

LARGE FILING SEPERATOR SHEET

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DESCRIPTION OF DOCUMENT:

RENEWAL APP. CONTINUED

PEPCO HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| LIABILITIES AND SHAREHOLDERS' EQUITY | December 31, 2006 | December 31, 2005 |
|---|------------------------------|------------------------------|
| <i>(Millions of dollars, except shares)</i> | | |
| CURRENT LIABILITIES | | |
| Short-term debt | \$ 349.6 | \$ 156.4 |
| Current maturities of long-term debt | 857.5 | 469.5 |
| Accounts payable and accrued liabilities | 700.7 | 1,002.2 |
| Capital lease obligations due within one year | 5.5 | 5.3 |
| Taxes accrued | 99.9 | 341.2 |
| Interest accrued | 80.1 | 84.6 |
| Other | 433.6 | 358.4 |
| Total Current Liabilities | <u>2,526.9</u> | <u>2,417.6</u> |
| DEFERRED CREDITS | | |
| Regulatory liabilities | 842.7 | 594.1 |
| Income taxes | 2,084.0 | 1,935.0 |
| Investment tax credits | 46.1 | 51.0 |
| Pension benefit obligation | 78.3 | 36.3 |
| Other postretirement benefit obligations | 405.0 | 284.2 |
| Other | 256.5 | 251.4 |
| Total Deferred Credits | <u>3,712.6</u> | <u>3,152.0</u> |
| LONG-TERM LIABILITIES | | |
| Long-term debt | 3,768.6 | 4,202.9 |
| Transition Bonds issued by ACE Funding | 464.4 | 494.3 |
| Long-term project funding | 23.3 | 25.5 |
| Capital lease obligations | 111.1 | 116.6 |
| Total Long-Term Liabilities | <u>4,367.4</u> | <u>4,839.3</u> |
| COMMITMENTS AND CONTINGENCIES (NOTE 12) | | |
| MINORITY INTEREST | 24.4 | 45.9 |
| SHAREHOLDERS' EQUITY | | |
| Common stock, \$.01 par value—authorized 400,000,000 shares—issued 191,932,445 shares and 189,817,723 shares, respectively | 1.9 | 1.9 |
| Premium on stock and other capital contributions | 2,645.0 | 2,586.3 |
| Accumulated other comprehensive loss | (103.4) | (22.8) |
| Retained earnings | 1,068.7 | 1,018.7 |
| Total Shareholders' Equity | <u>3,612.2</u> | <u>3,584.1</u> |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | <u><u>\$14,243.5</u></u> | <u><u>\$14,038.9</u></u> |

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

PEPCO HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Year Ended December 31,

(Millions of dollars)

OPERATING ACTIVITIES

| | 2006 | 2005 | 2004 |
|--|----------|----------|----------|
| Net income | \$ 248.3 | \$ 371.2 | \$ 260.6 |
| Adjustments to reconcile net income to net cash from operating activities: | | | |
| Depreciation and amortization | 413.2 | 427.3 | 446.2 |
| Gain on sale of assets | (.8) | (86.8) | (30.0) |
| Gain on settlement of claims with Mirant | — | (70.5) | — |
| Gain on sale of other investment | (13.2) | (8.0) | — |
| Extraordinary item | — | (15.2) | — |
| Rents received from leveraged leases under income earned | (56.1) | (79.3) | (76.4) |
| Impairment losses | 20.7 | 4.1 | 11.2 |
| Deferred income taxes | 243.6 | (51.6) | 217.5 |
| Investment tax credit adjustments | (4.7) | (5.1) | (8.0) |
| Prepaid pension expense | 21.9 | (43.2) | .9 |
| Energy supply contracts | (5.1) | (11.3) | (12.3) |
| Other deferred charges | (94.9) | 17.0 | 3.9 |
| Other deferred credits | 18.4 | (29.1) | (25.4) |
| Changes in: | | | |
| Accounts receivable | 225.1 | (153.7) | (171.0) |
| Regulatory assets and liabilities | (31.8) | 76.1 | (11.3) |
| Prepaid expenses | 4.5 | 10.3 | 22.0 |
| Materials and supplies | (8.3) | (76.4) | 3.5 |
| Accounts payable and accrued liabilities | (375.3) | 327.5 | 120.4 |
| Interest and taxes accrued | (472.9) | 270.7 | (36.1) |
| Proceeds from sale of claims with Mirant | — | 112.9 | — |
| Proceeds from Mirant settlement | 70.0 | — | — |

Net Cash From Operating Activities 202.6 986.9 715.7

INVESTING ACTIVITIES

| | | | |
|---|---------|---------|---------|
| Net investment in property, plant and equipment | (474.6) | (467.1) | (517.4) |
| Proceeds from/changes in: | | | |
| Sale of office building and other properties | 181.5 | 84.1 | 46.4 |
| Sale of Starpower investment | — | — | 29.0 |
| Proceeds from sale of marketable securities | — | — | 117.6 |
| Purchase of marketable securities | — | — | (98.2) |
| Purchases of other investments | (.6) | (2.1) | (.3) |
| Proceeds from sale of other investments | 24.2 | 33.8 | 15.1 |
| Net investment in receivables | 2.2 | (7.1) | 2.9 |
| Changes in restricted cash | 11.0 | 19.0 | (17.8) |
| Net other investing activities | 27.2 | 5.5 | 5.4 |

Net Cash Used By Investing Activities (229.1) (333.9) (417.3)

FINANCING ACTIVITIES

| | | | |
|---|---------|---------|-----------|
| Dividends paid on preferred stock of subsidiaries | (1.2) | (2.5) | (2.8) |
| Dividends paid on common stock | (198.3) | (188.9) | (176.0) |
| Common stock issued to the Dividend Reinvestment Plan | 29.8 | 27.5 | 29.2 |
| Redemption of debentures issued to financing trust | — | — | (95.0) |
| Redemption of preferred stock of subsidiaries | (21.5) | (9.0) | (53.3) |
| Redemption of variable rate demand bonds | — | (2.0) | — |
| Issuance of common stock | 17.0 | 5.7 | 288.8 |
| Issuances of long-term debt | 514.5 | 532.0 | 650.4 |
| Reacquisition of long-term debt | (578.0) | (755.8) | (1,119.7) |
| Issuances (repayments) of short-term debt, net | 193.2 | (161.3) | 136.3 |
| Cost of issuances | (5.6) | (9.0) | (26.7) |
| Net other financing activities | 3.9 | 2.3 | 9.7 |

Net Cash Used By Financing Activities (46.2) (561.0) (359.1)

Net (Decrease) Increase In Cash and Cash Equivalents (72.7) 92.0 (60.7)

Cash and Cash Equivalents at Beginning of Year 121.5 29.5 90.2

CASH AND CASH EQUIVALENTS AT END OF YEAR \$ 48.8 \$ 121.5 \$ 29.5

NON-CASH ACTIVITIES

| | | | |
|--|----------|----------|----------|
| Asset retirement obligations associated with removal costs transferred to regulatory liabilities | \$ 78.0 | \$ (9.9) | \$ (3.8) |
| Excess accumulated depreciation transferred to regulatory liabilities | \$ — | \$ 131.0 | \$ — |
| Sale of financed project account receivables | \$ — | \$ 50.0 | \$ — |
| Recoverable pension/OPEB costs included in regulatory assets | \$ 365.4 | \$ — | \$ — |

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash paid for interest (net of capitalized interest of \$3.8 million, \$3.8 million and \$2.9 million, respectively) and paid (received) for income taxes:

| | | | |
|--------------|----------|----------|-----------|
| Interest | \$ 331.8 | \$ 328.4 | \$ 356.9 |
| Income taxes | \$ 238.6 | \$ 44.1 | \$ (19.9) |

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

PEPCO HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

| | Common Stock | | Premium on Stock | Capital Stock Expense | Accumulated Other Comprehensive (Loss) Earnings | Retained Earnings |
|--|--------------|-----------|---------------------|-----------------------------|---|----------------------|
| | Shares | Par Value | | | | |

(Millions of dollars, except shares)

| | | | | | | |
|--|-------------|--------|-----------|----------|-----------|-----------|
| BALANCE, DECEMBER 31, 2003 | 171,769,448 | \$ 1.7 | \$2,246.6 | \$ (3.3) | \$ (22.7) | \$ 751.8 |
| Net Income | — | — | — | — | — | 260.6 |
| Other comprehensive loss | — | — | — | — | (29.3) | — |
| Dividends on common stock (\$1.00/sh.) | — | — | — | — | — | (176.0) |
| Reacquisition of subsidiary preferred stock | — | — | 1.0 | — | — | — |
| Issuance of common stock: | | | | | | |
| Original issue shares | 15,086,126 | .2 | 288.6 | (10.2) | — | — |
| DRP original shares | 1,471,936 | — | 29.2 | — | — | — |
| Reacquired Conectiv and Pepco PARS | — | — | .6 | — | — | — |
| Vested options converted to Pepco Holdings options | — | — | .2 | — | — | — |
| BALANCE, DECEMBER 31, 2004 | 188,327,510 | \$ 1.9 | \$2,566.2 | \$(13.5) | \$ (52.0) | \$ 836.4 |
| Net Income | — | — | — | — | — | 371.2 |
| Other comprehensive income | — | — | — | — | 29.2 | — |
| Dividends on common stock (\$1.00/sh.) | — | — | — | — | — | (188.9) |
| Reacquisition of subsidiary preferred stock | — | — | .1 | — | — | — |
| Issuance of common stock: | | | | | | |
| Original issue shares | 261,708 | — | 5.7 | — | — | — |
| DRP original shares | 1,228,505 | — | 27.5 | — | — | — |
| Reacquired Conectiv and Pepco PARS | — | — | .3 | — | — | — |
| BALANCE, DECEMBER 31, 2005 | 189,817,723 | \$ 1.9 | \$2,599.8 | \$(13.5) | \$ (22.8) | \$1,018.7 |
| Net Income | — | — | — | — | — | 248.3 |
| Other comprehensive income | — | — | — | — | (80.2) | — |
| Impact of initially applying SFAS No. 158, net of tax | — | — | — | — | (.4) | — |
| Dividends on common stock (\$1.04/sh.) | — | — | — | — | — | (198.3) |
| Reacquisition of subsidiary preferred stock | — | — | (.4) | — | — | — |
| Issuance of common stock: | | | | | | |
| Original issue shares | 882,153 | — | 17.0 | — | — | — |
| DRP original shares | 1,232,569 | — | 29.8 | — | — | — |
| Compensation expense on share-based awards | — | — | 13.1 | — | — | — |
| Treasury stock | — | — | (.8) | — | — | — |
| BALANCE, DECEMBER 31, 2006 | 191,932,445 | \$ 1.9 | \$2,658.5 | \$(13.5) | \$(103.4) | \$1,068.7 |

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) ORGANIZATION

Pepco Holdings, Inc. (PHI or Pepco Holdings) is a diversified energy company that, through its operating subsidiaries, is engaged primarily in two principal business operations:

- electricity and natural gas delivery (Power Delivery), and
- competitive energy generation, marketing and supply (Competitive Energy).

PHI was incorporated in Delaware in 2001, for the purpose of effecting the acquisition of Conectiv by Potomac Electric Power Company (Pepco). The acquisition was completed on August 1, 2002, at which time Pepco and Conectiv became wholly owned subsidiaries of PHI. Conectiv was formed in 1998 to be the holding company for Delmarva Power & Light Company (DPL) and Atlantic City Electric Company (ACE) in connection with the combination of DPL and ACE.

In 2006, the Public Utility Holding Company Act of 1935 (PUHCA 1935) was repealed and was replaced by the Public Utility Holding Company Act of 2005 (PUHCA 2005). As a result, PHI has ceased to be regulated by the Securities and Exchange Commission (SEC) as a public utility holding company and is now subject to the regulatory oversight of the Federal Energy Regulatory Commission (FERC). PHI has notified FERC that it will continue, until further notice, to operate pursuant to the financing order issued by the SEC under PUHCA 1935, which has an authorization period ending June 30, 2008, relating to the issuance of securities and guarantees, other financing transactions and the operation of the money pool by PHI and its subsidiaries that participate in the money pool.

PHI Service Company, a subsidiary service company of PHI, provides a variety of support services, including legal, accounting, treasury, tax, purchasing and information technology services to PHI and its operating subsidiaries. These services are provided pursuant to a service agreement among PHI, PHI Service Company, and the participating operating subsidiaries. The expenses of the service company are charged to PHI and the participating operating subsidiaries in accordance with costing methodologies set forth in the service agreement.

The following is a description of each of PHI's two principal business operations.

Power Delivery

The largest component of PHI's business is Power Delivery, which consists of the transmission and distribution of electricity and the distribution of natural gas.

PHI's Power Delivery business is conducted by its three regulated utility subsidiaries: Pepco, DPL and ACE. Each subsidiary is a regulated public utility in the jurisdictions that comprise its service territory. Pepco, DPL and ACE each owns and operates a network of wires, substations and other equipment that are classified either as transmission or distribution facilities. Transmission facilities are high-voltage systems that carry wholesale electricity into, or across, the utility's service territory. Distribution facilities are low-voltage systems that carry electricity to end-use customers in the utility's service territory.

Each company is responsible for the delivery of electricity and, in the case of DPL, natural gas in its service territory, for which it is paid tariff rates established by the local public service commission. Each company also supplies electricity at regulated rates to retail customers in its service territory who do not elect to purchase electricity from a competitive energy supplier. The regulatory term for this supply 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 |
| District of Columbia | SOS |
| Maryland | SOS |
| New Jersey | Basic Generation Service (BGS) |
| Virginia | Default Service |

In this Annual Report, these supply service obligations are referred to generally as Default Electricity Supply.

Competitive Energy

The Competitive Energy business provides competitive generation, marketing and supply of electricity and gas, and related energy management services, primarily in the mid-Atlantic region. PHI's Competitive Energy operations are conducted through subsidiaries of Conectiv Energy Holding Company (collectively, Conectiv Energy) and Pepco Energy Services, Inc. and its subsidiaries (collectively, Pepco Energy Services). Conectiv Energy and Pepco Energy Services are separate operating segments for financial reporting purposes.

Other Business Operations

Over the last several years, PHI has discontinued its investments in non-energy related businesses, including the sale of its aircraft investments and the sale of its 50% interest in Starpower Communications LLC (Starpower). Through its subsidiary, Potomac Capital Investment Corporation (PCI), PHI continues to maintain a portfolio of cross-border energy sale-leaseback transactions, with a book value at December 31, 2006 of approximately \$1.3 billion. This activity constitutes a fourth operating segment, which is designated as "Other Non-Regulated" for financial reporting purposes.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation Policy

The accompanying consolidated financial statements include the accounts of Pepco Holdings and its wholly owned subsidiaries. All intercompany balances and transactions between subsidiaries have been eliminated. Pepco Holdings uses the equity method to report investments, corporate joint ventures, partnerships, and affiliated companies in which it holds a 20% to 50% voting interest and cannot exercise control over the operations and policies of the investment. Under the equity method, Pepco Holdings 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, undivided interests in several jointly owned electric plants previously held by PHI, and certain transmission and other facilities currently held, are consolidated in proportion to PHI's percentage interest in the facility.

In accordance with the provisions of Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 46R (revised December 2003), entitled "Consolidation of Variable Interest Entities," (FIN 46R) Pepco Holdings deconsolidated several entities that had previously been consolidated and consolidated several small entities that had not previously been consolidated. FIN 46R addresses conditions under which an entity should be consolidated based upon variable interests rather than voting interests. For additional information regarding the impact of implementing FIN 46R, see the FIN 46R discussion 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 (GAAP), 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 Pepco Holdings include the assessment of contingencies, the calculation of future cash flows and fair value amounts for use in goodwill and asset impairment evaluations, fair value calculations (based on estimated market pricing) associated with derivative instruments, pension and other postretirement benefits assumptions, unbilled revenue calculations, the assessment of the probability of recovery of regulatory assets, and income tax provisions and reserves. Additionally, PHI is subject to legal, regulatory, and other proceedings and claims that arise in the ordinary course of its business. PHI records an estimated liability for these proceedings and claims based upon the probable and reasonably estimable criteria contained in Statement of Financial Accounting Standards (SFAS) No. 5, "Accounting for Contingencies." Although Pepco Holdings 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.

Changes in Accounting Estimates

During 2005, Pepco recorded the impact of an increase in estimated unbilled revenue (electricity and gas delivered to the customer but not yet billed), primarily reflecting a change in Pepco's unbilled revenue estimation process. This modification in accounting estimate increased net earnings for the year ended December 31, 2005 by approximately \$2.2 million.

During 2005, DPL and ACE each recorded the impact of reductions in estimated unbilled revenue, primarily reflecting an increase in the estimated amount of power line losses (electricity lost in the process of its transmission and distribution to customers). These changes in accounting estimates reduced net earnings for the year ended December 31, 2005 by approximately \$7.4 million, of which \$1.0 million was attributable to DPL and \$6.4 million was attributable to ACE.

During 2005, Conectiv Energy increased the estimated useful lives of its generation assets which resulted in lower depreciation expense of approximately \$5.3 million.

Revenue Recognition

Regulated Revenue

The Power Delivery businesses recognize revenue from the supply and delivery of electricity and gas upon delivery to their customers, including amounts for services rendered but not yet billed (unbilled revenue). Pepco Holdings recorded amounts for unbilled revenue of \$172.2 million and \$198.2 million as of December 31, 2006 and 2005, respectively. These amounts are included in the "accounts receivable" line item in the accompanying Consolidated Balance Sheets. Pepco Holdings' utility subsidiaries calculate unbilled revenue using an output based methodology. This methodology is based on the supply of electricity or gas intended for distribution to customers. The unbilled revenue process requires management to make assumptions and judgments about input factors such as customer sales mix, distance, temperature, and estimated power line losses, 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 and gas by the utility customers, such as fuel, energy, or other similar taxes, are components of the tariff rates charged by PHI subsidiaries and, as such, are billed to customers and recorded in Operating Revenues. Accruals for these taxes are recorded in Other Taxes. Excise tax related generally to the consumption of gasoline by PHI and its subsidiaries in the normal course of business is charged to operations, maintenance or construction, and is de minimis.

Competitive Revenue

The Competitive Energy businesses recognize revenue for the supply and delivery of electricity and gas upon delivery to the customer, including amounts for electricity and gas delivered, but not yet billed. Conectiv Energy recognizes revenue when delivery is complete. Unrealized derivative gains and losses are recognized in current earnings as revenue if the derivative activity does not qualify for hedge accounting or normal sales treatment under SFAS No. 133. Pepco Energy Services recognizes revenue for its wholesale and retail commodity business upon delivery to customers. Revenue for Pepco Energy Services' energy efficiency construction business is recognized using the percentage-of-completion method of revenue recognition which recognizes revenue as work is completed on the contract, and revenue from its operation and maintenance and other products and services contracts are recognized when earned. Revenue from the Other Non-Regulated business lines are principally recognized when services are performed or products are delivered; however, revenues from utility industry services contracts are recognized using the percentage-of-completion method of revenue recognition.

Regulation of Power Delivery Operations

The Power Delivery operations of Pepco are regulated by the District of Columbia Public Service Commission (DCPSC) and the Maryland Public Service Commission (MPSC).

The Power Delivery operations of DPL are regulated by the Delaware Public Service Commission (DPSC), the MPSC, and the Virginia State Corporation Commission (VSCC). DPL's natural gas transmission's practices are regulated by the U.S. Department of Transportation.

The Power Delivery operations of ACE are regulated by the New Jersey Board of Public Utilities (NJBPU).

The wholesale power transmission operations of each of Pepco, DPL, and ACE are regulated by FERC.

The requirements of SFAS No. 71 apply to the Power Delivery businesses of Pepco, DPL, and ACE. SFAS No. 71 allows regulated entities, in appropriate circumstances, to establish regulatory assets and liabilities 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. If management subsequently determines, based on changes in facts or circumstances, that a regulatory asset is not probable of recovery, then the regulatory asset must be eliminated through a charge to earnings.

The components of Pepco Holdings' regulatory asset balances at December 31, 2006 and 2005, are as follows:

| | <u>2006</u> | <u>2005</u> |
|---|-----------------------|------------------|
| | (Millions of dollars) | |
| Securitized stranded costs | \$ 773.0 | \$ 823.5 |
| Recoverable Pension and OPEB costs | 365.4 | — |
| Deferred energy supply costs | 6.9 | 18.3 |
| Deferred recoverable income taxes | 130.5 | 150.5 |
| Deferred debt extinguishment costs | 76.9 | 80.9 |
| Unrecovered purchased power contract costs | 13.5 | 18.2 |
| Deferred other postretirement benefit costs | 15.0 | 17.5 |
| Phase in credits | 31.0 | — |
| Asset retirement cost | 33.0 | — |
| Other | 125.6 | 93.1 |
| Total regulatory assets | <u>\$1,570.8</u> | <u>\$1,202.0</u> |

The components of Pepco Holdings' regulatory liability balances at December 31, 2006 and 2005, are as follows:

| | <u>2006</u> | <u>2005</u> |
|---|------------------------------|-----------------------|
| | <u>(Millions of dollars)</u> | |
| Deferred income taxes due to customers | \$ 69.3 | \$ 73.2 |
| Deferred energy supply costs | 164.9 | 40.9 |
| Regulatory liability for Federal and New Jersey tax benefit | 34.6 | 37.6 |
| Generation Procurement Credit, customer sharing commitment, and other | 34.3 | 76.5 |
| Accrued asset removal costs | 322.2 | 244.2 |
| Excess depreciation reserve | 105.8 | 121.7 |
| Asset retirement obligation | 63.2 | — |
| Gain from sale of Keystone and Conemaugh | 48.4 | — |
| Total regulatory liabilities | <u>\$842.7</u> | <u>\$594.1</u> |

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 discontinuation 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) (Transition Bonds). 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.

Recoverable Pension and OPEB Costs: Represents the funded status of Pepco Holdings' defined benefit pension and other postretirement benefit plans that is probable of recovery in rates under SFAS No. 71 by Pepco, DPL and ACE.

Deferred Energy Supply Costs: The regulatory liability balances of \$164.9 million and \$40.9 million for the years ended December 31, 2006 and 2005, respectively, primarily represent deferred costs related to a net over-recovery by ACE connected with the provision of BGS and other restructuring related costs incurred by ACE. This deferral received a return and is being recovered over 8 years beginning in 2007. The regulatory asset balances of \$6.9 million and \$18.3 million for the years ended December 31, 2006 and 2005, respectively, represent deferred fuel costs for DPL's gas business, which are recovered annually.

Deferred Recoverable Income Taxes: Represents a receivable from our customers for tax benefits applicable to utility operations of Pepco, DPL, and ACE previously flowed through before the companies were ordered to provide deferred income taxes. As the temporary differences between the financial statement and tax basis of assets reverse, the deferred recoverable balances are reversed. 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 ACE and DPL. The ACE amortization period began in July 1994 and will end in May 2014. The DPL amortization period began in February 1996 and will end in October 2007. Both earn a return.

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.

Phase In Credits: Represents a phase-in credit for participating Maryland and Delaware customers to mitigate the immediate impact of significant rate increases in 2006. The deferral period for Delaware is May 1, 2006 to January 1, 2008, with recovery to occur over a 17-month period beginning January 1, 2008. This deferral will be amortized on a straight-line basis. The deferral period for Maryland is June 1, 2006 to June 1, 2007, with recovery to occur over an 18-month period beginning June 2007. Recovery is rate per kilowatt-hour based on usage during the recovery period.

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 utility operations of Pepco, DPL, and ACE 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.

Regulatory Liability for Federal and New Jersey Tax Benefit: 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 generating plants divested by ACE 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 until such time as the Internal Revenue Service issues its final regulations with respect to normalization of these federal excess deferred taxes.

Generation Procurement Credit (GPC), Customer Sharing Commitment, and Other: Pepco's settlement agreements related to its December 2000 generation asset divestiture, 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 SOS 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. The GPC increased by \$42.3 million in December 2005 due to the settlement of Pepco's \$105 million allowed, pre-petition general unsecured claim against Mirant Corporation and its predecessors and its subsidiaries (Mirant) (the Pepco TPA Claim).

Accrued Asset Removal Costs: Represents Pepco's and DPL's asset retirement obligations 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.

Excess Depreciation Reserve: The excess depreciation reserve was recorded as part of a New Jersey rate case settlement. This excess reserve is the result of a change in depreciable lives and a change in depreciation technique from remaining life to whole life. The excess is being amortized over an 8.25 year period, which began in June 2005.

Asset Retirement Obligation: During the first quarter of 2006, ACE recorded an asset retirement obligation of \$60 million for B.L. England plant demolition and environmental remediation costs. Amortization of the liability is over a two-year period amortized quarterly. The cumulative amortization of \$33.0 million at December 31, 2006, is recorded as a regulatory asset—"Asset Retirement Cost." As discussed in Note (12) Commitments and Contingencies—"ACE Sale of Generating Assets," on February 8, 2007, ACE completed the sale of the B.L. England generating facility.

Gain from Sale of Keystone and Conemaugh: On September 1, 2006, ACE completed the sale of its interests in the Keystone and Conemaugh generating facilities to Duquesne Light Holdings Inc. for approximately \$177.0 million, which was subsequently decreased by \$1.6 million based on a post-closing 60-day true-up for applicable items not known at the time of the closing. Approximately \$81.3 million of the net gain from the sale has been used to offset a remaining regulatory asset balance, which ACE has been recovering in rates, and approximately \$49.8 million of the net gain is being returned to ratepayers over a 33-month period as a credit on their bills, which began during the October 2006 billing period. The balance to be repaid to customers is \$48.4 million as of December 31, 2006.

Accounting for Derivatives

Pepco Holdings and its subsidiaries use derivative instruments primarily to manage risk associated with commodity prices and interest rates. Risk management policies are determined by PHI's Corporate Risk Management Committee (CRMC), the members of which are PHI's Chief Risk Officer, Chief Operating Officer, Chief Financial Officer, General Counsel, Chief Information Officer and other senior executives. The CRMC monitors interest rate fluctuation, commodity price fluctuation, and credit risk exposure, and sets risk management policies that establish limits on unhedged risk and determine risk reporting requirements.

