Proxy Statement and 2005 Annual Report to Shareholders

Dear Fellow Shareholders,

I am pleased to report that PHI's strategy of focusing on a low-risk, stable, power delivery business, complemented by our growing competitive energy business is creating value for shareholders. Executing on our strategy has enabled us to deliver steady cash flow, a stronger balance sheet and an improved total return. Significantly, in January, for the first time since Pepco Holdings' creation, our Board of Directors declared a dividend increase. Since the merger, we've delivered on our commitment to create value by:

- Paying down over $1 billion in debt, leading to an improved equity ratio of 41.8 percent at the end of 2005;
- Divesting non-strategic businesses and assets;
- Managing our way through the Mirant bankruptcy;
- Investing nearly $1.3 billion in our utility infrastructure;
- Integrating our operating utilities to increase efficiency and lower costs;
- Developing an expanding and profitable commercial and industrial energy commodity business; and
- Successfully managing our wholesale energy business through a cyclical downturn and positioning it for market recovery.

I will provide further details on our progress in this letter.

2005 Results of Operations Improve

PHI had a successful year in 2005 with consolidated earnings of $371.2 million, or $1.96 per share, compared to $260.6 million, or $1.48 per share, in 2004.

Our power delivery business continues to achieve consistent results and, as planned, generates the majority of our earnings. In 2005, these earnings were boosted by warmer summer weather. Pepco Energy Services, our competitive retail arm, saw very favorable results driven primarily by an increase in retail electric load, and Conectiv Energy, our wholesale energy business, performed well despite a difficult market.

Lower interest expense and a number of special items in 2005 helped our earnings performance. Pepco, our Washington, D.C.-based utility, sold excess non-utility land located in the District of Columbia in August 2005 with an after-tax gain of about $40 million. In addition, Pepco sold its allowed claim in the Mirant Corporation bankruptcy proceeding for a cash payment of $112.4 million in December 2005. We

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anticipate that customers under existing gain-sharing arrangements will receive slightly more than $40 million of that amount. The remaining after-tax proceeds of about $42 million were recorded as earnings in 2005.

Excluding all special items, earnings would have been $287.8 million or $1.52 per share in 2005, compared to $273.6 million, or $1.56 per share in 2004. The 2005 per-share amount is diluted by 14 cents as a result of equity we issued in September 2004.

Forbes magazine affirmed our progress in January 2006 by naming PHI to Forbes Platinum 400, an exclusive list of America's "Best Big Companies." PHI was ranked against its industry peers in the areas of sales and earnings growth, stock market returns, debt to total capital and forecasts for continued earnings growth.

We are Meeting Industry Challenges

During 2005, we saw the continued evolution of the utility industry, shaped by events such as the passage of the Energy Policy Act and rising fuel prices.

The Energy Policy Act, enacted in August 2005, was the most comprehensive energy legislation in more than a decade. The Act mandated standards for electric reliability that are enforceable by the Federal Energy Regulatory Commission (FERC) through a national Electric Reliability Organization, a move which we have been actively supporting. It also contained provisions designed to provide incentives for transmission investment and to expedite siting of transmission lines. This is central to PHI as we have a number of key transmission projects either under way or planned over the next several years. Overall, the Energy Policy Act was a good step forward, but how far forward won't be known until all the additional regulations to implement the Act are fully developed.

Rising Energy Prices Present Challenges

In the forefront of our customers' and regulators' minds are rising energy prices. In 2006, PHI's Delaware customers will become the final PHI customer group to complete the transition to market pricing of electricity supply as rate caps expire in that state.

Since 1999, when deregulation laws were passed and rates were frozen, the cost of the primary fuels used to produce electricity has increased dramatically—delivered coal prices have almost doubled; crude oil prices have almost tripled; and natural gas prices have quadrupled. In Delaware, according to rules established by the Delaware Public Service Commission, in 2006 we bid out 100 percent of Delmarva Power's Delaware default supply load. Because of the increase in fuel prices, the average residential bill is expected to increase by 59 percent.

Customers in other PHI jurisdictions have moved to market-priced electricity supply over the past two years. Because we have been competitively bidding multiple contracts with staggered expiration dates, the impact of rising energy prices has been somewhat diffused in these jurisdictions.

We recognize that significant increases in energy bills can cause hardship for our customers. As a result, we presented a wide-ranging proposal to the Delaware regulatory commission to help ease the impact of rising energy prices, which includes a three step phase-in of rates for residential and small commercial customers over a 13-month period. Similarly, in Maryland, we have proposed programs to help stabilize rates. We also are launching a comprehensive energy conservation program in all our jurisdictions to help customers reduce their energy usage.

Expiration of Delivery Rate Caps is Drawing Near

In our Maryland and District of Columbia service areas, we are preparing rate cases in anticipation of delivery rate caps being lifted in December 2006 and August 2007, respectively. In Delaware, we have a base-rate case pending. Because of these cases, we foresee a period of continued high regulatory activity, as we seek to

include in rates the costs associated with doing business and a reasonable rate of return for building a reliable infrastructure to serve our customers.

The regulatory process will not be devoid of hurdles, but I believe PHI's history of constructive regulatory relationships, strengthened by our return to the heritage utility brands, will result in a balanced outcome for our customers and shareholders.

We had several successful regulatory outcomes in 2005. Our Atlantic City Electric utility settled a New Jersey rate case, which resulted in an annual pre-tax earnings increase of $20 million. We also reached a settlement that clears the way for us to proceed with the auction of the B.L. England generating station which, if not sold, we plan to retire in 2007.

Stock Performance and Equity Ratio Improve

As I noted earlier, we have made real progress in strengthening our balance sheet and executing on the operational front. As you may recall, the Mirant bankruptcy issues have been a concern to both equity and debt analysts. Now that most of the issues associated with Mirant's bankruptcy are being resolved in our favor, our stock price is improving and in 2005 tracked higher than other Standard & Poor's Midcap Utilities. In addition, at the end of 2005 we were in the top 10 of our peer group for stock yield.

I am particularly pleased with the pace with which we have paid down our debt. Our goal has been to improve our equity ratio by reducing debt by $1.3 billion during the 2003-2007 period. Through 2005, we paid down over $1.1 billion of debt and expect to reach our 2007 goal. As a result of these actions, the issuance of common equity in 2004, and earnings growth in 2005, our equity ratio has been steadily rising and we're on target to achieve a ratio in the mid 40 percent range by the end of 2007.

During 2005, we significantly improved our investor relations efforts, meeting more routinely with investors and providing more transparency to PHI. We believe Wall Street and our rating agencies now have a much better understanding of PHI's strategy, and these efforts, along with delivering good financial results, have been reflected in our stock price.

Prudent Investments Drive Expansion of Utility Rate Base

We believe our balance sheet progress is sustainable, even with higher capital expenditures. That's because our investments are prudent and focused—aimed to improve reliability, meet load growth and enhance customer service. Over the next five years, we plan to invest $2.4 billion in our utility infrastructure. About $540 million of this investment will be in transmission, including projects to replace electricity supply from B.L. England, and enhance reliability of electric service in the District of Columbia. In addition, we are building a 230 kilovolt line in Delaware which spans most of the length of the state. These investments lay the groundwork for the future and build our utility rate base.

Increased Dividend Reflects Strengthened Performance

I have said consistently that we would raise the dividend when appropriate to reflect improvement in our financial performance. Our growth in earnings, steady pay down of debt, and ability to manage costs while funding new investments, among other measures, have all combined to improve the balance sheet significantly and enabled your Board to declare in January 2006 a 4 percent increase in the annual dividend rate. Importantly, progress in all these areas is a testament to our strong and predictable cash flow.

A Look to the Future

I am encouraged by the future of our businesses. Utility sales are growing at a steady rate. The higher electrical system load, paired with record summer heat, produced all-time peak demand for electricity in each of our service areas in July 2005. The system performed well,

demonstrating our infrastructure planning, investment and maintenance are on track. In addition, we held a comprehensive emergency preparedness drill that tested our Incident Command System for handling large-scale outages, potential threats to the Company's reputation and other crisis situations.

