.3	$370.7	$288.9	$288.9	$373.7	$373.7	$310.5	$1,343.8
Total Operating Expenses	318.1	318.4	259.7	259.7	323.0	323.0	280.3	1,181.4
Operating Income	52.2	52.3	29.2	29.2	50.7	50.7	30.2	162.4
Other Expenses	(7.9)	(7.9)	(7.8)	(7.8)	(7.3)	(7.3)	(7.1)	(30.1)
Income Before Income Taxes	44.3	44.4	21.4	21.4	43.4	43.4	23.1	132.3
Income Tax Expense	20.5	18.3	8.9	8.9	19.6 (a)	19.6 (a)	10.8 (b)	57.6
Net Income	23.8	26.1	12.5	12.5	23.8	23.8	12.3	74.7
Dividends on Preferred Stock	.3	.3	.2	.2	.3	.3	.2	1.0
Earnings Available for Common Stock	$ 23.5	$ 25.8	$ 12.3	$ 12.3	$ 23.5	$23.5	$ 12.1	$ 73.7

	2004								
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Total
	(Millions of dollars)								
Total Operating Revenue	$350.7	$350.2	$297.6	$297.2	$319.8	$321.8	$277.2	$276.8	$1,246.0
Total Operating Expenses	304.7	306.0	256.3	262.9	288.1	288.2	250.8	248.4	1,105.5
Operating Income	46.0	44.2	41.3	34.3	31.7	33.6	26.4	28.4	140.5
Other Expenses	(7.9)	(7.9)	(7.4)	(7.4)	(6.6)	(6.6)	(7.5)	(7.5)	(29.4)
Income Before Income Tax Expense	38.1	36.3	33.9	26.9	25.1	27.0	18.9	20.9	111.1
Income Tax Expense	15.7	15.0	14.0	11.2	11.0	11.7	9.0	10.2	48.1
Net Income	22.4	21.3	19.9	15.7	14.1	15.3	9.9	10.7	63.0
Dividends on Preferred Stock	.2	.2	.3	.3	.2	.2	.3	.3	1.0
Earnings Available for Common Stock	$ 22.2	$ 21.1	$ 19.6	$ 15.4	$ 13.9	$ 15.1	$ 9.6	$ 10.4	$ 62.0

Note: Sales of electric energy are seasonal and, accordingly, comparisons by quarter within a year are not meaningful.

(a) Includes $2.0 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(b) Includes $1.0 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors
of Atlantic City Electric Company:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Atlantic City Electric Company (a wholly owned subsidiary of Pepco Holdings, Inc.) and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note 14 to the consolidated financial statements, the Company restated its financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003.

PricewaterhouseCoopers LLP
Washington, D.C.
March 13, 2006

ATLANTIC CITY ELECTRIC COMPANY
CONSOLIDATED STATEMENTS OF EARNINGS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
Operating Revenue	$1,520.4	$1,333.2	$1,236.0
Operating Expenses			
Fuel and purchased energy	912.0	806.7	778.7
Other operation and maintenance	193.2	193.2	208.1
Depreciation and amortization	123.9	132.8	112.5
Other taxes	22.9	20.7	23.2
Deferred electric service costs	120.2	36.3	(7.0)
Gain on sales of assets	-	(14.7)	-
Total Operating Expenses	1,372.2	1,175.0	1,115.5
Operating Income	148.2	158.2	120.5
Other Income (Expenses)			
Interest and dividend income	1.9	.7	5.6
Interest expense	(58.9)	(60.7)	(62.8)
Other income	6.3	6.1	7.3
Total Other Expenses	(50.7)	(53.9)	(49.9)
Distributions on Preferred Securities of Subsidiary Trust	-	-	1.8
Income Before Income Tax Expense and Extraordinary Item	97.5	104.3	68.8
Income Tax Expense	43.3	42.6	27.3
Income Before Extraordinary Item	54.2	61.7	41.5
Extraordinary Item (net of income taxes of $6.2 million and $4.1 million for the years ended December 31, 2005 and 2003, respectively)	9.0	-	5.9
Net Income	63.2	61.7	47.4
Dividends on Redeemable Serial Preferred Stock	.3	.3	.3
Earnings Available for Common Stock	$ 62.9	$ 61.4	$ 47.1

The accompanying Notes are an integral part of these Consolidated Financial Statements.

ATLANTIC CITY ELECTRIC COMPANY
CONSOLIDATED BALANCE SHEETS

ASSETS	December 31, 2005	(Restated) December 31, 2004
(Millions of dollars)		
CURRENT ASSETS		
Cash and cash equivalents	$ 8.2	$ 4.3
Restricted cash	11.5	13.7
Accounts receivable, less allowance for uncollectible accounts of $5.2 million and $4.5 million, respectively	206.0	176.4
Fuel, materials and supplies - at average cost	39.6	38.1
Prepaid expenses and other	12.3	4.9
Total Current Assets	277.6	237.4
INVESTMENTS AND OTHER ASSETS		
Regulatory assets	910.4	1,067.8
Restricted funds held by trustee	11.1	9.1
Prepaid pension expense	8.0	-
Other	22.6	24.1
Total Investments and Other Assets	952.1	1,101.0
PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment	1,915.6	1,818.7
Accumulated depreciation	(585.3)	(680.0)
Net Property, Plant and Equipment	1,330.3	1,138.7
TOTAL ASSETS	$2,560.0	$2,477.1

The accompanying Notes are an integral part of these Consolidated Financial Statements.

ATLANTIC CITY ELECTRIC COMPANY
CONSOLIDATED BALANCE SHEETS

LIABILITIES AND SHAREHOLDER'S EQUITY	December 31, 2005	(Restated) December 31, 2004
(In millions, except share data)		
CURRENT LIABILITIES		
Short-term debt	$ 22.6	$ 55.3
Current maturities of long-term debt	94.0	68.1
Accounts payable and accrued liabilities	182.2	84.9
Accounts payable to associated companies	38.3	14.0
Taxes accrued	75.8	19.4
Interest accrued	12.9	14.3
Other	37.3	35.6
Total Current Liabilities	463.1	291.6
DEFERRED CREDITS		
Regulatory liabilities	206.3	44.6
Income taxes	432.5	496.0
Investment tax credits	16.5	19.7
Pension benefit obligation	-	44.0
Other postretirement benefit obligation	46.4	44.7
Other	20.2	34.6
Total Deferred Credits	721.9	683.6
LONG-TERM LIABILITIES		
Long-term debt	376.7	441.6
Transition Bonds issued by ACE Funding	494.3	523.3
Capital lease obligations	.2	.2
Total Long-Term Liabilities	871.2	965.1
COMMITMENTS AND CONTINGENCIES (NOTE 11)		
REDEEMABLE SERIAL PREFERRED STOCK	6.2	6.2
SHAREHOLDER'S EQUITY		
Common stock, $3.00 par value, authorized 25,000,000 shares, 8,546,017 shares outstanding	25.6	25.6
Premium on stock and other capital contributions	293.4	293.4
Retained earnings	178.6	211.6
Total Shareholder's Equity	497.6	530.6
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	$2,560.0	$2,477.1

The accompanying Notes are an integral part of these Consolidated Financial Statements.

ATLANTIC CITY ELECTRIC COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
OPERATING ACTIVITIES			
Net income	$ 63.2	$ 61.7	$ 47.4
Adjustments to reconcile net income to net cash provided by operating activities:			
Extraordinary item	(15.2)	-	(10.0)
Gain on sale of assets	-	(14.7)	-
Depreciation and amortization	123.9	132.8	112.5
Investment tax credit adjustments	(3.2)	(4.7)	(2.0)
Deferred income taxes	(77.4)	(18.4)	.5
Energy supply contracts	(.3)	(.3)	(15.4)
Other deferred charges	-	(8.1)	1.4
Other deferred credits	1.0	(4.7)	(2.9)
Other postretirement benefit obligations	1.7	1.1	4.7
Prepaid pension expense	(52.0)	6.9	(9.5)
Changes in:			
Accounts receivable	(29.6)	(.5)	(9.8)
Regulatory assets and liabilities	122.5	33.6	(11.2)
Material and supplies	(1.5)	(3.8)	4.1
Prepaid expenses	1.6	(.2)	(6.8)
Accounts payable and accrued liabilities	129.4	(12.2)	(2.4)
Interest and taxes accrued	55.0	1.4	44.9
Net Cash Provided By Operating Activities	319.1	169.9	145.5
INVESTING ACTIVITIES			
Investment in property, plant and equipment	(117.2)	(160.2)	(87.7)
Proceeds from/changes in:			
Sale of other assets	-	11.0	-
Change in restricted cash	2.2	1.5	14.6
Other investing activities	(.5)	-	(.3)
Net Cash Used In Investing Activities	(115.5)	(147.7)	(73.4)
FINANCING ACTIVITIES			
Common stock repurchased	-	(67.6)	(84.4)
Common dividends paid	(95.9)	(10.6)	(41.4)
Preferred dividends paid	(.3)	(.3)	(.3)
Redemption of trust preferred stock	-	-	(70.0)
Redemption of debentures issued to financing trust	-	(25.0)	-
Long-term debt issued	-	174.7	152.0
Long-term debt redeemed	(68.1)	(229.1)	(142.5)
Principal portion of capital lease payments	-	.2	-
Net change in short-term debt	(32.7)	32.7	-
Costs of issuances and refinancings and other	(2.7)	.2	(4.0)
Net Cash Used In Financing Activities	(199.7)	(124.8)	(190.6)
Net Increase (Decrease) In Cash and Cash Equivalents	3.9	(102.6)	(118.5)
Cash and Cash Equivalents at Beginning of Year	4.3	106.9	225.4
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 8.2	$ 4.3	$ 106.9
NON-CASH ACTIVITIES			
Excess accumulated depreciation transferred to regulatory liabilities	$131.0	-	-
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Cash paid for interest (net of capitalized interest of $.8 million, $1.2 million, and $.9 million, respectively) and paid (received) for income taxes:			
Interest	$ 57.5	$ 60.7	$ 64.0
Income taxes	$ 17.4	$ 12.0	$ (4.1)

The accompanying Notes are an integral part of these Consolidated Financial Statements.

ATLANTIC CITY ELECTRIC COMPANY
CONSOLIDATED STATEMENTS OF SHAREHOLDER'S EQUITY

(In millions, except share data)	Common Stock Shares	Common Stock Par Value	Premium on Stock	Capital Stock Expense	Retained Earnings
BALANCE, DECEMBER 31, 2002 (AS REPORTED)	18,320,937	$55.0	$411.5	$(1.2)	$153.9
RESTATEMENT	-	-	-	-	$1.2
BALANCE, DECEMBER 31, 2002 (RESTATED)	18,320,937	$55.0	$411.5	$(1.2)	$155.1
Net Income (RESTATED)	-	-	-	-	47.4
Dividends:					
Preferred stock	-	-	-	-	(.3)
Common stock	-	-	-	-	(41.4)
Common stock repurchased	(5,434,084)	(16.3)	(68.5)	.4	-
BALANCE, DECEMBER 31, 2003 (RESTATED)	12,886,853	$38.7	$343.0	$ (.8)	$160.8
Net Income (RESTATED)	-	-	-	-	61.7
Dividends:					
Preferred stock	-	-	-	-	(.3)
Common stock	-	-	-	-	(10.6)
Common stock repurchased	(4,340,836)	(13.1)	(54.7)	.2	-
Capital contribution	-	-	5.7	-	-
BALANCE, DECEMBER 31, 2004 (RESTATED)	8,546,017	$25.6	$294.0	$ (.6)	$211.6
Net Income	-	-	-	-	63.2
Dividends:					
Preferred stock	-	-	-	-	(.3)
Common stock	-	-	-	-	(95.9)
BALANCE, DECEMBER 31, 2005	8,546,017	$25.6	$294.0	$ (.6)	$178.6

The accompanying Notes are an integral part of these Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

ATLANTIC CITY ELECTRIC COMPANY

(1) ORGANIZATION

Atlantic City Electric Company (ACE) is engaged in the generation, transmission and distribution of electricity in southern New Jersey. ACE provides Default Electricity Supply, which is the supply of electricity at regulated rates to retail customers in its service territory who do not elect to purchase electricity from a competitive supplier. Default Electricity Supply is also known as Basic Generation Service (BGS). ACE's service territory covers approximately 2,700 square miles and has a population of approximately 998,000. ACE is a wholly owned subsidiary of Conectiv, which is wholly owned by Pepco Holdings, Inc. (Pepco Holdings or PHI). Because PHI is a public utility holding company subject to the Public Utility Holding Company Act of 2005 (PUHCA 2005), the relationship between PHI and ACE and certain activities of ACE are subject to the regulatory oversight of the Federal Energy Regulatory Commission (FERC) under PUHCA 2005.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation Policy

The accompanying consolidated financial statements include the accounts of ACE and its wholly owned subsidiaries. All intercompany balances and transactions between subsidiaries have been eliminated. ACE uses the equity method to report investments, corporate joint ventures, partnerships, and affiliated companies where it holds a 20% to 50% voting interest and cannot exercise control over the operations and policies of the investee. Under the equity method, ACE records its interest in the entity as an investment in the accompanying Consolidated Balance Sheets, and its percentage share of the entity's earnings are recorded in the accompanying Consolidated Statements of Earnings. Additionally, the proportionate interests in jointly owned electric plants are consolidated.