PHI accounts for its derivative activities in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by subsequent pronouncements. SFAS No. 133 requires derivative instruments to be measured at fair value. Derivatives are recorded on the Consolidated Balance Sheets as other assets or other liabilities with offsetting gains and losses flowing through earnings unless they are designated as cash flow hedges. Derivatives can be accounted for in four ways under SFAS No. 133: (i) marked-to-market through current earnings, (ii) cash flow hedge accounting, (iii) fair value hedge accounting, and (iv) normal purchase and sales accounting.

Mark-to-market gains and losses on derivatives that are not designated as hedges are presented on the Consolidated Statements of Earnings as operating revenue. PHI uses mark-to-market accounting through earnings for derivatives that either do not qualify for hedge accounting or that management does not designate as hedges.

The gain or loss on a derivative that hedges exposure to variable cash flow of a forecasted transaction is initially recorded in Other Comprehensive Income (a separate component of common stockholders' equity) and is subsequently reclassified into earnings in the same category as the item being hedged when the forecasted transaction occurs. If a forecasted transaction is no longer probable, the deferred gain or loss in accumulated other comprehensive income is immediately reclassified to earnings. Gains or losses related to any ineffective portion of cash flow hedges are also recognized in earnings immediately.

Changes in the fair value of derivatives designated as fair value hedges result in a change in the value of the asset, liability, or firm commitment being hedged. Changes in fair value of the asset, liability, or firm commitment, and the hedging instrument, are recorded in the Consolidated Statements of Earnings.

Certain commodity forwards are not required to be recorded on a mark-to-market basis of accounting under SFAS No. 133. These contracts are designated as "normal purchases and sales" as permitted by SFAS No. 133. This type of contract is used in normal operations, settles physically, and follows standard accrual accounting. Unrealized gains and losses on these contracts do not appear on the Consolidated Balance Sheets. Examples of these transactions include purchases of fuel to be consumed in power plants and actual receipts and deliveries of electric power. Normal purchases and sales transactions are presented on a gross basis, normal sales as operating revenue, and normal purchases as fuel and purchased energy expenses.

PHI uses option contracts to mitigate certain risks. These options are normally marked-to-market through current earnings because of the difficulty in qualifying options for hedge accounting treatment. Market prices, when available, are used to value options. If market prices are not available, the market value of the options is

estimated using Black-Scholes closed form models. Option contracts typically make up only a small portion of PHI's total derivatives portfolio.

The fair value of derivatives is determined using quoted exchange prices where available. For instruments that are not traded on an exchange, external broker quotes are used to determine fair value. For some custom and complex instruments, internal models are used to interpolate broker quality price information. Models are also used to estimate volumes for certain transactions. The same valuation methods are used to determine the value of non-derivative commodity exposure for risk management purposes.

The impact of derivatives that are marked-to-market through current earnings, the ineffective portion of cash flow hedges, and the portion of fair value hedges that flows to current earnings are presented on a net basis in the Consolidated Statements of Earnings. When a hedging gain or loss is realized, it is presented on a net basis in the same category as the underlying item being hedged. Normal purchase and sale transactions are presented gross on the Consolidated Statements of Earnings as they are realized. The unrealized assets and liabilities that offset unrealized derivative gains and losses are presented gross on the Consolidated Balance Sheets except where contractual netting agreements are in place.

Conectiv Energy engages in commodity hedging activities to minimize the risk of market fluctuations associated with the purchase and sale of energy commodities (natural gas, petroleum, coal and electricity). The majority of these hedges relate to the procurement of fuel for its power plants, fixing the cash flows from the plant output, and securing power for its load supply obligations. Conectiv Energy's hedging activities are conducted using derivative instruments, including forward contracts, swaps and futures, designated as cash flow hedges which are designed to reduce the variability in future cash flows. Conectiv Energy's commodity hedging objectives, in accordance with its risk management policy, are primarily the assurance of stable and known cash flows and the fixing of favorable prices and margins when they become available.

Conectiv Energy assesses risk on a total portfolio basis and by component (e.g. generation output, generation fuel, load supply, etc.). Portfolio risk combines the generation fleet, load obligations, miscellaneous commodity sales and hedges. Derivatives designated as cash flow and fair value hedges (Accounting Hedges) are matched against each component using the product or products that most closely represent the underlying hedged item. The total portfolio is risk managed based on its megawatt position by month. If the total portfolio becomes too long or too short for a period as determined in accordance with Conectiv Energy's policies, steps are taken to reduce or increase hedges. Portfolio-level hedging includes the use of Accounting Hedges, derivatives that are being marked-to-market through earnings, and other physical commodity purchases and sales.

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 capacity contracts that do not meet the definition of derivatives. The primary goal of these activities is to reduce the exposure of its regulated retail gas customers to natural gas price spikes. All premiums paid and other transaction costs incurred as part of DPL's natural gas hedging activity, in addition to all gains and losses on the natural gas hedging activity, are fully recoverable through the gas cost rate clause included in DPL's gas tariff rates approved by the DPSC and are deferred under SFAS No. 71 until recovered. At December 31, 2006, DPL had a net deferred derivative payable of \$27.3 million, offset by a \$28.5 million regulatory asset. At December 31, 2005, DPL had a deferred derivative receivable on DPL's balance sheet of \$21.6 million, offset by a \$21.6 million regulatory liability.

Pepco Energy Services purchases electric and natural gas futures, swaps, options and forward contracts to hedge price risk in connection with the purchase of physical natural gas and electricity for delivery to customers. Pepco Energy Services accounts for its futures and swap contracts as cash flow hedges of forecasted transactions. Its options contracts are marked-to-market through current earnings. Its forward contracts are accounted for

under standard accrual accounting as these contracts meet the requirements for normal purchase and sale accounting under SFAS No. 133.

PCI has entered into interest rate swap agreements for the purpose of managing its overall borrowing rate and managing its interest rate exposure associated with debt it has issued. As of December 31, 2006, approximately 72.9% of PCI's fixed rate debt for its Medium-Term Note program has been swapped into variable rate debt in a transaction entered into in December 2001, which matures in December 2008. All of PCI's hedges on variable rate debt expired when the variable rate debt incurred under its Medium-Term Note program matured during 2005.

Emission Allowances

Emission allowances for sulfur dioxide and nitrous oxide are allocated to generation owners by the U.S. 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 generating unit 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. Allowances are traded among companies in an over-the-counter market, which allows companies to purchase additional allowances to avoid incurring penalties for noncompliance with applicable emissions standards or to sell excess allowances.

Pepco Holdings accounts for emission allowances as inventory in the balance sheet line item "Fuel, materials and supplies—at average cost." Allowances from EPA allocations 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. At December 31, 2006 and 2005, the book value of emission allowances was \$11.7 million and \$9.8 million, respectively. Pepco Holdings has established a committee to monitor compliance with emissions regulations and whether its power plants have the required number of allowances.

Accounting for Goodwill

Goodwill represents the excess of the purchase price of an acquisition over the fair value of the net assets acquired. The accounting for goodwill is governed by SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." Pepco Holdings' goodwill balance that was generated from Pepco's acquisition of Conectiv has been allocated to the Power Delivery business. 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. Substantially all of Pepco Holdings' goodwill was generated by the acquisition of Conectiv by Pepco.

A roll forward of PHI's goodwill balance follows (millions of dollars):

| | |
|--|------------------|
| Balance, December 31, 2004 | \$1,430.5 |
| Add: Adjustment to pre-merger tax reserve | .8 |
| Balance, December 31, 2005 | 1,431.3 |
| Add: Changes in estimates related to pre-merger tax liabilities | .6 |
| Less: Adjustment due to resolution of pre-merger tax contingencies | (9.1) |
| Impairment related to completed dispositions | (13.6) |
| Balance, December 31, 2006 | <u>\$1,409.2</u> |

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. Pepco Holdings tested its goodwill for impairment as of July 1, 2006. This test indicated that none of Pepco Holdings' goodwill balance was impaired.

Long-Lived Assets Impairment Evaluation

Pepco Holdings 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," 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.

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. 71, PHI's utility subsidiaries can capitalize as Allowance for Funds Used During Construction (AFUDC) the capital costs of financing the construction of plant and

equipment. The debt portion of AFUDC is recorded as a reduction of "interest expense" and the equity portion of AFUDC is credited to "other income" in the accompanying Consolidated Statements of Earnings.

Pepco Holdings recorded AFUDC for borrowed funds of \$2.8 million, \$3.3 million, and \$2.8 million for the years ended December 31, 2006, 2005, and 2004, respectively.

Pepco Holdings recorded amounts for the equity component of AFUDC of \$3.8 million, \$4.7 million and \$4.1 million for the years ended December 31, 2006, 2005, and 2004, respectively.

Leasing Activities

Pepco Holdings accounts for leases 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 PHI 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. Each quarter, PHI reviews the carrying value of each lease, which includes a review of the underlying lease financial assumptions, the timing and collectibility of cash flows, and the credit quality (including, if available, credit ratings) of the lessee. Changes to the underlying assumptions, if any, would be accounted for under SFAS No. 13 and reflected in the carrying value of the lease effective for the quarter within which they occur.

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 subsidiaries are also deferred and amortized over the lives of the new issues.

Pension and Other Postretirement Benefit Plans

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 (the PHI Retirement Plan). Pepco Holdings also provides supplemental retirement benefits to certain eligible executives and key employees through a nonqualified retirement plan and provides certain postretirement health care and life insurance benefits for eligible retired employees.

Pepco Holdings accounts for the PHI Retirement Plan and nonqualified retirement plans 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.

SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132 (R)"

On December 31, 2006, Pepco Holdings implemented SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132 (R)" (SFAS No. 158). SFAS No. 158 requires that companies recognize a net liability or asset to report the

funded status of their defined benefit pension and other postretirement benefit plans on the balance sheet. Recognizing the funded status of the company's benefit plans as a net liability or asset will require an offsetting adjustment to accumulated other comprehensive income in shareholders' equity or will be deferred as a regulatory asset or liability if probable of recovery in rates under SFAS No. 71, "Accounting for the Effects of Certain Types of Legislation." SFAS No. 158 does not change how pension and other postretirement benefits are accounted for and reported in the consolidated statements of earnings.

The incremental effect of applying SFAS No. 158 on Pepco Holdings' consolidated balance sheets was as follows (millions of dollars):

| | Before Application of SFAS No. 158 | Adjustments | After Application of SFAS No. 158 |
|--|--|-------------|---|
| Prepaid pension assets | \$187.0 | \$(187.0) | \$ — |
| Intangible asset | .1 | (.1) | — |
| Regulatory assets | — | 365.4 | 365.4 |
| Deferred income taxes (a) | 5.3 | .3 | 5.6 |
| Liability for pension benefits | 307.6 | 179.0 | 486.6 |
| Accumulated other comprehensive income ... | 8.0 | .4 | 8.4 |

(a) Related to additional minimum liability and implementation of SFAS No. 158.

The estimated net loss for the nonqualified pension plans that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is \$.9 million. The estimated prior service credit for the nonqualified pension plans that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is \$.1 million. The estimated net loss for the defined benefit pension and postretirement benefit plans that will be amortized from regulated assets into net periodic benefit cost over the next fiscal year is \$15.0 million. The estimated prior service cost and credit that will be amortized from regulatory assets into net periodic benefit cost over the next fiscal year is \$1.3 million and \$5.5 million, respectively.

See Note (6), Pensions and Other Postretirement Benefits, for additional information.

Severance Costs

In 2004, the 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. A roll forward of PHI's severance accrual balance is as follows (millions of dollars):

| | |
|----------------------------------|---------------|
| Balance, December 31, 2004 | \$ 7.1 |
| Accrued during 2005 | 5.0 |
| Payments during 2005 | (9.6) |
| Balance, December 31, 2005 | 2.5 |
| Accrued during 2006 | 7.3 |
| Payments during 2006 | (5.2) |
| Balance, December 31, 2006 | <u>\$ 4.6</u> |

Based on the number of employees that have accepted or are expected to accept the severance packages, substantially all of the severance liability will be paid by the end of 2007. Employees have the option of taking severance payments in a lump sum or over a period of time.

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 table below provides system-wide composite depreciation rates for the years ended December 31, 2006, 2005, and 2004.

| | Transmission & Distribution | | | Generation | | |
|-----------------------------|-----------------------------|------|------|------------|------|-------|
| | 2006 | 2005 | 2004 | 2006 | 2005 | 2004 |
| Pepco | 3.5% | 3.4% | 3.5% | — | — | — |
| DPL | 3.0% | 3.1% | 3.1% | — | — | — |
| ACE | 2.9% | 3.1% | 3.5% | .3%(a) | 2.4% | 2.3% |
| Conectiv Energy | — | — | — | 2.0% | 2.2% | 2.5% |
| Pepco Energy Services | — | — | — | 9.4% | 9.5% | 10.4% |

(a) Rate reflects the consolidated balance sheet classification of ACE's generation assets as "assets held for sale" in 2006 and therefore no depreciation expense was recorded.

Asset Retirement Obligations

In accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations" and FIN 47, asset removal costs are recorded as regulatory liabilities. At December 31, 2006, \$322.2 million of accrued asset removal costs (\$229.5 million for DPL and \$92.7 million for Pepco) and at December 31, 2005, \$244.2 million of accrued asset removal costs (\$179.2 million for DPL and \$65.0 million for Pepco) are reflected as regulatory liabilities in the accompanying Consolidated Balance Sheets. Public service 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 for 2006 and 2005, which relates to the regulated Power Delivery segment, has been recorded as a regulatory asset.

During the first quarter of 2006, ACE recorded an asset retirement obligation of \$60 million for B.L. England plant demolition and environmental remediation costs. Amortization of the liability is over a two-year period. As discussed in Note (12) Commitments and Contingencies—"ACE Sale of Generating Assets," on February 8, 2007, ACE completed the sale of the B.L. England generating facility.

Stock-Based Compensation

In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 (SAB 107), which provides implementation guidance on the interaction between SFAS 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.

Pepco Holdings adopted and implemented SFAS No. 123R, on January 1, 2006, using the modified prospective method. Under this method, Pepco Holdings recognizes compensation expense for share-based awards, modifications or cancellations after the effective date, based on the grant-date fair value. Compensation expense is recognized over the requisite service period. In addition, compensation cost recognized includes the cost for all share-based awards granted prior to, but not yet vested as of, January 1, 2006, measured at the grant-date fair value. A deferred tax asset and deferred tax benefit are also recognized concurrently with compensation expense for the tax effect of the deduction of stock options and restricted stock awards, which are deductible only upon exercise and vesting/release from restriction, respectively. In applying the modified prospective transition method, Pepco Holdings has not restated prior interim and annual financial results and therefore these prior periods do not reflect the revised recognition of share-based compensation cost as required by SFAS No. 123R.

In November 2005, the FASB issued FASB Staff Position (FSP) 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards" (FSP 123R-3). FSP 123R-3 provides an elective alternative transition method that includes a computation that establishes the beginning balance of the additional paid-in capital (APIC pool) related to the tax effects of employee and director stock-based compensation, and a simplified method to determine the subsequent impact on the APIC pool of employee and director stock-based awards that are outstanding upon adoption of SFAS No. 123R. Entities may make a one-time election to apply the transition method discussed in FSP 123R-3. That one-time election may be made within one year of an entity's adoption of SFAS No. 123R, or the FSP's effective date (November 11, 2005), whichever is later. Pepco Holdings adopted the alternative transition method at December 31, 2006.

Prior to the adoption of SFAS No. 123R, Pepco Holdings accounted for its share-based employee compensation under the intrinsic value method of expense recognition and measurement prescribed by Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees, and related Interpretations" (APB No. 25). Under this method, compensation expense was recognized for restricted stock awards but not for stock options granted since the exercise price was equal to the grant-date market price of the stock.

The issuance of SFAS No. 123, "Accounting for Stock-Based Compensation," in 1995 as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," permitted continued application of APB No. 25, but required tabular presentation of 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. This information for the years ended December 31, 2005 and 2004 is as follows:

| | For the Year Ended December 31, | |
|---|------------------------------------|----------------|
| | 2005 | 2004 |
| (Millions of dollars, except per share data) | | |
| Net Income | \$371.2 | \$260.6 |
| Add: Total stock-based employee compensation expense included in net income as reported (net of related tax effect of \$1.8 million and \$1.7 million, respectively) | 2.6 | 2.6 |
| 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 and \$2.5 million, respectively) | (2.8) | (3.8) |
| Pro forma net income | <u>\$371.0</u> | <u>\$259.4</u> |
| Basic earnings per share as reported | \$ 1.96 | \$ 1.48 |
| Pro forma basic earnings per share | \$ 1.96 | \$ 1.47 |
| Diluted earnings per share as reported | \$ 1.96 | \$ 1.48 |
| Pro forma diluted earnings per share | \$ 1.96 | \$ 1.47 |

Pepco Holdings estimates the fair value of each stock option award on the date of grant using the Black-Scholes-Merton option pricing model. This model uses assumptions related to expected option term, expected

volatility, expected dividend yield and risk-free interest rate. Pepco Holdings uses historical data to estimate option exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding.

No stock options were granted in 2004, 2005 or 2006.

No modifications were made to outstanding stock options prior to the adoption of SFAS No. 123R, and no changes in valuation methodology or assumptions in estimating the fair value of stock options have occurred with its adoption.

There were no cumulative adjustments recorded in the financial statements as a result of this new pronouncement; the percentage of forfeitures of outstanding stock options issued prior to SFAS No. 123R's adoption is estimated to be zero.

Outstanding stock option awards to purchase 1,500 shares were not vested as of January 1, 2006. The awards vested May 1, 2006. The total compensation cost recorded in 2006 related to the vesting of these options was immaterial.

Cash received from stock options exercised under all share-based payment arrangements for the years ended December 31, 2006, 2005 and 2004, was \$15.9 million, \$3.7 million, and \$.8 million, respectively. The actual tax benefit realized for the tax deductions resulting from these option exercises totaled \$.9 million, \$.3 million, and zero, respectively, for the years ended December 31, 2006, 2005 and 2004.

Pepco Holdings' policy is to issue new shares to satisfy stock option exercises and the vesting of restricted stock awards.

Accumulated Other Comprehensive (Loss) Earnings

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

| (Millions of dollars) | Commodity Derivatives | Treasury Lock | Interest Rate Swaps | Marketable Securities | Other (a) | Accumulated Other Comprehensive (Loss) Earnings |
|--|--------------------------|------------------|---------------------------|--------------------------|----------------|--|
| 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) |
| Current year change | (86.5) | 7.0 | — | — | (.7) | (80.2) |
| Impact of initially applying SFAS No. 158, net of tax | — | — | — | — | (.4) | (.4) |
| Balance, December 31, 2006 | <u>\$(61.9)</u> | <u>\$(33.1)</u> | <u>\$—</u> | <u>\$—</u> | <u>\$(8.4)</u> | <u>\$(103.4)</u> |

(a) Represents an adjustment for nonqualified pension plan minimum liability and the impact of initially applying SFAS No. 158.

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

| <u>Year Ended</u> | <u>Commodity Derivatives</u> | <u>Treasury Lock</u> | <u>Interest Rate Swaps</u> | <u>Marketable Securities</u> | <u>Other (a)</u> | <u>Other Comprehensive (Loss) Earnings</u> |
|-------------------------|----------------------------------|--------------------------|------------------------------------|----------------------------------|------------------|--|
| | | | (Millions of dollars) | | | |
| 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 |
| December 31, 2006 | \$(55.0) | \$4.7 | \$ - | \$ - | \$(.5) | \$(50.8) |

(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 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.

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 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 Sheets. 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 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, "Consolidation of Variable Interest Entities"

Subsidiaries of Pepco Holdings have power purchase agreements (PPAs) with a number of entities, including three contracts between unaffiliated non-utility generators (NUGs) and ACE and an agreement of Pepco with Panda-Brandywine, L.P. (Panda), entered into in 1991, pursuant to which Pepco is obligated to purchase from Panda 230 megawatts of capacity and energy annually through 2021 (Panda PPA). Due to a variable element in the pricing structure of the 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. In accordance with the provisions of FIN 46R, Pepco Holdings continued, during 2006, 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 have not been able to obtain such information.

Net purchase activities with the counterparties to the NUGs and the Panda PPA for the years ended December 31, 2006, 2005, and 2004, were approximately \$403 million, \$419 million, and \$341 million, respectively, of which approximately \$367 million, \$381 million, and \$312 million, respectively, related to power purchases under the NUGs and the Panda PPA. Pepco Holdings' exposure to loss under the Panda PPA is discussed in Note (12), Commitments and Contingencies, under "Relationship with Mirant Corporation." Pepco Holdings does not have loss exposure under the NUGs because cost recovery will be achieved from ACE's customers through regulated rates.

Impairment Losses

During 2006, Pepco Holdings recorded pre-tax impairment losses of \$18.9 million (\$13.7 million after-tax) related to certain energy services business assets owned by Pepco Energy Services. The impairments were recorded as a result of the execution of contracts to sell certain assets and due to the lower than expected production and related estimated cash flows from other assets. The fair value of the assets under contracts for sale was determined based on the sales contract price, while the fair value of the other assets was determined by estimating future expected production and cash flows.

Sale of Interest in Cogeneration Joint Venture

During the first quarter of 2006, Conectiv Energy recognized a \$12.3 million pre-tax gain (\$7.9 million after-tax) on the sale of its equity interest in a joint venture which owns a wood burning cogeneration facility in California.

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 other miscellaneous liabilities. The \$70 million paid pursuant to the Settlement Agreement and Release with Mirant Corporation, its predecessors, its subsidiaries and successors (Mirant) (the Settlement Agreement) was included in the 2006 balance.

Other Deferred Credits

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

Accounting for Planned Major Maintenance Activities

In accordance with FSP American Institute of Certified Public Accountants Industry Audit Guide, Audits of Airlines—"Accounting for Planned Major Maintenance Activities" (FSP AUG AIR-1), costs associated with planned major maintenance activities related to generation facilities are accounted for on an as incurred basis.

Reclassifications

Certain prior year amounts have been reclassified in order to conform to current year presentation.

New Accounting Standards

FSP FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors"

In March 2006, the FASB issued FSP FASB Technical Bulletin (FTB) 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors" (FSP FTB 85-4-1). This FSP provides initial and subsequent measurement guidance and financial statement presentation and disclosure guidance for investments by third-party investors in life settlement contracts. FSP FTB 85-4-1 also amends certain provisions of FASB Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance," and SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The guidance in FSP FTB 85-4-1 applies prospectively for all new life settlement contracts and is effective for fiscal years beginning after June 15, 2006 (the year ending December 31, 2007 for Pepco Holdings). Pepco Holdings has evaluated the impact of FSP FTB 85-4-1 and does not anticipate its adoption will have a material impact on its overall financial condition, results of operations, or cash flows.

EITF 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty"

In September 2005, the FASB ratified Emerging Issues Task Force (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, "Accounting for Nonmonetary Transactions." 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.

Pepco Holdings implemented EITF 04-13 on April 1, 2006. The implementation did not have a material impact on Pepco Holdings' overall financial condition, results of operations, or cash flows for the second quarter of 2006.

SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140"

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140" (SFAS No. 155). SFAS No. 155 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." SFAS No. 155 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 (year ending December 31, 2007 for Pepco Holdings). Pepco Holdings has evaluated the impact of SFAS No. 155 and does not anticipate that its implementation will have a material impact on its overall financial condition, results of operations, or cash flows.

SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140"

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets" (SFAS No. 156), an amendment of SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability upon undertaking an obligation to service a financial asset via certain servicing contracts, and for all separately

recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. Subsequent measurement is permitted using either the amortization method or the fair value measurement method for each class of separately recognized servicing assets and servicing liabilities.

SFAS No. 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006 (year ending December 31, 2007 for Pepco Holdings). Application is to be applied prospectively to all transactions following adoption of SFAS No. 156. Pepco Holdings has evaluated the impact of SFAS No. 156 and does not anticipate its adoption will have a material impact on its overall financial condition, results of operations, or cash flows.

FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)"

In April 2006, the FASB issued FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)" (FSP FIN 46(R)-6), which provides guidance on how to determine the variability to be considered in applying FIN 46(R), "Consolidation of Variable Interest Entities."

The guidance in FSP FIN 46(R)-6 is applicable prospectively beginning the first day of the first reporting period beginning after June 15, 2006.

Pepco Holdings started applying the guidance in FSP FIN 46(R)-6 to new and modified arrangements effective July 1, 2006.

EITF Issue No. 06-3, "Disclosure Requirements for Taxes Assessed by a Governmental Authority on Revenue-producing Transactions"

On June 28, 2006, the FASB ratified EITF Issue No. 06-3, "Disclosure Requirements for Taxes Assessed by a Governmental Authority on Revenue-producing Transactions" (EITF 06-3). EITF 06-3 provides guidance on an entity's disclosure of its accounting policy regarding the gross or net presentation of certain taxes and provides that if taxes included in gross revenues are significant, a company should disclose the amount of such taxes for each period for which an income statement is presented (i.e., both interim and annual periods). Taxes within the scope of EITF 06-3 are those that are imposed on and concurrent with a specific revenue-producing transaction. Taxes assessed on an entity's activities over a period of time are not within the scope of EITF 06-3. EITF 06-3 is effective for interim and annual reporting periods beginning after December 15, 2006 (March 31, 2007 for Pepco Holdings) although earlier application is permitted.

Pepco Holdings does not anticipate that the adoption of EITF 06-3 will materially impact its disclosure requirements.

FSP FAS 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction"

On July 13, 2006, the FASB issued FSP FAS 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction" (FSP FAS 13-2). FSP FAS 13-2, which amends SFAS No. 13, "Accounting for Leases," addresses how a change or projected change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction affects the accounting by a lessor for that lease.