In the face of escalating energy prices and consumer expectations, customer satisfaction remained steady. To serve our customers better, we are pursuing a strategy of operational excellence that focuses on enhancing information to customers; improving the accuracy of estimated restoration times and increasing community involvement which is so pivotal to our success.

Our utility business also is ramping up its productivity improvement efforts to enhance operational efficiencies and reduce costs. Extended labor agreements successfully negotiated over the past 18 months support our cost containment and productivity goals.

In our competitive energy businesses, I expect enhanced growth and value as well. Our wholesale energy business performed well through a cyclical downturn and is competitively positioned as the regional wholesale market begins to recover. We managed the challenges by engaging in a successful hedging strategy, reducing risk, increasing fuel storage capacity and leveraging our unique generation assets and our expertise.

In the retail arena, our commercial and industrial load continues to grow and the business is expanding into a number of new regions outside of the mid-Atlantic area. Performance continues to improve. The business now ranks sixth nationally in electric retail competitive energy supply.

Our Employees and Directors Make the Difference

None of our successes could have been accomplished without our valued employees, who often go the extra mile in the community serving customers and helping the environment, the homeless or other admirable causes. I am particularly proud of our crews' safe and selfless performance in the Gulf Coast region, where many employees traveled to restore electricity to hurricane victims. In addition, many of our employees made monetary, material and other contributions to those affected by the hurricanes.

I am pleased by the continued recognition by outside entities of our diversity focus. In 2005, PHI was recognized by *Fortune* and *Black Enterprise* magazines as a top employer for minorities; by AARP for employing individuals age 50 and older; by the *Veteran's Business Journal* as one of the "Top 10 Corporate Supplier Diversity Programs" for veteran-owned businesses and by Asian American Business Roundtable as the "2005 Corporate Small Business Advocate."

I would like to acknowledge your Board of Directors who in 2005 took a very active role in assessing PHI's strategy. Your Board provides strong oversight in governance and performance management, and I applaud their talent and commitment.

Overall, 2005 was a good year. Our total return to investors, balance sheet and cash flow each improved and I expect continued improvement in the future. PHI remains a very good value with a stable, regulated delivery business focus supported by a profitable and growing competitive business segment. We look forward to embracing this future and providing our shareholders with enhanced value.

Sincerely,

Dennis R. Wraase
Chairman of the Board,
President and Chief Executive Officer
March 30, 2006

701 Ninth Street, N.W.
Washington, D.C. 20068

Notice of Annual Meeting of Shareholders

March 30, 2006

NOTICE IS HEREBY GIVEN that the Annual Meeting of Shareholders of Pepco Holdings, Inc. will be held at 10:00 a.m. local time on Friday, May 19, 2006 (the doors will open at 9:00 a.m.), at the Company's offices located at 701 Ninth Street, N.W., Edison Place Conference Center (second floor), Washington, D.C. for the following purposes:

1. To elect five directors to serve for a term of one year;
2. To ratify the appointment of PricewaterhouseCoopers LLP as independent registered public accounting firm of the Company for 2006;
3. To transact such other business as may properly be brought before the meeting.

All holders of record of the Company's common stock at the close of business on Monday, March 20, 2006, will be entitled to vote on each matter submitted to a vote of shareholders at the meeting.

By order of the Board of Directors,

ELLEN SHERIFF ROGERS
Vice President and Secretary

IMPORTANT

You are cordially invited to attend the meeting in person.

Even if you plan to be present, you are urged to vote your shares promptly. To vote your shares, use the Internet or call the toll-free telephone number as described in the instructions attached to your proxy card, or complete, sign, date and return your proxy card in the envelope provided.

If you attend the meeting, you may vote either in person or by proxy.

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PROXY STATEMENT

Annual Meeting of Shareholders

Pepco Holdings, Inc.

March 30, 2006

This Proxy Statement is being furnished by the Board of Directors of Pepco Holdings, Inc. (the "Company" or "Pepco Holdings") in connection with its solicitation of proxies to vote on the matters to be submitted to a vote of shareholders at the 2006 Annual Meeting. This Proxy Statement, together with the Company's 2005 Annual Report to Shareholders, which is attached as Annex B to the Proxy Statement, the Notice of Annual Meeting, and a proxy card, is being first mailed to shareholders of record on or about April 4, 2006.

The Company is a holding company formed in connection with the merger of Potomac Electric Power Company ("Pepco") and Conectiv. As a result of the merger, which occurred on August 1, 2002, Pepco and Conectiv became wholly owned subsidiaries of the Company. The address of the Company's principal executive offices is 701 Ninth Street, N.W., Washington, D.C. 20068.

When and where will the Annual Meeting be held?

The Annual Meeting will be held at 10:00 a.m. local time on Friday, May 19, 2006 (the doors will open at 9:00 a.m.), at the Company's offices located at **701 Ninth Street, N.W., Edison Place Conference Center (second floor), Washington, D.C.** Admission to the meeting will be limited to Company shareholders or their authorized proxies. Admission tickets are not required.

Will the Annual Meeting be Web cast?

The live audio and slide presentation of the meeting can be accessed at the Company's Web site, www.pepcoholdings.com/investors. An audio only version will also be available. The dial-in information will be announced in a news release at a later date.

What matters will be voted on at the Annual Meeting?

1. The election of five directors for one-year terms.

   The Board recommends a vote FOR each of the five candidates nominated by the Board of Directors and identified in Item 1 in this Proxy Statement.

2. The ratification of the appointment by the Audit Committee of PricewaterhouseCoopers LLP as independent registered public accounting firm of the Company for 2006.

   The Board recommends a vote FOR this proposal.

How do I vote shares held in my own name?

If you own your shares in your own name, you can either attend the Annual Meeting and vote in person or you can vote by proxy without attending the meeting. You can vote by proxy in any of three ways:

- *Via Internet*: Go to www.voteproxy.com. Have your proxy card in hand when you access the Web site. You will be given simple voting instructions to follow to obtain your records and to create an electronic voting instruction form. At this Web site, you also can elect to access future proxy statements and annual reports via the Internet.
- *By Telephone*: Call toll-free 1-800-PROXIES (1-800-776-9437). Have your proxy card in hand when you call, and you will be given simple voting instructions to follow.
- *In Writing*: Complete, sign, date and return the enclosed proxy card in the postage-paid envelope that has been provided.

The Internet and telephone voting facilities for shareholders of record will close at 5:00 p.m. Eastern time on May 18, 2006. Your signed proxy card or the proxy you grant via the Internet or by telephone will be voted in accordance with your instructions. If you return a signed proxy card or grant a proxy via the Internet or by telephone, but do not indicate how you wish your shares to be voted, your shares will be voted FOR the election of each of the director nominees and FOR the ratification of PricewaterhouseCoopers LLP as the Company's 2006 independent registered public accounting firm.

How do I vote shares held through a brokerage firm, bank or other financial intermediary?

If you hold shares through a brokerage firm, bank or other financial intermediary, you will receive from that intermediary directions on how to direct the voting of your shares by the intermediary, which may include voting instructions given via the Internet or by telephone. If you hold your shares through a brokerage firm, bank or other financial intermediary you may not vote in person at the Annual Meeting unless you obtain a proxy from the recordholder.

Who is eligible to vote?

All shareholders of record at the close of business on March 20, 2006 (the "record date") are entitled to vote at the Annual Meeting. As of the close of business on the record date 190,037,810 shares of Pepco Holdings common stock, par value $.01 per share (the "Common Stock"), were outstanding. Each outstanding share of Common Stock entitles the holder of record to one vote on each matter submitted to the vote of shareholders at the Annual Meeting.

What is the quorum requirement?

In order to hold the Annual Meeting, the holders of a majority of the outstanding shares of Common Stock must be present at the meeting either in person or by proxy.

What shares are included on the enclosed proxy card?

The number of shares printed on the enclosed proxy card indicates the number of shares of Common Stock that, as of the record date, you held of record, plus (i) any shares held for your account under the Pepco Holdings Dividend Reinvestment Plan (the "Dividend Reinvestment Plan") and (ii) if you are a participant in the Pepco Holdings, Inc. Retirement Savings Plan (the "Retirement Savings Plan"), the shares held for your account under that plan. See *"How is stock in the 401(k) plans for employees voted?"*

How is stock in the Dividend Reinvestment Plan voted?