In accordance with the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46), issued in January 2003, with a revised interpretation issued in December 2003, FASB Interpretation No. 46-R, "Consolidation of Variable Interest Entities" (FIN 46R), ACE deconsolidated its trust preferred securities that had previously been consolidated. FIN 46 and FIN 46R address conditions when an entity should be consolidated based upon variable interests rather than voting interests. For additional information regarding the impact of implementing FIN 46 and FIN 46R, see the "New Accounting Standards" section later in this Note.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, such as compliance with Statement of Position 94-6, "Disclosure of Certain Significant Risks and Uncertainties," requires management to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. Examples of significant estimates used by ACE include the assessment of contingencies, the calculation of future cash flows and fair value amounts for use in asset impairment evaluations, pension and other postretirement benefits assumptions, unbilled revenue calculations, and judgment involved with assessing the probability of recovery of regulatory assets. Additionally, ACE is subject to legal, regulatory, and other proceedings and claims that arise in the ordinary course of its business. ACE records an estimated liability for these proceedings and claims based upon the probable and reasonably estimable criteria contained in SFAS No. 5, "Accounting for Contingencies." Although ACE believes that its estimates and assumptions are reasonable, they are based upon information available to management at the time the estimates are made. Actual results may differ significantly from these estimates.

Change in Accounting Estimates

During 2005, ACE recorded the impact of a reduction in estimated unbilled revenue, primarily reflecting an increase in the estimated amount of power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers). This change in accounting estimate reduced net earnings for the year ended December 31, 2005 by approximately $6.4 million.

Revenue Recognition

ACE recognizes revenue for the supply and delivery of electricity upon delivery to the customer, including amounts for services rendered, but not yet billed (unbilled revenue). ACE recorded amounts for unbilled revenue of $42.0 million and $57.2 million as of December 31, 2005 and December 31, 2004, respectively. These amounts are included in the "accounts receivable" line item in the accompanying Consolidated Balance Sheets. ACE calculates unbilled revenue using an output based methodology. This methodology is based on the supply of electricity or gas distributed to customers. The unbilled revenue process requires management to make assumptions and judgments about input factors such as customer sales mix and estimated power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers), which are inherently uncertain and susceptible to change from period to period, the impact of which could be material.

The taxes related to the delivery of electricity to its customers are a component of the Company's tariffs and, as such, is billed to customers and recorded in Operating Revenues. Accruals for these taxes by the Company are recorded in Other Taxes. Excise tax related generally to the consumption of gasoline by the Company in the normal course of business is charged to operations, maintenance or construction, and is de minimis.

Regulation of Power Delivery Operations

Certain aspects of ACE's utility businesses are subject to regulation by the NJBPU and its wholesale operations are subject to regulation by the Federal Energy Regulatory Commission (FERC).

Based on the regulatory framework in which it has operated, ACE has historically applied, and in connection with its transmission and distribution business continues to apply, the provisions of Statement of Financial Accounting Standards No. 71 (SFAS No. 71), "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 allows regulated entities, in appropriate circumstances, to establish regulatory assets and to defer the income statement impact of certain costs that are expected to be recovered in future rates. Management's assessment of the probability of recovery of regulatory assets requires judgment and interpretation of laws, regulatory commission orders, and other factors. Should existing facts or circumstances change in the future to indicate that a regulatory asset is not probable of recovery, then the regulatory asset must be charged to earnings.

The components of ACE's regulatory asset balances at December 31, 2005 and 2004 are as follows:

	2005	2004
	(Millions of dollars)	
Securitized stranded costs	$ 823.5	$ 887.7
Deferred energy supply costs	-	91.4
Deferred recoverable income taxes	16.1	13.3
Deferred debt extinguishment costs	16.6	17.8
Deferred other postretirement benefit costs	17.5	20.0
Unrecovered purchased power contract costs	12.2	13.2
Other	24.5	24.4
Total regulatory assets	$ 910.4	$1,067.8

The components of ACE's regulatory liability balances at December 31, 2005 and 2004 are as follows:

	2005	2004
	(Millions of dollars)	
Excess depreciation reserve	$121.7	$ -
Deferred energy supply costs	40.9	-
Regulatory liability for Federal and New Jersey tax benefit and other	43.7	44.6
Total regulatory liabilities	$206.3	$44.6

A description for each category of regulatory assets and regulatory liabilities follows:

Securitized Stranded Costs: Represents stranded costs associated with a non-utility generator (NUG) contract termination payment and the discontinuance of the application of SFAS No. 71 for ACE's electricity generation business. The recovery of these stranded costs has been securitized through the issuance of Transition Bonds by Atlantic City Electric Transition Funding LLC (ACE Funding). A customer surcharge is collected by ACE to fund principal and interest payments on the Transition Bonds. The stranded costs are amortized over the life of the Transition Bonds, which mature between 2010 and 2023.

Deferred Energy Supply Costs: Primarily represents deferred costs relating to the provision of Basic Generation Service (BGS) and other restructuring related costs incurred by ACE. All deferrals receive a return. ACE deferrals are recoverable over the next 9 years.

Deferred Recoverable Income Taxes: Represents deferred income tax assets recognized from the normalization of flow-through items as a result of amounts previously provided to customers. As temporary differences between the financial statement and tax basis of assets reverse, deferred recoverable income taxes are amortized. There is no return on these deferrals.

Deferred Debt Extinguishment Costs: Represents the costs of debt extinguishment for which recovery through regulated utility rates is considered probable and, if approved, will be amortized to interest expense during the authorized rate recovery period. A return is received on these deferrals.

Deferred Other Postretirement Benefit Costs: Represents the non-cash portion of other postretirement benefit costs deferred by ACE during 1993 through 1997. This cost is being recovered over a 15-year period that began on January 1, 1998. There is no return on this deferral.

Unrecovered Purchased Power Contract Costs: Represents deferred costs related to purchase power contracts at ACE, which are being recovered from July 1994 through May 2014 and which earn a return.

Other: Represents miscellaneous regulatory assets that generally are being amortized over 1 to 20 years and generally do not receive a return.

Excess Depreciation Reserve: The excess depreciation reserve was recorded as part of the New Jersey rate case settlement. This excess reserve is the result of a change in estimated depreciable lives from remaining life to whole life. The excess will be amortized over about 8.25 years.

Regulatory Liability for Federal and New Jersey Tax Benefit and Other: Securitized stranded costs include a portion of stranded costs attributable to the future tax benefit expected to be realized when the higher tax basis of the generating plants is deducted for New Jersey state income tax purposes as well as the future benefit to be realized through the reversal of federal excess deferred taxes. To account for the possibility that these tax benefits may be given to ACE's regulated electricity delivery customers through lower rates in the future, ACE established a regulatory liability. The regulatory liability related to federal excess deferred taxes will remain on ACE's Consolidated Balance Sheets until such time as the Internal Revenue Service issues its final regulations with respect to normalization of these federal excess deferred taxes.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, money market funds, and commercial paper with original maturities of three months or less. Additionally, deposits in PHI's "money pool," which ACE and certain other PHI subsidiaries use to manage short-term cash management requirements, are considered cash equivalents. Deposits in the money pool are guaranteed by PHI. PHI deposits funds in the money pool to the extent that the pool has insufficient funds to meet the needs of its participants, which may require PHI to borrow funds for deposit from external sources. Deposits in the PHI money pool were $4.0 million and $1.7 million at December 31, 2005, and 2004, respectively.

Restricted Cash

Restricted cash represents cash either held as collateral or pledged as collateral, and is restricted from use for general corporate purposes.

Capitalized Interest and Allowance for Funds Used During Construction

In accordance with the provisions of SFAS No. 34, "Capitalization of Interest Cost," the cost of financing the construction of ACE's subsidiaries electric generating plants is capitalized. Other non-utility construction projects also include financing costs in accordance with SFAS No. 34. In accordance with the provisions of SFAS No. 71, utilities can capitalize Allowance for Funds Used During Construction (AFUDC) as part of the cost of plant and equipment. AFUDC recognizes that utility construction is financed partially by debt and partially by equity.

ACE recorded AFUDC for borrowed funds of $.8 million, $1.2 million and $.9 million for the years ended December 31, 2005, 2004 and 2003, respectively. These amounts are recorded as a reduction of "interest expense" in the accompanying Consolidated Statements of Earnings.

ACE recorded amounts for the equity component of AFUDC of $1.6 million, $1.7 million and $1.2 million for the years ended December 31, 2005, 2004 and 2003, respectively. The amounts are included in the "other income" caption of the accompanying Consolidated Statements of Earnings.

Amortization of Debt Issuance and Reacquisition Costs

The amortization of debt discount, premium, and expense, including deferred debt extinguishment costs associated with the regulated electric businesses, is included in interest expense.

Emission Allowances

Emission allowances for Sulfur Dioxide (SO2) and Nitrous Oxide (NOX) are allocated to generation owners by the Environmental Protection Agency (EPA) based on Federal programs designed to regulate the emissions from power plants. The EPA allotments have no cost basis to the generation owners. Depending on the run-time of a generator in a given year, and other pollution controls it may have, the unit may need additional allowances above its allocation, or it may have excess allowances that it does not need. Allowances are traded among companies in an over-the-counter market so that generation companies can avoid stiff penalties for noncompliance.

ACE accounts for emission allowances as inventory. Allowances from EPA allocation are added to current inventory each year at a zero basis. Additional purchased allowances are recorded at cost. Allowances sold or consumed at the power plants are expensed at a weighted-average cost. This cost tends to be relatively low due to the zero-basis allowances. ACE has a committee established to ensure its plants are in compliance with emissions regulations and that its power plants have the required number of allowances on hand.

Income Taxes

ACE, as an indirect subsidiary of PHI, is included in the consolidated Federal income tax return of Pepco Holdings. Federal income taxes are allocated to ACE based upon the taxable income or loss amounts, determined on a separate return basis.

The Consolidated Financial Statements include current and deferred income taxes. Current income taxes represent the amounts of tax expected to be reported on ACE's state income tax returns and the amount of federal income tax allocated from PHI. Deferred income taxes are discussed below.

Deferred income tax assets and liabilities represent the tax effects of temporary differences between the financial statement and tax basis of existing assets and liabilities, and are measured using presently enacted tax rates. The portion of ACE's deferred tax liability applicable to its utility operations that has not been recovered from utility customers represents income taxes recoverable in the future and is included in "regulatory assets" on the Consolidated Balance Sheets. For additional information, see the discussion under "Regulation of Power Delivery Operations" above.

Deferred income tax expense generally represents the net change during the reporting period in the net deferred tax liability and deferred recoverable income taxes.

Investment tax credits from utility plant purchased in prior years are reported on the Consolidated Balance Sheets as "Investment tax credits." These investment tax credits are being amortized to income over the useful lives of the related utility plant.

Pension and Other Postretirement Benefit Plans

Pepco Holdings sponsors a retirement plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries (Retirement Plan). Following the consummation of the acquisition of Conectiv by Pepco on August 1, 2002, the Pepco General Retirement Plan and the Conectiv Retirement Plan were merged into the Retirement Plan on December 31, 2002. The provisions and benefits of the merged Retirement Plan for Pepco employees are identical to those of the original Pepco plan and for Conectiv employees are identical to the original Conectiv plan. Pepco Holdings also provides supplemental retirement benefits to certain eligible executives and key employees through nonqualified retirement plans and provides certain postretirement health care and life insurance benefits for eligible retired employees.

PHI accounts for the Retirement Plan in accordance with SFAS No. 87, "Employers' Accounting for Pensions," and its postretirement health care and life insurance benefits for eligible employees in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." PHI's financial statement disclosures were prepared in accordance with SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits."

Long-Lived Asset Impairment Evaluation

ACE is required to evaluate certain long-lived assets (for example, generating property and equipment and real estate) to determine if they are impaired when certain conditions exist. SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," provides the accounting for impairments of long-lived assets and indicates that companies are required to test long-lived assets for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. Examples of such events or changes include a significant decrease in the market price of a long-lived asset or a significant adverse change in the manner an asset is being used or its physical condition. For long-lived assets that are expected to be held and used, SFAS No. 144 requires that an impairment loss be recognized only if the carrying amount of an asset is not recoverable and exceeds its fair value.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. The carrying value of property, plant and equipment is evaluated for impairment whenever circumstances indicate the carrying value of those assets may not be recoverable under the provisions of SFAS No. 144. Upon retirement, the cost of regulated property, net of salvage, is charged to accumulated depreciation.