FSP FAS 13-2 will not be effective until the first fiscal year beginning after December 15, 2006 (year ending December 31, 2007 for Pepco Holdings). A material change in the timing of cash flows under PHI's cross-border leases as the result of a settlement with the Internal Revenue Service (IRS) or a change in tax law would require an adjustment to the book value of the leases and a charge to earnings equal to the repricing impact

of the disallowed deductions which could result in a material adverse effect on PHI's financial condition, results of operations, and cash flows.

FIN 48, "Accounting for Uncertainty in Income Taxes"

On July 13, 2006, the FASB issued FIN 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 clarifies the criteria for recognition of tax benefits in accordance with SFAS No. 109, "Accounting for Income Taxes," and prescribes a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Specifically, it clarifies that an entity's tax benefits must be "more likely than not" of being sustained prior to recording the related tax benefit in the financial statements. If the position drops below the "more likely than not" standard, the benefit can no longer be recognized. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

FIN 48 is effective the first fiscal year beginning after December 15, 2006 (year ending December 31, 2007 for Pepco Holdings). Pepco Holdings has completed its evaluation of FIN 48, which resulted in an immaterial impact to its retained earnings at January 1, 2007, and no impact on its results of operations and cash flows.

SFAS No. 157, "Fair Value Measurements"

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS No. 157) which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. However, it is possible that the application of this Statement will change current practice with respect to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years (year ending December 31, 2008 for Pepco Holdings).

Pepco Holdings is currently in the process of evaluating the impact of SFAS No. 157 on its financial condition, results of operations and cash flows.

FSP AUG AIR-1, "Accounting for Planned Major Maintenance Activities"

On September 8, 2006, the FASB issued FSP AUG AIR-1, which prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods. FSP AUG AIR-1 is effective the first fiscal year beginning after December 15, 2006 (year ending December 31, 2007 for Pepco Holdings).

Pepco Holdings does not believe that the implementation of FSP AUG AIR-1 will have a material impact on its financial condition, results of operations and cash flows.

"Staff Accounting Bulletin No. 108"

On September 13, 2006, the SEC issued SAB No. 108 (SAB 108) which expresses the SEC staff's views on the process of quantifying financial statement misstatements. SAB 108 requires that registrants quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements by quantifying an error using both the rollover and iron curtain approaches and by evaluating the error measured under each approach. Under SAB 108, a registrant's financial statements would require adjustment when either approach results in a material misstatement, after considering all relevant quantitative and qualitative factors. Further, the SEC believes that a registrant's

materiality assessment of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure. SAB 108 is effective for fiscal years ending on or after November 15, 2006.

Pepco Holdings implemented the guidance provided in SAB 108 during the year ended December 31, 2006.

EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance"

On September 20, 2006, the FASB ratified EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance" (EITF 06-5) which provides guidance on whether an entity should consider the contractual ability to surrender all of the individual-life policies (or certificates under a group life policy) together when determining the amount that could be realized in accordance with FASB 85-4, and whether a guarantee of the additional value associated with the group life policy affects that determination. EITF 06-5 provides that a policyholder should (i) determine the amount that could be realized under the insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy) and (ii) not discount the cash surrender value component of the amount that could be realized when contractual restrictions on the ability to surrender a policy exist unless contractual limitations prescribe that the cash surrender value component of the amount that could be realized is a fixed amount, in which case the amount that could be realized should be discounted in accordance with Opinion 21. EITF 06-5 is effective for fiscal years beginning after December 15, 2006 (year ending December 31, 2007 for Pepco Holdings).

Pepco Holdings does not anticipate that the adoption of EITF 06-5 will materially impact its disclosure requirements.

FASB Staff Position No. EITF 00-19-2, "Accounting for Registration Payment Arrangements"

On December 21, 2006, the FASB issued FSP No. EITF 00-19-2, "Accounting for Registration Payment Arrangements" (FSP EITF 00-19-2), which addresses an issuer's accounting for registration payment arrangements and specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB SFAS No. 5, "Accounting for Contingencies." FSP EITF 00-19-2 is effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that are entered into or modified subsequent to the date of its issuance. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of FSP EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years (December 31, 2007 for Pepco Holdings).

Pepco Holdings is evaluating the impact, if any, of FSP EITF 00-19-2 and does not anticipate its adoption will have a material impact on its overall financial condition, results of operations, or cash flows.

SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115"

On February 15, 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115" (SFAS No. 159) which permits entities to choose to elect to measure eligible financial instruments at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 applies under other accounting pronouncements that require or permit fair

value measurements and does not require any new fair value measurements. However, it is possible that the application of SFAS No. 159 will change current practice with respect to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

SFAS No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. SFAS No. 159 does not eliminate disclosure requirements included in other accounting standards.

SFAS No. 159 applies to fiscal years beginning after November 15, 2007 (year ending December 31, 2008 for Pepco Holdings), with early adoption permitted for an entity that has also elected to apply the provisions of SFAS No. 157, Fair Value Measurements. An entity is prohibited from retrospectively applying SFAS No. 159, unless it chooses early adoption. SFAS No. 159 also applies to eligible items existing at November 15, 2007 (or early adoption date). Pepco Holdings is in the process of evaluating the impact of SFAS No. 159 on its financial condition, results of operations and cash flows.

(3) SEGMENT INFORMATION

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, 2006 as Power Delivery, Connectiv 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 "Corp. & Other" column. Segment financial information for the years ended December 31, 2006, 2005, and 2004, is as follows.

| Year Ended December 31, 2006 | | | | | | |
|---------------------------------|--------------------------------|---------------------|-----------------------------|----------------------------|---------------------|------------|
| (Millions of dollars) | | | | | | |
| | Competitive Energy Segments | | | Other Non- Regulated | Corp. & Other(a) | PHI Cons. |
| | Power Delivery | Connectiv Energy | Pepco Energy Services | | | |
| Operating Revenue | \$5,118.8 | \$2,157.3(b) | \$1,668.9 | \$ 90.6 | \$ (672.7) | \$ 8,362.9 |
| Operating Expense (c) | 4,651.0(b) | 2,059.7 | 1,631.2(e) | 6.5 | (678.8) | 7,669.6 |
| Operating Income | 467.8 | 97.6 | 37.7 | 84.1 | 6.1 | 693.3 |
| Interest Income | 12.0 | 35.4 | 2.9 | 170.4 | (203.8) | 16.9 |
| Interest Expense | 180.5 | 63.8 | 4.9 | 201.3 | (111.4) | 339.1 |
| Other Income | 18.6 | 10.4(d) | 1.6 | 7.9 | 1.3 | 39.8 |
| Preferred Stock Dividends | 2.1 | — | — | 2.5 | (3.4) | 1.2 |
| Income Taxes | 124.5(f) | 32.5 | 16.7 | 8.4(f) | (20.7)(f) | 161.4 |
| Net Income (Loss) | 191.3 | 47.1 | 20.6 | 50.2 | (60.9) | 248.3 |
| Total Assets | 8,933.3 | 1,841.5 | 617.6 | 1,595.6 | 1,255.5 | 14,243.5 |
| Construction Expenditures | \$ 447.2 | \$ 11.8 | \$ 6.3 | \$ — | \$ 9.3 | \$ 474.6 |

Notes:

- (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 Connectiv 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. Included in Corp. & Other are intercompany amounts of \$(674.4) million for Operating Revenue, \$(668.2) million for Operating Expense,

\$ (280.8) million for Interest Income, \$(278.4) million for Interest Expense, and \$(2.5) million for Preferred Stock Dividends.

- (b) Power Delivery purchased electric energy and capacity and natural gas from Conectiv Energy in the amount of \$460.5 million for the year ended December 31, 2006.
- (c) Includes depreciation and amortization of \$413.2 million, consisting of \$354.3 million for Power Delivery, \$36.3 million for Conectiv Energy, \$11.8 million for Pepco Energy Services, \$1.8 million for Other Non-Regulated and \$9.0 million for Corp. & Other.
- (d) Includes \$12.3 million gain (\$7.9 million after-tax) on the sale of its equity interest in a joint venture which owns a wood burning cogeneration facility in California.
- (e) Includes \$18.9 million of impairment losses (\$13.7 million after-tax) related to certain energy services business assets.
- (f) In 2006, PHI resolved certain, but not all, tax matters that were raised in Internal Revenue Service audits related to the 2001 and 2002 tax years. Adjustments recorded related to these resolved tax matters resulted in a \$6.3 million increase in net income (\$2.5 million for Power Delivery and \$5.4 million for Other Non-Regulated, partially offset by an unfavorable \$1.6 million impact in Corp. & Other). To the extent that the matters resolved related to tax contingencies from the Conectiv heritage companies that existed at the August 2002 merger date, in accordance with accounting rules, an additional adjustment of \$9.1 million (\$3.1 million related to Power Delivery and \$6.0 million related to Other Non-Regulated) was recorded in Corp. & Other to eliminate the tax benefits recorded by Power Delivery and Other Non-Regulated against the goodwill balance that resulted from the merger. Also during 2006, the total favorable impact of \$2.6 million was recorded that resulted from changes in estimates related to prior year tax liabilities subject to audit (\$4.1 million for Power Delivery, partially offset by an unfavorable \$1.5 million for Corp. & Other).

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 | \$ 84.5 | \$ (813.0) | \$ 8,065.5 |
| Operating Expense (g) | 4,032.1(b)(e) | 2,499.7 | 1,445.1 | (3.8)(f) | (813.0) | 7,160.1 |
| Operating Income | 670.8 | 103.9 | 42.4 | 88.3 | — | 905.4 |
| Interest Income | 8.3 | 31.9 | 2.5 | 115.2 | (141.9) | 16.0 |
| Interest Expense | 175.0 | 58.7 | 5.6 | 149.1 | (50.8) | 337.6 |
| Other Income | 20.2 | 3.6 | 1.7 | 4.6 | 6.0 | 36.1 |
| Preferred Stock Dividends | 2.6 | — | — | 2.5 | (2.6) | 2.5 |
| Income Taxes | 228.6(c) | 32.6 | 15.3 | 12.8 | (34.1) | 255.2 |
| Extraordinary Item (net of tax of \$6.2 million) | 9.0(d) | — | — | — | — | 9.0 |
| Net Income (Loss) | 302.1 | 48.1 | 25.7 | 43.7 | (48.4) | 371.2 |
| Total Assets | 8,738.6 | 2,227.6 | 514.4 | 1,476.9 | 1,081.4 | 14,038.9 |
| Construction Expenditures | \$ 432.1 | \$ 15.4 | \$ 11.3 | \$ — | \$ 8.3 | \$ 467.1 |

Notes:

- (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. Included in Corp. & Other are intercompany amounts of \$(815.7) million for Operating Revenue, \$(810.2) million for Operating Expense, \$(217.6) million for Interest Income, \$(215.4) million for Interest Expense, and \$(2.5) million for Preferred Stock Dividends.

- (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. Also refer to Note (12) Commitments and Contingencies for a discussion of the IRS mixed service cost issue.
- (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 gain (\$40.7 million after-tax) from the sale of non-utility land owned by Pepco at Buzzard Point.
- (f) 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.
- (g) Includes depreciation and amortization of \$427.3 million, consisting of \$361.4 million for Power Delivery, \$40.4 million for Conectiv Energy, \$14.5 million for Pepco Energy Services, \$1.7 million for Other Non-Regulated and \$9.3 million for Corp. & Other.

| Year Ended December 31, 2004 | | | | | | |
|---------------------------------|-------------------|--------------------|-----------------------------|----------------------------|---------------------|------------|
| (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 | \$ 90.5 | \$ (821.5) | \$ 7,223.1 |
| Operating Expense (j) | 3,840.7(b)(c) | 2,282.6 | 1,148.8 | (2.5)(d) | (818.6) | 6,451.0 |
| Operating Income | 537.0 | 127.2 | 17.8 | 93.0 | (2.9) | 772.1 |
| Interest Income | 4.7 | 9.9 | .7 | 60.8 | (67.4) | 8.7 |
| Interest Expense | 178.1 | 47.8(e) | 2.8 | 96.6 | 48.0 | 373.3 |
| Other Income | 16.0 | 11.0(g) | 2.5 | (6.0)(h) | (.3) | 23.2 |
| Preferred Stock Dividends | 2.3 | — | — | 2.5 | (2.0) | 2.8 |
| Income Taxes (f) | 150.2 | 40.1 | 5.3 | 19.2(i) | (47.5) | 167.3 |
| Net Income (Loss) | 227.1 | 60.2 | 12.9 | 29.5 | (69.1) | 260.6 |
| Total Assets | 8,397.6 | 1,896.5 | 547.9 | 1,529.7 | 1,002.9 | 13,374.6 |
| Construction Expenditures | \$ 479.5 | \$ 11.6 | \$ 21.2 | \$ — | \$ 5.1 | \$ 517.4 |

Notes:

- (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. Included in Corp. & Other are intercompany amounts of \$(825.4) million for Operating Revenue, \$(820.8) million for Operating Expense, \$(29.0) million for Interest Income, \$(26.7) million for Interest Expense, and \$(2.5) million for Preferred Stock Dividends.
- (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 Corp. & 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 cogeneration 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 to \$28 million at June 30, 2004.
- (i) Includes a \$19.7 million charge related to an IRS settlement.
- (j) Includes depreciation and amortization of \$446.2 million, consisting of \$373.0 million for Power Delivery, \$45.2 million for Conectiv Energy, \$11.9 million for Pepco Energy Services, \$1.9 million for Other Non-Regulated and \$14.2 million for Corp. & Other.

(4) LEASING ACTIVITIES

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

| | 2006 | 2005 |
|-------------------------|-----------------------|------------------|
| | (Millions of dollars) | |
| Energy leveraged leases | \$1,321.8 | \$1,264.4 |
| Other | — | 33.5 |
| Total | <u>\$1,321.8</u> | <u>\$1,297.9</u> |

Pepco Holdings' \$1,321.8 million equity investment in energy leveraged leases at December 31, 2006, consists of electric power plants and natural gas distribution networks located outside of the United States. Of this amount, \$670.7 million of equity is attributable to facilities located in Austria, \$470.2 million in The Netherlands and \$180.9 million in Australia.

The components of the net investment in finance leases at December 31, 2006 and 2005 are summarized below (millions of dollars):

| | Leveraged Leases | Direct Finance Leases | Total Finance Leases |
|--|---------------------|-----------------------------|----------------------------|
| <u>At December 31, 2006:</u> | | | |
| Scheduled lease payments, net of non-recourse debt | \$2,284.6 | — | \$2,284.6 |
| Residual value | — | — | — |
| Less: Unearned and deferred income | (962.8) | — | (962.8) |
| Investment in finance leases held in trust | 1,321.8 | — | 1,321.8 |
| Less: Deferred taxes | (682.2) | — | (682.2) |
| Net Investment in Finance Leases Held in Trust | <u>\$ 639.6</u> | <u>—</u> | <u>\$ 639.6</u> |

| <u>At December 31, 2005:</u> | <u>Leveraged Leases</u> | <u>Direct Finance Leases</u> | <u>Total Finance Leases</u> |
|--|-----------------------------|--------------------------------------|-------------------------------------|
| 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 | <u>\$ 680.1</u> | <u>\$24.8</u> | <u>\$ 704.9</u> |

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

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--|-----------------------|---------------|---------------|
| | (Millions of dollars) | | |
| Pre-tax earnings from leveraged leases | \$88.2 | \$81.5 | \$83.5 |
| Income tax expense | <u>25.8</u> | <u>20.6</u> | <u>26.8</u> |
| Net Income from Leveraged Leases Held in Trust | <u>\$62.4</u> | <u>\$60.9</u> | <u>\$56.7</u> |

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 2007 through 2011 and thereafter are \$3.5 million for 2007, zero for 2008, zero for 2009, \$16.0 million for 2010, zero for 2011, and \$1,302.3 million thereafter. For a discussion of the Federal tax treatment of cross-border leases, see 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 \$48.7 million, \$51.2 million and \$46.2 million for the years ended December 31, 2006, 2005, and 2004, respectively.

The approximate annual commitments under all operating leases are \$35.8 million for 2007, \$36.6 million for 2008, 2009, 2010, and 2011, and \$346.7 million thereafter.

Capital lease assets recorded within Property, Plant and Equipment at December 31, 2006 and 2005, in millions of dollars, are comprised of the following:

| <u>At December 31, 2006</u> | <u>Original Cost</u> | <u>Accumulated Amortization</u> | <u>Net Book Value</u> |
|-----------------------------|--------------------------|-------------------------------------|---------------------------|
| Transmission | \$ 76.0 | \$18.0 | \$ 58.0 |
| Distribution | 76.0 | 18.0 | 58.0 |
| General | 2.6 | 2.0 | .6 |
| Total | <u>\$154.6</u> | <u>\$38.0</u> | <u>\$116.6</u> |
| <u>At December 31, 2005</u> | | | |
| Transmission | \$ 76.0 | \$15.7 | \$ 60.3 |
| Distribution | 79.7 | 19.3 | 60.4 |
| General | 2.8 | 1.6 | 1.2 |
| Total | <u>\$158.5</u> | <u>\$36.6</u> | <u>\$121.9</u> |

The approximate annual commitments under all capital leases are \$15.5 million for 2007, \$15.4 million for 2008, \$15.2 million for 2009, 2010 and 2011, and \$121.9 million thereafter.

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is comprised of the following:

| <u>At December 31, 2006</u> | <u>Original Cost</u> | <u>Accumulated Depreciation</u> | <u>Net Book Value</u> |
|--|--------------------------|-------------------------------------|---------------------------|
| | (Millions of dollars) | | |
| Generation | \$ 1,811.6 | \$ 608.9 | \$1,202.7 |
| Distribution | 6,285.6 | 2,321.2 | 3,964.4 |
| Transmission | 1,850.3 | 680.0 | 1,170.3 |
| Gas | 349.8 | 97.6 | 252.2 |
| Construction work in progress | 343.5 | — | 343.5 |
| Non-operating and other property | 1,178.9 | 535.4 | 643.5 |
| Total | <u>\$11,819.7</u> | <u>\$4,243.1</u> | <u>\$7,576.6</u> |
| <u>At December 31, 2005</u> | | | |
| 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 | 1,183.3 | 512.8 | 670.5 |
| Total | <u>\$11,441.0</u> | <u>\$4,072.2</u> | <u>\$7,368.8</u> |

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.

Asset Sales

As discussed in Note (12), Commitments and Contingencies, on September 1, 2006, ACE completed the sale of its interest in the Keystone and Conemaugh generating facilities for approximately \$177.0 million, which was subsequently decreased by \$1.6 million based on a post-closing 60-day true up for applicable items not known at the time of closing.

Additionally, on February 8, 2007, ACE completed the sale of the B.L. England generating facility for a price of \$9.0 million, subject to adjustment.

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 PCI's final three aircraft investments, and \$6.6 million on the sale of non-utility 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 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, 2006 is shown below.

| <u>Jointly Owned Plant</u> | <u>Ownership Share</u> | <u>Plant in Service</u> | <u>Accumulated Depreciation</u> | <u>Construction Work in Progress</u> |
|-------------------------------|------------------------|-------------------------|---------------------------------|--------------------------------------|
| | | | (Millions of dollars) | |
| Transmission Facilities | Various | \$35.8 | \$22.4 | \$— |
| Other Facilities | Various | 5.1 | 2.0 | — |
| Total | | <u>\$40.9</u> | <u>\$24.4</u> | <u>\$—</u> |

(6) PENSIONS AND OTHER POSTRETIREMENT BENEFITS

Pension Benefits and Other Postretirement Benefits

Pepco Holdings sponsors a defined benefit retirement plan (the PHI 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.

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.

Pepco Holdings accounts for the PHI Retirement Plan and nonqualified retirement plans 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." In addition, on December 31, 2006, Pepco Holdings implemented SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an

amendment of FASB Statements No. 87, 88, 106 and 132 (R)" (SFAS No. 158) which requires that companies recognize a net liability or asset to report the funded status of their defined benefit pension and other postretirement benefit plans on the balance sheet with an offset to accumulated other comprehensive income in shareholders' equity or a deferral in a regulatory asset or liability if probable of recovery in rates under SFAS No. 71 "Accounting For the Effects of Certain Types of Legislation." SFAS No. 158 does not change how pension and other postretirement benefits are accounted for and reported in the consolidated statements of earnings. PHI's financial statement disclosures are prepared in accordance with SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," as revised and amended by SFAS No. 158. Refer to Note (2) "Summary of Significant Accounting Policies—Pension and Other Postretirement Benefit Plans" for additional information.

All amounts in the following tables are in millions of dollars.

| At December 31, | Pension Benefits | | Other Postretirement Benefits | |
|--|------------------|------------------|-------------------------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| Change in Benefit Obligation | | | | |
| Benefit obligation at beginning of year | \$1,746.0 | \$1,648.0 | \$ 610.2 | \$ 593.5 |
| Service cost | 40.5 | 37.9 | 8.4 | 8.5 |
| Interest cost | 96.9 | 96.1 | 34.6 | 33.6 |
| Amendments | — | — | — | — |
| Actuarial (gain) loss | (42.4) | 81.1 | (3.6) | 12.8 |
| Benefits paid | (125.7) | (117.1) | (38.4) | (38.2) |
| Benefit obligation at end of year | <u>\$1,715.3</u> | <u>\$1,746.0</u> | <u>\$ 611.2</u> | <u>\$ 610.2</u> |
| Change in Plan Assets | | | | |
| Fair value of plan assets at beginning of year | \$1,578.4 | \$1,523.5 | \$ 173.7 | \$ 164.9 |
| Actual return on plan assets | 177.8 | 106.4 | 23.2 | 10.0 |
| Company contributions | 3.2 | 65.6 | 47.7 | 37.0 |
| Benefits paid | (125.7) | (117.1) | (38.4) | (38.2) |
| Fair value of plan assets at end of year | <u>\$1,633.7</u> | <u>\$1,578.4</u> | <u>\$ 206.2</u> | <u>\$ 173.7</u> |
| Funded Status at end of year (plan assets less plan obligations) | \$ (81.6) | \$ (167.6) | \$(405.0) | \$(436.5) |

The following table provides a reconciliation of the projected benefit obligation, plan assets and funded status of the plans prior to the implementation of SFAS No. 158.

| | Pension Benefits | | Other Postretirement Benefits | |
|--|------------------|-----------------|-------------------------------|------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Fair value of plan assets at end of year | \$1,633.7 | \$1,578.4 | \$ 206.2 | \$ 173.7 |
| Benefit obligation at end of year | <u>1,715.3</u> | <u>1,746.0</u> | <u>611.2</u> | <u>610.2</u> |
| Funded status at end of year | <u>(81.6)</u> | <u>(167.6)</u> | <u>(405.0)</u> | <u>(436.5)</u> |
| Amounts not recognized: | | | | |
| Unrecognized net actuarial loss | 242.8 | 350.5 | 167.6 | 188.6 |
| Unrecognized prior service cost | 1.1 | 1.9 | (32.1) | (26.2) |
| Net amount recognized | <u>\$ 162.3</u> | <u>\$ 184.8</u> | <u>\$(269.5)</u> | <u>\$(274.1)</u> |

The following table provides a reconciliation of the amounts recognized in PHI's Consolidated Balance Sheets as of December 31 prior to the implementation of SFAS No. 158:

| | Pension Benefits | | Other Postretirement Benefits | |
|--|------------------|----------------|-------------------------------|------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Prepaid benefit cost | \$187.0 | \$208.9 | \$ — | \$ — |
| Accrued benefit cost | (24.7) | (24.1) | (269.5) | (274.1) |
| Additional minimum liability for nonqualified plan | (13.4) | (12.2) | — | — |
| Intangible assets for nonqualified plan | .1 | .1 | — | — |
| Accumulated other comprehensive income for nonqualified plan | 13.3 | 12.1 | — | — |
| Net amount recognized | <u>\$162.3</u> | <u>\$184.8</u> | <u>\$(269.5)</u> | <u>\$(274.1)</u> |

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, 2006 and 2005 prior to the implementation of SFAS No. 158.

| | Pension Benefits | |
|--|------------------|--------|
| | 2006 | 2005 |
| Projected benefit obligation for nonqualified plan | \$38.7 | \$38.6 |
| Accumulated benefit obligation for nonqualified plan | 38.1 | 36.3 |
| Fair value of plan assets for nonqualified plan | — | — |

In 2006 and 2005, 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). The amount of reduction to shareholders' equity (net of income taxes) in 2006 was \$8.0 million and in 2005 was \$7.3 million. The recording of this reduction did not affect net income, cash flows, or compliance with debt covenants in 2006 or 2005.

The following table provides the amounts recognized in PHI's Consolidated Balance Sheets as of December 31, 2006 after the implementation of SFAS No. 158:

| | Pension Benefits | | Other Postretirement Benefits | |
|--|------------------|----------------|-------------------------------|------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Prepaid pension costs | \$ — | \$208.9 | \$ — | \$ — |
| Prepaid other postretirement benefit costs | — | — | — | 10.1 |
| Intangible asset for nonqualified plan | — | .1 | — | — |
| Regulatory asset | 229.9 | — | 135.5 | — |
| Current liabilities | (3.3) | — | — | — |
| Pension benefit obligation | (78.3) | (36.3) | — | — |
| Other postretirement benefit obligations | — | — | (405.0) | (284.2) |
| Deferred income tax | 5.6 | 4.8 | — | — |
| Accumulated other comprehensive income, net of tax | 8.4 | 7.3 | — | — |
| Net amount recognized | <u>\$162.3</u> | <u>\$184.8</u> | <u>\$(269.5)</u> | <u>\$(274.1)</u> |

Amounts included in accumulated other comprehensive income (pre-tax) and regulatory assets at December 31, 2006 after implementation of SFAS No. 158 consist of:

| | Pension Benefits | Other Postretirement Benefits |
|--|------------------|-------------------------------|
| Unrecognized net actuarial loss | \$242.8 | \$167.6 |
| Unamortized prior service cost (credit) | 1.1 | (36.6) |
| Unamortized transition liability | — | 4.5 |
| | <u>243.9</u> | <u>135.5</u> |
| Accumulated other comprehensive income (\$8.4 million, net of tax) | 14.0 | — |
| Regulatory assets | <u>229.9</u> | <u>135.5</u> |
| | <u>\$243.9</u> | <u>\$135.5</u> |

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

| | Pension Benefits | | | Other Postretirement Benefits | | |
|--|------------------|----------------|----------------|-------------------------------|----------------|---------------|
| | 2006 | 2005 | 2004 | 2006 | 2005 | 2004 |
| Service cost | \$ 40.5 | \$ 37.9 | \$ 35.9 | \$ 8.4 | \$ 8.5 | \$ 8.6 |
| Interest cost | 96.9 | 96.1 | 94.7 | 34.6 | 33.6 | 35.4 |
| Expected return on plan assets | (130.0) | (125.5) | (124.2) | (11.5) | (10.9) | (9.9) |
| Amortization of prior service cost | .8 | 1.1 | 1.1 | (4.0) | (3.3) | (1.8) |
| Amortization of net loss | 17.5 | 10.9 | 6.5 | 14.3 | 11.3 | 11.3 |
| Net periodic benefit cost | <u>\$ 25.7</u> | <u>\$ 20.5</u> | <u>\$ 14.0</u> | <u>\$ 41.8</u> | <u>\$ 39.2</u> | <u>\$43.6</u> |

The 2006 combined pension and other postretirement net periodic benefit cost of \$67.5 million includes \$32.1 million for Pepco, \$.7 million for DPL and \$14.3 million for ACE. The remaining net periodic benefit cost includes amounts for other PHI subsidiaries.