Shares held by the Dividend Reinvestment Plan will be voted by the Plan administrator in accordance with your instructions on the proxy card or given via the Internet or by telephone. Any shares held in the Dividend Reinvestment Plan for which no voting instructions are given will not be voted.

What does it mean if I receive more than one proxy card?

If you receive more than one proxy card, it is because your shares are registered in different names or with different addresses. You must sign, date and return each proxy card that you receive (or grant a proxy for the shares represented by each proxy card via the Internet or by telephone) in order for all of your shares to be voted at the Annual Meeting. To enable us to provide better shareholder service, we encourage shareholders to have all their shares registered in the same name with the same address.

How is stock in the 401(k) plans for employees voted?

If you are a current or former employee who is a participant in the Retirement Savings Plan (which is the successor plan to the (i) Potomac Electric Power Company Savings Plan for Bargaining Unit Employees,

(ii) Potomac Electric Power Company Retirement Savings Plan for Management Employees (which also is the successor to the Potomac Electric Power Company Savings Plan for Non-Exempt, Non-Bargaining Unit Employees; the Potomac Electric Power Company Retirement Savings Plan for Management Employees was formerly known as the Potomac Electric Power Company Savings Plan for Exempt Employees), (iii) Conectiv Savings and Investment Plan and the Conectiv PAYSOP/ESOP and (iv) Atlantic Electric 401(k) Savings and Investment Plan-B), then the number of shares printed on the enclosed proxy card includes shares of Common Stock held through the plan. By completing, dating, signing and returning this proxy card or granting a proxy via the Internet or by telephone, you will be providing the plan trustee with instructions on how to vote the shares held in your account. If you do not provide voting instructions for your plan shares, the plan trustee will vote your shares on each matter in proportion to the voting instructions given by all of the other participants in the plan.

Can I change my vote after I have returned my proxy card or granted a proxy via the Internet or by telephone?

If you own your shares in your own name or through the Dividend Reinvestment Plan or Retirement Savings Plan, you may revoke your proxy, regardless of the manner in which it was submitted, by:

- sending a written statement to that effect to the Secretary of the Company before your proxy is voted;
- submitting a properly signed proxy dated a later date;
- submitting a later dated proxy via the Internet or by telephone; or
- voting in person at the Annual Meeting.

If you hold shares through a brokerage firm, bank or other financial intermediary, you should contact that intermediary for instructions on how to change your vote.

How can I obtain more information about the Company?

The Company's 2005 Annual Report to Shareholders is included as Annex B after page A-3 of this Proxy Statement. You may also visit the Company's Web site at www.pepcoholdings.com.

1. ELECTION OF DIRECTORS

Twelve directors currently constitute the entire Board of Directors of the Company. Immediately prior to the commencement of the 2006 Annual Meeting, the number of directors will be increased to 13. In 2005, the Company's Restated Certificate of Incorporation was amended to reinstate the annual election of Board members except that any director who prior to the 2006 Annual Meeting was elected to a term that continues beyond the 2006 Annual Meeting will continue in office for the remainder of his or her elected term or until his or her earlier death, resignation or removal. Accordingly, at the Annual Meeting, five directors are to be elected, each to hold office for a one-year term that expires at the 2007 Annual Meeting, and until his or her successor is elected and qualified. The five directors who will continue in office until 2007 and the three directors who will continue in office until 2008 are listed on pages 8 and 9, respectively, of this Proxy Statement.

Terence C. Golden, Frank O. Heintz, George F. MacCormack, Lawrence C. Nussdorf and Lester P. Silverman were recommended for nomination to the Board by the Corporate Governance/Nominating Committee. Messrs. Heintz and Silverman were identified for consideration as nominees by one or more non-management directors. Messrs. Golden, MacCormack and Nussdorf are incumbent directors.

The Board of Directors recommends a vote FOR each of the five nominees listed on the following page.

What vote is required to elect the directors?

Each director shall be elected by a majority of the votes cast "for" his or her election.

In January 2006, the Company's Bylaws were amended to provide that each director shall be elected by a majority of the votes cast "for" his or her election, except that in a contested election where the number of nominees exceeds the number of directors to be elected, directors shall be elected by a plurality of the votes cast. Accordingly, at the 2006 Annual Meeting, a nominee will be elected as a director only if a majority of the votes present and entitled to vote are cast "for" his election. In accordance with the Company's Bylaws, any incumbent nominee who fails to receive a majority of votes cast "for" his or her election is required to resign from the Board no later than 90 days after the date of the certification of the election results.

What happens if a nominee is unable to serve as a director?

Each nominee identified in this Proxy Statement has confirmed that he is willing and able to serve as a director. However, should any of the nominees, prior to the Annual Meeting, become unavailable to serve as a director for any reason, the Board of Directors either may reduce the number of directors to be elected or, on the recommendation of the Corporate Governance/Nominating Committee, select another nominee. If another nominee is selected, all proxies will be voted for that nominee.

NOMINEES FOR ELECTION AS DIRECTORS

For Terms Expiring in 2007

Terence C. Golden, age 61, since 2000 has been Chairman of Bailey Capital Corporation in Washington, D.C. Bailey Capital Corporation is a private investment company. From 1995 until 2000, Mr. Golden was President, Chief Executive Officer and a director of Host Marriott Corporation. He continues to serve as a director of Host Marriott Corporation and of the Morris & Gwendolyn Cafritz Foundation. Mr. Golden also currently serves as Chairman of the Federal City Council. Mr. Golden was a director of Pepco from 1998 until August 1, 2002. He has been a director of the Company since August 1, 2002.

Frank O. Heintz, age 62, is retired President and Chief Executive Officer of Baltimore Gas and Electric Company, the gas and electric utility serving central Maryland, a position he held from 2000 through 2004. Preceding leadership positions included Executive Vice President for Utility Operations and Vice President of Gas Services. From 1982 to 1995, Mr. Heintz was Chairman of the Maryland Public Service Commission, the state agency regulating gas, electric, telephone and certain water and sewerage utilities. Previously he served as agency head of the Maryland Employment Security Administration and was an elected member of the Maryland legislature. Mr. Heintz currently does not serve as a director of the Company.

George F. MacCormack, age 62, is retired Group Vice President, DuPont, Wilmington, Delaware, a position he held from 1999 through 2003. He was previously Vice President and General Manager (1998), White Pigments & Mineral Products Strategic Business Unit and Vice President and General Manager (1995), Specialty Chemicals Strategic Business Unit for DuPont. Mr. MacCormack was a director of Conectiv from 2000 until August 1, 2002. He has been a director of the Company since August 1, 2002.

Lawrence C. Nussdorf, age 59, since 1998 has been President and Chief Operating Officer of Clark Enterprises, Inc., a privately held investment and real estate company based in Bethesda, Maryland, whose interests include the Clark Construction Group, LLC, a general contracting company, of which Mr. Nussdorf has been Vice President and Treasurer since 1977. Mr. Nussdorf was a director of Pepco from 2001 until August 1, 2002. He has been a director of the Company since August 1, 2002.

Lester P. Silverman, age 59, is Director Emeritus of McKinsey & Company, Inc., having retired from the international management consulting firm in 2005. Mr. Silverman joined McKinsey in 1982 and was head of the firm's Electric Power and Natural Gas practice from 1991 to 1999. From 2000 to 2004, Mr. Silverman was the leader of McKinsey's Global Nonprofit Practice. Previous positions included Principal Deputy Assistant Secretary for Policy and Evaluation in the U.S. Department of Energy from 1980 to 1981 and Director of Policy Analysis in the U.S. Department of the Interior from 1978 to 1980. Mr. Silverman is currently an Adjunct Lecturer at Georgetown University, Washington, D.C., and a trustee of several national and Washington, D.C.-area nonprofit organizations. Mr. Silverman currently does not serve as a director of the Company.