The annual provision for depreciation on electric property, plant and equipment is computed on the straight-line basis using composite rates by classes of depreciable property. Accumulated depreciation is charged with the cost of depreciable property retired, less salvage and other recoveries. The system-wide composite depreciation rates for 2005, 2004 and 2003 for ACE's generation, transmission and distribution system property were 3.1%, 3.3% and 3.2%, respectively. Property, plant and equipment other than electric facilities is generally depreciated on a straight-line basis over the useful lives of the assets.

Accounts Receivable and Allowance for Uncollectible Accounts

ACE's subsidiaries accounts receivable balances primarily consist of customer accounts receivable, other accounts receivable, and accrued unbilled revenue. Accrued unbilled revenue represents revenue earned in the current period but not billed to the customer until a future date (usually within one month after the receivable is recorded). ACE uses the allowance method to account for uncollectible accounts receivable.

FIN 46R

ACE has power purchase agreements (PPAs) with a number of entities, including three non-utility generation contracts (NUGs). Due to a variable element in the pricing structure of the NUGs, ACE potentially assumes the variability in the operations of the plants related to these PPAs and, therefore, has a variable interest in the entities. As required by FIN 46R, ACE continued, during 2005, to conduct exhaustive efforts to obtain information from these entities, but was unable to obtain sufficient information to conduct the analysis required under FIN 46R to determine whether these three entities were variable interest entities or if ACE was the primary beneficiary. As a result, ACE has applied the scope exemption from the application of FIN 46R for enterprises that have conducted exhaustive efforts to obtain the necessary information, but have not been able to obtain such information.

Net power purchase activities with the counterparties to the NUGs for the years ended December 31, 2005, 2004 and 2003, were approximately $327 million, $265 million and $247 million, respectively, of which $289 million, $236 million and $220 million, respectively, related to power purchases under the NUGs. ACE does not have exposure to loss under the PPA agreements since cost recovery will be achieved from its customers through regulated rates.

Other Non-Current Assets

The other assets balance principally consists of real estate under development, equity and other investments, and deferred compensation trust assets.

Other Current Liabilities

The other current liability balance principally consists of customer deposits, accrued vacation liability, and the current portion of deferred income taxes.

Other Deferred Credits

The other deferred credits balance principally consists of miscellaneous deferred liabilities.

Dividend Restrictions

In addition to its future financial performance, the ability of ACE to pay dividends is subject to limits imposed by: (i) state corporate and regulatory laws, which impose limitations on the funds that can be used to pay dividends and, in the case of regulatory laws, may require the prior approval of ACE's utility regulatory commission before dividends can be paid; (ii) the prior rights of holders of existing and future preferred stock, mortgage bonds and other long-term debt issued by ACE and any other restrictions imposed in connection with the incurrence of liabilities; and (iii) certain provisions of the charter of ACE, which impose restrictions on payment of common stock dividends for the benefit of preferred stockholders.

New Accounting Standards

SFAS No. 154

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections (SFAS No. 154), a replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. The reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS No. 154. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 (the year ended December 31, 2006 for Pepco Holdings). Early adoption is permitted.

EITF 04-13

In September 2005, the FASB ratified EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" (EITF 04-13), which addresses circumstances under which two or more exchange transactions involving inventory with the same counterparty should be viewed as a single exchange transaction for the purposes of evaluating the effect of APB Opinion 29. EITF 04-13 is effective for new arrangements entered into, or modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006 (April 1, 2006 for ACE). EITF 04-13 would not affect ACE's net income, overall financial condition, or cash flows, but rather could result in certain revenues and costs, including wholesale revenues and purchased power expenses, being presented on a net basis. ACE is in the process of evaluating the impact of EITF 04-13 on its Consolidated Statements of Earnings presentation of purchases and sales.

(3) SEGMENT INFORMATION

In accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," ACE has one segment, its regulated utility business.

(4) LEASING ACTIVITIES

ACE leases other types of property and equipment for use in its operations. Amounts charged to operating expenses for these leases were $11.0 million in 2005, $11.7 million in 2004, and $10.0 million in 2003. Future minimum rental payments for all non-cancelable lease agreements are less than $10 million per year for each of the next five years.

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is comprised of the following:

At December 31, 2005	Original Cost	Accumulated Depreciation	Net Book Value
		(Millions of dollars)	
Generation	$ 77.4	$ 29.4	$ 48.0
Distribution	1,090.0	313.5	776.5
Transmission	534.4	188.3	346.1
Construction work in progress	56.8	-	56.8
Non-operating and other property	157.0	54.1	102.9
Total	$1,915.6	$585.3	$1,330.3
At December 31, 2004			
Generation	$ 73.5	$ 27.8	$ 45.7
Distribution	1,039.4	416.7	622.7
Transmission	428.6	180.7	247.9
Construction work in progress	118.4	-	118.4
Non-operating and other property	158.8	54.8	104.0
Total	$1,818.7	$680.0	$1,138.7

The balances of all property, plant and equipment, which is primarily electric transmission and distribution property, are stated at original cost. Utility plant is generally subject to a first mortgage lien. The system-wide composite depreciation rates in 2005 and 2004 for ACE's generation, transmission and distribution system property were approximately 3.1% and 3.3%, respectively.

Jointly Owned Plant

ACE's Consolidated Balance Sheet includes its proportionate share of assets and liabilities related to jointly owned plant. ACE has ownership interests in electric generating plants, transmission facilities, and other facilities in which various parties have ownership interests. ACE's proportionate share of operating and maintenance expenses of the jointly owned plant is included in the corresponding expenses in ACE's Consolidated Statements of Earnings. ACE is responsible for providing its share of financing for the jointly owned facilities. Information with respect to ACE's share of jointly owned plant as of December 31, 2005 is shown below.

Jointly Owned Plant	Ownership Share	Megawatt Capability Owned	Plant in Service	Accumulated Depreciation	Construction Work in Progress
				(Millions of dollars)	
Coal-Fired Electric Generating Plants					
Keystone	2.47%	42	$19.9	$ 6.5	$ .9
Conemaugh	3.83%	65	37.6	13.9	.9
Transmission Facilities	Various		24.9	14.2	-
Other Facilities	Various		1.1	.4	-
Total			$83.5	$35.0	$1.8

As discussed in Note (12), Commitments and Contingencies, during the fourth quarter of 2005, ACE entered into an agreement to sell its interests in Keystone and Conemaugh. The sale is expected to be completed by the third quarter of 2006.

(6) PENSIONS AND OTHER POSTRETIREMENT BENEFITS

Pension Benefits

Pepco Holdings sponsors a defined benefit Retirement Plan that covers substantially all employees of Pepco, DPL, ACE and certain employees of other Pepco Holdings' subsidiaries. Pepco Holdings also provides supplemental retirement benefits to certain eligible executive and key employees through nonqualified retirement plans.

Other Postretirement Benefits

Pepco Holdings provides certain postretirement health care and life insurance benefits for eligible retired employees. Certain employees hired on January 1, 2005 or later will not have company subsidized retiree medical coverage; however, they will be able to purchase coverage at full cost through PHI.

During 2004, PHI amended its postretirement health care plans for certain groups of eligible employees effective January 1, 2005 or January 1, 2006. The amendments included changes to coverage and retiree cost-sharing, and are reflected as a reduction in PHI's 2004 net periodic benefit cost and a reduction of $42 million in the projected benefit obligation at December 31, 2004.

Pepco Holdings uses a December 31 measurement date for its plans. Plan assets are stated at their market value as of the measurement date, December 31. All dollar amounts in the following tables are in millions of dollars.

	Pension Benefits		Other Postretirement Benefits	
Change in Benefit Obligation	**2005**	**2004**	**2005**	**2004**
Benefit obligation at beginning of year	$1,648.0	$1,579.2	$593.5	$511.9
Service cost	37.9	35.9	8.5	8.6
Interest cost	96.1	94.7	33.6	35.4
Amendments	-	-	-	(42.4)
Actuarial loss	81.1	51.4	12.8	117.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Benefit obligation at end of year	$1,746.0	$1,648.0	$610.2	$593.5
Change in Plan Assets				
Fair value of plan assets at beginning of year	$1,523.5	$1,462.8	$164.9	$145.2
Actual return on plan assets	106.4	161.1	10.0	15.7
Company contributions	65.6	12.8	37.0	41.0
Benefits paid	(117.1)	(113.2)	(38.2)	(37.0)
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$173.7	$164.9

The following table provides a reconciliation of the projected benefit obligation, plan assets and funded status of the plans.

	Pension Benefits		Other Postretirement Benefits	
	2005	**2004**	**2005**	**2004**
Fair value of plan assets at end of year	$1,578.4	$1,523.5	$ 173.7	$164.9
Benefit obligation at end of year	1,746.0	1,648.0	610.2	593.5
Funded status (plan assets less than plan obligations)	(167.6)	(124.5)	(436.5)	(428.6)
Amounts not recognized:				
Unrecognized net actuarial loss	350.5	261.2	188.6	188.5
Unrecognized prior service cost	1.9	3.0	(26.2)	(29.5)
Net amount recognized	$ 184.8	$ 139.7	$(274.1)	$(269.6)

The following table provides a reconciliation of the amounts recognized in PHI's Consolidated Balance Sheet as of December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Prepaid benefit cost	$208.9	$165.7	$ -	$ -
Accrued benefit cost	(24.1)	(26.0)	(274.1)	(269.6)
Additional minimum liability for nonqualified plan	(12.2)	(7.0)	-	-
Intangible assets for nonqualified plan	.1	.1	-	-
Accumulated other comprehensive income for nonqualified plan	12.1	6.9	-	-
Net amount recognized	$184.8	$139.7	$(274.1)	$(269.6)

The accumulated benefit obligation for the Retirement Plan (the qualified defined benefit pension plan) was $1,556.2 million and $1,462.9 million at December 31, 2005, and 2004, respectively. The table below provides the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for the PHI nonqualified pension plan with an accumulated benefit obligation in excess of plan assets at December 31, 2005 and 2004.

	Pension Benefits	
	2005	2004
Projected benefit obligation for nonqualified plan	$38.6	$35.3
Accumulated benefit obligation for nonqualified plan	$36.3	$32.9
Fair value of plan assets for nonqualified plan	-	-

In 2005 and 2004, PHI was required to recognize an additional minimum liability and an intangible asset related to its nonqualified pension plan as prescribed by SFAS No. 87. The liability was recorded as a reduction to shareholders' equity (other comprehensive income), and the equity will be restored to the balance sheet in future periods when the accrued benefit liability exceeds the accumulated benefit obligation at future measurement dates. The amount of reduction to shareholders' equity (net of income taxes) in 2005 was $7.3 million and in 2004 was $4.1 million. The recording of this reduction did not affect net income or cash flows in 2005 or 2004 or compliance with debt covenants.

The table below provides the components of net periodic benefit costs recognized for the years ended December 31.

	Pension Benefits 2005	Pension Benefits 2004	Pension Benefits 2003	Other Postretirement Benefits 2005	Other Postretirement Benefits 2004	Other Postretirement Benefits 2003
Service cost	$ 37.9	$ 35.9	$ 33.0	$ 8.5	$ 8.6	$ 9.5
Interest cost	96.1	94.7	93.7	33.6	35.4	32.9
Expected return on plan assets	(125.5)	(124.2)	(106.2)	(10.9)	(9.9)	(8.3)
Amortization of prior service cost	1.1	1.1	1.0	-	-	-
Amortization of net loss	10.9	6.5	13.9	8.0	9.5	8.0
Net periodic benefit cost	$ 20.5	$ 14.0	$ 35.4	$39.2	$43.6	$42.1

Approximately $16.9 million, $17.6 million and $20.8 million were included in capital and operating and maintenance expense, in 2005, 2004 and 2003, respectively, for ACE's allocated portion of PHI's combined pension and other postretirement benefit expense.

The following weighted average assumptions were used to determine the benefit obligations at December 31:

	Pension Benefits 2005	Pension Benefits 2004	Other Postretirement Benefits 2005	Other Postretirement Benefits 2004
Discount rate	5.625%	5.875%	5.625%	5.875%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%
Health care cost trend rate assumed for next year	n/a	n/a	8.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)			5.00%	5.00%
Year that the rate reaches the ultimate trend rate			2009	2009

Assumed health care cost trend rates may have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects (millions of dollars):

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on total of service and interest cost	$ 1.8	$ (1.7)
Effect on postretirement benefit obligation	27.0	(25.1)

The following weighted average assumptions were used to determine the net periodic benefit cost for years ended December 31:

	Pension Benefits		Other Postretirement Benefits	
	2005	2004	2005	2004
Discount rate	5.875%	6.250%	5.875%	6.250%
Expected long-term return on plan assets	8.500%	8.750%	8.500%	8.750%
Rate of compensation increase	4.500%	4.500%	4.500%	4.500%

A cash flow matched bond portfolio approach to developing a discount rate is used to value FAS 87 and FAS 106 liabilities. The hypothetical portfolio includes high quality instruments with maturities that mirror the benefit obligations.