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

| | Pension Benefits | | Other Postretirement Benefits | |
|---|------------------|--------|-------------------------------|--------|
| | 2006 | 2005 | 2006 | 2005 |
| Discount rate | 6.000% | 5.625% | 6.000% | 5.625% |
| Rate of compensation increase | 4.500% | 4.500% | 4.500% | 4.500% |
| Health care cost trend rate assumed for next year | | n/a | 8.00% | 8.00% |
| 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 | | | 2010 | 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):

| | <u>1-Percentage- Point Increase</u> | <u>1-Percentage- Point Decrease</u> |
|--|---|---|
| Increase (decrease) on total service and interest cost | \$ 2.1 | \$ (1.8) |
| Increase (decrease) on postretirement benefit obligation | \$34.4 | \$(25.2) |

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

| | <u>Pension Benefits</u> | | <u>Other Postretirement Benefits</u> | |
|--|-------------------------|-------------|--|-------------|
| | <u>2006</u> | <u>2005</u> | <u>2006</u> | <u>2005</u> |
| Discount rate | 5.625% | 5.875% | 5.625% | 5.875% |
| Expected long-term return on plan assets | 8.500% | 8.500% | 8.500% | 8.500% |
| 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 SFAS No. 87 and SFAS No. 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-term horizon, are expected to yield a return on assets of 8.50%.

Plan Assets

The PHI Retirement Plan weighted average asset allocations at December 31, 2006, and 2005, by asset category are as follows:

| Asset Category | <u>Plan Assets at December 31,</u> | | <u>Target Plan Asset Allocation</u> | <u>Minimum/ Maximum</u> |
|-------------------------|--|-------------|---|-----------------------------|
| | <u>2006</u> | <u>2005</u> | | |
| Equity securities | 58% | 62% | 60% | 55% - 65% |
| Debt securities | 34% | 37% | 35% | 30% - 50% |
| Other | 8% | 1% | 5% | 0% - 10% |
| Total | 100% | 100% | 100% | |

Pepco Holdings' Other Postretirement plan weighted average asset allocations at December 31, 2006, and 2005, by asset category are as follows:

| Asset Category | <u>Plan Assets at December 31,</u> | | <u>Target Plan Asset Allocation</u> | <u>Minimum/ Maximum</u> |
|-------------------------|--|-------------|---|-----------------------------|
| | <u>2006</u> | <u>2005</u> | | |
| Equity securities | 64% | 67% | 60% | 55% - 65% |
| Debt securities | 33% | 24% | 35% | 20% - 50% |
| Other | 3% | 9% | 5% | 0% - 10% |
| Total | 100% | 100% | 100% | |

In developing an asset allocation policy for the PHI 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 PHI 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—PHI Retirement Plan

Pepco Holdings' funding policy with regard to the PHI Retirement Plan is to maintain a funding level in excess of 100% with respect to its accumulated benefit obligation (ABO). The PHI Retirement Plan currently meets the minimum funding requirements of the Employment Retirement Income Security Act of 1974 (ERISA) without any additional funding. In 2006 and 2005, PHI made discretionary tax-deductible cash contributions to the plan of zero and \$60.0 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 2007; 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 2006 and 2005, Pepco contributed \$6.0 million and \$3.1 million, respectively, DPL contributed \$6.8 million and \$6.0 million, respectively, and ACE contributed \$6.6 million and \$7.0 million, respectively, to the plans. Contributions of \$13.5 million and \$6.4 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 2007.

Expected Benefit Payments

Estimated future benefit payments to participants in PHI's pension and postretirement welfare benefit plans, which reflect expected future service as appropriate, as of December 31, 2006 are as follows (millions of dollars):

| <u>Years</u> | <u>Pension Benefits</u> | <u>Other Postretirement Benefits</u> |
|-------------------------|-------------------------|--------------------------------------|
| 2007 | \$106.2 | \$ 39.7 |
| 2008 | 109.0 | 41.3 |
| 2009 | 113.9 | 43.0 |
| 2010 | 116.8 | 44.3 |
| 2011 | 123.9 | 45.4 |
| 2012 through 2016 | 653.5 | 237.3 |

Medicare Prescription Drug Improvement and Modernization Act of 2003

On December 8, 2003, the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the Medicare Act) became effective. The Medicare Act introduced a prescription drug benefit under Medicare (Medicare Part D), as well as a federal subsidy to sponsors of retiree health care benefits plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. Pepco Holdings sponsors post-retirement health care plans that provide prescription drug benefits that PHI plan actuaries have determined are actuarially equivalent to Medicare Part D. PHI elected to recognize the effects of the Medicare Act during the fourth quarter of 2003, which reduced the accumulated postretirement benefit obligation by approximately \$28 million. In 2006, Pepco Holdings received \$1.6 million in federal Medicare prescription drug subsidies.

(7) DEBT

LONG-TERM DEBT

The components of long-term debt are shown below.

| Interest Rate | Maturity | At December 31, | |
|--|-------------|-----------------------|-----------|
| | | 2006 | 2005 |
| | | (Millions of dollars) | |
| First Mortgage Bonds | | | |
| Pepco: | | | |
| 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)(b) | 2013 | 200.0 | 200.0 |
| 4.65% (a)(b) | 2014 | 175.0 | 175.0 |
| Variable (a)(b) | 2022 | 109.5 | — |
| 6.00% (a) | 2022 | — | 30.0 |
| 6.375% (a) | 2023 | — | 37.0 |
| 5.375% (a) | 2024 | — | 42.5 |
| 5.375% (a) | 2024 | 38.3 | 38.3 |
| 5.75% (a)(b) | 2034 | 100.0 | 100.0 |
| 5.40% (a)(b) | 2035 | 175.0 | 175.0 |
| ACE: | | | |
| 6.18% – 7.15% | 2006 – 2008 | 51.0 | 116.0 |
| 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)(b) | 2029 | 54.7 | 54.7 |
| 5.80% (a)(b) | 2034 | 120.0 | 120.0 |
| 5.80% (a)(b) | 2036 | 105.0 | — |
| Amortizing First Mortgage Bonds | | | |
| DPL: | | | |
| 6.95% | 2006 – 2008 | 7.6 | 10.5 |
| Total First Mortgage Bonds | | \$1,591.6 | \$1,554.5 |

- (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. 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.

- (b) Represents a series of First Mortgage Bonds issued by the indicated company as collateral for an outstanding series of senior notes that will, at such time as there are no First Mortgage Bonds of the issuing company outstanding (other than collateral First Mortgage Bonds securing payment of senior notes), cease to secure the corresponding series of senior notes and will be cancelled.

| Interest Rate | Maturity | At December 31, | |
|--------------------------------------|-------------|-----------------|----------------|
| | | 2006 | 2005 |
| (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 | | <u>\$208.3</u> | <u>\$208.3</u> |
| 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 |
| 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 |
| Total Medium-Term Notes (unsecured) | | <u>\$201.5</u> | <u>\$221.5</u> |
| Recourse Debt | | | |
| PCI: | | | |
| 6.59% – 6.69% | 2014 | \$ 11.1 | \$ 11.1 |
| 7.62% | 2007 | 34.3 | 34.3 |
| 8.12% (a) | 2008 | 92.0 | 92.0 |
| Total Recourse Debt | | <u>\$137.4</u> | <u>\$137.4</u> |
| Notes (secured) | | | |
| Pepco Energy Services: | | | |
| 7.85% | 2017 | \$ 9.9 | \$ 9.2 |

- (a) Debt issued at a fixed rate of 8.24%. The debt was swapped into variable rate debt at the time of issuance.

NOTE: Schedule is continued on next page.

| Interest Rate | Maturity | At December 31, | |
|---|----------|-----------------------|------------------|
| | | 2006 | 2005 |
| | | (Millions of dollars) | |
| Notes (unsecured) | | | |
| PHI: | | | |
| 3.75% | 2006 | \$ — | \$ 300.0 |
| 5.50% | 2007 | 500.0 | 500.0 |
| Variable | 2010 | 250.0 | 250.0 |
| 4.00% | 2010 | 200.0 | 200.0 |
| 6.45% | 2012 | 750.0 | 750.0 |
| 5.90% | 2016 | 200.0 | — |
| 7.45% | 2032 | 250.0 | 250.0 |
| Pepco: | | | |
| Variable | 2006 | — | 50.0 |
| DPL: | | | |
| 5.00% | 2014 | 100.0 | 100.0 |
| 5.00% | 2015 | 100.0 | 100.0 |
| 5.22% | 2016 | 100.0 | — |
| Total Notes (unsecured) | | <u>\$2,450.0</u> | <u>\$2,500.0</u> |
| Nonrecourse debt | | | |
| PCI: | | | |
| 6.60% | 2018 | \$ — | \$ 15.9 |
| Acquisition fair value adjustment | | — | .1 |
| Total Long-Term Debt | | <u>\$4,598.7</u> | <u>\$4,646.9</u> |
| Net unamortized discount | | (4.9) | (5.9) |
| Current maturities of long-term debt | | <u>(825.2)</u> | <u>(438.1)</u> |
| Total Net Long-Term Debt | | <u>\$3,768.6</u> | <u>\$4,202.9</u> |
| Transition Bonds Issued by ACE Funding | | | |
| 2.89% | 2010 | \$ 34.5 | \$ 55.2 |
| 2.89% | 2011 | 23.0 | 31.3 |
| 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 | | <u>\$ 494.5</u> | <u>\$ 523.5</u> |
| Net unamortized discount | | (.2) | (.2) |
| Current maturities of long-term debt | | <u>(29.9)</u> | <u>(29.0)</u> |
| Total Transition Bonds issued by ACE Funding | | <u>\$ 464.4</u> | <u>\$ 494.3</u> |

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.

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 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, 2006, are \$855.1 million in 2007, \$323.6 million in 2008, \$82.2 million in 2009, \$531.9 million in 2010, \$69.9 million in 2011, and \$3,230.4 million thereafter.

Pepco Energy Services Project Funding represents funding for energy savings contracts performed by Pepco Energy Services. The aggregate amounts of maturities for the Project Funding debt outstanding at December 31, 2006, are \$2.4 million in 2007, \$2.5 million in 2008, \$2.0 million in 2009, \$2.0 million in 2010, \$1.7 million in 2011, and \$15.1 million thereafter, and includes the current portion of Project Funding that was provided in exchange for the sale of the customers' accounts receivable.

PHI's long-term debt is subject to certain covenants. PHI and its subsidiaries are in compliance with all requirements.

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, 2006 and 2005 is as follows.

| | 2006 | 2005 |
|----------------------------------|-----------------------|----------------|
| | (Millions of dollars) | |
| Commercial paper | \$195.4 | \$ — |
| Variable rate demand bonds | 154.2 | 156.4 |
| Total | <u>\$349.6</u> | <u>\$156.4</u> |

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 \$36 million, \$67.1 million, \$91.1 million and \$1.2 million of commercial paper outstanding at December 31, 2006, respectively. The weighted average interest rate for Pepco Holdings, Pepco, DPL and ACE commercial paper issued during 2006 was 5.1%, 5.25%, 5.3% and 4.79%, respectively. The weighted average maturity for Pepco Holdings, Pepco, DPL and ACE was nine, five, seven and four days respectively for all commercial paper issued during 2006.

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 2006 mature in 2007 to 2009 (\$8.3 million), 2014 to 2017 (\$48.6 million), 2024 (\$33.3 million) and 2028 to 2031 (\$64 million). The weighted average interest rate for VRDB was 3.55% during 2006 and 2.61% during 2005.

Credit Facility

In April 2006, Pepco Holdings, Pepco, DPL and ACE extended their five-year credit agreement for one additional year from 2010 to 2011. The aggregate borrowing limit under the facility is \$1.2 billion and the facility commitment expiration date is May 5, 2011. 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, 2006 and 2005.

(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 the subsidiaries included in its consolidated group pursuant to a written tax sharing agreement that was approved by the SEC 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.

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

Provision for Consolidated Income Taxes

| | For the Year Ended December 31, | | |
|--|---------------------------------|---------|-----------|
| | 2006 | 2005 | 2004 |
| | (Millions of dollars) | | |
| Operations | | | |
| Current Tax (Benefit) Expense | | | |
| Federal | \$ (77.5) | \$236.2 | \$ (33.2) |
| State and local | — | 81.9 | (9.0) |
| Total Current Tax (Benefit) Expense | (77.5) | 318.1 | (42.2) |
| Deferred Tax Expense (Benefit) | | | |
| Federal | 202.8 | (24.4) | 185.1 |
| State and local | 40.8 | (33.4) | 32.4 |
| Investment tax credits | (4.7) | (5.1) | (8.0) |
| Total Deferred Tax Expense (Benefit) | 238.9 | (62.9) | 209.5 |
| Total Income Tax Expense from Operations | \$161.4 | \$255.2 | \$167.3 |
| Extraordinary Item | | | |
| Deferred Tax Expense | | | |
| Federal | — | 4.8 | — |
| State and local | — | 1.4 | — |
| Total Deferred Tax on Extraordinary Item | — | 6.2 | — |
| Total Consolidated Income Tax Expense | \$161.4 | \$261.4 | \$167.3 |

Reconciliation of Consolidated Income Tax Expense

| | For the Year Ended December 31, | | | | | |
|--|---------------------------------|-------|---------|-------|---------|-------|
| | 2006 | | 2005 | | 2004 | |
| | Amount | Rate | Amount | Rate | Amount | Rate |
| | (Millions of dollars) | | | | | |
| Income Before Income Taxes and Extraordinary Item | \$409.7 | | \$617.4 | | \$427.9 | |
| Preferred Dividends | 1.2 | | 2.5 | | 2.8 | |
| Income Before Preferred Dividends, Income Taxes and Extraordinary Item | \$410.9 | | \$619.9 | | \$430.7 | |
| Income tax at federal statutory rate | \$143.8 | .35 | \$217.1 | .35 | \$150.7 | .35 |
| Increases (decreases) resulting from | | | | | | |
| Depreciation | 8.1 | .02 | 7.8 | .01 | 9.4 | .02 |
| Asset removal costs | (3.2) | (.01) | (3.3) | (.01) | (1.7) | — |
| State income taxes, net of federal effect | 25.6 | .06 | 30.8 | .05 | 27.4 | .06 |
| Software amortization | 3.0 | .01 | 5.2 | .01 | (3.6) | (.01) |
| Tax credits | (4.7) | (.01) | (4.7) | (.01) | (5.9) | (.01) |
| Cumulative effect of local tax consolidation | — | — | — | — | (13.2) | (.03) |
| IRS settlement | (.1) | — | — | — | 19.7 | .05 |
| Company dividends reinvested in 401(k) plan | (2.1) | (.01) | (2.1) | — | (2.1) | (.01) |
| Leveraged leases | (9.3) | (.02) | (7.8) | (.01) | (8.2) | (.02) |
| Change in estimates related to prior year tax liabilities | 2.6 | .01 | 17.9 | .03 | (1.0) | — |
| Other, net | (2.3) | (.01) | (5.7) | (.01) | (4.2) | (.01) |
| Total Consolidated Income Tax Expense | \$161.4 | .39 | \$255.2 | .41 | \$167.3 | .39 |

Components of Consolidated Deferred Tax Liabilities (Assets)

| | At December 31, | |
|---|-----------------------|-----------|
| | 2006 | 2005 |
| | (Millions of dollars) | |
| Deferred Tax Liabilities (Assets) | | |
| Depreciation and other book to tax basis differences | \$1,774.6 | \$1,630.8 |
| Deferred taxes on amounts to be collected through future rates | 43.0 | 49.5 |
| Deferred investment tax credit | (23.4) | (25.7) |
| Contributions in aid of construction | (60.5) | (57.9) |
| Goodwill, accumulated other comprehensive income, and valuation adjustments | (187.1) | (116.8) |
| Deferred electric service and electric restructuring liabilities | (58.6) | (21.7) |
| Finance and operating leases | 607.6 | 516.9 |
| Contracts with NUGs | 72.6 | 77.3 |
| Capital loss carryforward | (.4) | (1.2) |
| Federal net operating loss | (.3) | (64.7) |
| Federal Alternative Minimum Tax credit | (5.2) | (6.9) |
| State net operating loss | (45.5) | (54.0) |
| Valuation allowance (State NOLs) | 29.5 | 30.0 |
| Other postretirement benefits | (51.8) | (43.4) |
| Unrealized losses on fair value declines | (1.7) | (13.3) |
| Property taxes, contributions to pension plan, and other | (33.2) | (51.1) |
| Total Deferred Tax Liabilities, Net | 2,059.6 | 1,847.8 |
| Deferred tax assets included in Other Current Assets | 24.4 | 87.2 |
| Total Consolidated Deferred Tax Liabilities, Net Non-Current | \$2,084.0 | \$1,935.0 |

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.

Resolution of Certain Internal Revenue Service Audit Matters

In 2006, PHI resolved certain, but not all, tax matters that were raised in Internal Revenue Service audits related to the 2001 and 2002 tax years. Adjustments recorded related to these resolved tax matters resulted in a \$6.3 million increase in net income (\$2.5 million for Power Delivery and \$5.4 million for Other Non-Regulated, partially offset by an unfavorable \$1.6 million impact in Corp. & Other). To the extent that the matters resolved related to tax contingencies from the Conectiv heritage companies that existed at the August 2002 merger date, in accordance with accounting rules, an additional adjustment of \$9.1 million (\$3.1 million related to Power Delivery and \$6.0 million related to Other Non-Regulated) was recorded in Corp. & Other to eliminate the tax benefits recorded by Power Delivery and Other Non-Regulated against the goodwill balance that resulted from the merger. Also during 2006, the total favorable impact of \$2.6 million was recorded that resulted from changes in estimates related to prior year tax liabilities subject to audit (\$4.1 million for Power Delivery, partially offset by an unfavorable \$1.5 million for Corp. & Other).

Non Financial Lease Asset

The IRS, as part of its normal audit of PCI's income tax returns, has questioned whether PCI is entitled to certain ongoing tax deductions being taken by PCI as a result of the adoption by PCI of a carry-over tax basis for a non-lease financial asset acquired in 1998 by a subsidiary of PCI. On December 14, 2004, PCI and the IRS agreed to a Notice of Proposed Adjustment settling this and certain other tax matters. This settlement resulted in a cash outlay in February 2006 for additional taxes and interest of approximately \$22.8 million associated with the examination of PCI's 2001-2002 tax returns and an anticipated refund of taxes and interest of approximately \$7.1 million when the examination of PCI's 2003 return is completed. In addition, in the fourth quarter of 2004, PCI 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 PCI prior to September 30, 2004, and approximately \$3.4 million of interest on the additional taxes. During 2006 and 2005, PCI recorded tax charges to earnings of approximately \$.1 million and \$.9 million, respectively, for interest on the additional taxes.

Taxes Other Than Income Taxes

Taxes other than income taxes for each year are shown below. The total amounts below include \$332.9 million, \$333.4 million, and \$305.0 million for the years ended December 31, 2006, 2005, and 2004, respectively, related to the Power Delivery Business, which are recoverable through rates.

| | 2006 | 2005 | 2004 |
|------------------------------------|-----------------------|----------------|----------------|
| | (Millions of dollars) | | |
| Gross Receipts/Delivery | \$149.1 | \$148.3 | \$138.1 |
| Property | 62.7 | 60.4 | 60.1 |
| County Fuel and Energy | 84.3 | 89.0 | 70.6 |
| Environmental, Use and Other | 46.9 | 44.5 | 42.6 |
| Total | <u>\$343.0</u> | <u>\$342.2</u> | <u>\$311.4</u> |

(9) MINORITY INTEREST

The outstanding preferred stock issued by subsidiaries of PHI as of December 31, 2006 and 2005 consisted of the following. The shares of each of these series are redeemable solely at the option of the issuer.

| Serial Preferred Stock | Redemption Price | Shares Outstanding | | December 31, | |
|---|------------------|--------------------|---------|-----------------------|---------------|
| | | 2006 | 2005 | 2006 | 2005 |
| | | | | (Millions of dollars) | |
| Pepco (1) | | | | | |
| \$2.44 Series of 1957 | \$ 51.00 | — | 216,846 | \$ — | \$10.9 |
| \$2.46 Series of 1958 | \$ 51.00 | — | 99,789 | — | 5.0 |
| \$2.28 Series of 1965 | \$ 51.00 | — | 112,709 | — | 5.6 |
| | | | | <u>\$ —</u> | <u>\$21.5</u> |
| DPL (2) | | | | | |
| 4.0% Series of 1943, \$100 per share par value | \$105.00 | 19,809 | 19,809 | \$ 2.0 | \$ 2.0 |
| 3.7% Series of 1947, \$100 per share par value | \$104.00 | 39,866 | 39,866 | 4.0 | 4.0 |
| 4.28% Series of 1949, \$100 per share par value | \$104.00 | 28,460 | 28,460 | 2.8 | 2.8 |
| 4.56% Series of 1952, \$100 per share par value | \$105.00 | 19,571 | 19,571 | 2.0 | 2.0 |
| 4.20% Series of 1955, \$100 per share par value | \$103.00 | 25,404 | 25,404 | 2.5 | 2.5 |
| 5.0% Series of 1956, \$100 per share par value | \$104.00 | 48,588 | 48,588 | 4.9 | 4.9 |
| | | | | <u>\$18.2</u> | <u>\$18.2</u> |
| ACE | | | | | |
| 4.0% Series of 1944, \$100 per share par value | \$105.50 | 24,268 | 24,268 | \$ 2.4 | \$ 2.4 |
| 4.35% Series of 1949, \$100 per share par value | \$101.00 | 2,942 | 2,942 | .3 | .3 |
| 4.35% Series of 1953, \$100 per share par value | \$101.00 | 1,680 | 1,680 | .2 | .2 |
| 4.10% Series of 1954, \$100 per share par value | \$101.00 | 20,504 | 20,504 | 2.0 | 2.0 |
| 4.75% Series of 1958, \$100 per share par value | \$101.00 | 8,631 | 8,631 | .9 | .9 |
| 5.0% Series of 1960, \$100 per share par value | \$100.00 | 4,120 | 4,120 | .4 | .4 |
| | | | | <u>\$ 6.2</u> | <u>\$ 6.2</u> |
| Total Preferred Stock of Subsidiaries | | | | <u>\$24.4</u> | <u>\$45.9</u> |

- (1) In October 2005, Pepco redeemed the following shares of preferred stock: (i) 74,103 shares of \$2.46 Series of 1958, (ii) 13,148 shares of \$2.28 Series of 1965, and 22,795 shares of \$2.44 Series of 1957, for an aggregate redemption amount of \$3.7 million, \$.7 million and \$1.1 million, respectively. On March 1, 2006, Pepco redeemed the remaining outstanding shares of each series of its preferred stock, at 102% of par, for an aggregate redemption amount of \$21.9 million.

- (2) On January 18, 2007, DPL redeemed all of the outstanding shares of its preferred stock, at prices ranging from 103% to 105% of par, in an aggregate amount of approximately \$18.9 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.

Total stock-based compensation expense recorded in the Consolidated Statements of Earnings for the years ended December 31, 2006, 2005, and 2004 is \$5.8 million, \$4.4 million, and \$4.3 million, respectively. For the years ended December 31, 2006, 2005, and 2004, \$1 million, zero, and zero, respectively, in tax benefits was recognized in relation to stock-based compensation costs of stock awards. No compensation costs related to restricted stock grants were capitalized for the years ended December 31, 2006, 2005 and 2004.

PHI recognizes compensation expense related to Performance Restricted Stock Awards based on the fair value of the awards at date of grant. PHI estimates the fair value of market condition awards using a Monte Carlo simulation model, in a risk-neutral framework, based on the following assumptions:

| | Performance Period | |
|--------------------------------|--------------------|-------------|
| | 2004-2006 | 2005-2007 |
| Risk-free interest rate (%) | 2.11 | 3.37 |
| Peer volatilities (%) | 16.3 - 62.5 | 15.5 - 60.1 |
| Peer correlations | 0.13 - 0.69 | 0.15 - 0.72 |
| Fair value of restricted share | \$ 24.06 | \$ 26.92 |

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, May 2001, January 2002, and May 2002 are exercisable.

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.

| | 2006 | | 2005 | | 2004 | |
|----------------------------------|-------------------|------------------------|-------------------|------------------------|-------------------|------------------------|
| | Number of Options | Weighted Average Price | Number of Options | Weighted Average Price | Number of Options | Weighted Average Price |
| Beginning-of-year balance | 1,864,250 | \$22.1944 | 2,063,754 | \$21.8841 | 2,115,037 | \$21.8131 |
| Options exercised | 733,526 | \$21.7081 | 196,299 | \$18.9834 | 41,668 | \$18.9385 |
| Options forfeited | — | \$ — | 3,205 | \$19.0300 | 9,615 | \$19.0300 |
| End-of-year balance | 1,130,724 | \$22.5099 | 1,864,250 | \$22.1944 | 2,063,754 | \$21.8841 |
| Exercisable at end of year | 1,130,724 | \$22.5099 | 1,814,350 | \$22.1840 | 1,739,032 | \$21.9944 |

All stock options have an expiration date of ten years from the date of grant.