DIRECTORS CONTINUING IN OFFICE

Terms Expiring in 2007

Jack B. Dunn, IV, age 55, since October 1995 has been Chief Executive Officer and since October 2004 has been President of FTI Consulting, Inc., a publicly held multi-disciplined consulting firm with practices in the areas of corporate finance/restructuring, forensic and litigation consulting and economic consulting, located in Baltimore, Maryland. He has served as a Director of FTI since 1992 and served as Chairman of the Board from December 1998 to October 2004. Mr. Dunn is a limited partner of the Baltimore Orioles and is a director of Aether Holdings, Inc. He has been a director of the Company since May 21, 2004.

Richard B. McGlynn, age 67, is an attorney. From 1995-2000, he was Vice President and General Counsel of United Water Resources, Inc., Harrington Park, New Jersey and from 1992-1995, he was a partner in the law firm LeBoeuf, Lamb, Green & MacRae. He was a director of Atlantic Energy, Inc. from 1986 to 1998. Mr. McGlynn was a director of Conectiv from 1998 until August 1, 2002. He has been a director of the Company since August 1, 2002.

Peter F. O'Malley, age 67, since 1989 has been of counsel to O'Malley, Miles, Nylen & Gilmore, P.A., a law firm headquartered in Calverton, Maryland. Mr. O'Malley currently serves as the President of Aberdeen Creek Corp., a privately held company engaged in investment, business consulting and development activities. Mr. O'Malley is a director of FTI Consulting, Inc. and Legg Mason Trust Co. He was a director of Pepco from 1982 until August 1, 2002. He has been a director of the Company since August 1, 2002 and currently serves as the Lead Independent Director.

Frank K. Ross, age 62, is retired managing partner for the mid-Atlantic Audit and Risk Advisory Services Practice and managing partner of the Washington, D.C. office of the accounting firm KPMG LLP, positions he held from July 1, 1996 to December 31, 2003. He is currently a Visiting Professor of Accounting at Howard University, Washington, D.C. and the Director of its Center for Accounting Education. He is a director of Cohen & Steers Mutual Funds. Mr. Ross serves on The Greater Washington, D.C. Urban League, Gallaudet University and the Hoop Dreams Scholarship Fund boards. He has been a director of the Company since May 21, 2004.

William T. Torgerson, age 61, has been Vice Chairman of the Company since June 1, 2003 and has been General Counsel of the Company since August 1, 2002. From August 1, 2002 to June 2003, he was also Executive Vice President of the Company. From December 2000 to August 2002, he was Executive Vice President and General Counsel of Pepco. Mr. Torgerson has been a director of Pepco and Conectiv since August 1, 2002. Mr. Torgerson has been a director of the Company since May 21, 2004.

DIRECTORS CONTINUING IN OFFICE

Terms Expiring in 2008

Edmund B. Cronin, Jr., age 68, since 2000 has been Chairman of the Board, and since 1995 has been President and Chief Executive Officer of Washington Real Estate Investment Trust, based in Rockville, Maryland, which owns income-producing real estate in the mid-Atlantic region. Mr. Cronin was a director of Pepco from 1998 until August 1, 2002. He has been a director of the Company since August 1, 2002.

Pauline A. Schneider, age 62, joined the Washington office of the law firm of Hunton & Williams in 1985 and has been a partner since 1987. From October 2000 to October 2002, Ms. Schneider served as Chair of the Board of MedStar Health, Inc., a community-based healthcare organization that includes seven major hospitals in the Washington, D.C./Baltimore area. Also, between 1998 and 2002, she chaired the Board of The Access Group, Inc., a not-for-profit student loan provider headquartered in Wilmington, Delaware. She continues her service on both boards. She is a director of DiamondCluster International, Inc. Ms. Schneider was a director of Pepco from 2001 until August 1, 2002. She has been a director of the Company since August 1, 2002.

Dennis R. Wraase, age 62, is Chairman, President and Chief Executive Officer of the Company. Since May 2004 he has been Chairman of Pepco, Atlantic City Electric Company and Delmarva Power & Light Company. He was Chief Executive Officer from August 2002 through October 2005 and President and Chief Operating Officer of Pepco from January 2001 through August 1, 2002. Mr. Wraase became President of the Company in August 2002. From August 2002 through May 2003, Mr. Wraase was Chief Operating Officer of the Company. Mr. Wraase became CEO of the Company in June 2003. He has been a director of the Company since 2001, and has been Chairman since May 2004.

Which directors are "independent?"

According to the listing standards of the New York Stock Exchange ("NYSE"), a majority of the Company's directors are required to be "independent" as defined by the NYSE listing standards. Applying these standards, the Board has determined that nine of the Company's current 12 directors, consisting of Messrs. Dunn, Golden, MacCormack, McGlynn, Nussdorf, O'Malley, and Ross and Mmes. McKenzie (who is retiring effective with the Annual Meeting) and Schneider qualify as independent and that if Messrs. Golden, Heintz, MacCormack, Nussdorf and Silverman are elected at the Annual Meeting, ten of the Company's 13 directors consisting of Messrs. Dunn, Golden, Heintz, MacCormack, McGlynn, Nussdorf, O'Malley, Ross and Silverman and Ms. Schneider following the Annual Meeting will qualify as independent.

For a director to be considered independent under NYSE listing standards, a director cannot have any of the disqualifying relationships enumerated by the NYSE listing standards and the Board must determine that the director does not otherwise have any direct or indirect material relationship with the Company. In accordance with the NYSE listing standards, the Board of Directors, as part of the Company's Corporate Governance Guidelines, has adopted categorical standards to assist it in determining whether a relationship between a director and the Company is a material relationship that would impair the director's independence. Under these standards, which incorporate the disqualifying relationships specifically enumerated by the NYSE listing standards, a Company director is not "independent" if any of the conditions specified are met.

a. The director is, or has been within the last three years, an employee of the Company, or an immediate family member is, or has been within the last three years, an executive officer of the Company. An executive officer of the Company is the president, principal financial officer, controller, any vice-president in charge of a principal business unit, division or function, any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the Company. Officers of the Company's subsidiaries are deemed to be officers of the Company if they perform such policy-making functions for the Company.

b. The director has received, or has an immediate family member who has received, during any 12-month period within the last three years, more than $100,000 in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

c. (A) The director or an immediate family member is a current partner of a firm that is the Company's internal or external auditor; (B) the director is a current employee of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the Company's audit within that time.

d. The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the Company's present executive officers at the same time serves or served on that company's compensation committee.

e. The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the Company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million or 2% of such other company's consolidated gross revenues. Contributions to tax exempt organizations shall not be considered "payments" for purposes of this categorical standard, provided however that the Company shall disclose in its annual proxy statement any such contributions made by the Company to any tax exempt organization in which any independent director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year from the Company to the tax exempt organization exceed the greater of $1 million, or 2% of such tax exempt organization's consolidated gross revenues.

f. For purposes of considering the existence or materiality of a director's relationship with the Company or the relationship with the Company of an organization with which the director is associated, payments for electricity, gas or other products or services made in the normal course of business at prices generally applicable to similarly situated customers shall not be included.

g. Additional provisions applicable to members of the Audit Committee.

    i. A director who is a member of the Audit Committee may not accept directly or indirectly any consulting, advisory, or other compensatory fee from the Company or any subsidiary of the Company, provided that, unless the rules of the NYSE provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service (provided that such compensation is not contingent in any way on continued service). The term "indirect acceptance" by a member of the Audit Committee of any consulting, advisory, or other compensatory fee includes acceptance of such fee by a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member or by an entity in which such member is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the Company or any subsidiary of the Company.

    ii. A director who is an "affiliated person" of the Company or its subsidiaries (other than in his or her capacity as a member of the Board or a Board Committee) as defined by the Securities and Exchange Commission ("SEC") shall not be considered independent for purposes of Audit Committee membership. A director who beneficially owns more than 3% of the Company's common stock will be considered to be an "affiliated person."

What are the Committees of the Board? How often did the Board and each Committee of the Board meet in 2005?

In 2005, the Board of Directors held eight meetings. The Board has five separately designated standing Committees:

- the Audit Committee;
- the Compensation/Human Resources Committee;
- the Corporate Governance/Nominating Committee;
- the Executive Committee; and
- the Finance Committee.

Each Committee's charter can be found on the Company's Web site (www.pepcoholdings.com) under the link: Corporate Governance.