In selecting an expected rate of return on plan assets, PHI considers actual historical returns, economic forecasts and the judgment of its investment consultants on expected long-term performance for the types of investments held by the plan. The plan assets consist of equity and fixed income investments, and when viewed over a long time horizon, are expected to yield a return on assets of 8.50%.

Plan Assets

Pepco Holdings' Retirement Plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

	Plan Assets at December 31		Target Plan Asset	Minimum/
Asset Category	2005	2004	Allocation	Maximum
Equity securities	62%	66%	60%	55% - 65%
Debt securities	37%	33%	35%	30% - 50%
Other	1%	1%	5%	0% - 10%
Total	100%	100%	100%	

Pepco Holdings' other postretirement plan weighted-average asset allocations at December 31, 2005, and 2004, by asset category are as follows:

	Plan Assets at December 31		Target Plan Asset	Minimum/
Asset Category	2005	2004	Allocation	Maximum
Equity securities	67%	65%	60%	55% - 65%
Debt securities	24%	32%	35%	20% - 50%
Cash	9%	3%	5%	0% - 10%
Total	100%	100%	100%	

In developing an asset allocation policy for its Retirement Plan and Other Postretirement Plan, PHI examined projections of asset returns and volatility over a long-term horizon. In connection with this analysis, PHI examined the risk/return tradeoffs of alternative asset classes and asset mixes given long-term historical relationships, as well as prospective capital market returns. PHI also conducted an asset/liability study to match projected asset growth with projected liability growth and provide sufficient liquidity for projected benefit payments. By incorporating the results of these analyses with an assessment of its risk posture, and taking into account industry practices, PHI developed its asset mix guidelines. Under these guidelines, PHI diversifies assets in order to protect against large investment losses and to reduce the probability of excessive performance volatility while maximizing return at an acceptable risk level. Diversification of assets is implemented by allocating monies to various asset classes and investment styles within asset classes, and by retaining investment management firm(s) with complementary investment philosophies, styles and approaches. Based on the assessment of demographics, actuarial/funding, and business and financial characteristics, PHI believes that its risk posture is slightly below average relative to other pension plans. Consequently, Pepco Holdings believes that a slightly below average equity exposure (i.e., a target equity asset allocation of 60%) is appropriate for the Retirement Plan and the Other Postretirement Plan.

On a periodic basis, Pepco Holdings reviews its asset mix and rebalances assets back to the target allocation over a reasonable period of time.

No Pepco Holdings common stock is included in pension or postretirement program assets.

Cash Flows

Contributions - Retirement Plan

Pepco Holdings' funding policy with regard to the Retirement Plan is to maintain a funding level in excess of 100% with respect to its accumulated benefit obligation (ABO). PHI's Retirement Plan currently meets the minimum funding requirements of ERISA without any additional funding. In 2005 and 2004, PHI made discretionary tax-deductible cash contributions to the plan of $60.0 million and $10.0 million, respectively, in line with its funding policy. Assuming no changes to the current pension plan assumptions, PHI projects no funding will be required under ERISA in 2006; however, PHI may elect to make a discretionary tax-deductible contribution, if required to maintain its plan assets in excess of its ABO.

Contributions - Other Postretirement Benefits

In 2005, PHI combined its health and welfare plans and the existing IRC 501 (C) (9) Voluntary Employee Beneficiary Association (VEBA) trusts for Pepco, DPL and ACE to fund a portion of their estimated postretirement liabilities. ACE contributed $7.0 million and $9.3 million to the PHI-sponsored plan in 2005 and 2004, respectively. Assuming no changes to the current plan assumptions, ACE expects to contribute amounts similar to its allocated portion of PHI's other postretirement benefit expense to the other postretirement welfare benefit plan in 2006.

Expected Benefit Payments

Estimated future benefit payments to participants in PHI's qualified pension and postretirement welfare benefit plans, which reflect expected future service as appropriate, as of December 31, 2005 are in millions of dollars:

Years	Pension Benefits	Other Postretirement Benefits
2006	$ 91.6	$ 37.2
2007	99.7	39.5
2008	102.2	41.7
2009	104.7	43.1
2010	106.1	44.3
2011 through 2015	553.0	229.7

(7) LONG-TERM DEBT

Long-term debt outstanding as of December 31, 2005 and 2004 is presented below.

Type of Debt	Interest Rates	Maturity	2005	2004
			(Millions of dollars)	
First Mortgage Bonds:				
	6.18%-7.15%	2005-2008	$116.0	$156.0
	7.25%-7.63%	2010-2014	8.0	8.0
	6.63%	2013	68.6	68.6
	7.68%	2015-2016	17.0	17.0
	6.80% (a)	2021	38.9	38.9
	5.60% (a)	2025	4.0	4.0
	Variable (a)	2029	54.7	54.7
	5.80% (a)	2034	120.0	120.0
			427.2	467.2
Medium-Term Notes (unsecured)	7.52%	2007	15.0	15.0
Total long-term debt			442.2	482.2
Net unamortized discount			(.5)	(.6)
Current maturities of long-term debt			(65.0)	(40.0)
Total net long-term debt			$376.7	$441.6
Transition Bonds ACE Funding:				
	2.89%	2010	$ 55.2	$ 75.2
	2.89%	2011	31.3	39.4
	4.21%	2013	66.0	66.0
	4.46%	2016	52.0	52.0
	4.91%	2017	118.0	118.0
	5.05%	2020	54.0	54.0
	5.55%	2023	147.0	147.0
			523.5	551.6
Net unamortized discount			(.2)	(.2)
Current maturities of long-term debt			(29.0)	(28.1)
Total net long-term transition bonds issued by ACE Funding			$494.3	$523.3

(a) Represents a series of First Mortgage Bonds issued by ACE as collateral for an outstanding series of senior notes or tax-exempt bonds issued by ACE. The maturity date, optional and mandatory prepayment provisions, if any, interest rate, and interest payment dates on each series of senior notes or tax-exempt bonds are identical to the terms of the collateral First Mortgage Bonds by which it is secured. Payments of principal and interest on a series of senior notes or tax-exempt bonds satisfy the corresponding payment obligations on the related series of collateral First Mortgage Bonds. At such time as there are no First Mortgage Bonds of an issuing company outstanding, other than collateral First Mortgage Bonds securing payment of senior notes and tax-exempt bonds, each outstanding series of senior notes and tax-exempt bonds of the company will automatically cease to be secured by the corresponding series of collateral First Mortgage Bonds and all of the outstanding collateral First Mortgage Bonds of the company will be cancelled. Because each series of senior notes and tax-exempt bonds and the series of collateral First Mortgage Bonds securing that series of senior notes or tax-exempt bonds effectively represents a single financial obligation, the senior notes and the tax-exempt bonds are not separately shown on the table.

The outstanding First Mortgage Bonds issued by ACE are secured by a lien on substantially all of ACE's property, plant and equipment.

Atlantic City Electric Transition Funding L.L.C. (ACE Funding) was established in 2001 solely for the purpose of securitizing authorized portions of ACE's recoverable stranded costs through the issuance and sale of bonds (Transition Bonds). The proceeds of the sale of each series of Transition Bonds have been transferred to ACE in exchange for the transfer by ACE to ACE Funding of the right to collect a non-bypassable transition bond charge from ACE customers pursuant to bondable stranded costs rate orders issued by the NJBPU in an amount sufficient to fund the principal and interest payments on the Transition Bonds and related taxes, expenses and fees (Bondable Transition Property). The assets of ACE Funding, including the Bondable Transition Property, and the Transition Bond charges collected from ACE's customers are not available to creditors of ACE. The Transition Bonds are obligations of ACE Funding and are non-recourse to ACE.

The aggregate principal amount of long-term debt including Transition Bonds outstanding at December 31, 2005, that will mature in each of 2006 through 2010 and thereafter is as follows: 2006-$94 million; 2007-$45.9 million; 2008-$81 million; 2009-$32.2 million; 2010-$34.7 million; and thereafter $677.9 million.

SHORT-TERM DEBT

ACE has traditionally used a number of sources to fulfill short-term funding needs, such as commercial paper, short-term notes, and bank lines of credit. Proceeds from short-term borrowings are used primarily to meet working capital needs, but may also be used to temporarily fund long-term capital requirements. A detail of the components of ACE's short-term debt at December 31, 2005 and 2004 is as follows.

	2005	2004
	(Millions of dollars)	
Commercial paper	$ -	$32.7
Variable rate demand bonds	22.6	22.6
Total	$22.6	$55.3

Commercial Paper

ACE maintains an ongoing commercial paper program of up to $250 million. The commercial paper notes can be issued with maturities up to 270 days from the date of issue. The commercial paper program is backed by a $500 million credit facility, described below under the heading "Credit Facility," shared with Pepco and DPL.

ACE had no commercial paper outstanding at December 31, 2005 and $32.7 million of commercial paper outstanding at December 31, 2004. The weighted average interest rate for commercial paper issued during 2005 was 3.24%. Interest rates for commercial paper issued during 2004 ranged from 1.07% to 2.63%. Maturities were less than 270 days for all commercial paper issued.

Variable Rate Demand Bonds

Variable Rate Demand Bonds ("VRDB") are subject to repayment on the demand of the holders and for this reason are accounted for as short-term debt in accordance with GAAP. However, bonds submitted for purchase are remarketed by a remarketing agent on a best efforts basis. ACE expects the bonds submitted for purchase will continue to be remarketed successfully due to the credit worthiness of the company and because the remarketing resets the interest rate to the then-current market rate. The company also may utilize one of the fixed rate/fixed term conversion options of the bonds to establish a maturity which corresponds to the date of final maturity of the bonds. On this basis, ACE views VRDBs as a source of long-term financing. The VRDB outstanding in 2005 and 2004 mature in 2014 ($18.2 million) and 2017 ($4.4 million). The weighted average interest rate for VRDB was 2.47% during 2005 and ranged from .82% to 1.98% in 2004.

Credit Facility

In May 2005, Pepco Holdings, Pepco, DPL and ACE entered into a five-year credit agreement with an aggregate borrowing limit of $1.2 billion. This agreement replaces a $650 million five-year credit agreement that was entered into in July 2004 and a $550 million three-year credit agreement entered into in July 2003. Pepco Holdings' credit limit under this agreement is $700 million. The credit limit of each of Pepco, DPL and ACE is the lower of $300 million and the maximum amount of debt the company is permitted to have outstanding by its regulatory authorities, except that the aggregate amount of credit used by Pepco, DPL and ACE at any given time under the agreement may not exceed $500 million. Under the terms of the credit agreement, the companies are entitled to request increases in the principal amount of available credit up to an aggregate increase of $300 million, with any such increase proportionately increasing the credit limit of each of the respective borrowers and the $300 million sublimits for each of Pepco, DPL and ACE. The interest rate payable by the respective companies on utilized funds is determined by a pricing schedule with rates corresponding to the credit rating of the borrower. Any indebtedness incurred under the credit agreement would be unsecured.

The credit agreement is intended to serve primarily as a source of liquidity to support the commercial paper programs of the respective companies. The companies also are permitted to use the facility to borrow funds for general corporate purposes and issue letters of credit. In order for a borrower to use the facility, certain representations and warranties made by the borrower at the time the credit agreement was entered into also must be true at the time the facility is utilized, and the borrower must be in compliance with specified covenants, including the financial covenant described below. However, a material adverse change in the borrower's business, property, and results of operations or financial condition subsequent to the entry into the credit agreement is not a condition to the availability of credit under the facility. Among the covenants contained in the credit agreement are (i) the requirement that each borrowing company maintain a ratio of total indebtedness to total capitalization of 65% or less, computed in accordance with the terms of the credit agreement, (ii) a restriction on sales or other dispositions of assets, other than sales and dispositions permitted by the credit agreement, and (iii) a restriction on the incurrence of liens on the assets of a borrower or any of its significant subsidiaries other than liens permitted by the credit agreement. The failure to satisfy any of the covenants or the occurrence of specified events that constitute an event of default could result in the acceleration of the repayment obligations of the borrower. The events of default include (i) the failure of any borrowing company or any of its significant subsidiaries to pay when due, or the acceleration of, certain indebtedness under other borrowing arrangements, (ii) certain bankruptcy events, judgments or decrees against any borrowing company or its significant subsidiaries, and (iii) a change in control (as defined in the credit agreement) of Pepco Holdings or the failure of Pepco Holdings to own all of the voting stock of Pepco, DPL and ACE. The agreement does not include any ratings triggers. There were no balances outstanding at December 31, 2005 and 2004.