The aggregate intrinsic value of stock options outstanding and exercisable at December 31, 2006, 2005, and 2004 was \$4.1 million, \$1.1 million, and \$(1.1) million, respectively.

The total intrinsic value of stock options exercised during the years ended December 31, 2006, 2005, and 2004 was \$2.2 million, \$.8 million, and \$.1 million, respectively. For the years ended December 31, 2006, 2005, and 2004, \$.9 million, \$.3 million, and zero, respectively, in tax benefits was recognized in relation to stock-based compensation costs of stock options.

As of December 31, 2006, an analysis of options outstanding by exercise prices is as follows:

| Range of Exercise Prices | Number Outstanding and Exercisable at December 31, 2006 | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in Years) |
|--------------------------|---|---------------------------------|--|
| \$13.08 to \$19.30 | 326,083 | \$18.7373 | 5.4 |
| \$21.83 to \$29.78 | 804,641 | \$24.0387 | 3.3 |
| \$13.08 to \$29.78 | 1,130,724 | \$22.5099 | 3.9 |

Prior to the adoption of SFAS No. 123R on January 1, 2006, Pepco Holdings recognized 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 2006, 2005 and 2004 with respect to stock options granted under the LTIP.

There were no options granted in 2006, 2005, or 2004.

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 2006, 2005 and 2004 under Pepco Holdings' Performance Restricted Stock Program for performance periods 2007-2009, 2006-2008 and 2005-2007 were 190,657, 218,108 and 247,400, respectively. Additionally, beginning in 2006, time-restricted share award opportunities with a requisite service period of three years were established under the LTIP. The target number of share award opportunities for these awards was 95,314 for the 2007-2009 time period and 109,057 for the 2006-2008 time period. The fair value per share on award date for the performance restricted stock was \$25.54 for the 2007-2009 award, \$23.28 for the 2006-2008 award, and \$26.92 for the 2005-2007 award. Depending on the extent to which the performance criteria are satisfied, the executives are eligible to earn shares of common stock and dividends accrued thereon over the vesting period, under the Performance Restricted Stock Program ranging from 0% to 200% of the target share award opportunities, inclusive of dividends accrued. There were 418,426 awards earned with respect to the 2004-2006 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 nonqualified 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. As of December 31, 2006, 95,513 converted shares have vested and 7,823 shares remain unvested.

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 vested on June 1, 2006.

The 2006 activity for non-vested share opportunities is summarized below. The information presented in the table is for Pepco Holdings, including Conectiv PARS converted to Pepco Holdings restricted stock.

| | <u>Number of Shares</u> | <u>Weighted Average Grant Date Fair Value</u> |
|---|-----------------------------|---|
| Non-vested share opportunities at January 1, 2006 | 832,813 | \$ 22.933 |
| Granted | 327,165 | \$ 23.280 |
| Reinvested dividends | 7,560 | \$ 19.735 |
| Vested | (104,593) | \$(19.515) |
| Forfeiture due to non-performance | (303,357) | \$(20.201) |
| Forfeited | (30,819) | \$(25.169) |
| Non-vested share opportunities at December 31, 2006 | 728,769 | \$ 24.588 |

The total fair value of restricted stock awards vested during the years ended December 31, 2006, 2005, and 2004 was \$2.0 million, \$2.7 million, and \$1.0 million, respectively.

As of December 31, 2006, there was approximately \$3.8 million of unrecognized compensation cost (net of estimated forfeitures) related to non-vested stock granted under the plans. That cost is expected to be recognized over a weighted-average period of 2 years.

For the years ended December 31, 2006, 2005, and 2004, Pepco Holdings recorded dividends from its subsidiaries as follows:

| <u>Subsidiary</u> | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|-----------------------|-----------------------|----------------|----------------|
| | (Millions of dollars) | | |
| Pepco | \$ 99.0 | \$ 62.9 | \$102.4 |
| DPL | 15.0 | 36.4 | 68.0 |
| ACE | 109.0 | 95.9 | 10.6 |
| Conectiv Energy | — | 50.0 | — |
| | <u>\$223.0</u> | <u>\$245.2</u> | <u>\$181.0</u> |

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 ACE's charter which imposes restrictions on payment of common stock dividends for the benefit of preferred stockholders. Restricted net assets related to PHI's consolidated subsidiaries amounted to approximately \$1.9 billion at December 31, 2006 and 2005. PHI had no restricted retained earnings or restricted net income at December 31, 2006 and 2005.

Directors' Deferred Compensation

Under the Pepco Holdings' Executive and Director Deferred Compensation Plan, Pepco Holdings directors may elect to defer all or part of their retainer or meeting fees that constitute normal compensation. Deferred retainer or meeting fees can be invested in phantom Pepco Holdings shares and earn dividends as well as appreciation equal to the amount of increase in fair value of the phantom shares. The ultimate payout is in cash. The amount deferred and invested in phantom Pepco Holdings shares in the years ended December 31, 2006, 2005 and 2004 was \$.1 million, \$.1 million and \$.3 million, respectively.

Compensation recognized in respect of dividends and increase in fair value in the years ended December 31, 2006, 2005 and 2004 was \$.3 million, \$.1 million and \$.2 million, respectively. The balance of deferred compensation invested in phantom Pepco Holdings' shares at December 31, 2006 and 2005 was \$1.8 million and \$1.4 million.

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, | | |
|---|--|----------------|----------------|
| | 2006 | 2005 | 2004 |
| | (Millions of dollars, except share data) | | |
| Income (Numerator): | | | |
| Net Income | \$248.3 | \$371.2 | \$260.6 |
| Add: (Loss) gain on redemption of subsidiary's preferred stock | (.8) | (.1) | .5 |
| Earnings Applicable to Common Stock | <u>\$247.5</u> | <u>\$371.1</u> | <u>\$261.1</u> |
| Shares (Denominator) (a): | | | |
| Weighted average shares outstanding for basic computation: | | | |
| Average shares outstanding | 190.7 | 189.0 | 176.8 |
| Adjustment to shares outstanding | (.1) | (.1) | — |
| Weighted Average Shares Outstanding for Computation of Basic Earnings Per Share of Common Stock | <u>190.6</u> | <u>188.9</u> | <u>176.8</u> |
| Weighted average shares outstanding for diluted computation: | | | |
| Average shares outstanding | 190.7 | 189.0 | 176.8 |
| Adjustment to shares outstanding | .4 | .2 | — |
| Weighted Average Shares Outstanding for Computation of Diluted Earnings Per Share of Common Stock | <u>191.1</u> | <u>189.2</u> | <u>176.8</u> |
| Basic earnings per share of common stock | \$ 1.30 | \$ 1.96 | \$ 1.48 |
| Diluted earnings per share of common stock | \$ 1.30 | \$ 1.96 | \$ 1.48 |

- (a) The number of 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 .6 million for the year ended December 31, 2006 and 1.4 million for the years ended December 31, 2005 and 2004.

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 1,232,569, 1,228,505, and 1,471,936 original issue shares sold under the DRP in 2006, 2005 and 2004, respectively.

The following table presents Pepco Holdings' common stock reserved and unissued at December 31, 2006:

| <u>Name of Plan</u> | <u>Number of Shares</u> |
|---|-----------------------------|
| DRP | 3,713,555 |
| Connectiv Incentive Compensation Plan (a) | 1,396,836 |
| Potomac Electric Power Company Long-Term Incentive Plan (a) | 838,700 |
| Pepco Holdings, Inc. Long-Term Incentive Plan | 9,626,494 |
| Pepco Holdings, Inc. Non-Management Directors Compensation Plan | 496,858 |
| Pepco Holdings, Inc. Savings Plan (b) | 5,045,000 |
| Total | <u>21,117,443</u> |

- (a) No further awards will be made under this plan.

- (b) Effective January 30, 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 Potomac Electric Power Company Retirement Savings Plan for Management Employees (which resulted from the merger, effective January 1, 2005, of the Potomac Electric Power Company Savings Plan for Non-Bargaining Unit, Non-Exempt Employees and the Potomac Electric Power Company Savings Plan for Exempt Employees), (iii) the Conectiv Savings and Investment Plan, and (iv) the Atlantic City Electric 401(k) Savings and Investment Plan—B.

(11) FAIR VALUES OF FINANCIAL INSTRUMENTS

The estimated fair values of Pepco Holdings' financial instruments at December 31, 2006 and 2005 are shown below.

| | At December 31, | | | |
|--|-----------------|-----------------------|-----------------|------------|
| | 2006 | (Millions of dollars) | 2005 | |
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Assets | | | | |
| Derivative Instruments | \$ 109.1 | \$ 109.1 | \$ 260.0 | \$ 260.0 |
| Liabilities and Capitalization | | | | |
| Long-Term Debt | \$3,768.6 | \$3,807.3 | \$4,202.9 | \$4,308.0 |
| Transition Bonds issued by ACE Funding | \$ 464.4 | \$ 462.3 | \$ 494.3 | \$ 496.7 |
| Derivative Instruments | \$ 186.8 | \$ 186.8 | \$ 201.3 | \$ 201.3 |
| Long-Term Project Funding | \$ 23.3 | \$ 23.3 | \$ 25.5 | \$ 25.5 |
| Serial Preferred Stock | \$ — | \$ — | \$ 21.5 | \$ 18.2 |
| Redeemable Serial Preferred Stock | \$ 24.4 | \$ 21.7 | \$ 24.4 | \$ 17.2 |

The methods and assumptions described below were used to estimate, at December 31, 2006 and 2005, 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 generating assets to Mirant (formerly Southern Energy, Inc.). In July 2003, Mirant 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 the Plan of Reorganization (the Reorganization Plan) of Mirant and the Mirant business emerged from bankruptcy on January 3, 2006, as a new corporation of the same name (for purposes of this section, together with its predecessors, Mirant).

As part of the bankruptcy proceeding, Mirant had been seeking to reject certain ongoing contractual arrangements under the Asset Purchase and Sale Agreement entered into by Pepco and Mirant for the sale of the generating assets that are described below. The Reorganization Plan did not resolve the issues relating to Mirant's efforts to reject these obligations nor did it resolve certain Pepco damage claims against the Mirant bankruptcy estate.

Power Purchase Agreement

The Panda PPA obligates Pepco to purchase from Panda 230 megawatts of energy and capacity annually through 2021. At the time of the sale of Pepco's generating assets to Mirant, the purchase price of the energy and capacity under the Panda PPA 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 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).

The SMECO Agreement

Under the Asset Purchase and Sale Agreement, Pepco assigned to Mirant a Facility and Capacity Agreement entered into by Pepco with Southern Maryland Electric Cooperative, Inc. (SMECO), under which Pepco was obligated to purchase from SMECO the capacity of an 84-megawatt combustion turbine installed and owned by SMECO at a former Pepco generating facility at a cost of approximately \$500,000 per month until 2015 (the SMECO Agreement). Pepco is responsible to SMECO for the performance of the SMECO Agreement if Mirant fails to perform its obligations thereunder.

Settlement Agreements with Mirant

On May 30, 2006, Pepco, PHI, and certain affiliated companies entered into a Settlement Agreement and Release (the Settlement Agreement) with Mirant, which, subject to court approval, settles all outstanding issues between the parties arising from or related to the Mirant bankruptcy. Under the terms of the Settlement Agreement:

- Mirant will assume the Asset Purchase and Sale Agreement, except for the PPA-Related Obligations, which Mirant will be permitted to reject.
- Pepco will receive an allowed claim under the Reorganization Plan in an amount that will result in a total aggregate distribution to Pepco, net of certain transaction expenses, of \$520 million, consisting of (i) \$450 million in damages resulting from the rejection of the PPA-Related Obligations and (ii) \$70 million in settlement of other Pepco damage claims against the Mirant bankruptcy estate (the Pepco Distribution).
- Except as described below, the \$520 million Pepco Distribution will be effected by means of the issuance to Pepco of shares of Mirant common stock (consisting of an initial distribution of 13.5 million shares of Mirant common stock, followed thereafter by a number of shares of Mirant common stock to

be determined), which Pepco will be obligated to resell promptly in one or more block sale transactions. If the net proceeds that Pepco receives from the resale of the shares of Mirant common stock are less than \$520 million, Pepco will receive a cash payment from Mirant equal to the difference, and if the net proceeds that Pepco receives from the resale of the shares of Mirant common stock are more than \$520 million, Pepco will make a cash payment to Mirant equal to the difference.

- If the closing price of shares of Mirant common stock is less than \$16.00 per share for four business days in a twenty consecutive business day period, and Mirant has not made a distribution of shares of Mirant common stock to Pepco under the Settlement Agreement, Mirant has the one-time option to elect to assume, rather than reject, the PPA-Related Obligations. If Mirant elects to assume the PPA-Related Obligations, the Pepco Distribution will be reduced to \$70 million.
- All pending appeals, adversary actions or other contested matters between Pepco and Mirant will be dismissed with prejudice, and each will release the other from any and all claims relating to the Mirant bankruptcy.

Separately, Mirant and SMECO have entered into a Settlement Agreement and Release (the SMECO Settlement Agreement). The SMECO Settlement Agreement provides that Mirant will assume, rather than reject, the SMECO Agreement. This assumption ensures that Pepco will not incur liability to SMECO as the guarantor of the SMECO Agreement due to the rejection of the SMECO Agreement, although Pepco will continue to guarantee to SMECO the future performance of Mirant under the SMECO Agreement.

According to their terms, the Settlement Agreement and the SMECO Settlement Agreement will become effective when the Bankruptcy Court or the United States District Court for the Northern District of Texas (the District Court), as applicable, has entered a final order, not subject to appeal or rehearing, approving both the Settlement Agreement and the SMECO Settlement Agreement.

On August 9, 2006, the Bankruptcy Court issued an order approving the Settlement Agreement and the SMECO Settlement Agreement. On August 18, 2006, certain holders of Mirant bankruptcy claims, who had objected to approval of the Settlement Agreement and the SMECO Settlement Agreement before the Bankruptcy Court, appealed the approval order to the District Court. On December 26, 2006, the District Court issued an order affirming the Bankruptcy Court's order approving the Settlement Agreement. On January 25, 2007, the parties that previously appealed the Bankruptcy Court's order filed a notice of appeal of the District Court's order with the United States Court of Appeals for the Fifth Circuit (the Fifth Circuit). On February 12, 2007, the Fifth Circuit issued a briefing schedule. The brief of the appealing creditors is due on March 26, 2007, while Mirant's and Pepco's briefs are due on April 30, 2007.

In August 2006, Mirant made a cash payment to Pepco of \$70 million, which became due in accordance with the terms of the Settlement Agreement as a result of the approval of the Settlement Agreement by the Bankruptcy Court. If the Bankruptcy Court order approving the Settlement Agreement becomes a final order after the exhaustion of all appeals, the payment will be taken into account as if it were proceeds from the resale by Pepco of shares of the Mirant common stock, as described above, and treated as a portion of the \$520 million payment due Pepco. If the Bankruptcy Court approval of the Settlement Agreement is not upheld on appeal, Pepco must repay this cash payment to Mirant. Therefore, no income statement impact has been recognized in relation to the \$70 million payment.

Until the approval of the Settlement Agreement and the SMECO Settlement Agreement becomes final, Mirant is required to continue to perform all of its contractual obligations to Pepco and SMECO. Pepco intends to use the \$450 million portion of the Pepco Distribution related to the rejection of the PPA-Related Obligations to pay for future capacity and energy purchases under the Panda PPA.

In litigation prior to the entry into the Settlement Agreement, the District Court had entered orders denying Mirant's attempt to reject the PPA-Related Obligations and directing Mirant to resume making payments to Pepco pursuant to the PPA-Related Obligations, which Mirant had suspended. Mirant is making the payments as

required by the District Court order. On July 19, 2006, the Fifth Circuit issued an opinion affirming the District Court's orders. On September 4, 2006, Mirant filed a petition for rehearing and motion to stay the appeals pending completion of the settlement between the parties. On September 12, 2006, the Fifth Circuit issued an Order denying Mirant's motion for stay. On September 21, 2006, the Fifth Circuit issued an Order summarily denying Mirant's petition for rehearing. The appeal period has expired and that order is now final and nonappealable.

Rate Proceedings

PHI's regulated utility subsidiaries currently have four active distribution base rate cases underway. Pepco has filed electric distribution base rate cases in the District of Columbia and Maryland; DPL has filed a gas distribution base rate case in Delaware (which is the subject of a settlement agreement as discussed below) and an electric base rate case in Maryland. In each of these cases, the utility has proposed the adoption of a bill stabilization adjustment mechanism (BSA) for retail customers. The BSA will increase rates if revenues from distribution deliveries fall below the level approved by the applicable regulatory commission and will decrease rates if revenues from distribution deliveries are above the commission-approved level. The end result will be that the utility will collect its authorized revenues for distribution deliveries. As a consequence, a BSA "decouples" revenue from unit sales consumption and ties the growth in revenues to the growth in the number of customers. Some advantages of the BSA are that it (i) eliminates revenue fluctuations due to weather and changes in customer usage patterns and, therefore, provides for more predictable utility distribution revenues that are better aligned with costs, (ii) provides for more reliable fixed-cost recovery, (iii) tends to stabilize customers' delivery bills, and (iv) removes any disincentives for the regulated utilities to promote energy efficiency programs for their customers, because it breaks the link between overall sales volumes and delivery revenues. DPL has proposed a monthly BSA in the gas base rate case and, in each of the electric base rate cases, the companies have proposed a quarterly BSA.

Delaware

On August 31, 2006, DPL submitted its 2006 Gas Cost Rate (GCR) filing to the DPSC, which permits DPL to recover gas procurement costs through customer rates. The proposed decrease of approximately 9.6% is in anticipation of decreasing natural gas commodity costs. On October 3, 2006, the DPSC issued its initial order approving the proposed rates, which became effective November 1, 2006, subject to refund pending final DPSC approval after evidentiary hearings. Any amounts subject to refund would be deferred, resulting in no earnings impact.

On February 23, 2007, DPL submitted an additional filing to the DPSC that proposed a 4.3% decrease in the GCR effective April 1, 2007, in compliance with its gas service tariff and to ensure collections are more aligned with expenses. DPL expects DPSC approval of the rate decrease in late March 2007, subject to refund pending final DPSC approval after evidentiary hearings.

On August 31, 2006, DPL submitted an application to the DPSC for an increase in gas distribution base rates, including a proposed BSA. The application requested an annual increase of approximately \$15 million or an overall increase of 6.6%, including certain miscellaneous tariff fees, reflecting a proposed return on equity (ROE) of 11.00%. If the BSA is not approved, the proposed annual increase would be \$15.5 million or an overall increase of 6.8%, reflecting an ROE of 11.25%. On October 17, 2006, the DPSC authorized DPL to place into effect beginning November 1, 2006, subject to refund, gas base rates designed to produce an annual interim increase in revenue of approximately \$2.5 million. On February 16, 2007, all of the parties in this proceeding (DPL, DPSC staff and the Delaware Division of Public Advocate) filed a settlement agreement with the DPSC. The settlement provisions include a \$9.0 million increase in distribution rates, including certain miscellaneous tariff fees (of which \$2.5 million was put into effect on November 1, 2006, as noted above), an ROE of 10.25%, and a change in depreciation rates that result in a \$2.1 million reduction in pre-tax annual depreciation expense. Although the settlement agreement does not include a BSA, it provides for all of the parties to the case to participate in any generic statewide proceeding for the purpose of investigating BSA mechanisms for electric and

gas distribution utilities. In a separate proceeding, DPL has requested that a docket be opened for this purpose. Under the settlement agreement, rates will become effective on April 1, 2007. A DPSC decision is expected by the end of March 2007.

District of Columbia

In February 2006, Pepco filed an update to the District of Columbia GPC for the periods February 8, 2002 through February 7, 2004 and February 8, 2004 through February 7, 2005. The GPC provides for sharing of the profit from SOS sales. The update to the GPC in the District of Columbia takes into account the \$112.4 million in proceeds received by Pepco from the December 2005 sale of an allowed bankruptcy claim against Mirant arising from a settlement agreement entered into with Mirant relating to Mirant's obligation to supply energy and capacity to fulfill Pepco's SOS obligations in the District of Columbia. The filing also incorporates true-ups to previous disbursements in the GPC for the District of Columbia. In the filing, Pepco requested that \$24.3 million be credited to District of Columbia customers during the twelve-month period beginning April 2006. On June 15, 2006, the DCPSC granted conditional approval of the GPC update as filed, effective July 1, 2006. Final approval by the DCPSC is pending.

On December 12, 2006, Pepco submitted an application to the DCPSC to increase electric distribution base rates, including a proposed BSA. The application requested an annual increase of approximately \$46.2 million or an overall increase of 13.5%, reflecting a proposed ROE of 10.75%. If the BSA is not approved, the proposed annual increase would be \$50.5 million or an overall increase of 14.8%, reflecting an ROE of 11.00%. The application also proposed a Pension/OPEB Expense Surcharge that will allow Pepco to reflect in its distribution rates the increases and decreases that occur in the level of its pension and other post-employment benefits expense. A DCPSC decision is expected in mid-September 2007.

Maryland

On November 17, 2006, DPL and Pepco each submitted an application to the MPSC to increase electric distribution base rates, including a proposed BSA. The applications requested an annual increase for DPL of approximately \$18.4 million or an overall increase of 3.2%, including certain miscellaneous tariff fees, and an annual increase for Pepco of approximately \$47.4 million or an overall increase of 10.9%, reflecting a proposed ROE for each of 11.00%. If the BSA is not approved, the proposed annual increase for DPL would be \$20.3 million or an overall increase of 3.6%, and for Pepco would be \$55.7 million or an overall increase of 12.9%, reflecting a proposed ROE for each of 11.25%. Each of the applications also proposed a Pension/OPEB Expense Surcharge that would allow the utility to reflect in its distribution rates the increases and decreases that occur in the level of its pension and other post-employment benefits expense. The applications requested that rates go into effect on December 17, 2006. In an order dated December 11, 2006, the MPSC suspended the proposed rates pending MPSC approval. MPSC decisions are expected in June 2007.

Federal Energy Regulatory Commission

On May 15, 2006, Pepco, ACE and DPL updated their FERC-approved formula transmission rates based on the FERC Form 1 data for 2005 for each of the utilities. These rates became effective on June 1, 2006, as follows: for Pepco, \$12,009 per megawatt per year; for ACE, \$14,155 per megawatt per year; and for DPL, \$10,034 per megawatt per year. By operation of the formula rate process, the new rates incorporate true-ups from the 2005 formula rates that were effective June 1, 2005 and the new 2005 customer demand or peak load. Also, beginning in January 2007, the new rates will be applied to 2006 customer demand data, replacing the 2005 demand data that is currently used. This demand component is driven by the prior year peak loads experienced in each respective zone. Further, the rate changes will be positively impacted by changes to distribution rates for Pepco and DPL based on the merger settlements in Maryland and the District of Columbia. The net earnings impact expected from the network transmission rate changes is estimated to be a reduction of approximately \$5 million year over year (2005 to 2006).

ACE Restructuring Deferral Proceeding

Pursuant to orders issued by the NJBPU under the 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) 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.

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 (the base rate case ended in a settlement approved by the NJBPU in May 2005, the result of which is that any net rate impact from the deferral account recoveries and credits in future years will depend in part on whether rates associated with other deferred accounts considered in the case continue to generate over-collections relative to costs), 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. Although ACE believes the record does not justify the level of disallowance imposed by the NJBPU in the final order, the \$44.6 million of disallowed incurred costs were reserved during the years 1999 through 2003 (primarily 2003) through charges to earnings, primarily in the operating expense line item "deferred electric service costs," with a corresponding reduction in the regulatory asset balance sheet account. In August 2004, ACE filed a notice of appeal with respect to the July 2004 final order with the Appellate Division of the Superior Court of New Jersey (the Appellate Division), which hears appeals of the decisions of New Jersey administrative agencies, including the NJBPU. Briefs in the appeal were also filed by the Division of the New Jersey Ratepayer Advocate and by Cogentrix Energy Inc., the co-owner of two cogeneration power plants with contracts to sell ACE approximately 397 megawatts of electricity, as cross-appellants between August 2005 and January 2006. The Appellate Division has not yet set the schedule for oral argument.

Divestiture Cases

District of Columbia

Final briefs on Pepco's District of Columbia divestiture proceeds sharing application were filed with the DCPSC 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 (IRC) and its implementing regulations. As of December 31, 2006, the District of Columbia allocated portions of EDIT and ADITC associated with the divested generating assets were approximately \$6.5 million and \$5.8 million, respectively.

Pepco believes that a sharing of EDIT and ADITC would violate the 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, 2006), as well as its District of Columbia jurisdictional transmission and distribution-related ADITC balance (\$4.7 million as of December 31, 2006) 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 were filed in March 2006, and a public hearing was held in April 2006. Pepco filed a letter with the DCPSC in January 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 related to this issue 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 or cash flows.

Maryland

Pepco filed its divestiture proceeds plan application with the MPSC 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, 2006, the Maryland allocated portions of EDIT and ADITC associated with the divested generating 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, 2006), 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, 2006), as well as its Maryland retail jurisdictional ADITC transmission and distribution-related balance (\$8.4 million as of December 31, 2006), 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 in January 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 related to this issue will be terminated without the issuance of any regulations.

In December 2003, Pepco appealed the Hearing Examiner's decision to the MPSC as it relates to the treatment of EDIT and ADITC and corporate reorganization costs. The MPSC has not issued any ruling on the appeal and Pepco does not believe that it will do so until action is taken by the IRS as described above. 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 in addition to the additional gain-sharing payments relating to the disallowed severance payments, which Pepco is not contesting. 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 or cash flows.