At each meeting, the Board and each of the Committees made up of independent directors (or, in the case of the Finance Committee, directors who are not employees of the Company or any of its subsidiaries ("non-management directors")) set aside time to meet in executive session without management directors (in the case of Board meetings) or other management personnel present. The executive session of the Board is convened by the Lead Independent Director. The Compensation/Human Resources Committee meets separately with its compensation consultant. The Audit Committee meets separately with the Vice President and General Auditor and the independent registered public accounting firm.

The *Audit Committee* held nine meetings in 2005. The Audit Committee represents and assists the Board in discharging its responsibility of oversight, but the existence of the Committee does not alter the traditional roles and responsibilities of the Company's management and its independent registered public accounting firm with

respect to the accounting and control functions and financial statement presentation. The Audit Committee is responsible for, among other things, representing and assisting the Board in oversight of (i) the integrity of the Company's financial statements, accounting and financial reporting processes and audits of the Company's consolidated financial statements, (ii) the Company's compliance with legal and regulatory requirements, (iii) the qualifications, independence and the retention, compensation and performance of the Company's independent registered public accounting firm, and (iv) the design and performance of the Company's internal audit function. The Audit Committee also reviews the Company's guidelines and policies with respect to risk assessment. The Committee has full power and authority to obtain advice and assistance from independent legal, accounting or other advisors as it may deem appropriate to carry out its duties. Committee members are Directors Golden, McGlynn, Nussdorf (Chairman) and Ross. The Board has determined that directors Golden, Nussdorf and Ross each is an "audit committee financial expert" as defined by the rules of the SEC. The Board has determined that each of the members of the Audit Committee is independent as defined by the Company's Corporate Governance Guidelines and in accordance with the listing standards of the NYSE.

The *Compensation/Human Resources Committee* held six meetings in 2005. The Committee, together with the other independent members of the Board of Directors, sets the CEO's compensation level. The Committee approves the salaries of the five most highly compensated officers (other than the CEO), the heads of the major subsidiaries and the Vice Presidents of the Company; administers the Company's executive incentive compensation programs; and establishes the structure of compensation and amounts of awards under the Pepco Holdings, Inc. Long-Term Incentive Plan (the "Long-Term Incentive Plan"). The Committee exercises the powers of the Board with respect to the Company's annual salary administration program for all management employees. The Committee also makes recommendations to the Board concerning the Company's retirement and other benefit plans and oversees corporate workforce diversity issues. Committee members are Directors MacCormack, McGlynn (Chairman), McKenzie, O'Malley and Ross. The Board has determined that each of the members of the Compensation/Human Resources Committee is independent as defined by the Company's Corporate Governance Guidelines and in accordance with the listing standards of the NYSE.

The *Corporate Governance/Nominating Committee* held seven meetings in 2005. The Committee's duties and responsibilities include making recommendations to the Board regarding the governance of the Company and the Board, and helping to ensure that the Company is properly managed to protect and enhance shareholder value and to meet the Company's obligations to shareholders, customers, the industry and under the law. The Committee is responsible for making recommendations to the Board regarding Board structure, practices and policies, including Board committee chairmanships and assignments and the compensation of Board members, assessing Board performance and effectiveness, and ensuring that processes are in place with regard to corporate strategy, management development and management succession, business plans and corporate and government affairs. The Committee evaluates annually the performance of the Company's Chief Executive Officer and reports its appraisal to the other independent directors. The Committee also is responsible for ensuring that the technology and systems used by the Company are adequate to properly run the business and for it to remain competitive. The Committee reviews and recommends to the Board candidates for nomination for election as directors. Committee members are Directors Dunn, McGlynn, McKenzie, O'Malley (Chairman) and Schneider. The Board has determined that each of the members of the Corporate Governance/Nominating Committee is independent as defined by the Company's Corporate Governance Guidelines and in accordance with the listing standards of the NYSE.

The *Executive Committee* held one meeting in 2005. The Committee has, and may exercise when the Board is not in session, all the powers of the Board in the management of the property, business and affairs of the Company, except as otherwise provided by law. The Committee does not hold regularly scheduled meetings. Committee members are Directors Cronin, McKenzie (Chairman), O'Malley, Torgerson and Wraase.

The *Finance Committee* held eight meetings in 2005. The Committee oversees the financial objectives, policies, procedures and activities of the Company and considers the long- and short-term strategic plans of the Company. The Committee reviews with management the Company's risk mitigation profile. Committee members are Directors Cronin, Dunn, Golden (Chairman), MacCormack, Nussdorf and Schneider.

In 2005, each director attended at least 75% of the aggregate number of meetings held by the Board and each Committee of which he or she was a member. The Board has adopted an attendance policy, set forth in the Corporate Governance Guidelines, under which attendance in person is required at all regularly scheduled shareholder, Board and Committee meetings (except where scheduled as a conference call) and is the preferred method of attendance at specially called meetings. The Chairman has the authority to waive the requirement of this policy if, in the Chairman's opinion, it is in the Company's best interests to do so. Of the Company's 12 directors at the time of the 2005 Annual Meeting, 11 attended.

How do I send a communication to the Board of Directors or to a specific individual director?

The Company's directors encourage interested parties, including employees and shareholders, to contact them directly and, if desired, confidentially and/or anonymously regarding matters of concern or interest, including concerns regarding questionable accounting or auditing matters. The names of the Company's directors can be found on pages 7–9 of this Proxy Statement and on the Company's Web site (www.pepcoholdings.com) under the link: Corporate Governance. The Company's directors may be contacted by writing to them either individually or as a group or partial group (such as all non-management directors), c/o Corporate Secretary, Pepco Holdings, Inc., 701 Ninth Street, N.W., Room 1300, Washington, D.C. 20068. If you wish your communication to be treated confidentially, please write the word "CONFIDENTIAL" prominently on the envelope and address it to the director by name so that it can be forwarded without being opened. Communications addressed to multiple recipients, such as to "directors," "all directors," "all non-management directors," "independent directors," etc. will necessarily have to be opened and copied by the Office of the Corporate Secretary in order to forward them, and hence cannot be transmitted unopened, but will be treated as confidential communications. If you wish to remain anonymous, do not sign your letter or include a return address on the envelope. Communications from Company employees regarding accounting, internal accounting controls, or auditing matters may be submitted in writing addressed to: Vice President and General Auditor, Pepco Holdings, Inc., 701 Ninth Street, N.W., Room 8220, Washington, D.C. 20068 or by telephone to 202-872-3524. Such communications will be handled initially by the Internal Audit Group, which reports to the Audit Committee, and will be reported by the Internal Audit Group to the Audit Committee. If for any reason the employee does not wish to submit a communication to the Vice President and General Auditor, it may be addressed to the Chairman of the Audit Committee using the procedure set forth above, or can be sent via mail, telephone, facsimile or e-mail to the Company's Ethics Officer. Employees may also leave messages on the Company's Ethics Officer hotline.

What are the directors paid for their services?

Commencing January 1, 2005, each of the Company's non-management directors is paid an annual retainer of $45,000, plus a fee of $2,000 for each Board and Committee meeting attended. Each non-management director who chairs a standing Committee of the Board receives an additional retainer of $5,000, except that the Chairman of the Audit Committee receives $7,500. The director who serves as Lead Independent Director receives, in addition to any other compensation, an additional retainer of $2,500.

Each non-management director is required to own at least 7,500 shares of Common Stock or Common Stock equivalents ("phantom stock"). Non-management directors serving as of January 1, 2005, have until December 31, 2007, to meet this requirement. Newly elected or appointed non-management directors are required to reach this ownership level within three years after the date of their election or appointment.

Under the Non-Management Director Compensation Plan (the "Director Compensation Plan"), each non-management director is entitled to elect to receive his or her annual retainer, retainer for service as a Committee chairman, if any, and meeting fees in: (1) cash, (2) shares of Common Stock, (3) a credit to an account for the director established under the Company's Executive and Director Deferred Compensation Plan ("Deferred Compensation Plan") or (4) any combination thereof. A non-management director who elects to have all or any portion of his or her compensation for services as a director credited to an account under the Deferred Compensation Plan can elect to have his or her account balance under the plan: (i) maintained in the form of phantom stock and credited with additional phantom stock when the Company pays a dividend on its Common

Stock, (ii) credited with a return based on the prevailing prime rate or (iii) credited with a return based on the return on one or more investment funds selected by the Compensation/Human Resource Committee. Distributions to participants under the Deferred Compensation Plan are made in cash, in either a lump sum or installments, commencing at a time selected by the participant.