(8) INCOME TAXES

ACE, as an indirect subsidiary of PHI, is included in the consolidated Federal income tax return of PHI. Federal income taxes are allocated to ACE pursuant to a written tax sharing agreement which was approved by the Securities and Exchange Commission pursuant to regulations under the Public Utility Holding Company Act of 1935 in connection with the establishment of PHI as a holding company as part of Pepco's acquisition of Conectiv on August 1, 2002. Under this tax sharing agreement, PHI's consolidated Federal income tax liability is allocated based upon PHI's and its subsidiaries' separate taxable income or loss, with the exception of the tax benefits applicable to non-acquisition debt expenses of PHI. Such tax benefits are allocated only to subsidiaries with taxable income.

The provision for consolidated income taxes, reconciliation of consolidated income tax expense, and components of consolidated deferred income tax liabilities (assets) are shown below.

Provision for Consolidated Income Taxes

		For the Year Ended December 31, 2005	2004	2003
		(Millions of dollars)		
Operations				
Federal:	Current	$104.7	$ 59.9	$ 20.1
	Deferred	(71.5)	(23.6)	1.9
State:	Current	22.7	4.4	12.7
	Deferred	(11.6)	6.6	(5.4)
Investment tax credit adjustments, net		(1.0)	(4.7)	(2.0)
Total Income Tax Expense from Operations		$ 43.3	$ 42.6	$ 27.3
Extraordinary item				
Federal:	Current	-	-	-
	Deferred	4.8	-	3.2
State:	Current	-	-	-
	Deferred	1.4	-	.9
		6.2	-	4.1
Total Income Tax Expense		$49.5	$42.6	$31.4

Reconciliation of Income Tax Expense

	For the Year Ended December 31, 2005 Amount	Rate	2004 Amount	Rate	2003 Amount	Rate
	(Millions of dollars)					
Statutory federal income tax expense	$34.1	.35	$36.5	.35	$24.1	.35
State income taxes, net of federal benefit	7.1	.07	7.1	.07	4.7	.07
Plant basis differences	.5	.01	2.0	.02	-	-
Investment tax credit amortization	(1.0)	(.01)	(4.7)	(.05)	(2.0)	(.03)
Prior period income taxes	.2	-	2.4	.02	-	-
Change in estimates related to prior year tax liabilities	2.9	.03	(.4)	-	-	-
Other, net	(.5)	(.01)	(.3)	-	.5	.01
Total Income Tax Expense	$43.3	.44	$42.6	.41	$27.3	.40

Components of Deferred Income Tax Liabilities (Assets)

The tax effects of temporary differences that give rise to ACE's net deferred tax liability are shown below, the majority of which are recoverable in rates.

	2005	2004
	(Millions of dollars)	
Deferred tax liabilities:		
Depreciation and other book to tax basis differences	$ 415.8	$ 430.6
Deferred recoverable income taxes	5.6	4.7
Payment for termination of purchased power contracts with non-utility electric generators	77.3	82.1
Deferred electric service expenses	-	29.8
Other	9.2	17.3
Total deferred tax liabilities	507.9	564.5
Deferred tax assets:		
Deferred investment tax credits	(8.2)	(9.8)
Other	(77.6)	(58.7)
Total deferred tax assets	(85.8)	(68.5)
Total net deferred tax liability	422.1	496.0
Deferred tax asset included in Other Current Assets	10.4	-
Total net deferred tax liability, non-current	$ 432.5	$ 496.0

Taxes Other Than Income Taxes

Taxes other than income taxes for each year are shown below.

	2005	2004	2003
	(Millions of dollars)		
Gross Receipts/Delivery	$20.9	$18.4	$20.6
Property	1.8	3.0	1.6
Environmental, Use and Other	.2	(.7)	1.0
Total	$22.9	$20.7	$23.2

(9) PREFERRED STOCK

The preferred stock amounts outstanding as of December 31, 2005 and 2004 are as follows:

Series	Redemption Price	Shares Outstanding 2005	Shares Outstanding 2004	December 31, 2005 (Millions of dollars)	December 31, 2004 (Millions of dollars)
Serial Preferred Stock					
$100 per share par value					
4.00%-5.00%	$100.00-$105.50	62,145	62,305	$6.2	$6.2

(10) FAIR VALUES OF FINANCIAL INSTRUMENTS

The estimated fair values of ACE's financial instruments at December 31, 2005 and 2004 are shown below.

	2005 Carrying Amount	2005 Fair Value	2004 Carrying Amount	2004 Fair Value
	(Millions of dollars)			
Long-term debt	$376.7	$402.3	$441.6	$463.7
Redeemable Serial Preferred Stock	$ 6.2	$ 4.4	$ 6.2	$ 4.3
Transition Bonds issued by ACE Funding	$494.3	$496.7	$523.3	$537.5

The methods and assumptions below were used to estimate, at December 31, 2005 and 2004, the fair value of each class of financial instruments shown above for which it is practicable to estimate a value.

The fair values of the Long-term Debt, which includes First Mortgage Bonds, Medium-Term Notes, and Transition Bonds issued by ACE Funding, excluding amounts due within one year, were derived based on current market prices, or for issues with no market price available, were based on discounted cash flows using current rates for similar issues with similar terms and remaining maturities.

The fair value of the Redeemable Serial Preferred Stock, excluding amounts due within one year, were derived based on quoted market prices or discounted cash flows using current rates of preferred stock with similar terms.

The carrying amounts of all other financial instruments in ACE's accompanying consolidated financial statements approximate fair value.

(11) COMMITMENTS AND CONTINGENCIES

REGULATORY AND OTHER MATTERS

Rate Proceedings

Federal Energy Regulatory Commission

On January 31, 2005, ACE filed at FERC to reset its rates for network transmission service using a formula methodology. ACE also sought a 12.4% return on common equity and a 50-basis-point return on equity adder that FERC had made available to transmission utilities who had joined Regional Transmission Organizations and thus turned over control of their assets to an independent entity. FERC issued an order on May 31, 2005, approving the rates to go into effect June 1, 2005, subject to refund, hearings, and further orders. The new rates reflect an increase of 3.3% ACE's transmission rates. ACE continues in settlement discussions under the supervision of a FERC administrative law judge and cannot predict the ultimate outcome of this proceeding.

Restructuring Deferral

Pursuant to orders issued by the NJBPU under New Jersey Electric Discount and Energy Competition Act (EDECA), beginning August 1, 1999, ACE was obligated to provide BGS to retail electricity customers in its service territory who did not choose a competitive energy supplier. For the period August 1, 1999 through July 31, 2003, ACE's aggregate costs that it was allowed to recover from customers exceeded its aggregate revenues from supplying BGS. These under-recovered costs were partially offset by a $59.3 million deferred energy cost liability existing as of July 31, 1999 (LEAC Liability) that was related to ACE's Levelized Energy Adjustment Clause and ACE's Demand Side Management Programs. ACE established a regulatory asset in an amount equal to the balance of under-recovered costs.

In August 2002, ACE filed a petition with the NJBPU for the recovery of approximately $176.4 million in actual and projected deferred costs relating to the provision of BGS and other restructuring related costs incurred by ACE over the four-year period August 1, 1999 through July 31, 2003, net of the $59.3 million offset for the LEAC Liability. The petition also requested that ACE's rates be reset as of August 1, 2003 so that there would be no under-recovery of costs embedded in the rates on or after that date. The increase sought represented an overall 8.4% annual increase in electric rates and was in addition to the base rate increase discussed above. ACE's recovery of the deferred costs is subject to review and approval by the NJBPU in accordance with EDECA.

In July 2004, the NJBPU issued a final order in the restructuring deferral proceeding confirming a July 2003 summary order, which (i) permitted ACE to begin collecting a portion of the deferred costs and reset rates to recover on-going costs incurred as a result of EDECA, (ii) approved the recovery of $125 million of the deferred balance over a ten-year amortization period beginning August 1, 2003, (iii) transferred to ACE's then pending base rate case for further consideration approximately $25.4 million of the deferred balance, and (iv) estimated the overall deferral balance as of July 31, 2003 at $195 million, of which $44.6 million was disallowed recovery by ACE. ACE believes the record does not justify the level of disallowance imposed by the NJBPU in the final order. In August 2004, ACE filed with the Appellate Division of the Superior Court of New Jersey, which hears appeals of New Jersey administrative agencies, including the NJBPU, a Notice of Appeal with respect to the July 2004 final order. ACE's initial brief was filed on August 17, 2005. Cross-appellant briefs on behalf of the Division of the New Jersey Ratepayer Advocate and Cogentrix Energy Inc., the co-owner of two cogeneration power plants with contracts to sell ACE approximately 397 megawatts of electricity, were filed on October 3, 2005. The NJBPU Staff filed briefs on December 12, 2005. ACE filed its reply briefs on January 30, 2006.

Default Electricity Supply Proceedings

New Jersey

On October 12, 2005, the NJBPU, following the evaluation of proposals submitted by ACE and the other three electric distribution companies located in New Jersey, issued an order reaffirming the current BGS auction process for the annual period from June 1, 2006 through May 2007. The NJBPU order maintains the current size and make up of the Commercial and Industrial Energy Pricing class (CIEP) and approved the electric distribution companies' recommended approach for the CIEP auction product, but deferred a decision on the level of the retail margin funds.

Proposed Shut Down of B.L. England Generating Facility

In April 2004, pursuant to a NJBPU order, ACE filed a report with the NJBPU recommending that ACE's B.L. England generating facility, a 447 megawatt plant, be shut down. The report stated that, while operation of the B.L. England generating facility was necessary at the time of the report to satisfy reliability standards, those reliability standards could also be satisfied in other ways. The report concluded that, based on B.L. England's current and projected operating costs resulting from compliance with more restrictive environmental requirements, the most cost-effective way in which to meet reliability standards is to shut down the B.L. England generating facility and construct additional transmission enhancements in southern New Jersey.

In December 2004, ACE filed a petition with the NJBPU requesting that the NJBPU establish a proceeding that will consist of a Phase I and Phase II and that the procedural process for the Phase I proceeding require intervention and participation by all persons interested in the prudence of the decision to shut down B.L. England generating facility and the categories of stranded costs associated with shutting down and dismantling the facility and remediation of the site. ACE contemplates that Phase II of this proceeding, which would be initiated by an ACE filing in 2008 or 2009, would establish the actual level of prudently incurred stranded costs to be recovered from customers in rates. The NJBPU has not acted on this petition.

In a January 24, 2006 Administrative Consent Order (ACO) among PHI, Conectiv, ACE, the New Jersey Department of Environmental Protection (NJDEP) and the Attorney General of New Jersey, ACE agreed to shut down and permanently cease operations at the B.L. England generating facility by December 15, 2007 if ACE does not sell the plant. The shut-down of the B.L. England generating facility will be subject to necessary approvals from the relevant agencies and the outcomes of the auction process, discussed under "ACE Auction of Generating Assets," below.

ACE Auction of Generation Assets

In May 2005, ACE announced that it would again auction its electric generation assets, consisting of its B.L. England generating facility and its ownership interests in the Keystone and Conemaugh generating stations. On November 15, 2005, ACE announced an agreement to sell its interests in the Keystone and Conemaugh generating stations to Duquesne Light Holdings Inc. for $173.1 million. The sale, subject to approval by the NJBPU as well as other regulatory agencies and certain other legal conditions, is expected to be completed mid-year 2006.

Based on the expressed need of the potential B.L. England bidders for the details of the ACO relating to the shut down of the plant that was being negotiated between ACE and the NJDEP, ACE elected to delay the final bid due date for B.L. England until such time as a final ACO was complete and available to bidders. With the January 24, 2006 execution of the ACO by all parties, ACE is proceeding with the auction process. Indicative bids were received on February 16, 2006 and final bids are scheduled to be submitted on or about April 19, 2006.

Under the terms of sale, any successful bid for B.L. England must include assumption of all environmental liabilities associated with the plant in accordance with the auction standards previously issued by the NJBPU.

Any sale of B.L. England will not affect the stranded costs associated with the plant that already have been securitized. If B.L. England is sold, ACE anticipates that, subject to regulatory approval in Phase II of the proceeding described above, approximately $9.1 million of additional assets may be eligible for recovery as stranded costs. The net gains on the sale of the Keystone and Conemaugh generating stations will be an offset to stranded costs associated with the shutdown of B. L. England or will be offset through other ratemaking adjustments. Testimony filed by ACE with the NJBPU in December 2005 estimated net gains of approximately $126.9 million; however, the net gains ultimately realized will be dependent upon the timing of the closing of the sale of Keystone and Conemaugh generating stations, transaction costs and other factors.