New Jersey

In connection with the divestiture by ACE of its nuclear generating assets, the NJBPU in July 2000 preliminarily determined that the amount of stranded costs associated with the divested assets that ACE could recover from ratepayers should be reduced by approximately \$94.5 million, representing the amount of the accumulated deferred federal income taxes (ADFIT) associated with the divested nuclear assets. However, due to uncertainty under federal tax law regarding whether the sharing of federal income tax benefits associated with the divested assets, including ADFIT, with ACE's customers would violate the normalization rules, ACE submitted a request to the IRS for a Private Letter Ruling (PLR) to clarify the applicable law. The NJBPU has delayed its final determination of the amount of recoverable stranded costs until after the receipt of the PLR.

On May 25, 2006, the IRS issued a PLR in which it stated that returning to ratepayers any of the unamortized ADFIT attributable to accelerated depreciation on the divested assets after the sale of the assets by means of a reduction of the amount of recoverable stranded costs would violate the normalization rules.

On June 9, 2006, ACE submitted a letter to the NJBPU to request that the NJBPU conduct proceedings to finalize the determination of the stranded costs associated with the sale of ACE's nuclear assets in accordance with the PLR. ACE's request remains pending.

Default Electricity Supply Proceedings

Delaware

Effective May 1, 2006, SOS replaced fixed-rate POLR service for customers who do not choose an alternative electricity supplier. In October 2005, the DPSC approved DPL as the SOS provider to its Delaware delivery customers. DPL obtains the electricity to fulfill its SOS supply obligation under contracts entered pursuant to a competitive bid procedure approved by the DPSC. The bids received for the May 1, 2006, through May 31, 2007, period have had the effect of increasing rates significantly for all customer classes, including an average residential customer increase of 59%, as compared to the fixed rates previously in effect.

To address this increase in rates, Delaware in April 2006 enacted legislation that provides for a deferral of the financial impact on customers of the increases through a three-step phase-in of the rate increases, with 15% of the increase taking effect on May 1, 2006, 25% of the increase taking effect on January 1, 2007, and any remaining balance taking effect on June 1, 2007, subject to the right of customers to elect not to participate in the deferral program. Customers who do not "opt-out" of the rate deferral program are required to pay the amounts

deferred, without any interest charge, over a 17-month period beginning January 1, 2008. As of December 31, 2006, approximately 53% of the eligible Delaware customers have opted not to participate in the deferral of the SOS rates offered by DPL. With approximately 47% of the eligible customers participating in the phase-in program, DPL anticipates a maximum deferral balance of \$51.4 million.

Maryland

Pursuant to orders issued by the MPSC in November 2006, Pepco and DPL each is the SOS provider to its delivery customers who do not choose an alternative electricity supplier. Each company purchases the power supply required to satisfy its SOS obligations from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure approved and supervised by the MPSC. In March 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. Due to significant increases in the cost of fuels used to generate electricity, the auction results had the effect of increasing the average monthly electric bill by about 38.5% and 35% for Pepco's and DPL's Maryland residential customers, respectively.

On April 21, 2006, the MPSC approved a settlement agreement among Pepco, DPL, the staff of the MPSC and the Office of Peoples Counsel of Maryland, which provides for a rate mitigation plan for the residential customers of each company. Under the plan, the full increase for each company's residential customers who affirmatively elect to participate are being phased-in in increments of 15% on June 1, 2006, 15.7% on March 1, 2007 and the remainder on June 1, 2007. Customers electing to participate in the rate deferral plan will be required to pay the deferred amounts over an 18-month period beginning June 1, 2007. Both Pepco and DPL will accrue the interest cost to fund the deferral program. The interest cost will be absorbed by Pepco and DPL during the period that the deferred balance is accumulated and collected from customers, to the extent of and offset against the margins that the companies otherwise would earn for providing SOS to residential customers. As of December 31, 2006, approximately 2% of Pepco's residential customers and approximately 1% of DPL's residential customers had elected to participate in the phase-in program.

On June 23, 2006, Maryland enacted legislation that extended the period for customers to elect to participate in the phase-in of higher rates and revised the obligation to provide SOS to residential and small commercial customers until further action of the General Assembly. The legislation also provides for a customer refund reflecting the difference between the interest expense on an initially projected deferred balance at a 25% customer participation level and the interest expense on a deferred balance based on actual participation levels referred to above. The total amount of the refund is approximately \$1.1 million for Pepco customers and approximately \$.3 million for DPL customers. At Pepco's 2% level of participation, Pepco estimates that the deferral balance, net of taxes, will be approximately \$1.4 million. At DPL's 1% level of participation, DPL estimates that the deferral balance, net of taxes, will be approximately \$.2 million. In July 2006, the MPSC approved revised tariff riders filed in June 2006 by Pepco and DPL to implement the legislation.

Virginia

On March 10, 2006, DPL filed for a rate increase with the VSCC for its Virginia Default Service customers to take effect on June 1, 2006, which was intended to allow DPL to recover its higher cost for energy established by the competitive bid procedure. On June 19, 2006, the VSCC issued an order that granted a rate increase for DPL of \$11.5 million (\$8.5 million less than requested by DPL in its March 2006 filing), to go into effect July 1, 2006. In determining the amount of the approved increase, the VSCC applied the proxy rate calculation to DPL's fuel factor, rather than allowing full recovery of the costs DPL incurred in procuring the supply necessary for its Default Service obligation. The estimated after-tax earnings and cash flow impacts of the decision are reductions of approximately \$3.6 million in 2006 (including the loss of revenue in June 2006 associated with the Default Service rate increase being deferred from June 1 until July 1) and \$2.0 million in 2007. The order also mandated that DPL file an application by March 1, 2007 (which has been delayed until April 2, 2007 by subsequent VSCC order) for Default Service rates to become effective June 1, 2007, which should include a calculation of the fuel factor that is consistent with the procedures set forth in the order.

In February 2007, the Virginia General Assembly passed amendments to the Virginia Electric Utility Restructuring Act (the Virginia Restructuring Act) that modified the method by which investor-owned electric utilities in Virginia will be regulated by the VSCC. These amendments to the Virginia Restructuring Act, subject to further amendment or veto by the Virginia governor and subsequent action by the General Assembly, will be effective on July 1, 2007. The amendments provide that, as of December 31, 2008, the following will come to an end: (i) capped rates (the previous expiration date was December 31, 2010); (ii) DPL's Default Service obligation (previously, DPL was obligated to continue to offer Default Service until relieved of that obligation by the VSCC); and (iii) customer choice, except that customers with loads of 5 megawatts or greater will continue to be able to buy from competitive suppliers, as will smaller non-residential customers that aggregate their loads to reach the 5 megawatt threshold and obtain VSCC approval. Additionally, if an ex-customer of Default Service wants to return to DPL as its energy supplier, it must give 5 years notice or obtain approval of the VSCC that the return is in the public interest. In this event, the ex-customer must take DPL's service at market based rates. DPL also believes that the amendments to the Virginia Restructuring Act will terminate, as of December 31, 2008, the ratemaking provisions within the memorandum of agreement entered into by DPL, the staff of the VSCC and the Virginia Attorney General's office in the docket approving DPL's generating asset divestiture in 2000 (the MOA), including the application of the proxy rate calculation to DPL's fuel factor as discussed above; however, the VSCC's interpretation of these provisions is not known. It should be noted that in DPL's view, in the absence these amendments, the MOA and all of its provisions (including the proxy rate calculation) expire on July 1, 2007; the VSCC staff and the Virginia Attorney General disagree with DPL's position. Assuming the ratemaking provisions of the MOA end on December 31, 2008 pursuant to the amended Virginia Restructuring Act, the amendments provide that DPL shall file a rate case in 2009 and every 2 years thereafter. The ROE to be allowed by the VSCC will be set within a range, the lower of which is essentially the average of vertically integrated investor-owned electric utilities in the southeast with an upper point that is 300 basis points above that average. The VSCC has authority to set rates higher or lower to allow DPL to maintain the opportunity to earn the determined ROE and to credit back to customers, in whole or in part, earnings that were 50 basis points or more in excess of the determined ROE. The amended Virginia Restructuring Act includes various incentive ROEs for the construction of new generation and would allow the VSCC to penalize or reward DPL for efficient operations or, if DPL were to add new generation, for generating unit performance. There are also enhanced ratemaking features if DPL pursues conservation, demand management and energy efficiency programs or pursues renewable energy portfolios.

ACE Sale of Generating Assets

On September 1, 2006, ACE completed the sale of its interests in the Keystone and Conemaugh generating facilities to Duquesne Light Holdings Inc. for approximately \$177.0 million, which was subsequently decreased by \$1.6 million based on a post-closing 60-day true-up for applicable items not known at the time of the closing. Approximately \$81.3 million of the net gain from the sale has been used to offset the remaining regulatory asset balance, which ACE has been recovering in rates, and approximately \$49.8 million of the net gain is being returned to ratepayers over a 33-month period as a credit on their bills, which began with the October 2006 billing month. The balance to be repaid to customers is \$48.4 million as of December 31, 2006.

On February 8, 2007, ACE completed the sale of the B.L. England generating facility to RC Cape May Holdings, LLC (RC Cape May), an affiliate of Rockland Capital Energy Investments, LLC, for a price of \$9.0 million, after adjustment for, among other things, variances in the value of fuel and material inventories at the time of closing, plant operating capacity, the value of certain benefits for transferred employees and the actual closing date. The purchase price will be further adjusted based on a post-closing 60-day true-up for applicable items not known at the time of the closing. In addition, RC Cape May and ACE have agreed to arbitration concerning whether RC Cape May must pay to ACE, as part of the purchase price, an additional \$3.1 million remaining in dispute. RC Cape May also assumed certain liabilities associated with the B.L. England generating station, including substantially all environmental liabilities. This transaction is further described below under the heading "Environmental Litigation."

The sale of B.L. England will not affect the stranded costs associated with the plant that already have been securitized. ACE anticipates that approximately \$9 million to \$10 million of additional regulatory assets related to B.L. England may, subject to NJBPU approval, be eligible for recovery as stranded costs. The emission allowance credits associated with B. L. England will be monetized for the benefit of ACE's ratepayers pursuant to the NJBPU order approving the sale. Net proceeds from the sale of the plant and monetization of the emission allowance credits, which will be determined after the sale upon resolution of certain adjustments, will be credited to ACE's ratepayers in accordance with the requirements of EDECA and NJBPU orders.

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 January 31, 2007, there are approximately 180 cases still pending against Pepco in the State Courts of Maryland; of which approximately 85 cases were filed after December 19, 2000, and have been tendered to Mirant for defense and indemnification pursuant to the terms of the Asset Purchase and Sale Agreement. Under the terms of the Settlement Agreement, Mirant has agreed to assume this contractual obligation. For a description of the Settlement Agreement, see the discussion of the relationship with Mirant above.

While the aggregate amount of monetary damages sought in the remaining suits (excluding those tendered to Mirant) exceeds \$360 million, PHI and Pepco believe 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, neither PHI nor Pepco believes 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.

Cash Balance Plan Litigation

In 1999, Conectiv established a cash balance retirement plan to replace defined benefit retirement plans then maintained by ACE and DPL. Following the acquisition by Pepco of Conectiv, this plan became the Conectiv Cash Balance Sub-Plan within the PHI Retirement Plan. On September 26, 2005, three management employees of PHI Service Company filed suit in the United States District Court for the District of Delaware (the Delaware District Court) against the PHI Retirement Plan, PHI and Conectiv (the PHI Parties), alleging violations of ERISA, on behalf of a class of management employees who did not have enough age and service when the Cash Balance Sub-Plan was implemented in 1999 to assure that their accrued benefits would be calculated pursuant to the terms of the predecessor plans sponsored by ACE and DPL. A fourth plaintiff was added to the case to represent DPL-heritage "grandfathered" employees who will not be eligible for early retirement at the end of the grandfathered period.

The plaintiffs have challenged the design of the Cash Balance Sub-Plan and are seeking a declaratory judgment that the Cash Balance Sub-Plan is invalid and that the accrued benefits of each member of the class

should be calculated pursuant to the terms of the predecessor plans. Specifically, the complaint alleges that the use of a variable rate to compute the plaintiffs' accrued benefit under the Cash Balance Sub-Plan results in reductions in the accrued benefits that violate ERISA. The complaint also alleges that the benefit accrual rates and the minimal accrual requirements of the Cash Balance Sub-Plan violate ERISA as did the notice that was given to plan participants upon implementation of the Cash Balance Sub-Plan.

The PHI Parties filed a motion to dismiss the suit, which was denied by the court on July 11, 2006. The Delaware District Court stayed one count of the complaint regarding alleged age discrimination pending a decision in another case before the United States Court of Appeals for the Third Circuit (the Third Circuit). On January 30, 2007, the Third Circuit issued a ruling in the other case that PHI's counsel believes should result in the favorable disposition of all of the claims (other than the claim of inadequate notice) against the PHI Parties in the Delaware District Court. The PHI Parties filed pleadings apprising the Delaware District Court of the Third Circuit's decision on February 16, 2007, at the same time they filed their opposition to plaintiffs' motion.

While PHI believes it has an increasingly strong legal position in the case and that it is therefore unlikely that the plaintiffs will prevail, PHI estimates that, if the plaintiffs were to prevail, the ABO and projected benefit obligation (PBO), calculated in accordance with SFAS No. 87, each would increase by approximately \$12 million, assuming no change in benefits for persons who have already retired or whose employment has been terminated and using actuarial valuation data as of the time the suit was filed. The ABO represents the present value that participants have earned as of the date of calculation. This means that only service already worked and compensation already earned and paid is considered. The PBO is similar to the ABO, except that the PBO includes recognition of the effect that estimated future pay increases would have on the pension plan obligation.

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 administrative consent order (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 a 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 submitted a final FS to MDE on February 15, 2007. The costs of cleanup (as determined by the RI/FS and subsequent negotiations with MDE) are anticipated to be approximately \$2.7 million. The remedial action will include dredging activities within Cambridge Creek, which are expected to take place as early as October 2007, and soil excavation on DPL's and adjacent property as early as January 2008.

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 the EPA that they, along with a number of other utilities and non-utilities, were potentially responsible parties (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).

In March 2006, the United States District Court for the Eastern District of Pennsylvania approved 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. Department of Justice 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 the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. 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.

As of December 31, 2006, 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 November 1991, the New Jersey Department of Environmental Protection (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 August 2006, NJDEP issued a No Further Action Letter (NFA) and Covenant Not to Sue for the site. Among other things, the NFA requires the PRPs to monitor the effectiveness of institutional (deed restriction) and engineering (cap) controls at the site every two years and to continue 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 \$555,000 to \$600,000. 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 resolving (i) New Jersey's claim for alleged violations of the federal Clean Air Act (CAA) and

(ii) the NJDEP's concerns regarding ACE's compliance with New Source Review requirements of the CAA and Air Pollution Control Act 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.

Federal Tax Treatment of Cross-Border Leases

PCI maintains a portfolio of cross-border energy sale-leaseback transactions, which, as of December 31, 2006, had a book value of approximately \$1.3 billion, and from which PHI currently derives approximately \$57 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 June 9, 2006, the IRS issued its final revenue agent's report (RAR) for its audit of PHI's 2001 and 2002 income tax returns. In the RAR, the IRS disallowed the tax benefits claimed by PHI with respect to these leases for those years. The tax benefits claimed by PHI with respect to these leases from 2001 through December 31, 2006 were approximately \$287 million. PHI has filed a protest against the IRS adjustments and the unresolved audit has been forwarded to the Appeals Office. 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 appropriate based on applicable statutes, regulations and case law, and intends to contest the adjustments proposed by the IRS; however, there is no assurance that PHI's position will prevail.

On July 13, 2006, the FASB issued FSP FAS 13-2, which amends SFAS No. 13 effective for fiscal years beginning after December 15, 2006. This amendment requires a lease to be repriced and the book value adjusted when there is a change or probable change in the timing of tax benefits of the lease regardless of whether the change results in a deferral or permanent loss of tax benefits. Accordingly, a material change in the timing of cash flows under PHI's cross-border leases as the result of a settlement with the IRS would require an adjustment to the book value of the leases and a charge to earnings equal to the repricing impact of the disallowed deductions which could result in a material adverse effect on PHI's financial condition, results of operations, and cash flows. PHI believes its tax position was appropriate and at this time does not believe there is a probable change in the timing of its tax benefits that would require repricing the leases and a charge to earnings.

On February 1, 2007 the U.S. Senate passed the Small Business and Work Opportunity Act of 2007. Included in this legislation is a provision which would apply passive loss limitation rules to leases with foreign tax indifferent parties effective for taxable years beginning after December 31, 2006, even if the leases were entered into on or prior to March 12, 2004. On February 16, 2007, the U.S. House of Representatives passed the Small Business Relief Act of 2007. This bill does not include any provision that would modify the current treatment of leases with tax indifferent parties. Enactment into law of a bill that is similar to that passed by the U.S. Senate 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. Furthermore, under FSP FAS 13-2, PHI would be required to adjust the book values of its leases and record a charge to earnings equal to the repricing impact of the disallowed deductions which could result in a material adverse effect on PHI's financial condition, results of operations 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.

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. The change allowed the companies to accelerate the deduction of certain expenses that were previously capitalized and depreciated. Through December 31, 2005, these accelerated deductions 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 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 tax periods beginning in 2005. Based on those regulations, PHI in its 2005 federal tax return adopted an alternative method of accounting for capitalizable construction costs that management believes will be acceptable to the IRS.

On the same day that the new regulations were released, the IRS issued Revenue Ruling 2005-53, which is intended to limit the ability of certain taxpayers to utilize the method of accounting for income tax purposes they utilized on their tax returns for 2004 and prior years with respect to capitalizable construction costs. In line with this Revenue Ruling, the IRS RAR for the 2001 and 2002 tax returns disallowed substantially all of the incremental tax benefits that Pepco, DPL and ACE had claimed on those returns by requiring the companies to capitalize and depreciate certain expenses rather than treat such expenses as current deductions. PHI's protest of the IRS adjustments is among the unresolved audit matters relating to the 2001 and 2002 audits pending before the Appeals Office.

In February 2006, PHI paid approximately \$121 million of taxes to cover the amount of taxes that management estimated to be payable based on the method of tax accounting that PHI, pursuant to the proposed regulations, has adopted on its 2005 tax return. However, if the IRS is successful in requiring Pepco, DPL and ACE to capitalize and depreciate construction costs that result in a tax and interest assessment greater than management's estimate of \$121 million, PHI will be required to pay additional taxes and interest only to the extent these adjustments exceed the \$121 million payment made in February 2006.

IRS Examination of Like-Kind Exchange Transaction

In 2001, Conectiv and certain of its subsidiaries (the Conectiv Group) were divesting nonstrategic electric generating facilities and replacing these facilities with mid-merit electric generating capacity. As part of this strategy, the Conectiv Group exchanged its interests in two older coal-fired plants for the more efficient gas-fired Hay Road II generating facility, which was owned by an unaffiliated third party. For tax purposes, Conectiv treated the transaction as a "like-kind exchange" under IRC Section 1031. As a result, approximately \$88 million of taxable gain was deferred for federal income tax purposes.

The transaction was examined by the IRS as part of the normal Conectiv tax audit. In May 2006, the IRS issued its RAR for the audit of Conectiv's 2000, 2001 and 2002 income tax returns. In the RAR, the IRS exam team disallowed the qualification of the exchange under IRC Section 1031. In July 2006, Conectiv filed a protest of this disallowance to the IRS Office of Appeals.

PHI believes that its tax position related to this transaction is proper based on applicable statutes, regulations and case law and intends to vigorously contest the disallowance. However, there is no absolute assurance that Conectiv's position will prevail. If the IRS prevails, Conectiv would be subject to additional income taxes, interest and possible penalties. However, a portion of the denied benefit would be offset by additional tax depreciation.

As of December 31, 2006, if the IRS fully prevails, the potential cash impact on PHI would be current income tax and interest payments of approximately \$29 million and the earnings impact would be approximately \$7 million in after-tax interest.

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, 2006, 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 | | | | Total |
|---|----------------|---------------|---------------|---------------|----------------|
| | PHI | DPL | ACE | Other | |
| Energy marketing obligations of Conectiv Energy (1) | \$100.9 | \$— | \$— | \$— | \$100.9 |
| Energy procurement obligations of Pepco Energy Services (1) | 206.7 | — | — | — | 206.7 |
| Guaranteed lease residual values (2) | .5 | 3.3 | 3.2 | — | 7.0 |
| Other (3) | 2.9 | — | — | 1.9 | 4.8 |
| Total | <u>\$311.0</u> | <u>\$ 3.3</u> | <u>\$ 3.2</u> | <u>\$ 1.9</u> | <u>\$319.4</u> |

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 retail customer load obligations and 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, 2006, obligations under the guarantees were approximately \$7.0 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 a subsidiary building lease of \$2.9 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, 2006, the guarantees cover the remaining \$1.9 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.

Dividends

On January 25, 2007, the Board of Directors declared a dividend on common stock of 26 cents per share payable March 30, 2007, to shareholders of record March 12, 2007.

Contractual Obligations

As of December 31, 2006, 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 \$2,716.2 million in 2007, \$2,303.8 million in 2008 to 2009, \$742.7 million in 2010 to 2011, and \$2,791.8 million in 2012 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 two primary risk management objectives are (1) 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 (2) to manage the spread between retail sales commitments and the cost of supply used to service those commitments. To a lesser extent, Conectiv Energy also engages in market activities in an effort to profit from short-term price differentials in electricity prices between different locations. 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.

Pepco Holdings' subsidiaries attempt to minimize credit risk exposure to wholesale energy counterparties through, among other things, formal credit policies, regular assessment of counterparty creditworthiness and the establishment of a credit limit for each counterparty, monitoring procedures that include stress testing, the use of standard agreements which allow for the netting of positive and negative exposures associated with a single counterparty and collateral requirements under certain circumstances, and has established reserves for credit losses.

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 \$33.1 million in Accumulated Other Comprehensive Income (AOCI) at December 31, 2006 related to this transaction. The portion expected to be reclassified to earnings during the next 12 months is \$5.6 million. In addition, interest rate swaps have been executed in support of PCT'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, 2006. 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, 2006
(Millions of dollars)

| <u>Contracts</u> | <u>Accumulated OCI (Loss) After-tax (1)</u> | <u>Portion Expected to be Reclassified to Earnings during the Next 12 Months</u> | <u>Maximum Term</u> |
|------------------------------|---|--|---------------------|
| Other Energy Commodity | \$(61.9) | \$(18.1) | 63 months |
| Interest Rate | (33.1) | (5.6) | 308 months |
| Total | <u>\$(95.0)</u> | <u>\$(23.7)</u> | |

- (1) Accumulated Other Comprehensive Loss as of December 31, 2006, includes an \$(8.4) million balance related to minimum pension liability. This balance is not included in this table as there is not a cash flow hedge associated with it.

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, 2006, 2005, and 2004, and where they were reported in the Consolidated Statements of Earnings during the period.

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--|--------------|--------------|----------------|
| Operating Revenue | \$.4 | \$ 3.0 | \$ 2.5 |
| Fuel and Purchased Energy Expenses | <u>(.3)</u> | <u>(2.7)</u> | <u>(8.5)</u> |
| Total | <u>\$.1</u> | <u>\$.3</u> | <u>\$(6.0)</u> |

In connection with their energy commodity activities, the Competitive Energy businesses designate certain derivatives as fair value hedges. The net pre-tax gains/(losses) recognized during the twelve months ended December 31, 2006, 2005 and 2004 included in the Consolidated Statements of Earnings for fair value hedges and the associated hedged items are shown in the following table (in millions of dollars).

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Gain/(Loss) on Derivative Instruments | .2 | — | — |
| Gain/Loss on Hedged Items | <u>(.2)</u> | <u>—</u> | <u>—</u> |

For the year ended 2006, a \$.3 million loss was reclassified from other comprehensive income (OCI) to earnings because the forecasted hedged transactions were deemed to be no longer probable. For the year ended 2005, there were no forecasted hedged transactions or firm commitments 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, 2006, 2005, and 2004.

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|------------------------------|------------------|---------------|---------------|
| Proprietary Trading | \$ — | \$.1 | \$ (.4) |
| Other Energy Commodity | <u>64.7</u> | <u>37.8</u> | <u>24.2</u> |
| Total | <u>\$64.7(1)</u> | <u>\$37.9</u> | <u>\$23.8</u> |

- (1) Includes \$.3 million of ineffective fair value hedges.

(14) EXTRAORDINARY ITEM

On April 19, 2005, ACE, the staff of the 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.