Although under the terms of the Long-Term Incentive Plan, each non-management director is entitled to a grant, on May 1 of each year, of an option to purchase 1,000 shares of Common Stock, in 2003, the Board of Directors discontinued these grants.

The Company also provides directors with travel accident insurance for Company-related travel, directors' and officers' liability insurance coverage and reimburses directors for travel, hotel and other out-of-pocket expenses incurred in connection with their performance of their duties as directors. The Company also provides the directors with free parking in the Company's headquarters building, which is also available for use by the directors other than in connection with the performance of their duties as directors.

The following table sets forth, as of March 24, 2006, for each non-management director who has elected to receive all or a portion of his or her annual retainer and meeting fees in phantom stock under the Deferred Compensation Plan, the number of credited phantom stock units (each corresponding to one share of Common Stock).

Name of Director	**Pepco Holdings Phantom Stock Units**
Edmund B. Cronin, Jr.	24,794
Terence C. Golden	17,941
George F. MacCormack	4,235
Richard B. McGlynn	2,129
Lawrence C. Nussdorf	3,053
Peter F. O'Malley	5,074
Pauline A. Schneider	423

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth, as of March 24, 2006, for each director, director nominee, the five executive officers named in the Summary Compensation Table on page 17 and all directors and executive officers as a group (i) the number of shares of Common Stock beneficially owned, (ii) the number of shares of Common Stock that could be purchased through the exercise of stock options then-currently exercisable or scheduled to become exercisable within 60 days thereafter, and (iii) total beneficial ownership. The Common Stock is the Company's only class of equity or voting securities. Each of the individuals listed, and all directors and executive officers as a group, beneficially owned less than 1% of the outstanding shares of Common Stock.

Name of Beneficial Owner	Shares of Common Stock Owned(1)	Common Stock Acquirable Within 60 Days	Total Beneficial Ownership(2)
Edmund B. Cronin, Jr.	1,425	5,000	6,425
Jack B. Dunn, IV	10,495	0	10,495
Terence C. Golden (3)	52,132	4,000	56,132
Frank O. Heintz (4)	1,500	0	1,500
George F. MacCormack	11,282	0	11,282
Richard B. McGlynn	5,762	0	5,762
Floretta D. McKenzie	6,873	5,000	11,873
Lawrence C. Nussdorf	5,000	2,000	7,000
Peter F. O'Malley (5)	10,000	5,000	15,000
Joseph M. Rigby	19,711	16,025	35,736
Frank K. Ross	5,758	0	5,758
Pauline A. Schneider	3,560	2,000	5,560
Thomas S. Shaw	78,031	68,333	146,364
Lester P. Silverman	1,000	0	1,000
William H. Spence	13,232	0	13,232
William T. Torgerson	39,434	120,843	160,277
Dennis R. Wraase	99,213	165,843	265,056
All Directors and Executive Officers as a Group (19 Individuals)	426,875	538,412	965,287

(1) Includes shares held under the Dividend Reinvestment Plan and Retirement Savings Plan. Also includes shares awarded under the Long-Term Incentive Plan that vest over time if the executive officer has the right to vote the shares. Unless otherwise noted, each beneficial holder has sole voting power and sole dispositive power with respect to the shares.

(2) Consists of the sum of the two preceding columns.

(3) Includes 11,600 shares owned by Mr. Golden's spouse. Mr. Golden disclaims beneficial ownership of these shares.

(4) Shares are owned in the Frank O. Heintz Trust of which Mr. Heintz is Trustee.

(5) Includes 4,086 shares owned by Aberdeen Creek Corporation, of which Mr. O'Malley is the sole owner.

The following table sets forth, as of March 24, 2006, the number and percentage of shares of Common Stock reported as beneficially owned by all persons known by the Company to own beneficially 5% or more of the Common Stock.

Name and Address of Beneficial Owner	Shares of Common Stock Owned	Percent of Common Stock Outstanding
Barclays Global Investors, NA 45 Fremont Street, 17th Floor, San Francisco, CA 94105	10,364,900(6)	5.48%
UBS AG Bahnhofstrasse 45 P.O. Box CH-8021 Zurich, Switzerland	12,683,488(7)	6.7%

(6) This disclosure is based on information furnished in Schedule 13G, dated January 31, 2006, and filed with the SEC on January 26, 2006, jointly by Barclays Global Investors, NA, Barclays Global Fund Advisors, Barclays Global Investors, Ltd., and Barclays Global Investors Japan Trust and Banking Company Limited, in which Barclays Global Investors, NA reports that it is the beneficial owner with sole dispositive power of 7,281,531 shares of Common Stock, Barclays Global Fund Advisors reports that it is the beneficial owner with sole dispositive power of 2,322,161 shares of Common Stock, Barclays Global Investors, Ltd. reports that it is the beneficial owner with sole dispositive power of 598,026 shares of Common Stock, and Barclays Global Investors Japan Trust and Banking Company Limited reports that it is the beneficial owner with sole dispositive power of 163,182 shares of Common Stock.

(7) This disclosure is based on information furnished in Schedule 13G/A, dated February 14, 2006, and filed with the SEC on February 14, 2006, by UBS AG (for the benefit and on behalf of the Traditional Investments division of the UBS Global Asset Management business group of UBS AG), in which UBS AG reports that it is the beneficial owner of 12,683,488 shares of Common Stock (consisting of 12,683,488 shares as to which it has shared dispositive power and 7,138,660 shares as to which it has sole voting power).

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires the directors and executive officers of a company with a class of equity securities registered under Section 12 of the Exchange Act and any beneficial owner of more than 10% of any class of the company's equity securities to file with the SEC certain reports of holdings and transactions in the company's equity securities. Based on a review of the reports filed for 2005 and on written confirmations provided by its directors and executive officers, the Company believes that during 2005 all of its directors and executive officers filed on a timely basis the reports required by Section 16(a), except that Frank K. Ross, a director of the Company, filed one day late a report on Form 4 disclosing the purchase of 3,000 shares of the Company's Common Stock.

EXECUTIVE COMPENSATION

The following table sets forth compensation information for each of the last three fiscal years ended December 31, for the Chief Executive Officer and the four other most highly compensated executive officers of the Company determined on the basis of aggregate salary and bonus for the year ended December 31, 2005 (collectively, the "Named Executive Officers"). The information presented in the table includes compensation paid by the Company or its subsidiaries.

SUMMARY COMPENSATION TABLE

		Annual Compensation			Long-Term Compensation			
					Awards		Payouts	
Name and Principal Position	**Year**	**Salary**	**Bonus**	**Other Annual Compen-sation(8)**	**Restricted Stock Awards(9)**	**Securities Underlying Options**	**LTIP Payouts(10)**	**All Other Compen-sation(11)**
Dennis R. Wraase	2005	$825,000	$601,920	$10,744	$ 0	0	$220,546	$48,761
Chairman, President	2004	730,250	438,588	9,343	0	0	197,069	39,028
and Chief Executive Officer	2003	558,333	0	8,124	299,997	0	0	29,488
William T. Torgerson	2005	$492,000	$299,136	$ 9,021	$ 0	0	$151,416	$30,058
Vice Chairman	2004	475,000	237,737	7,845	0	0	135,312	28,965
and General Counsel	2003	396,000	0	6,821	0	0	0	23,310
Thomas S. Shaw	2005	$488,000	$296,704	$ 0	$ 0	0	$184,166	$20,742
Executive Vice President	2004	474,000	237,237	0	0	0	164,613	16,909
and Chief Operating Officer	2003	460,000	0	0	0	0	0	10,434
Joseph M. Rigby	2005	$350,000	$170,240	$ 0	$ 0	0	$ 80,624	$10,278
Senior Vice President	2004	299,167	119,786	0	0	0	72,088	6,726
and Chief Financial Officer	2003	260,000	58,656	0	0	0	0	7,870
William H. Spence	2005	$285,000	$190,124	$ 0	$ 0	0	$ 80,624	$13,836
Senior Vice President	2004	267,000	171,018	0	0	0	72,088	8,160
	2003	260,000	0	0	0	0	0	10,315

(8) *Other Annual Compensation*. Amounts in this column for each year represent above-market earnings earned by the executive on deferred compensation under the Pepco Deferred Compensation Plan assuming retirement at age 65. The amounts are reduced if the executive terminates employment prior to age 62 for any reason other than death, total or permanent disability or a change in control of Pepco. In the event of a change in control and termination of the participant's employment, the participant will receive a lump sum payment equal to the net present value of the expected payments at age 65 discounted using the Pension Benefit Guaranty Corporation immediate payment interest rate plus one-half of one percent. Payments to the executives are funded by Pepco-owned life insurance policies held in trust.