IRS Mixed Service Cost Issue

During 2001, ACE changed its methods of accounting with respect to capitalizable construction costs for income tax purposes, which allow the companies to accelerate the deduction of certain expenses that were previously capitalized and depreciated. Through December 31, 2005, these accelerated deductions have generated incremental tax cash flow benefits of approximately $49 million for ACE, primarily attributable to its 2001 tax returns. On August 2, 2005, the IRS issued Revenue Ruling 2005-53 (the Revenue Ruling) that will limit the ability of ACE to utilize this method of accounting for income tax purposes on its tax returns for 2004 and prior years. ACE intends to contest any IRS adjustment to its prior year income tax returns based on the Revenue Ruling. However, if the IRS is successful in applying this Revenue Ruling, ACE would be required to capitalize and depreciate a portion of the construction costs previously deducted and repay the associated income tax benefits, along with interest thereon. During 2005, ACE recorded a $2.0 million increase in income tax expense to account for the accrued interest that would be paid on the portion of tax benefits that ACE estimates would be deferred to future years if the construction costs previously deducted are required to be capitalized and depreciated.

On the same day as the Revenue Ruling was issued, the Treasury Department released regulations that, if adopted in their current form, would require ACE to change its method of accounting with respect to capitalizable construction costs for income tax purposes for all future tax periods beginning in 2005. Under these regulations, ACE will have to capitalize and depreciate a portion of the construction costs that it has previously deducted and include the impact of this adjustment in taxable income over a two-year period beginning with tax year 2005. ACE is continuing to work with the industry to determine an alternative method of accounting for capitalizable construction costs acceptable to the IRS to replace the method disallowed by the proposed regulations.

In February 2006, PHI paid approximately $121 million, a portion of which is attributable to ACE, of taxes to cover the amount of taxes management estimates will be payable once a new final method of tax accounting is adopted on its 2005 tax return, due to the proposed regulations. Although the increase in taxable income will be spread over the 2005 and 2006 tax return periods, the cash payments would have all occurred in 2006 with the filing of the 2005 tax return and the ongoing 2006 estimated tax payments. This $121 million tax payment was accelerated to eliminate the need to accrue additional federal interest expense for the potential IRS adjustment related to the previous tax accounting method PHI used during the 2001-2004 tax years.

Contractual Obligations

As of December 31, 2005, ACE's contractual obligations under non-derivative fuel and power purchase contracts (excluding BGS supplier load commitments) were $308.8 million in 2006, $589.9 million in 2007 to 2008, $548.0 million in 2009 to 2010, and $3,070.5 million in 2011 and thereafter.

(12) RELATED PARTY TRANSACTIONS

PHI Service Company provides various administrative and professional services to PHI and its regulated and unregulated subsidiaries including ACE. The cost of these services is allocated in accordance with cost allocation methodologies set forth in the service agreement using a variety of factors, including the subsidiaries' share of employees, operating expenses, assets, and other cost causal methods. These intercompany transactions are eliminated in consolidation and no profit results from these transactions. PHI Service Company costs directly charged or allocated to ACE for the years ended December 31, 2005, 2004 and 2003 were $82.2 million, $86.3 million and $89.5 million, respectively.

In addition to the PHI Service Company charges described above, ACE's financial statements include the following related party transactions in its Consolidated Statements of Earnings:

	For the Year Ended December 31,		
	2005	2004	2003
(Expense) Income	(Millions of dollars)		
Purchased power from Conectiv Energy Supply (b)	$(85.8)	$(41.6)	$ -
Tolling arrangement with Conectiv Energy Supply (a)	-	-	7.2
Meter reading services provided by Millennium Account Services LLC (d)	(3.7)	(3.7)	(3.5)
Inter-company lease transactions related to computer services (a)	1.6	1.7	1.9
Inter-company lease transactions related to facilities (a)	(1.9)	(1.9)	(1.8)
Inter-company labor charges for facility work (a)	.2	.2	.2
Inter-company use revenue (a)	1.3	1.3	1.2
Inter-company use expense (a)	(1.0)	(.9)	(.9)
Inter-company interest expense (c)	(.4)	(.3)	(.2)
Money pool interest income (c)	1.5	.5	1.0

(a) Included in operating revenue.
(b) Included in fuel and purchased energy.
(c) Included in interest and dividend income.
(d) Included in other operation and maintenance.

As of December 31, 2005 and 2004, ACE had the following balances due (to)/from related parties:

	2005	2004
Asset (Liability)	(Millions of dollars)	
Receivable from Related Party		
King Street Assurance	$ -	$ 2.6
Payable to Related Party (current)		
PHI Service Company	(7.2)	(11.9)
Conectiv Energy Supply	(30.9)	(4.5)
Other Related Party Activity	(.2)	(.2)
Total Net Payable to Related Parties	$(38.3)	$(14.0)
Money Pool Balance with Pepco Holdings (included in cash and cash equivalents)	$ 4.0	$ 1.7
Money Pool Interest Receivable (included in accounts receivable)	$ .5	$ -

(13) EXTRAORDINARY ITEMS

On April 19, 2005, ACE, the staff of the New Jersey Board of Public Utilities (NJBPU), the New Jersey Ratepayer Advocate, and active intervenor parties agreed on a settlement in ACE's electric distribution rate case. As a result of this settlement, ACE reversed $15.2 million in accruals related to certain deferred costs that are now deemed recoverable. The after tax credit to income of $9.0 million is classified as an extraordinary gain in the 2005 financial statements since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.

In July 2003, the NJBPU approved the recovery of $149.5 million of stranded costs related to ACE's B.L. England generating facility. As a result of the order, ACE reversed $10.0 million of accruals for the possible disallowances related to these stranded costs. The after tax credit to income of $5.9 million is classified as an extraordinary gain in the 2003 financial statements, since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.

(14) RESTATEMENT

Our parent company, Pepco Holdings, restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements. The restatement includes the correction of other errors for the same periods, primarily relating to unbilled revenue, taxes, and various accrual accounts, which were considered by management to be immaterial. These other errors would not themselves have required a restatement absent the restatement to correct the accounting for deferred compensation arrangements. The restatement of Pepco Holdings consolidated financial statements was required solely because the cumulative impact of the correction, if recorded in the fourth quarter of 2005, would have been material to that period's reported net income. The restatement to correct the accounting for the deferred compensation arrangements had no impact on ACE; however, ACE restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to reflect the correction of other errors. The correction of these other errors, primarily relating to taxes and various accrual accounts, was considered by management to be immaterial. The following table sets forth for ACE, for the years ended December 31, 2004 and 2003, the impact of the restatement to correct the errors noted above (millions of dollars):

	December 31, 2004		December 31, 2003	
	Previously Reported	Restated	Previously Reported	Restated
Consolidated Statement of Earnings				
Total Operating Revenue	$1,333.2	$1,333.2	$1,236.0	$1,236.0
Total Operating Expenses	1,173.9	1,175.0	1,116.0	1,115.5
Total Operating Income	159.3	158.2	120.0	120.5
Other Expenses	(52.4)	(53.9)	(49.4)	(49.9)
Income Before Income Tax Expense	106.9	104.3	68.8	68.8
Net Income	$ 64.6	$ 61.7	$ 47.4	$ 47.4
Consolidated Balance Sheets				
Total Current Assets	$ 229.0	$ 237.4	$ 329.7	$ 335.8
Total Investments and Other Assets	1,102.6	1,101.0	1,205.3	1,205.3
Net Property, Plant and Equipment	1,139.1	1,138.7	1,041.5	1,041.1
Total Assets	2,470.7	2,477.1	2,576.5	2,582.2
Total Current Liabilities	283.7	291.6	258.0	261.9
Total Deferred Credits	683.4	683.6	723.0	723.6
Total Long-Term Liabilities	965.1	965.1	1,048.8	1,048.8
Total Shareholder's Equity	532.3	530.6	540.5	541.7
Total Liabilities and Shareholder's Equity	$2,470.7	$2,477.1	$2,576.5	$2,582.2
Consolidated Statement of Cash Flows				
Net Cash Provided by Operating Activities	$ 173.1	$ 169.9	$ 144.9	$ 145.5
Net Cash Used in Investing Activities	$ (147.7)	$ (147.7)	$ (73.4)	$ (73.4)
Net Cash Used in Financing Activities	$ (128.4)	$ (124.8)	$ (189.9)	$(190.6)
Consolidated Statement of Shareholder's Equity				
Retained Earnings at December 31,	$ (213.3)	$ 211.6	$ 159.6	$ 160.8

(15) QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The unaudited quarterly financial information for the three months ended March 31, 2005, June 30, 2005, and September 30, 2005 and all interim periods during the year ended December 31, 2004 have been restated to reflect the correction of certain immaterial errors. See Note 14 for further discussion. The quarterly data presented below reflect all adjustments necessary in the opinion of management for a fair presentation of the interim results. Quarterly data normally vary seasonally because of temperature variations, differences between summer and winter rates, and the scheduled downtime and maintenance of electric generating units.

	2005							
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated		Total
	(Millions of dollars)							
Total Operating Revenue	$309.3	$309.3	$290.7	$290.7	$548.5	$548.6	$371.8	$1,520.4
Total Operating Expenses	289.6	287.7	257.8	257.7	475.2	475.1	351.7	1,372.2
Operating Income	19.7	21.6	32.9	33.0	73.3	73.5	20.1	148.2
Other Expenses	(11.7)	(12.3)	(11.9)	(12.5)	(12.5)	(13.2)	(12.7)	(50.7)
Income Before Income Taxes	8.0	9.3	21.0	20.5	60.8	60.3	7.4	97.5
Income Tax Expense	3.0	4.0	8.4	8.2	26.8 (c)	26.6 (c)	4.5 (d)	43.3
Income Before Extraordinary Item	5.0	5.3	12.6	12.3	34.0	33.7	2.9	54.2
Extraordinary Item	9.0 (a)	9.0(a)	-	-	-	-	-	9.0
Net Income	14.0	14.3	12.6	12.3	34.0	33.7	2.9	63.2
Dividends on Preferred Stock	.1	.1	.1	.1	.1	.1	-	.3
Earnings Available for Common Stock	$ 13.9	$ 14.2	$ 12.5	$ 12.2	$ 33.9	$ 33.6	$ 2.9	$ 62.9

	2004								
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Total
	(Millions of dollars)								
Total Operating Revenue	$322.4	$322.4	$315.9	$315.9	$420.6	$420.6	$274.3	$274.3	$1,333.2
Total Operating Expenses	298.3	298.8	257.2 (b)	257.1 (b)	363.4	363.3	255.0	255.8	1,175.0
Operating Income	24.1	23.6	58.7	58.8	57.2	57.3	19.3	18.5	158.2
Other Expenses	(12.5)	(12.8)	(13.9)	(14.2)	(12.9)	(13.3)	(13.1)	(13.6)	(53.9)
Income Before Income Taxes	11.6	10.8	44.8	44.6	44.3	44.0	6.2	4.9	104.3
Income Tax Expense	4.8	4.5	18.4	18.3	18.7	17.8	.4	2.0	42.6
Net Income	6.8	6.3	26.4	26.3	25.6	26.2	5.8	2.9	61.7
Dividends on Preferred Stock	.1	.1	.1	.1	.1	.1	-	-	.3
Earnings Available for Common Stock	$ 6.7	$ 6.2	$ 26.3	$ 26.2	$ 25.5	$ 26.1	$ 5.8	$ 2.9	$ 61.4

NOTE: Sales of electric energy are seasonal and, accordingly, comparisons by quarter within a year are not meaningful.

(a) Relates to ACE's electric distribution rate case settlement that was accounted for in the first quarter of 2005. This resulted in ACE's reversal of $9.0 million in after tax accruals related to certain deferred costs that are now deemed recoverable. This amount is classified as an extraordinary gain since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.

(b) Includes a $14.7 million pre-tax ($8.6 million after tax) gain from the condemnation settlement associated with the transfer of Vineland distribution assets.

(c) Includes $1.7 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(d) Includes $.3 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(16) SUBSEQUENT EVENT

On February 9, 2006, certain institutional buyers tentatively agreed to purchase in a private placement $105 million of ACE's senior notes having an interest rate of 5.80% and a term of 30 years. The execution of a definitive purchase agreement and closing is expected on or about March 15, 2006. The proceeds from the notes would be used to repay outstanding commercial paper issued by ACE to fund the payment at maturity of $105 million in principal amount of various issues of medium-term notes.

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Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None for all registrants.