(15) QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

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.

| | 2006 | | | | |
|--|--------------------------------------|-------------------|------------------|-------------------|------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Total |
| | (Millions, except per share amounts) | | | | |
| Total Operating Revenue | \$1,951.9 | \$1,916.6 | \$2,589.9 | \$1,904.5 | \$8,362.9 |
| Total Operating Expenses | 1,798.0 | 1,753.4 | 2,347.1 | 1,771.1 | 7,669.6(b) |
| Operating Income | 153.9 | 163.2 | 242.8 | 133.4 | 693.3 |
| Other Expenses | (61.5)(a) | (72.5) | (76.2) | (72.2) | (282.4) |
| Preferred Stock Dividend Requirements of | | | | | |
| Subsidiaries | .4 | .3 | .3 | .2 | 1.2 |
| Income Before Income Tax Expense | 92.0 | 90.4 | 166.3 | 61.0 | 409.7 |
| Income Tax Expense | 35.2 | 39.2 | 62.3 | 24.7 | 161.4 |
| Net Income | 56.8 | 51.2 | 104.0 | 36.3 | 248.3 |
| Basic and Diluted Earnings Per Share of | | | | | |
| Common Stock | \$.29 | \$.27 | \$.54 | \$.19 | \$ 1.30 |
| Cash Dividends Per Common Share | \$.26 | \$.26 | \$.26 | \$.26 | \$ 1.04 |

| | 2005 | | | | |
|--|--------------------------------------|-------------------|------------------|-------------------|-----------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Total |
| | (Millions, except per share amounts) | | | | |
| Total Operating Revenue | \$1,798.8 | \$1,720.2 | \$2,483.6 | \$2,062.9 | \$8,065.5 |
| Total Operating Expenses | 1,654.1 | 1,535.8 | 2,115.3(e) | 1,854.9(f)(g) | 7,160.1 |
| Operating Income | 144.7 | 184.4 | 368.3 | 208.0 | 905.4 |
| Other Expenses | (67.8) | (74.8) | (72.4) | (70.5) | (285.5) |
| Preferred Stock Dividend Requirements of | | | | | |
| Subsidiaries | .6 | .7 | .6 | .6 | 2.5 |
| Income Before Income Tax Expense | 76.3 | 108.9 | 295.3 | 136.9 | 617.4 |
| Income Tax Expense | 30.6 | 42.5 | 127.3(d) | 54.8(h) | 255.2 |
| Income Before Extraordinary Item | 45.7 | 66.4 | 168.0 | 82.1 | 362.2 |
| Extraordinary Item (c) | 9.0 | — | — | — | 9.0 |
| Net Income | 54.7 | 66.4 | 168.0 | 82.1 | 371.2 |
| Basic and Diluted Earnings Per Share of | | | | | |
| Common Stock Before Extraordinary | | | | | |
| Item | .24 | .35 | .89 | .43 | 1.91 |
| Extraordinary Item Per Share of Common | | | | | |
| Stock | .05 | — | — | — | .05 |
| Basic and Diluted Earnings Per Share of | | | | | |
| Common Stock | \$.29 | \$.35 | \$.89 | \$.43 | \$ 1.96 |
| Cash Dividends Per Common Share | \$.25 | \$.25 | \$.25 | \$.25 | \$ 1.00 |

(a) Includes \$12.3 million gain (\$7.9 million after-tax) on the sale of its equity interest in a joint venture which owns a wood burning cogeneration facility in California.

(b) Includes \$18.9 million of impairment losses (\$13.7 million after-tax) related to certain energy services business assets.

- (c) 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.
- (d) Includes \$8.3 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.
- (e) Includes \$68.1 million gain (\$40.7 million after-tax) from sale of non-utility land owned by Pepco at Buzzard Point.
- (f) Includes \$70.5 million (\$42.2 million after-tax) gain (net of customer sharing) from settlement of the Pepco TPA Claim and the Pepco asbestos claim against the Mirant bankruptcy estate.
- (g) Includes \$13.3 million gain (\$8.9 million after-tax) recorded by PCI's liquidation of a financial investment that was written off in 2001.
- (h) Includes \$2.6 million in income tax expense related to IRS Ruling 2005-53.

(16) SUBSEQUENT EVENTS

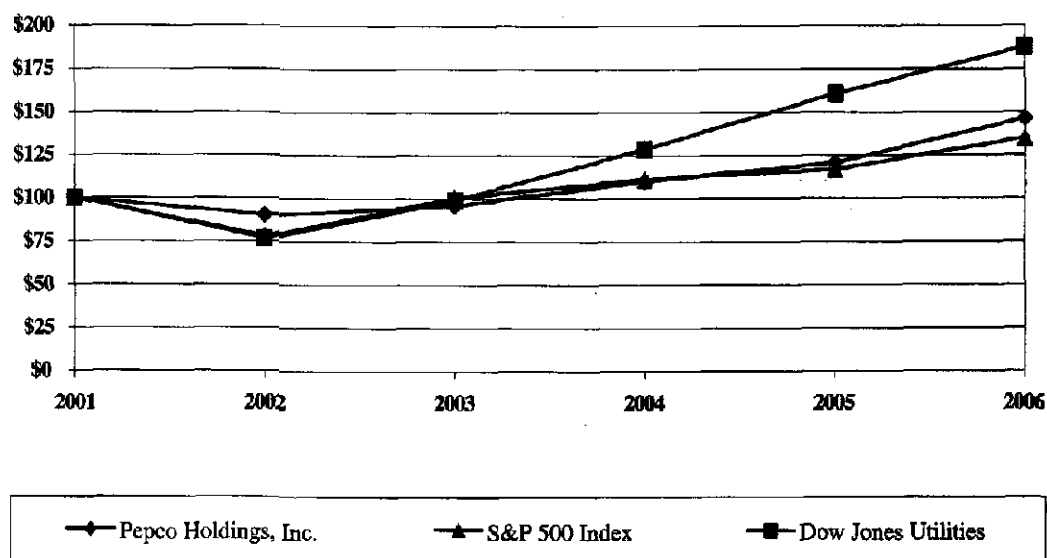
On January 18, 2007, DPL redeemed all outstanding shares of its Redeemable Serial Preferred Stock of each series at redemption prices ranging from 103% to 105% of par, for an aggregate redemption amount of approximately \$18.9 million.

On February 8, 2007, ACE completed the sale of the B.L. England generating facility for a price of \$9.0 million, subject to adjustment.

FIVE-YEAR PERFORMANCE GRAPH 2002-2006

The following chart compares the five-year cumulative total return to shareholders of Pepco Holdings, Inc. consisting of the change in stock price and reinvestment of dividends with the five-year cumulative total return on the Standard & Poor's 500 Stock Index (the "S&P 500") and the Dow Jones Utilities Index. Prior to August 1, 2002, the total return is for the common stock of Potomac Electric Power Company. After August 1, 2002, the total return is for the common stock of Pepco Holdings, Inc.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN AMONG PEPCO HOLDINGS, INC., THE S&P 500 INDEX AND THE DOW JONES UTILITIES INDEX



| | Cumulative Total Return | | | | | |
|---------------------------|-------------------------|---------|----------|----------|----------|----------|
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Pepco Holdings, Inc. | \$100.00 | \$90.09 | \$ 95.85 | \$109.93 | \$120.54 | \$146.30 |
| S&P 500 Index | \$100.00 | \$77.95 | \$100.27 | \$111.15 | \$116.59 | \$134.96 |
| Dow Jones Utilities | \$100.00 | \$76.68 | \$ 98.97 | \$128.72 | \$160.85 | \$187.61 |

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Rockville, Maryland
(*Real estate investment trust*)

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Chief Executive Officer,
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FTI Consulting, Inc.
Baltimore, Maryland
(*Consulting*)

Terence C. Golden^{1,5}
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Bailey Capital Corporation
Washington, D.C.
(*Private investment company*)

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Company

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General Counsel
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Maryland (*Private
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Professor of Accounting,
Howard University
Washington, D.C.

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Partner
Orrick, Herrington &
Sutcliffe LLP
Washington, D.C. (*Law*)

Lester P. Silverman^{2,5}
Director Emeritus
McKinsey & Company, Inc.

William T. Torgerson³
Vice Chairman and General
Counsel
Pepco Holdings, Inc.

Dennis R. Wraase³
Chairman of the Board,
President and Chief
Executive Officer
Pepco Holdings, Inc.

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Dennis R. Wraase
Chairman of the Board,
President and Chief
Executive Officer

William T. Torgerson
Vice Chairman and General
Counsel

Thomas S. Shaw
Executive Vice President and
Chief Operating Officer
(President and Chief
Executive Officer, Potomac
Electric Power Company,
Delmarva Power & Light
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Senior Vice President and
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Beverly L. Perry
Senior Vice President
Government Affairs and
Public Policy

Ronald K. Clark
Vice President and Controller

Kenneth P. Cohn
Vice President and Chief
Information Officer

Charles R. Dickerson
Vice President, Strategic
Planning and Chief Risk
Officer

Jill R. Downs
Vice President, Corporate
Communications

Kirk J. Emge
Vice President, Legal
Services

Paul W. Friel
Vice President and General
Auditor

Ernest L. Jenkins
Vice President, People
Strategy and Human
Resources

Anthony J. Kamerick
Vice President and Treasurer

Ellen Sheriff Rogers
Vice President, Corporate
Governance, Secretary and
Assistant Treasurer

Karen G. Almquist
Assistant Treasurer and
Assistant Secretary

Donna J. Kinzel
Assistant Treasurer

Allen E. Webb
Assistant Controller

Kathy A. White
Assistant Controller

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John U. Huffman
President and Chief
Operating Officer
Pepco Energy Services, Inc.

David M. Velazquez
President and Chief
Executive Officer
Connectiv Energy Holding
Company

¹ Member of the Audit Committee of which Mr. Nussdorf is Chairman.

² Member of the Corporate Governance/Nominating Committee of which Mr. O'Malley is Chairman.

³ Member of the Executive Committee of which Mr. MacCormack is Chairman.

⁴ Member of the Compensation/Human Resources Committee of which Mr. McGlynn is Chairman.

⁵ Member of the Finance Committee of which Mr. Golden is Chairman.

INVESTOR INFORMATION

Fiscal Agents

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Brooklyn, NY 11219-9821

By telephone:

Toll free 1-866-254-6502

Via e-mail:

pepco@amstock.com

Inquiries concerning your Pepco Holdings, Inc. shareholdings (such as status of your account, dividend payments, change of address, lost certificates or transfer of ownership of shares) or to enroll in the dividend reinvestment plan or direct deposit of dividends, should be directed to American Stock Transfer & Trust Company as listed above.

A copy of Pepco Holdings' Form 10-K for the year ended December 31, 2006, is available without charge by contacting American Stock Transfer & Trust Company as listed above.

Other Information

For Historical Stock Prices (Potomac Electric Power Company, Conectiv, Delmarva Power & Light Company and Atlantic Energy), and other Pepco Holdings, Inc. company information, including our Corporate Governance Guidelines, Corporate Business Policies (which in their totality constitute our code of business conduct and ethics) and Board Committee Charters, please visit our Web site at www.pepcoholdings.com

To exchange Potomac Electric Power Company or Conectiv common stock certificates for Pepco Holdings, Inc. stock certificates, contact American Stock Transfer & Trust Company.

Pepco Holdings, Inc. Notes, Potomac Electric Power Company Bonds and Atlantic City Electric Company Bonds

In writing:

The Bank of New York
100 Barclay Street, 8W
New York, NY 10286

By telephone:

Toll Free: 1-800-548-5075

Delmarva Power & Light Company Bonds

In writing:

The Bank of New York
Global Corporate Trust Services
Bondholder Relations
2001 Bryan Street
Dallas, TX 75201

By telephone:

Toll free 1-800-275-2048

Investor Relations Contact

Donna J. Kinzel, Director, Investor Relations
Telephone: 302-429-3004
E-mail: Donna.Kinzel@pepcoholdings.com
New York Stock Exchange Ticker Symbol: POM

Pepco Holdings, Inc. filed its annual CEO Certification with the New York Stock Exchange on June 14, 2006, and filed its annual CEO and CFO Certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 as exhibits to its Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 1, 2007.

Stock Market Information

| 2006 | High | Low | Dividend | 2005 | High | Low | Dividend |
|---|---------|---------|----------|---------------------------------------|---------|---------|----------|
| 1st Quarter | \$24.28 | \$22.15 | \$.26 | 1st Quarter | \$23.25 | \$20.26 | \$.25 |
| 2nd Quarter | \$23.92 | \$21.79 | \$.26 | 2nd Quarter | \$24.20 | \$20.50 | \$.25 |
| 3rd Quarter | \$25.50 | \$22.64 | \$.26 | 3rd Quarter | \$24.46 | \$21.87 | \$.25 |
| 4th Quarter | \$26.99 | \$24.25 | \$.26 | 4th Quarter | \$23.89 | \$20.36 | \$.25 |
| (Close on December 29, 2006: \$26.01) | | | | (Close on December 31, 2005: \$22.37) | | | |
| Number of Shareholders at December 31, 2006: 68,186 | | | | | | | |

C-3

C-3 *Exhibit C-3 “Financial Statements,” provide copies of the applicant’s two most recent years of audited financial statements (balance sheet, income statement, and cash flow statement). If audited financial statements are not available, provide officer certified financial statements. If the applicant has not been in business long enough to satisfy this requirement, it shall file audited or officer certified financial statements covering the life of the business.*

The Applicant is a wholly owned subsidiary of Pepco Holdings, Inc. (“PHI”). As such, the Applicant no longer compiles or reports its own independently audited financial statements. All data regarding the financial performance of the Applicant has been consolidated into the financial reporting of its parent company. A copy of PHI’s 2006 10-K filing is included with this application in response to requirement C-2. PHI is a publicly traded corporation listed on the New York Stock Exchange under the symbol POM. Additional financial reports and data regarding the Applicant and PHI are available for download from the PHI’s investor relations website, located at <http://www.pepcoholdings.com/investors>.

C-4

C-4 Exhibit C-4 “Financial Arrangements,” *provide copies of the applicant's financial arrangements to conduct CRES as a business activity (e.g., guarantees, bank commitments, contractual arrangements, credit agreements, etc.).*

The Applicant intends to finance its activities in Ohio based on ongoing operations in existing service areas. Applicant maintains credit arrangements with numerous wholesale counterparties and intends to employ those relationships to conduct business within the State of Ohio. Applicant does not believe that the personnel and operational resources it will require to serve the Ohio market will create significant business costs.

The Applicant also maintains a borrowing agreement with its parent company, Pepco Holdings, Inc. (“PHI”). This agreement has a current borrowing limit of \$300 Million.

Applicant believes that its existing financial arrangements are sufficient to allow it to provide retail electric service in Ohio and does not anticipate making additional significant arrangements to support its activities in Ohio.

C-5

C-5 Exhibit C-5 “**Forecasted Financial Statements,**” *provide two years of forecasted financial statements (balance sheet, income statement, and cash flow statement) for the applicant’s CRES operation, along with a list of assumptions, and the name, address, email address, and telephone number of the preparer.*

While the Applicant wishes to maintain its Ohio electricity supplier license, it does not believe that the current Ohio market will present any viable electricity sales opportunities during 2008. As a result, the Applicant is projecting \$0 income and \$0 costs to support its Ohio operations over the next two years.

Questions regarding this forecast may be directed to:

Sandra Minch Guthorn
Manager, Manager- Energy Policy
Pepco Energy Services, Inc.
1300 North 17th Street, Suite 1600
Arlington, VA 22209
410-375-3506
Sguthorn@PepcoEnergy.com

The chief assumptions included in this forecast are:

- the belief that competitive retail market conditions, mainly regulatory factors, will continue to remain unfavorable within the Applicant’s targeted markets; and
- the belief that prevailing wholesale market will continue to disallow the Applicant from effectively competing against regulated, default service within its targeted markets.

C-6

C-6 *Exhibit C-6 "Credit Rating," provide a statement disclosing the applicant's credit rating as reported by two of the following organizations: Duff & Phelps, Dun and Bradstreet Information Services, Fitch IBCA, Moody's Investors Service, Standard & Poors, or a similar organization. In instances where an applicant does not have its own credit ratings, it may substitute the credit ratings of a parent or affiliate organization, provided the applicant submits a statement signed by a principal officer of the applicant's parent or affiliate organization that guarantees the obligations of the applicant.*

The Applicant does not have its own credit rating. The ratings for the Applicant's parent company, Pepco Holdings, Inc. ("PHI") are as follows:

| | | |
|---------------------------|------------------------|------|
| Standards & Poors | Senior Unsecured Debt: | BBB- |
| | Short Term Debt: | A-2 |
| Moody's Investors Service | Senior Unsecured Debt: | Baa3 |
| | Short Term Debt: | P-3 |

PHI is a public corporation trading under the ticker symbol POM.

The Applicant has numerous parental guarantees in place which facilitate transactions with various wholesale entities. The purpose of these guarantees is to provide credit support for the Applicant's commitment to pay for wholesale energy.

C-7

C-7 **Exhibit C-7 “Credit Report,”** *provide a copy of the applicant’s credit report from Experion, Dun and Bradstreet or a similar organization.*

D&B Comprehensive Report

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ATTN: Sarah

Report Printed: JAN 07 2008

Overview

BUSINESS SUMMARY

PEPCO ENERGY SERVICES, INC.

(SUBSIDIARY OF PEPCO HOLDINGS INC, WASHINGTON, DC)
1300 N 17th St Ste 1600
Arlington, VA 22209

D&B D-U-N-S Number: 10-617-3672

This is a headquarters (subsidiary) location.
Branch(es) or division(s) exist.

Web site: www.pepcoenergy.com

Telephone: 703 253-1800

Chief executive: JOHN HUFFMAN, CEO

Year started: 1995

Employs: 400 (150 here)

Sales \$: \$1,900,000,000

History: CLEAR

SIC: 4924
4911

Line of business: Natural gas distribution, electric services

Credit Score Class: 1

Low risk of severe payment delinquency over next 12 months

Financial Stress Class: 1

Low risk of severe financial stress over the next 12 months

12-Month D&B PAYDEX®: 77

When weighted by dollar amount, payments to suppliers average 5 days beyond terms.

D&B Rating: 1R2
Number of employees: 1R is 10 or more employees.

Composite credit appraisal: 2 is good.

EXECUTIVE SUMMARY

The Financial Stress Class of 1 for this company shows that firms with this classification had a failure rate of 1.2% (120 per 10,000), which is lower than the average of businesses in D&B's database

The Credit Score class of 1 for this company shows that 2.0% of firms with this classification paid one or more bills severely delinquent, which is lower than the average of businesses in D&B's database.

| Predictive Scores | This Business | Comments |
|------------------------|---------------|--|
| Financial Stress Class | 1 | Failure Rate lower than the average of businesses in D&B's database |
| Financial Stress Score | 1512 | Highest Risk: 1,001; Lowest Risk: 1,875 |
| Credit Score Class | 1 | Probability of Severely Delinquent Payment is lower than the average of businesses in D&B's database |
| Credit Score | 573 | Highest Risk: 101; Lowest Risk: 670 |

Other Key Indicators

| | | |
|-----------------------------------|--|---|
| PAYDEX Scores | 5 days beyond terms | Pays more promptly than the average for its industry of 6 days beyond terms |
| Industry Median | 6 days beyond terms | |
| Present management control | 13 years | |
| UCC Filings | UCC filing(s) are reported for this business | |
| Public Filings | No record of open Suit(s), Lien(s), or Judgment(s) in the D&B database | |
| History | Is clear | |

CREDIT CAPACITY SUMMARY

D&B Rating: 1R2
Number of employees: 1R Indicates 10 or more employees.
Composite credit appraisal: 2 is good.

The 1R and 2R ratings categories reflect company size based on the total number of employees for the business. They are assigned to business files that do not contain a current financial statement. In 1R and 2R Ratings, the 2, 3, or 4 creditworthiness indicator is based on analysis by D&B of public filings, trade payments, business age and other important factors. 2 is the highest Composite Credit Appraisal a company not supplying D&B with current financial information can receive. For more information, see the D&B Rating Key.

| | | | |
|------------------------------|-----------------|------------------------------|-------------|
| Sales: | \$1,900,000,000 | Payment Activity: | |
| # of Employees Total: | 400 (150 here) | (based on 79 experiences) | |
| | | Average High Credit: | \$37,145 |
| | | Highest Credit: | \$800,000 |
| | | Total Highest Credit: | \$2,571,950 |

Jump to:

[Overview](#) | [Payments](#) | [Public Filings](#) | [History & Operations](#) | [Banking & Finance](#)

Scores

FINANCIAL STRESS SUMMARY

The Financial Stress Summary Model predicts the likelihood of a firm ceasing business without paying all creditors in full, or reorganization or obtaining relief from creditors under state/federal law over the next 12 months. Scores were calculated using a statistically valid model derived from D&B's extensive data files.

Financial Stress Class: 1

Low risk of severe financial stress, such as a bankruptcy, over the next 12 months.

Incidence of Financial Stress

Among Businesses with this Class: 1.20% (120 per 10,000)
 Average of Businesses in D&B's Database: 2.60% (260 per 10,000)

Financial Stress National Percentile: 98 (Highest Risk: 1; Lowest Risk: 100)

Financial Stress Score: 1512 (Highest Risk: 1,001; Lowest Risk: 1,875)

The Financial Stress Score of this business is based on the following factors:

- Control age or date entered in D&B files indicates higher risk.

Notes:

- The Financial Stress Class indicates that this firm shares some of the same business and financial characteristics of other companies with this classification. It does not mean the firm will necessarily experience financial stress.
- The Incidence of Financial Stress shows the percentage of firms in a given Class that discontinued operations with loss to creditors. The Average Incidence of Financial Stress is based on businesses in D&B's database and is provided for comparative purposes.
- The Financial Stress National Percentile reflects the relative ranking of a company among all scorable companies in D&B's file.
- The Financial Stress Score offers a more precise measure of the level of risk than the Class and Percentile. It is especially helpful to customers using a scorecard approach to determining overall business performance.
- All Financial Stress Class, Percentile, Score and Incidence statistics are based on sample data from 2004.

| Norms | National % |
|------------------------------------|------------|
| This Business | 98 |
| Region: SOUTH ATLANTIC | 52 |
| Industry: INFRASTRUCTURE | 49 |
| Employee Range: 100-499 | 99 |
| Years in Business: 11-25 | 52 |

This business has a Financial Stress Percentile that shows:

- Lower risk than other companies in the same region.
- Lower risk than other companies in the same industry.
- Higher risk than other companies in the same employee size range.
- Lower risk than other companies with a comparable number of years in business.

CREDIT SCORE CLASS SUMMARY

The Credit Score Class predicts the likelihood of a firm paying in a severely delinquent manner (90+ Days Past Terms) over the next twelve months. It was calculated using statistically valid models and the most recent payment information in D&B's files.

Credit Score Class: 1

Low risk of severe payment delinquency over next 12 months.

Incidence of Delinquent Payment

Among Companies with this Class: 2.00%
Average Compared to Businesses in D&B's Database: 20.10%

Credit Score Percentile: 98 (Highest Risk: 1; Lowest Risk: 100)

Credit Score: 573 (Highest Risk: 101; Lowest Risk: 670)

The Credit Score of this business is based on the following factors:

- No record of open lien(s), or judgment(s) in the D&B files.
- Business does not own facilities.

Notes:

- The Credit Score Class indicates that this firm shares some of the same business and payment characteristics of other companies with this classification. It does not mean the firm will necessarily experience delinquency.
- The Incidence of Delinquent Payment is the percentage of companies with this classification that were reported 90 days past due or more by creditors. The calculation of this value is based on an inquiry weighted sample.
- The Percentile ranks this firm relative to other businesses. For example, a firm in the 80th percentile has a lower risk of paying in a severely delinquent manner than 79% of all scorable companies in D&B's files.
- The Credit Score offers a more precise measure of the level of risk than the Class and Percentile. It is especially helpful to customers using a scorecard approach to determining overall business performance.
- All Credit Class, Percentile, Score and Incidence statistics are based on sample data from 2004.

| Norms | National % |
|-----------------------------|------------|
| This Business | 98 |
| Region: SOUTH ATLANTIC | 51 |
| Industry: INFRASTRUCTURE | 42 |
| Employee Range: 100-499 | 75 |
| Years in Business: 11-25 | 64 |

This business has a Credit Score Percentile that shows:

- Lower risk than other companies in the same region.
- Lower risk than other companies in the same industry.
- Lower risk than other companies in the same employee size range.
- Lower risk than other companies with a comparable number of years in business.

Jump to:

[Overview](#) | [Scores](#) | [Public Filings](#) | [History & Operations](#) | [Banking & Finance](#)

Payments

PAYMENT TRENDS

| | |
|---|----------|
| Total Payment Experiences in D&B's File: | 79 |
| Payments Within Terms: (not dollar weighted) | 90% |
| Total Placed For Collection: | 0 |
| Average Highest Credit: | \$37,145 |

| | | |
|-----------------------------|----|--|
| Current PAYDEX is: | 77 | equal to 5 days beyond terms |
| Industry Median is: | 76 | equal to 6 days beyond terms |
| Payment Trend currently is: | | unchanged, compared to payments three months ago |

| | |
|-----------------------------|------------------|
| Largest High Credit: | \$800,000 |
| Highest Now Owing: | \$95,000 |
| Highest Past Due: | \$75,000 |

Indications of slowness can be the result of dispute over merchandise, skipped invoices, etc. Accounts are sometimes placed for collection even though the existence or amount of the debt is disputed.

PAYDEX Scores

Shows the D&B PAYDEX scores as calculated on the most recent 3 months and 12 months of payment experiences.

The D&B PAYDEX is a unique, dollar weighted indicator of payment performance based on up to payment experiences as reported to D&B by trade references. A detailed explanation of how to read and interpret PAYDEX scores can be found at the end of this report.

3-Month D&B PAYDEX: **71**

When weighted by dollar amount, payments to suppliers average 14 days beyond terms.

Based on payments collected over last 3 months.

12-Month D&B PAYDEX: **77**

When weighted by dollar amount, payments to suppliers average 5 days beyond terms.

Based on payments collected over last 12 months.

PAYDEX Yearly Trend

12 Month PAYDEX Scores Comparison to Industry

| | 2/07 | 3/07 | 4/07 | 5/07 | 6/07 | 7/07 | 8/07 | 9/07 | 10/07 | 11/07 | 12/07 | 1/08 |
|---------------------------|------|------|------|------|------|------|------|------|-------|-------|-------|------|
| This Business | 80 | 80 | 80 | 79 | 79 | 79 | 79 | 79 | 79 | 78 | 77 | 77 |
| Industry Quartiles | | | | | | | | | | | | |
| Upper | | 79 | | | 79 | | | 79 | | | 79 | |
| Median | | 76 | | | 76 | | | 76 | | | 76 | |
| Lower | | 71 | | | 71 | | | 71 | | | 71 | |

- Current PAYDEX for this Business is 77, or equal to 5 days beyond terms
- The 12-month high is 80, or equal to generally within terms
- The 12-month low is 77, or equal to 5 days beyond terms

PAYDEX Comparison to Industry

Shows PAYDEX scores of this Business compared to the Primary Industry from each of the last four quarters. The Primary Industry is Natural gas distribution, electric services, based on SIC code 4924.