In addition to the compensation shown in the above Summary Compensation Table, each of the Named Executive Officers was entitled to one or more of the following personal benefits: financial planning services, tax preparation services, personal use of company-owned automobiles or an automobile allowance, club dues and use of Company-leased entertainment venues other than for business purposes. For each of the Named Executive Officers, the aggregate value of these perquisites in each of the three years, was less than the lesser of $50,000 or 10% of the individual's total annual salary and bonus, and accordingly, consistent with the rules of the SEC, the value of these perquisites has not been included in the Table.

(9) *Restricted Stock*. The amount in this column for 2003 for Mr. Wraase represents the dollar value on the grant date of restricted shares of Common Stock awarded under the Company's Long-Term Incentive Plan. These restricted shares vest on June 1, 2006, if Mr. Wraase is continuously employed by the Company through that date. Dividends are paid on the restricted shares. The dollar value has been calculated by multiplying the number of restricted shares by the market price of the Common Stock on the grant date.

The number and aggregate market value of all restricted shares of Common Stock held by the Named Executive Officers at December 31, 2005, were: Mr. Wraase, 14,822 shares with a market value of $329,567; Mr. Shaw, 44,871 shares with a market value of $997,707; Mr. Rigby, 1,923 shares with a market value of $42,758; and Mr. Spence, 1,923 shares with a market value of $42,758. Mr. Torgerson held no restricted shares at December 31, 2005.

(10) *Incentive Plan Payouts.* Amounts in this column for the executives represent the value of Common Stock awarded under the Company's Merger Integration Success Program, which is a component of the Long-Term Incentive Plan. Amounts in this column for 2005 are for the performance cycle ending December 31, 2005 which vested on March 7, 2006. Amounts in this column for 2004 are for the performance cycle ending December 31, 2004 which vested on March 11, 2005. The value of the vested Common Stock has been calculated by multiplying the number of vested shares by the market price of the Common Stock on the day preceding the vesting date.

(11) *All Other Compensation*. Amounts in this column for 2005 consist of (i) the Company's contributions to the Retirement Savings Plan for Management Employees of $13,915 and $13,556 for Messrs. Wraase and Torgerson, respectively, and the Company's contribution to the Conectiv Savings and Investment Plan of $8,278, $9,108 and $9,225 for Messrs. Shaw, Rigby and Spence, respectively (ii) the Company's contributions to the Executive Deferred Compensation Plan due to Internal Revenue Service limitations on maximum contributions to the Company's Retirement Savings Plan for Management Employees and, in the case of Messrs. Shaw, Rigby and Spence, the Conectiv Savings and Investment Plan, of $22,218, $9,105, $7,686, $0 and $3,675 for Messrs. Wraase, Torgerson, Shaw, Rigby and Spence, respectively, and (iii) the term life insurance premiums paid by the Company for Messrs. Wraase, Torgerson, Shaw, Rigby and Spence of $12,628, $7,397, $4,778, $1,170 and $936, respectively.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES

			Number of Shares Underlying Unexercised Options at End of Fiscal Year		Value of Unexercised In-the-Money Options at End of Fiscal Year (12)	
Name	**Shares Acquired on Exercise (#)**	**Value Realized ($)**	**Exercisable**	**Unexercisable**	**Exercisable**	**Unexercisable**
Dennis R. Wraase	0	$0	153,843	12,000	$ 0	0
William T. Torgerson	0	$0	111,093	9,750	$ 0	0
Thomas S. Shaw	0	$0	68,333	0	$219,007	0
Joseph M. Rigby	0	$0	16,025	0	$ 51,360	0
William H. Spence	0	$0	16,025	0	$ 51,360	0

(12) *Value of Unexercised In-the-Money Options at End of Fiscal Year*. The value of unexercised in-the-money options at December 30, 2005, is calculated by multiplying the number of shares by the amount by which the fair market value of the Common Stock on the last trading day of 2005, as reported by the NYSE, exceeded the option exercise price. For Messrs. Wraase and Torgerson, the closing price of the Common Stock on the last trading day of 2005 was less than the option exercise prices of all of their options, making the value of the unexercised in-the-money options zero.

PEPCO PENSION PLAN TABLE

Average Annual Salary in Final Three Years of Employment	Annual Retirement Benefits					
	Years in Plan					
	15	20	25	30	35	40
$550,000	$144,000	$193,000	$241,000	$289,000	$337,000	$ 385,000
$650,000	$171,000	$228,000	$284,000	$341,000	$398,000	$ 455,000
$750,000	$197,000	$263,000	$328,000	$394,000	$459,000	$ 525,000
$850,000	$223,000	$298,000	$372,000	$446,000	$521,000	$ 595,000
$950,000	$249,000	$333,000	$416,000	$499,000	$582,000	$ 665,000
$1,050,000	$276,000	$368,000	$459,000	$551,000	$643,000	$ 735,000
$1,150,000	$302,000	$403,000	$503,000	$604,000	$704,000	$ 805,000
$1,250,000	$328,000	$438,000	$547,000	$656,000	$766,000	$ 875,000
$1,350,000	$354,000	$473,000	$591,000	$709,000	$827,000	$ 945,000
$1,450,000	$381,000	$508,000	$634,000	$761,000	$888,000	$1,015,000

The Pepco Holdings Retirement Plan consists of the Pepco General Retirement Plan and the Conectiv Retirement Plan.

The Pepco General Retirement Plan provides participating employees with at least five years of service with retirement benefits based on the participant's average salary (the term "salary" being equal to the amounts contained in the Salary column of the Summary Compensation Table) for the final three years of employment and the number of years of credited service under the Plan at the time of retirement. Normal retirement under this Plan is age 65. Plan benefits are subject to an offset for any Social Security benefits. Benefits under the Plan may be reduced under provisions of the Internal Revenue Code and by salary deferrals under Pepco's deferred compensation plans (but not the participant's pre-tax contributions made under the Retirement Savings Plan). If an executive's retirement benefits under the Plan are reduced by either or both of these limitations, Pepco will pay a supplemental retirement benefit to the eligible executive that is designed to maintain total retirement benefits at the formula level of the Plan. In addition, for executives who retire at age 59 or older, their retirement benefit will be calculated by adding the average of the highest three annual incentive awards in the last five consecutive years to their average salary over the final three years of their employment. The annual incentive amounts are equal to the amounts shown in the Bonus column of the Summary Compensation Table. The current age, years of credited service and compensation (assuming the individual had retired on January 1, 2006) used to determine retirement benefits (including supplemental benefits) for the officers named in the Summary Compensation Table who are participants in the Plan are as follows: Mr. Wraase, age 62, 37 years of credited service and $1,142,274 and Mr. Torgerson, age 61, 36 years of credited service and $688,682. Annual benefits at age 65 (including the effect of the Social Security offset) are illustrated in the table above.

Messrs. Shaw, Rigby and Spence participate in the Conectiv Retirement Plan and the Conectiv Supplemental Executive Retirement Plan. The Conectiv Retirement Plan is a cash balance pension plan, but also includes certain "grandfathered" rights under the Delmarva Retirement Plan, in which Messrs. Shaw and Spence participated, and under the Atlantic City Electric Retirement Plan, in which Mr. Rigby participated, that apply to employees who had attained either 20 years of service or age 50 on or before January 1, 1999. The Conectiv Supplemental Executive Retirement Plan provides supplemental retirement benefits to which the participating executives would be entitled in the absence of federal tax law limitations on the benefits payable under the Conectiv Retirement Plan.