Item 9A. CONTROLS AND PROCEDURES

Pepco Holdings, Inc.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision, and with the participation of management, including the chief executive officer and the chief financial officer, Pepco Holdings has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of December 31, 2005, and, based upon this evaluation, the chief executive officer and the chief financial officer of Pepco Holdings have concluded that these controls and procedures are effective to provide reasonable assurance that material information relating to Pepco Holdings and its subsidiaries that is required to be disclosed in reports filed with, or submitted to, the SEC under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified by the SEC rules and forms and (ii) is accumulated and communicated to management, including its chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Management's Consideration of the Restatement

As discussed in Note 15 of the Notes to Consolidated Financial Statements in Part II, Item 8 of this Form 10-K, Pepco Holdings restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements and to correct errors with respect to unbilled revenue, taxes and various accrual accounts. In coming to the conclusion that the Company's disclosure controls and procedures and the Company's internal control over financial reporting were effective as of December 31, 2005 management concluded that the restatement items described in Note 15 of the Notes to Consolidated Financial Statements in Part II, Item 8 of this Form 10-K, individually or in the aggregate, did not constitute a material weakness. In coming to this conclusion management reviewed and analyzed the Securities and Exchange Commission's Staff Accounting Bulletin ("SAB") No. 99, "Materiality," paragraph 29 of Accounting Principles Board Opinion No. 28, "Interim Financial Reporting," and SAB Topic 5F, "Accounting Changes Not Retroactively Applied Due to Immateriality," and took into consideration (i) that the restatement adjustments did not have a material impact on the financial statements of prior interim or annual periods taken as a whole; (ii) that the cumulative impact of the restatement adjustments on shareholders' equity was not material to the financial statements of prior interim or annual periods; and (iii) that Pepco Holdings decided to restate its previously issued financial statements solely because the cumulative impact of the adjustments would have been material to the fourth quarter of 2005 reported net income.

Management's Report on Internal Control Over Financial Reporting

See "Management's Report on Internal Control Over Financial Reporting" in Part II, Item 8 of this Form 10-K.

Attestation Report of the Registered Public Accounting Firm

See "Report of Independent Registered Public Accounting Firm" in Part II, Item 8 of this Form 10-K.

Changes in Internal Control Over Financial Reporting

During the quarter ended December 31, 2005, there was no change in Pepco Holdings' internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, Pepco Holdings' internal controls over financial reporting.

Pepco Holdings' subsidiary, Conectiv Energy, which operates a competitive energy business, is in the process of installing new energy transaction software that provides additional functionality, such as enhanced PJM reconciliation capability, hedge accounting, greater risk analysis capability and enhanced regulatory reporting capability. During the second quarter of 2006, Conectiv Energy anticipates implementing the new software for all energy commodity transactions. The Conectiv Energy implementation will be the first commercial implementation of this software and extensive pre-implementation testing has been performed to ensure internal controls over financial reporting continue to be effective. Operating effectiveness of internal controls over financial reporting will continue to be evaluated post implementation.

<u>Potomac Electric Power Company</u>

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision, and with the participation of management, including the chief executive officer and the chief financial officer, Pepco has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of December 31, 2005, and, based upon this evaluation, the chief executive officer and the chief financial officer of Pepco have concluded that these controls and procedures are effective to provide reasonable assurance that material information relating to Pepco that is required to be disclosed in reports filed with, or submitted to, the SEC under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified by the SEC rules and forms and (ii) is accumulated and communicated to management, including its chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Management's Consideration of the Restatement

As discussed in Note 13 of the Notes to Financial Statements in Part II, Item 8 of this Form 10-K, Pepco restated its previously reported financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements and to correct errors with respect to unbilled revenue, taxes, and various accrual accounts. In coming to the conclusion that the Company's disclosure controls and procedures were effective as of December 31, 2005, management concluded that the restatement items described in Note 13 of the Notes to Financial Statements in Part II, Item 8 of this Form 10-K, individually or in the aggregate, did not constitute a material weakness. In coming to this conclusion management reviewed and analyzed the Securities and Exchange Commission's Staff Accounting Bulletin ("SAB") No. 99, "Materiality," paragraph 29 of Accounting Principles Board Opinion No. 28, "Interim Financial Reporting," and SAB Topic 5F, "Accounting Changes Not Retroactively Applied Due to Immateriality," and took into consideration (i) that the restatement adjustments did not have a material impact on the financial statements of prior interim or annual periods taken as a whole; (ii) that the cumulative impact of the restatement adjustments on shareholder's equity was not material to the financial statements of prior interim or annual periods; and (iii) that Pepco decided to restate its previously issued financial statements solely because the cumulative impact of the adjustments would have been material to the fourth quarter of 2005 reported net income.

Changes in Internal Control Over Financial Reporting

During the quarter ended December 31, 2005, there was no change in Pepco's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, Pepco's internal controls over financial reporting.

Delmarva Power and Light Company

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision, and with the participation of management, including the chief executive officer and the chief financial officer, DPL has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of December 31, 2005, and, based upon this evaluation, the chief executive officer and the chief financial officer of DPL have concluded that these controls and procedures are effective to provide reasonable assurance that material information relating to DPL that is required to be disclosed in reports filed with, or submitted to, the SEC under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified by the SEC rules and forms and (ii) is accumulated and communicated to management, including its chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Management's Consideration of the Restatement

As further discussed in Note 13 of the Notes to Financial Statements in Part II, Item 8 of this Form 10-K, DPL restated its financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct errors with respect to unbilled revenue, taxes and various accrual accounts. In coming to the conclusion that the Company's disclosure controls and procedures were effective as of December 31, 2005, management concluded that the restatement items described in Note 13 of the Notes to Financial Statements in Part II, Item 8 of this Form 10-K, individually or in the aggregate, did not constitute a material weakness. In coming to this conclusion management reviewed and analyzed the Securities and Exchange Commission's Staff Accounting Bulletin ("SAB") No. 99, "Materiality," paragraph 29 of Accounting Principles Board Opinion No. 28, "Interim Financial Reporting," and SAB Topic 5F, "Accounting Changes Not Retroactively Applied Due to Immateriality," and took into consideration (i) that the restatement adjustments did not have a material impact on the financial statements of prior interim or annual periods taken as a whole; (ii) that the cumulative impact of the restatement adjustments on shareholder's equity was not material to the financial statements of prior interim or annual periods; and (iii) that the Company decided to restate its previously issued financial statements solely because of corrections recorded in Pepco Holdings consolidated financial statements.

Changes in Internal Control Over Financial Reporting

During the quarter ended December 31, 2005, there was no change in DPL's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, DPL's internal controls over financial reporting.

Atlantic City Electric Company

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision, and with the participation of management, including the chief executive officer and the chief financial officer, ACE has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of December 31, 2005, and, based upon this evaluation, the chief executive officer and the chief financial officer of ACE have concluded that these controls and procedures are effective to provide reasonable assurance that material information relating to ACE and its subsidiaries that is required to be disclosed in reports filed with, or submitted to, the SEC under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified by the SEC rules and forms and (ii) is accumulated and communicated to management, including its chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Management's Consideration of the Restatement

As further discussed in Note 14 of the Notes to Consolidated Financial Statements in Part II, Item 8 of this Form 10-K, ACE restated its consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct errors with respect to taxes and various accrual accounts. In coming to the conclusion that the Company's disclosure controls and procedures were effective as of December 31, 2005, management concluded that the restatement items described in Note 14 of the Notes to Consolidated Financial Statements in Part II, Item 8 of this Form 10-K, individually or in the aggregate, did not constitute a material weakness. In coming to this conclusion management reviewed and analyzed the Securities and Exchange Commission's Staff Accounting Bulletin ("SAB") No. 99, "Materiality," paragraph 29 of Accounting Principles Board Opinion No. 28, "Interim Financial Reporting," and SAB Topic 5F, "Accounting Changes Not Retroactively Applied Due to Immateriality," and took into consideration (i) that the restatement adjustments did not have a material impact on the financial statements of prior interim or annual periods taken as a whole; (ii) that the cumulative impact of the restatement adjustments on shareholder's equity was not material to the financial statements of prior interim or annual periods; and (iii) that ACE restated its previously issued consolidated financial statements solely because of corrections recorded in Pepco Holdings consolidated financial statements.

Changes in Internal Control Over Financial Reporting

During the quarter ended December 31, 2005, there was no change in ACE's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, ACE's internal controls over financial reporting.

Item 9B. OTHER INFORMATION

Pepco Holdings, Inc.

The following table sets forth for each Named Executive Officer of Pepco Holdings, Inc. ("PHI") (which officers were determined by reference to SEC Regulation S-K, Item 402(a)(3) based on 2004 compensation) information concerning determinations made on March 7, 2006 by the PHI Compensation/Human Resources Committee with respect to (i) annual bonus for 2005, and (ii) long-term incentive plan payout for the performance cycle ending in 2005 under the Merger Integration Success Program.

Name	Title	2005 Annual Bonus (1)	2006 Incentive Plan Payout (2)
Dennis R. Wraase	Chairman, President and Chief Executive Officer	$601,920	$220,546
William T. Torgerson	Vice Chairman and General Counsel	$299,136	$151,416
Thomas S. Shaw	Executive Vice President and Chief Operating Officer	$296,704	$184,166
Joseph M. Rigby	Senior Vice President and Chief Financial Officer	$170,240	$ 80,624
William H. Spence	Senior Vice President	$190,124	$ 80,624

(1) Consists of awards under the Annual Executive Incentive Compensation Plan based on the extent to which the following criteria established in 2004 were satisfied: (1) earnings relative to the corporate plan, (2) cash available for debt reduction, (3) electric system reliability, (4) diversity and (5) safety.

(2) Amounts in this column represent the value of Common Stock awarded under the Merger Integration Success Program which is a component of PHI's Long-Term Incentive Plan. In 2002, PHI granted award opportunities under the Merger Integration Success Program under which the recipient would have been entitled to earn some or all of the maximum award of Common Stock based on PHI's performance and the extent to which operating efficiencies and expense reduction goals were attained through December 31, 2003. Although the goals were met in 2003, the Compensation/Human Resources Committee determined that the shares would not vest until 2005, and then only if the cost reduction goals were maintained and PHI's financial performance remained satisfactory. On March 7, 2006, the PHI Compensation/Human Resources Committee approved the vesting of these awards under the Merger Integration Success Program. The value of the vested Common Stock has been calculated by multiplying the number of vested shares by the market price of the Common Stock on the day preceding the vesting date. Also, in 2002, PHI granted award opportunities under the Performance Restricted Stock Program pursuant to which the recipient would have been entitled to earn some or all of the maximum award of shares of PHI's Common Stock, based on PHI's total shareholder return compared to other companies in a peer group comprised of 20 gas and electric distribution companies over a three-year period January 1, 2003 through December 31, 2005. For the three-year period, total shareholder return was below the threshold level of performance and, accordingly, no Common Stock was earned.

Potomac Electric Power Company

None.

Delmarva Power & Light Company

None

Atlantic City Electric Company

None

Part III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Pepco Holdings, Inc.

Except as set forth below, the information required by this Item 10 with regard to PHI is incorporated by reference to the information contained in PHI's definitive proxy statement for the 2006 Annual Meeting of Shareholders to be filed with the SEC on or about March 30, 2006.

Executive Officers of PHI

The names of the executive officers of Pepco Holdings and their ages and the positions they held as of March 13, 2006 are set forth in the following table. Their business experience during the past five years is set forth in the footnotes to the following table.

PEPCO HOLDINGS

Name	Age	Office and Length of Service
Dennis R. Wraase	61	**Chairman of the Board, President and Chief Executive Officer** 5/04 - Present (1)
William T. Torgerson	61	**Vice Chairman and General Counsel** 6/03 - Present (2)
Thomas S. Shaw	58	**Executive Vice President and Chief Operating Officer** 8/02 - Present (3)
Joseph M. Rigby	49	**Senior Vice President and Chief Financial Officer** 5/04 - Present (4)
Ed R. Mayberry	58	**Senior Vice President** 8/02 - Present (5)
Beverly L. Perry	58	**Senior Vice President**

		10/02 - Present (6)
William J. Sim	61	**Senior Vice President** 8/02 - Present (7)
William H. Spence	49	**Senior Vice President** 8/02 - Present (8)
Ronald K. Clark	50	**Vice President and Controller** 8/05 - Present (9)

(1) Mr. Wraase was President and Chief Operating Officer of PHI from August 2002 until June 2003 and President and Treasurer from February 2001 until August 2002. Mr. Wraase is Chairman of Pepco and was Chief Executive Officer from August 2002 until October 2005. Since May 2004, he has also been Chairman of DPL and ACE. He was President and Chief Operating Officer of Pepco from January 2001 until August 2002.

(2) Mr. Torgerson was Executive Vice President and General Counsel of PHI from August 2002 until June 2003 and Secretary from February 2001 until August 2002. Mr. Torgerson served as Executive Vice President and General Counsel of Pepco from January 2001 until August 2002.