Quarterly PAYDEX Scores Comparison to Industry

Previous Year

| | 3/06 | 6/06 | 9/06 | 12/06 |
|---------------------------|------|------|------|-------|
| This Business | 74 | 76 | 80 | 74 |
| Industry Quartiles | | | | |
| Upper | 79 | 79 | 79 | 79 |
| Median | 76 | 76 | 76 | 77 |

Current Year

| | 3/07 | 6/07 | 9/07 | 12/07 |
|---------------------------|------|------|------|-------|
| This Business | 80 | 79 | 79 | 77 |
| Industry Quartiles | | | | |
| Upper | 79 | 79 | 79 | 79 |
| Median | 76 | 76 | 76 | 76 |

| | | | | | | | | | |
|-------|----|----|----|----|-------|----|----|----|----|
| Lower | 71 | 71 | 71 | 71 | Lower | 71 | 71 | 71 | 71 |
|-------|----|----|----|----|-------|----|----|----|----|

- Current PAYDEX for this Business is **77**, or equal to 5 days beyond terms
- The present industry median score is **76**, or equal to 6 days beyond terms.
- Industry upper quartile represents the performance of the payers in the 75th percentile
- Industry lower quartile represents the performance of the payers in the 25th percentile

Payment Habits

For all payment experiences within a given amount of credit extended, shows the percent that this Business paid within terms. Provides number of experiences used to calculate the percentage, and the total dollar value of the credit extended.

Dollar Range Comparisons:

| \$ Credit Extended | # Payment Experiences | \$ Total Dollar Amount | % of Payments Within Terms |
|--------------------|-----------------------|------------------------|----------------------------|
| OVER \$100,000 | 5 | \$2,000,000 | 97 |
| \$50,000 - 99,999 | 5 | \$365,000 | 69 |
| \$15,000 - 49,999 | 4 | \$100,000 | 75 |
| \$5,000 - 14,999 | 7 | \$42,500 | 94 |
| \$1,000 - 4,999 | 7 | \$10,000 | 85 |
| Under \$1,000 | 40 | \$8,400 | 87 |

Payment experiences reflect how bills are met in relation to the terms granted. In some instances, payment beyond terms can be the result of disputes over merchandise, skipped invoices, etc.

PAYMENT SUMMARY

The Payment Summary section reflects payment information in D&B's file as of the date of this report.

There are 79 payment experiences in D&B's file for the most recent 12 months, with 39 experiences reported during the last three month period.

Below is an overview of the company's dollar-weighted payments, segmented by its suppliers' primary industries:

| | Total Rcv'd (#) | Total Dollar Amts (\$) | Largest High Credit (\$) | Within Terms (%) | Days Slow <31 31-60 61-90 90> (%) | | | |
|------------------------|-----------------------|------------------------------|--------------------------------|------------------------|---|---|---|----|
| Top Industries: | | | | | | | | |
| Executive office | 9 | 5,650 | 5,000 | 100 | 0 | 0 | 0 | 0 |
| Mfg. refrig/heat equip | 7 | 427,250 | 200,000 | 88 | 12 | 0 | 0 | 0 |
| Telephone communictns | 7 | 3,050 | 2,500 | 98 | 2 | 0 | 0 | 0 |
| Nonclassified | 5 | 117,650 | 75,000 | 36 | 0 | 0 | 0 | 64 |
| Whol electrical equip | 4 | 802,800 | 800,000 | 100 | 0 | 0 | 0 | 0 |
| Misc equipment rental | 3 | 13,000 | 7,500 | 98 | 0 | 2 | 0 | 0 |
| Public finance | 3 | 7,500 | 7,500 | 100 | 0 | 0 | 0 | 0 |
| Misc general gov't | 3 | 850 | 750 | 100 | 0 | 0 | 0 | 0 |
| Misc publishing | 3 | 750 | 750 | 100 | 0 | 0 | 0 | 0 |

| | | | | | | | | |
|-----------------------|---|---------|---------|-----|-----|----|-----|----|
| Radiotelephone commun | 3 | 500 | 250 | 100 | 0 | 0 | 0 | 0 |
| Short-trl busn credit | 2 | 85,000 | 70,000 | 59 | 41 | 0 | 0 | 0 |
| Whol plumb/hydrnics | 2 | 50,000 | 25,000 | 50 | 0 | 50 | 0 | 0 |
| Misc business service | 2 | 5,000 | 5,000 | 100 | 0 | 0 | 0 | 0 |
| Trucking non-local | 2 | 1,050 | 1,000 | 100 | 0 | 0 | 0 | 0 |
| Whol industrial suppl | 2 | 350 | 250 | 100 | 0 | 0 | 0 | 0 |
| Reg misc coml sector | 2 | 150 | 100 | 100 | 0 | 0 | 0 | 0 |
| Mfg environment cntrl | 1 | 800,000 | 800,000 | 100 | 0 | 0 | 0 | 0 |
| Natural gas distrib | 1 | 100,000 | 100,000 | 100 | 0 | 0 | 0 | 0 |
| Custom programming | 1 | 95,000 | 95,000 | 100 | 0 | 0 | 0 | 0 |
| Hvy const eqpt rental | 1 | 5,000 | 5,000 | 50 | 50 | 0 | 0 | 0 |
| Mfg surgical supplies | 1 | 1,000 | 1,000 | 0 | 100 | 0 | 0 | 0 |
| Whol electronic parts | 1 | 1,000 | 1,000 | 50 | 0 | 0 | 0 | 50 |
| Data processing svcs | 1 | 750 | 750 | 100 | 0 | 0 | 0 | 0 |
| Mfg public bldg fum | 1 | 750 | 750 | 0 | 0 | 0 | 100 | 0 |
| Whol durable goods | 1 | 500 | 500 | 100 | 0 | 0 | 0 | 0 |
| Mfg industrial gases | 1 | 500 | 500 | 100 | 0 | 0 | 0 | 0 |
| Ret computer/software | 1 | 250 | 250 | 100 | 0 | 0 | 0 | 0 |
| Ret-direct selling | 1 | 250 | 250 | 100 | 0 | 0 | 0 | 0 |
| Passenger car rental | 1 | 100 | 100 | 100 | 0 | 0 | 0 | 0 |
| Mfg computers | 1 | 100 | 100 | 100 | 0 | 0 | 0 | 0 |
| Business association | 1 | 100 | 100 | 100 | 0 | 0 | 0 | 0 |
| Admin economic prgm | 1 | 50 | 50 | 100 | 0 | 0 | 0 | 0 |
| Photocopying service | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |

Other payment categories:

| | | | |
|------------------------|---|--------|--------|
| Cash experiences | 0 | 0 | 0 |
| Payment record unknown | 2 | 46,000 | 45,000 |
| Unfavorable comments | 1 | 50 | 50 |

Placed for collections:

| | | | |
|---------------------|----|-----|---------|
| With D&B | 0 | 0 | 0 |
| Other | 0 | N/A | 0 |
| Total in D&B's file | 79 | | 800,000 |

The highest Now Owes on file is \$95,000 The highest Past Due on file is \$75,000

Accounts are sometimes placed for collection even though the existence or amount of the debt is disputed. Indications of slowness can be result of dispute over merchandise, skipped invoices, etc..

PAYMENT DETAILS

Detailed payment history

| Date Reported (mm/yy) | Paying Record | High Credit (\$) | Now Owes (\$) | Past Due (\$) | Selling Terms | Last Sale Within (months) |
|--------------------------|---------------|---------------------|------------------|------------------|---------------|---------------------------------|
| 12/07 | Ppt | 100,000 | 0 | 0 | N30 | 1 mo |
| | Ppt | 5,000 | 5,000 | 250 | | 1 mo |
| | Ppt | 100 | 50 | 0 | | 1 mo |
| | Ppt-Slow 60 | | 500 | 500 | | 1 mo |
| | Ppt-Slow 120 | 1,000 | 100 | 0 | N30 | 1 mo |
| | Slow 120 | 75,000 | 75,000 | 75,000 | | 4-5 mos |

| | | | | | | |
|-------|---------------|---------|--------|--------|-----------------|----------|
| | (007) | 1,000 | 0 | 0 | N30 | 1 mo |
| | (008) | 50 | | | | 1 mo |
| | Satisfactory. | | | | | |
| 11/07 | Ppt | 200,000 | 0 | 0 | | 6-12 mos |
| | Ppt | 95,000 | 95,000 | 0 | | 1 mo |
| | Ppt | 65,000 | 40,000 | 0 | N30 | 1 mo |
| | Ppt | 60,000 | 0 | 0 | | 6-12 mos |
| | Ppt | 15,000 | 15,000 | 0 | | 1 mo |
| | Ppt | 7,500 | 0 | 0 | | 1 mo |
| | Ppt | 5,000 | 5,000 | 0 | | 1 mo |
| | Ppt | 2,500 | 0 | 0 | | 6-12 mos |
| | Ppt | 1,000 | 0 | 0 | N30 | 1 mo |
| | Ppt | 1,000 | 0 | 0 | | 2-3 mos |
| | Ppt | 750 | 750 | 0 | | 1 mo |
| | Ppt | 250 | 0 | 0 | N30 | 2-3 mos |
| | Ppt | 250 | 0 | 0 | N30 | 2-3 mos |
| | Ppt | 250 | 250 | 250 | N30 | 1 mo |
| | Ppt | 100 | | | | 1 mo |
| | Ppt | 100 | | | | 1 mo |
| | Ppt | 100 | | | | 1 mo |
| | Ppt | 100 | | | | 6-12 mos |
| | Ppt | 100 | 100 | | | |
| | Ppt | 50 | 0 | 0 | | 6-12 mos |
| | Ppt | 50 | 50 | 0 | | 1 mo |
| | Ppt | 50 | 50 | | | 6-12 mos |
| | Ppt | 0 | 0 | 0 | | 4-5 mos |
| | Ppt-Slow 30 | 100,000 | 0 | 0 | N30 | 6-12 mos |
| | Ppt-Slow 30 | 70,000 | 0 | 0 | | 1 mo |
| | Slow 60 | 25,000 | 25,000 | 25,000 | | 1 mo |
| | Slow 90 | 750 | 750 | 750 | | |
| | (036) | 50 | 50 | 50 | | 4-5 mos |
| | Bad debt. | | | | | |
| 10/07 | Ppt | 750 | 50 | 0 | | |
| | Ppt | 500 | 0 | 0 | | 2-3 mos |
| | Ppt | 0 | 0 | 0 | | 1 mo |
| | Ppt | 0 | 0 | 0 | | 1 mo |
| 09/07 | Ppt | 25,000 | 25,000 | 0 | | 1 mo |
| | Ppt | 7,500 | 1,000 | | Lease Agreement | |
| | Ppt | 500 | 0 | 0 | | 6-12 mos |
| | Ppt | 0 | 0 | 0 | | 6-12 mos |
| | Ppt-Slow 30 | 100 | 50 | 0 | | 1 mo |
| 08/07 | Ppt | 7,500 | | | | 1 mo |
| | Ppt-Slow 30 | 5,000 | 5,000 | 750 | | 1 mo |
| | (048) | 45,000 | 0 | 0 | | 4-5 mos |
| 07/07 | Ppt | 250 | 250 | 0 | | 1 mo |
| | Ppt | 100 | 0 | 0 | | 6-12 mos |
| | Slow 15 | 0 | 0 | | | 1 mo |
| | (052) | 100 | | | | 4-5 mos |
| | Satisfactory. | | | | | |
| | (053) | 50 | | | | 6-12 mos |

| | | | | | | |
|-------|---------------|---------|-----|---|-----|----------|
| | Satisfactory. | | | | | |
| 06/07 | Ppt | 250 | 0 | 0 | | 1 mo |
| | Ppt | 100 | 50 | 0 | | 1 mo |
| | Ppt | 50 | 0 | 0 | | 1 mo |
| 05/07 | Ppt | | | | | 1 mo |
| | Ppt | | | | | 1 mo |
| | Ppt | 35,000 | 0 | 0 | | 6-12 mos |
| | Ppt | 100 | 100 | | | |
| | Ppt | 50 | 50 | | | |
| 04/07 | Ppt | 100 | 0 | 0 | | 6-12 mos |
| 03/07 | Ppt | 50 | 0 | 0 | | 6-12 mos |
| 02/07 | Ppt | 800,000 | 0 | 0 | N30 | 4-5 mos |
| 01/07 | Ppt | 1,000 | 0 | 0 | N30 | 6-12 mos |
| | Ppt | 250 | 0 | 0 | N30 | 6-12 mos |
| | Ppt | 100 | 0 | 0 | | 6-12 mos |
| 11/06 | (068) | 50 | | | | 2-3 mos |
| | Satisfactory. | | | | | |
| 09/06 | Ppt | 0 | 0 | | | 6-12 mos |
| 07/06 | (070) | 750 | | | | 1 mo |
| | Satisfactory. | | | | | |
| 06/06 | Ppt | 5,000 | | | | 6-12 mos |
| 03/06 | Ppt | 2,500 | 0 | 0 | | 6-12 mos |
| | Ppt | 250 | 0 | 0 | N30 | 6-12 mos |
| | Slow 30 | 1,000 | 0 | 0 | | 6-12 mos |
| 02/06 | Ppt | 250 | 0 | 0 | | 6-12 mos |
| | Ppt | 50 | | | | 1 mo |
| | (077) | 50 | | | | 6-12 mos |
| | Satisfactory. | | | | | |
| 01/06 | Ppt | 800,000 | 0 | 0 | | 1 mo |
| 12/05 | (079) | 50 | | | | 2-3 mos |
| | Satisfactory. | | | | | |

Payments Detail Key: red = 30 or more days beyond terms

Payment experiences reflect how bills are met in relation to the terms granted. In some instances payment beyond terms can be the result of disputes over merchandise, skipped invoices etc.

Each experience shown is from a separate supplier. Updated trade experiences replace those previously reported.

Jump to:

[Overview](#) | [Scores](#) | [Payments](#) | [History & Operations](#) | [Banking & Finance](#)

Public Filings

PUBLIC FILINGS

The following data includes both open and closed filings found in D&B's database on the subject company.

| Record Type | # of Records | Most Recent Filing Date |
|------------------------|--------------|-------------------------|
| Bankruptcy Proceedings | 0 | - |
| Judgments | 0 | - |
| Liens | 0 | - |
| Suits | 0 | - |

The following Public Filing data is for information purposes only and is not the official record. Certified copies can only be obtained from the official source.

UCC FILINGS

Collateral: Leased Equipment including proceeds and products - Leased Computer equipment including proceeds and products - Leased Business machinery/equipment including proceeds and products
Type: Original
Sec. party: CIT TECHNOLOGY FINANCING SERVICES, INC., JACKSONVILLE, FL
Debtor: PEPCO ENERGY SERVICES, INC.
Filing number: 6392834 8
Filed with: SECRETARY OF STATE/UCC DIVISION, DOVER, DE
Date filed: 11/10/2006
Latest Info Received: 12/08/2006

The public record items contained in this report may have been paid, terminated, vacated or released prior to the date this report was printed.

GOVERNMENT ACTIVITY**Activity summary**

| | |
|---|-----|
| Borrower (Dir/Guar): | NO |
| Administrative debt: | NO |
| Contractor: | YES |
| Grantee: | NO |
| Party excluded from federal program(s): | NO |

Possible candidate for socio-economic program consideration

| | |
|---------------------|-----|
| Labor surplus area: | N/A |
| Small Business: | N/A |
| 8(A) firm: | N/A |

The details provided in the Government Activity section are as reported to Dun & Bradstreet by the federal government and other sources.

Jump to:[Overview](#)[Scores](#)[Payments](#)[Public Filings](#)[Banking & Finance](#)**History & Operations****HISTORY**

The following information was reported **12/06/2007**:

Officer(s): JOHN HUFFMAN, CEO
JAMES MCDONELL, SR V-PRES-CFO
MARK KUMM, PRES AMG
PETER MEIER, V. PRES & GEN COUNSEL
DAVID WEISS, PRES PMG
ROBERT BARRON, PRES

DIRECTOR(S): THE OFFICER(S)

Business started 1995. 100% of capital stock is owned by parent.

JOHN HUFFMAN born 1947. 2006.

JAMES MCDONELL born 1957. Occupational Background: 1999 to present active with the subject. 1990-1999 was working with Columbia Energy Group and worked at a number of positions like Dir. of Finance & Planning, Dir. of Capital Allocation and VP. 1985-1990 was working with Andersen Consulting in New York, NY where worked in the utility practice.

MARK KUMM. Antecedents are unknown.

PETER MEIER. Attended Univ. of Virginia and graduated Law in 1987 with a bach. degree. Antecedents are unknown.

DAVID WEISS. Antecedents are unknown.

Business address has changed from 2000 K Street NW, Ste 750, Washington, DC, 20006 to 2000 K St NW, Ste 750, Washington, DC, 20006.

Business address has changed from 2000 K St NW, Ste 750, Washington, DC, 20006 to 1300 N 17th St, Ste 1600, Arlington, VA, 22209.

CORPORATE FAMILY

For more details on the Corporate Family, view the interactive global family tree

Parent:

Select business below to buy a Comprehensive Report.

| | | |
|----------------------|----------------|---------------------------|
| Pepco Holdings, Inc. | Washington, DC | DUNS # <u>10-589-5010</u> |
|----------------------|----------------|---------------------------|

Subsidiaries (US):

Select businesses below to buy Comprehensive Report(s).

| | | |
|------------------------------|----------------------|---------------------------|
| Fauquier Landfill Gas, LLC | Arlington, VA | DUNS # <u>14-499-9609</u> |
| Met Electrical Testing LLC | Lanham, MD | DUNS # <u>04-497-9318</u> |
| North Atlantic Utilities Inc | Glen Cove, NY | DUNS # <u>16-163-3425</u> |
| Pepco Building Services Inc | Ellicott City, MD | DUNS # <u>07-357-5255</u> |
| Substation Test Co | Forestville, MD | DUNS # <u>03-984-1341</u> |
| Unitemp Inc | South Plainfield, NJ | DUNS # <u>04-987-1106</u> |

Branches (US):

Select companies below to buy Business Information Report(s).

| | | |
|-----------------------------|---------------------|---------------------------|
| Pepco Energy Services Inc | Washington, DC | DUNS # <u>01-266-9458</u> |
| Pepco Energy Services, Inc. | Indianapolis, IN | DUNS # <u>12-884-7105</u> |
| Pepco Energy Services, Inc. | Springfield, MO | DUNS # <u>13-905-1465</u> |
| Pepco Energy Services, Inc. | Manchester, NH | DUNS # <u>03-689-6806</u> |
| Pepco Energy Services, Inc. | Piscataway, NJ | DUNS # <u>14-822-4160</u> |
| Pepco Energy Services, Inc. | Raleigh, NC | DUNS # <u>62-127-6455</u> |
| Pepco Energy Services, Inc. | Cleveland, OH | DUNS # <u>87-918-2934</u> |
| Pepco Energy Services, Inc. | Pittsburgh, PA | DUNS # <u>13-414-6468</u> |
| Pepco Energy Services, Inc. | North Kingstown, RI | DUNS # <u>78-457-5321</u> |
| Pepco Energy Services, Inc. | Arlington, VA | DUNS # <u>08-636-2345</u> |
| Pepco Energy Services, Inc. | Chesapeake, VA | DUNS # <u>13-818-4317</u> |

Affiliates (US): (Affiliated companies share the same parent company as this business.)

Select businesses below to buy Comprehensive Report(s).

| | | |
|---------------------------------|----------------|---------------------------|
| Connectiv | Wilmington, DE | DUNS # <u>00-942-0485</u> |
| Millennium Account Services LLC | Ocean View, NJ | DUNS # <u>05-808-9538</u> |

Pepco Communications, Inc.
PHI Service Company
Potomac Capital Investment Corporation
Potomac Electric Power Company

Lanham, MD
Washington, DC
Washington, DC
Washington, DC

DUNS # 04-009-2731
DUNS # 18-330-8043
DUNS # 13-044-0308
DUNS # 00-692-0284

BUSINESS REGISTRATION

CORPORATE AND BUSINESS REGISTRATIONS REPORTED BY THE SECRETARY OF STATE OR OTHER OFFICIAL
SOURCE AS OF DEC 25 2007:

Registered Name: PES Home Services of Virginia, Inc.

| | | | |
|--------------------------------|---------------------------|---------------------------|-------|
| Business type: | CORPORATION | Common stock | |
| Corporation type: | NOT AVAILABLE | Authorized shares: | 1,000 |
| Date incorporated: | AUG 11 2000 | Par value: | |
| State of incorporation: | VIRGINIA | | |
| Filing date: | AUG 11 2000 | | |
| Registration ID: | 0544750 | | |
| Duration: | PERPETUAL | | |
| Status: | TERMINATED (VOLUNTARY) | | |
| Status attained: | NOV 30 2007 | | |

Where filed: STATE CORPORATE COMMISSION, RICHMOND, VA

Registered agent: CORPORATION SERVICE COMPANY, 11 S 12TH ST; PO BOX 1463, RICHMOND, VA,
232180000
Agent appointed: SEP 23 2004
Agent status: ACTIVE

Principals: MEIER, PETER E, DIRECTOR, SECRETARY

OPERATIONS

12/06/2007

Description: Subsidiary of Pepco Holdings Inc, Washington, DC started 1999 which operates as a holding company. Parent company owns 100% of capital stock.

As noted, this company is a subsidiary of Pepco Holdings Inc, DUNS number 105895010, and reference is made to that report for background information on the parent company and its management.

Provides natural gas distribution (50%). Provides electric services, specializing in power generation, power transmission and power distribution (50%).

Terms are net 10 days, contractual basis and net 15 days. Sells to general public, non profit organizations, commercial concerns and government. Territory : Regional.

Nonseasonal.

Employees: 400 which includes officer(s) and 10 part-time. 150 employed here.

Facilities: Shares 20,000 sq. ft. on 15 & 16 floor of a multi story brick building.

Location: Central business section on main street.

Branches: This business has additional branches; detailed branch information is available in D&B's linkage or family tree products.

Subsidiaries: This business has multiple subsidiaries, detailed subsidiary information is available in Dun & Bradstreet's linkage or family tree products.

SIC & NAICS

SIC:

Based on information in our file, D&B has assigned this company an extended 8-digit SIC. D&B's use of 8-digit SICs enables us to be more specific to a company's operations than if we use the standard 4-digit code.

The 4-digit SIC numbers link to the description on the Occupational Safety & Health Administration (OSHA) Web site. Links open in a new browser window.

| | |
|----------|------------------------------|
| 49240000 | Natural gas distribution |
| 49119902 | Generation, electric power |
| 49119903 | Transmission, electric power |
| 49119901 | Distribution, electric power |

NAICS:

| | |
|--------|--|
| 221210 | Natural Gas Distribution |
| 221119 | Other Electric Power Generation |
| 221121 | Electric Bulk Power Transmission and Control |
| 221122 | Electric Power Distribution |

Jump to:

[Overview](#)[Scores](#)[Payments](#)[Public Filings](#)[History & Operations](#)

Banking & Finance

UPDATE

12/06/2007

On Dec 6, 2007, Peter Meler submitted the following figures dated Dec 6, 2007.

Gross Annual sale is estimated for 2007 at \$1,900,000,000.

KEY BUSINESS RATIOS

D&B has been unable to obtain sufficient financial information from this company to calculate business ratios. Our check of additional outside sources also found no information available on its financial performance. To help you in this instance, ratios for other firms in the same industry are provided below to support your analysis of this business.

Based on this number of establishments: 16

Industry Norms based on 16 establishments

| | This Business | Industry Median | Industry Quartile |
|----------------------------|---------------|-----------------|-------------------|
| Profitability | | | |
| Return on Sales | UN | 4.9 | UN |
| Return on Net Worth | UN | 10.0 | UN |
| Short-Term Solvency | | | |
| Current Ratio | UN | 1.1 | UN |
| Quick Ratio | UN | 0.5 | UN |
| Efficiency | | | |

| | | | |
|------------------------------------|----|-------|----|
| Assets Sales | UN | 150.8 | UN |
| Sales / Net Working Capital | UN | 13.4 | UN |
| Utilization | | | |
| Total Liabs / Net Worth | UN | 191.9 | UN |

UN = Unavailable

FINANCE

07/10/2007

On JUL 10 2007 Scott Davis, Credit Mgr, deferred financial statement.

Scott Davis submitted the following partial estimates dated JUL 10 2007:

Sales for 2006 were \$1,900,000,000.

CUSTOMER SERVICE

If you have questions about this report, please call our Customer Resource Center at 1.800.234.3867 from anywhere within the U.S. If you are outside the U.S. contact your local D&B office.

*** Additional Decision Support Available ***

Additional D&B products, monitoring services and specialized investigations are available to help you evaluate this company or its industry. Call Dun & Bradstreet's Customer Resource Center at 1.800.234.3867 from anywhere within the U.S. or visit our website at www.dnb.com.

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C-8

C-8 **Exhibit C-8 “Bankruptcy Information,”** *provide a list and description of any reorganizations, protection from creditors or any other form of bankruptcy filings made by the applicant, a parent or affiliate organization that guarantees the obligations of the applicant or any officer of the applicant in the current year or within the two most recent years preceding the application.*

The Applicant certifies that it and its parent and affiliate organizations have not conducted bankruptcy related reorganization or sought protection from creditors or made any other form of bankruptcy filings within the current year or within the two most recent years preceding this application. The Applicant further certifies that no officer of the Applicant has sought protection from creditors or made any other form of bankruptcy filings within the current year or within the two most recent years preceding this application.

C-9

C-9 **Exhibit C-9 “Merger Information,”** *provide a statement describing any dissolution or merger or acquisition of the applicant within the five most recent years preceding the application.*

The Applicant has conducted only one acquisition within the five most recent years preceding this application. The information below summarizes this acquisition:

February 27, 2003 – Pepco Energy Services acquired CMS Viron’s Federal Government Business Unit and its 50% interest in the entity now known as Pepco Government Services, LLC. These assets relate to energy performance contracting and energy efficiency projects.

With regard to dissolution, Pepco Building Services, a wholly owed subsidiary of Pepco Energy Services, sold five businesses in 2006. They were:

MET Electrical Services
Substation Test
Unitemp
G&L Associates
Engineered Services

These companies are businesses that served primarily commercial and industrial customers by providing heating, ventilation, air conditioning, electrical testing and maintenance, and building automation services.