(3) Mr. Shaw has served as President since May 2004 and Chief Executive Officer of DPL since August 2002. Mr. Shaw has served as President and Chief Operating Officer of Conectiv since September 2000. He was also Executive Vice President of DPL from 1998 until 2002.

(4) Mr. Rigby served as President from July 2001 until May 2004 and as Chief Executive Officer of ACE from August 2002 until May 2004. He served as President of DPL from August 2002 until May 2004 and has served as Senior Vice President of Conectiv since September 2000.

(5) Dr. Mayberry has served as President and Chief Executive Officer of Pepco Energy Services since May 1995.

(6) Ms. Perry served as Vice President of Pepco from April 1999 to August 2002.

(7) Mr. Sim has served as President and Chief Executive Officer of Pepco since October 2005. Mr. Sim was President and Chief Operating Officer of Pepco from August 2002 until October 2005 and was Senior Vice President of Pepco from January 2001 until August 2002.

(8) Mr. Spence has served as President and Chief Operating Officer, Conectiv Energy, since August 2002 and as Senior Vice President of Conectiv since September 2000.

(9) Mr. Clark has been employed by PHI since June 2005 and has also served as Vice President and Controller of Pepco and DPL and Controller of ACE since August 2005. From July 2004 until June 2005, he was Vice President, Financial Reporting and Policy for MCI, Inc. From June 2002 until December 2003, Mr. Clark served as Vice President, Controller and Chief Accounting Officer of Allegheny Energy, Inc. From January 2002 until May 2002, he was Controller of Lockheed Martin Global Telecommunications, a business segment of Lockheed Martin Corporation, and from April 2001 until January 2002, he was Assistant Controller of that entity. From March 1995 until March 2001, Mr. Clark served as Director, Financial Transactions and Reporting for Lockheed Martin Corporation.

The PHI executive officers serve until the next succeeding Annual Meeting and until their respective successors have been elected and qualified.

INFORMATION FOR THIS ITEM IS NOT REQUIRED FOR PEPCO, DPL, AND ACE AS THEY MEET THE CONDITIONS SET FORTH IN GENERAL INSTRUCTIONS I(1)(a) AND (b) OF FORM 10-K AND THEREFORE ARE FILING THIS FORM WITH THE REDUCED FILING FORMAT.

Item 11. EXECUTIVE COMPENSATION

Pepco Holdings, Inc.

The information required by this Item 11 with regard to PHI is incorporated herein by reference to the information contained under the caption "Executive Compensation" in its definitive Proxy Statement for the 2006 Annual Meeting of Shareholders to be filed with the SEC on or about March 30, 2006.

INFORMATION FOR THIS ITEM IS NOT REQUIRED FOR PEPCO, DPL, AND ACE AS THEY MEET THE CONDITIONS SET FORTH IN GENERAL INSTRUCTIONS I(1)(a) AND (b) OF FORM 10-K AND THEREFORE ARE FILING THIS FORM WITH THE REDUCED FILING FORMAT.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Pepco Holdings, Inc.

The information required by Item 12 for Pepco Holdings concerning the security ownership of certain beneficial owners and management is incorporated herein by reference to information contained under the caption "Security Ownership of Certain Beneficial Owners and Management" in its definitive proxy statement for the 2006 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission on or about March 30, 2006.

The following table provides information as of December 31, 2005, with respect to the shares of PHI's common stock that may be issued under PHI's existing equity compensation plans.

Equity Compensation Plans Information

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options	(b) Weighted-Average Exercise Price of Outstanding Options	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity Compensation Plans Approved by Shareholders (1)	(2)	(2)	9,673,810
Equity Compensation Plans Not Approved by Shareholders (3)	0	0	497,976
Total	0	0	10,171,786

(1) Consists solely of the Pepco Holdings, Inc. Long-Term Incentive Plan.

(2) In connection with the merger of Pepco and Conectiv (i) outstanding options granted under the Potomac Electric Power Company Long-Term Incentive Plan were converted into options to purchase 1,365,941 shares of PHI common stock and (ii) options granted under the Conectiv Incentive Compensation Plan were converted into options to purchase 756,660 shares of PHI common stock, of which 3,205 were forfeited in 2005 and 196,299 were exercised in 2005. Collectively, these outstanding options to purchase an aggregate of 1,864,250 shares of PHI common stock have a weighted average exercise price of $22.1944.

(3) On January 1, 2005, the PHI Non-Management Directors Compensation Plan (the "Plan") became effective, pursuant to which 500,000 shares of PHI common stock became available for future issuance. Under the Plan, each director who is not an employee of PHI or any of its subsidiaries ("non-management director") is entitled to elect to receive his or her annual retainer, retainer for service as a committee chairman, if any, and meeting fees in: (i) cash, (ii) shares of PHI's common stock, (iii) a credit to an account for the director established under the Company's Executive and Director Deferred Compensation Plan or (iv) any combination thereof. The Plan expires on December 31, 2014 unless terminated earlier by the Board of Directors.

INFORMATION FOR THIS ITEM IS NOT REQUIRED FOR PEPCO, DPL, AND ACE AS THEY MEET THE CONDITIONS SET FORTH IN GENERAL INSTRUCTIONS I(1)(a) AND (b) OF FORM 10-K AND THEREFORE ARE FILING THIS FORM WITH THE REDUCED FILING FORMAT.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Pepco Holdings, Inc.

The information required by Item 13, if any, with regard to PHI is incorporated herein by reference to the information contained in its definitive proxy statement for the 2006 Annual Meeting of Shareholders to be filed with the SEC on or about March 30, 2006.

INFORMATION FOR THIS ITEM IS NOT REQUIRED FOR PEPCO, DPL AND ACE AS THEY MEET THE CONDITIONS SET FORTH IN GENERAL INSTRUCTIONS I(1)(a) AND (b) OF FORM 10-K AND THEREFORE ARE FILING THIS FORM WITH THE REDUCED FILING FORMAT.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item 14 with regard to PHI (which includes the information required with regard to Pepco, DPL and ACE) is incorporated herein by reference to information contained in PHI's definitive proxy statement for the 2006 Annual Meeting of Shareholders to be filed with the SEC on or about March 30, 2006.

Part IV

Item 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) Documents List

1. FINANCIAL STATEMENTS

The financial statements filed as part of this report consist of:

The financial statements of each registrant set forth in Item 8. "Financial Statements and Supplemental Data."

2. FINANCIAL STATEMENT SCHEDULES

Pepco Holdings restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements. The restatement includes the correction of other errors for the same periods, primarily relating to unbilled revenue, taxes, and various accrual accounts, which were considered by management to be immaterial. These other errors would not themselves have required a restatement absent the restatement to correct the accounting for deferred compensation arrangements. This restatement was required solely because the cumulative impact of the correction, if recorded in the fourth quarter of 2005, would have been material to that period's reported net income. See Note 15 "Restatement" for further discussion.

All other financial statement schedules, other than those included below, are omitted because either they are not applicable, or the required information is presented in the financial statements, which are included in Item 8. "Financial Statements and Supplemental Data," herein.

	Registrants			
Item	Pepco Holdings	Pepco	DPL	ACE
Schedule I, Condensed Financial Information of Parent Company	372	N/A	N/A	N/A
Schedule II, Valuation and Qualifying Accounts	375	376	376	377

Schedule I, Condensed Financial Information of Parent Company is submitted below.

PEPCO HOLDINGS, INC. (Parent Company)
STATEMENTS OF EARNINGS

	For the Year Ended December 31,		
	2005	(Restated) 2004	(Restated) 2003
	(In millions, except per share data)		
OPERATING REVENUE	$ -	$ -	$ -
OPERATING EXPENSES			
Depreciation and amortization	2.1	3.8	5.9
Other operation and maintenance	5.4	2.5	1.9
Total operating expenses	7.5	6.3	7.8
OPERATING LOSS	(7.5)	(6.3)	(7.8)
OTHER INCOME (EXPENSES)			
Interest and dividend income	.1	.5	.3
Interest expense	(77.1)	(97.6)	(89.2)
Income from equity investments	406.5	317.8	158.4
	329.5	220.7	69.5
INCOME BEFORE INCOME TAXES AND EXTRAORDINARY ITEM	322.0	214.4	61.7
INCOME TAXES	(40.2)	(46.2)	(39.7)
INCOME BEFORE EXTRAORDINARY ITEM	$362.2	$260.6	$101.4
EXTRAORDINARY ITEM (net of income taxes of $6.2 million and $4.1 million for the years ended December 31, 2005 and 2003, respectively)	9.0	-	5.9
NET INCOME	$371.2	$260.6	$107.3
EARNINGS PER SHARE			
Basic and diluted before extraordinary item	$ 1.91	$ 1.48	$ .60
Basic and diluted extraordinary item	.05	-	.03
Basic and diluted earnings per share of common stock	$ 1.96	$ 1.48	$ .63

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

PEPCO HOLDINGS, INC. (Parent Company)
BALANCE SHEETS

	As of December 31,	
	2005	(Restated) 2004
	(In millions, except share data)	
ASSETS		
Current Assets		
Cash and cash equivalents	$ 43.2	$ 95.5
Prepaid and other	29.1	28.3
	72.3	123.8
Investments and Other Assets		
Notes receivable from subsidiary companies	1,137.2	1,088.0
Investment in consolidated companies	4,590.8	4,209.6
Other	44.7	54.2
	5,772.7	5,351.8
Property, Plant and Equipment		
Property, plant, and equipment	13.7	13.7
Accumulated depreciation	(13.7)	(11.6)
Net plant in service	-	2.1
Total Assets	$5,845.0	$5,477.7
CAPITALIZATION AND LIABILITIES		
Current Liabilities		
Short-term debt	$ 300.0	$ 128.6
Accounts payable	4.9	4.2
Interest and taxes accrued	7.4	7.1
	312.3	139.9
Long-Term Debt	1,948.6	1,998.8
Commitments and Contingencies		
Capitalization		
Common stock, $.01 par value; authorized 400,000,000 shares; issued 189,817,723 and 188,327,510 shares, respectively	1.9	1.9
Premium on stock and other capital contributions	2,586.3	2,552.7
Accumulated other comprehensive loss	(22.8)	(52.0)
Retained earnings	1,018.7	836.4
Total common stockholders' equity	3,584.1	3,339.0
Total Capitalization and Liabilities	$5,845.0	$5,477.7

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

PEPCO HOLDINGS, INC. (Parent Company)
STATEMENTS OF CASH FLOWS

	For the Year Ended December 31,		
	2005	(Restated) 2004	(Restated) 2003
	(Millions of dollars)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 371.2	$ 260.6	$ 107.3
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	6.6	8.5	5.9
Distributions from related parties (less than) in excess of earnings	(344.1)	(188.6)	12.1
Extraordinary item	(15.2)	-	(10.0)
Deferred income taxes, net	3.8	20.7	(27.8)
Net change in:			
Prepaid and other	(1.0)	(.1)	.9
Accounts payable	.7	2.4	(1.9)
Interest and taxes	.5	(60.5)	18.5
Other, net	12.1	14.3	14.9
Net cash provided by operating activities	34.6	57.3	119.9
CASH FLOWS FROM INVESTING ACTIVITIES			
Net investment in property, plant and equipment	-	-	(2.2)
Net cash used by investing activities	-	-	(2.2)
CASH FLOWS FROM FINANCING ACTIVITIES			
Dividends paid on common stock	(188.9)	(176.0)	(170.7)
Common stock issued to the Dividend Reinvestment Plan	27.5	29.2	31.2
Issuance of common stock	5.7	288.8	1.6
Long-term debt issued	250.0	-	500.0
Long-term debt redeemed	-	(200.0)	-
Notes receivable from associated companies	(49.1)	(93.2)	(448.6)
(Repayments) issuances of short-term debt, net	(128.6)	128.6	(210.9)
Costs of issuances and refinancings	(3.2)	(12.7)	(7.9)
Other financing activities	(.3)	-	(6.3)
Net cash used by financing activities	(86.9)	(35.3)	(311.6)
Net change in cash and cash equivalents	(52.3)	22.0	(193.9)
Beginning of year cash and cash equivalents	95.5	73.5	267.4
End of year cash and cash equivalents	$ 43.2	$ 95.5	$ 73.5

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

NOTES TO FINANCIAL INFORMATION

Pepco Holdings restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements. The restatement includes the correction of other errors for the same periods, primarily relating to unbilled revenue, taxes, and various accrual accounts, which were considered by management to be immaterial. These other errors would not themselves have required a restatement absent the restatement to correct the accounting for deferred compensation arrangements. This restatement was required solely because the cumulative impact of the correction, if recorded in the fourth quarter of 2005, would have been material to that period's reported net income. The impact of the restatement related to the deferred compensation arrangements on periods prior to 2003 has been reflected as a reduction of approximately $23 million to Pepco Holdings' retained earnings balance as of January 1, 2003.