Under the Conectiv Retirement Plan, a record-keeping account in a participant's name is credited with an amount equal to a percentage of the participant's total pay, including base pay, overtime and bonuses, depending on the participant's age at the end of the plan year. For Messrs. Shaw, Rigby and Spence, the percentage currently is 10%, 9% and 9%, respectively. These accounts also receive interest credits equal to prevailing U.S. Treasury Bill rates during the year. In addition, some of the annuity benefits earned by participants under the

former Delmarva Retirement Plan and Atlantic City Electric Retirement Plan are fully protected as of December 31, 1998, and were converted to an equivalent cash amount and included in each participant's initial cash balance account. Benefits generally become vested after five years of service. When a participant terminates employment, the amount credited to his or her account is converted into an annuity or paid in a lump sum. There is no Social Security offset under the Conectiv Retirement Plan. The estimated retirement benefits, including supplemental retirement benefits, payable to Messrs. Shaw, Rigby and Spence under the Conectiv Retirement Plan, calculated based on the cash balance formula and including the Delmarva Retirement Plan or Atlantic City Electric Retirement Plan credit, if the executive were to retire at normal retirement age of 65, expressed in the form of a lump sum payment, would be $7,238,000 for Mr. Shaw, $3,758,000 for Mr. Rigby and $2,067,000 for Mr. Spence.

Under the Conectiv Retirement Plan's grandfathering provisions, employees who participated in the Delmarva Retirement Plan or the Atlantic City Electric Retirement Plan and who met age and service requirements as of January 1, 1999, are assured a minimum retirement benefit calculated for all years of service up to the earlier of December 31, 2008, or retirement according to their original benefit formula under the applicable plan. There is no Social Security offset under either the Delmarva Retirement Plan or the Atlantic City Electric Retirement Plan. This benefit will be compared to the cash balance account and the employee will receive whichever is greater. The benefit is payable in the form of various annuity options or a lump sum. On December 31, 2008, the participant's grandfathered benefit under the Delmarva Retirement Plan or Atlantic City Electric Retirement Plan will be frozen, and all future benefit accruals will be under the cash balance formula of the Conectiv Retirement Plan.

Messrs. Shaw and Spence were participants in the Delmarva Retirement Plan. Their annual benefits under the Plan at age 65, as supplemented by the Conectiv Supplemental Executive Retirement Plan, are illustrated in the table below. Mr. Shaw's current years of credited service and earnings (assuming he had retired on January 1, 2006) used to determine retirement benefits (including supplemental benefits) are as follows: age 58, 34 years of credited service and $913,091. Mr. Spence's current years of credited service and earnings (assuming he had retired on January 1, 2006) used to determine retirement benefits (including supplemental benefits) are as follows: age 48, 18 years of credited service and $455,604. Earnings consist of base salary and bonus as shown in the Salary and Bonus columns of the Summary Compensation Table.

DELMARVA PENSION PLAN TABLE

Average Annual Earnings for the 5 Consecutive Years of Earnings that result in the Highest Average	Annual Retirement Benefits — Years in Plan					
	15	20	25	30	35	40
$300,000	$ 72,000	$ 96,000	$120,000	$144,000	$168,000	$192,000
$400,000	$ 96,000	$128,000	$160,000	$192,000	$224,000	$256,000
$500,000	$120,000	$160,000	$200,000	$240,000	$280,000	$320,000
$600,000	$144,000	$192,000	$240,000	$288,000	$336,000	$384,000
$700,000	$168,000	$224,000	$280,000	$336,000	$392,000	$448,000
$800,000	$192,000	$256,000	$320,000	$384,000	$448,000	$512,000
$900,000	$216,000	$288,000	$360,000	$432,000	$504,000	$576,000
$1,000,000	$240,000	$320,000	$400,000	$480,000	$560,000	$640,000
$1,100,000	$264,000	$352,000	$440,000	$528,000	$616,000	$704,000

Mr. Rigby was a participant in the Atlantic City Electric Retirement Plan. His annual benefits under the Plan at age 65, as supplemented by the Conectiv Supplemental Executive Retirement Plan, are illustrated in the table below. Mr. Rigby's current years of credited service and earnings (assuming he had retired on January 1, 2006) used to determine retirement benefits (including supplemental benefits) are as follows: age 49, 27 years of credited service and $469,786. Earnings consist of base salary and bonus as shown in the Salary and Bonus columns of the Summary Compensation Table.

ATLANTIC CITY ELECTRIC PENSION PLAN TABLE

Average Salary and Bonus of the Highest Five Consecutive Years of the Ten Years Preceding Retirement	Annual Retirement Benefits — Years in Plan					
	15	20	25	30	35	40
$200,000	$ 48,000	$ 64,000	$ 80,000	$ 96,000	$112,000	$128,000
$300,000	$ 72,000	$ 96,000	$120,000	$144,000	$168,000	$192,000
$400,000	$ 96,000	$128,000	$160,000	$192,000	$224,000	$256,000
$500,000	$120,000	$160,000	$200,000	$240,000	$280,000	$320,000
$600,000	$144,000	$192,000	$240,000	$288,000	$336,000	$384,000

EMPLOYMENT AGREEMENTS

Messrs. Wraase, Torgerson, Shaw, Rigby and Spence each have employment agreements with the Company. Mr. Wraase's and Mr. Torgerson's agreements each provide for employment through August 1, 2007, and automatically extend until April 1, 2009 for Mr. Wraase and June 1, 2009 for Mr. Torgerson, unless either the Company or the executive gives notice that it shall not be extended. Mr. Shaw's agreement provides for his employment through August 1, 2007. Messrs. Rigby's and Spence's agreements provide for their respective employment through August 1, 2005, and automatically extend for successive periods of three years thereafter, unless either the Company or the executive gives notice that it shall not be so extended. Each of the employment agreements provides that the executive (i) will receive an annual salary in an amount not less than his base salary in effect as of August 1, 2002, and incentive compensation as determined by the Board of Directors and (ii) will be entitled to participate in retirement plans, fringe benefit plans, supplemental benefit plans and other plans and programs, on the same basis as other senior executives of the Company.

Under each of the employment agreements, the executive is entitled to certain benefits if his employment is terminated prior to the expiration of the initial term of the agreement (or, if extended, the expiration of the extension period) either (i) by the Company other than for cause, death or disability or (ii) by the executive if his base salary is reduced, he is not in good faith considered for incentive awards, the Company fails to provide him with retirement benefits and other benefits provided to similarly situated executives, he is required to relocate by more than 50 miles from Washington, D.C. (or, in the case of Mr. Shaw, he is required to relocate by more than 50 miles from Wilmington, Delaware, except that he may be required to locate to the Washington, D.C. area), or he is demoted from a senior management position. These benefits include: (i) a lump sum payment in cash equal to three times (a) the sum of the executive's highest annual base salary rate in effect during the three-year period preceding termination and (b) the higher of (1) the annual target bonus for the year in which the termination of employment occurs or (2) the highest annual bonus received by the executive in any of the three preceding calendar years and (ii) the executive's annual bonus for the year preceding termination of employment, if not yet paid, and a pro rata portion of the executive's annual bonus for the year in which the executive's employment terminates. In addition, any outstanding shares of restricted stock will become immediately vested, and the executive will be entitled to receive unpaid salary through the date of termination and certain supplemental retirement benefits under existing plans of the Company. Each of the agreements also provides that the executive is entitled to receive a gross-up payment equal to the amount of any federal excise taxes imposed upon compensation payable upon termination of employment and the additional taxes that result from such payment. In addition, under his employment agreement, Mr. Shaw on each of August 1, 2003, 2004 and 2005 was credited with one additional year of service and deemed one year older than his actual age for purposes of determining his benefits under the Conectiv Supplemental Executive Retirement Plan.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Pauline Schneider, a director of the Company, is a partner in the law firm of Hunton & Williams. Hunton & Williams rendered legal services to subsidiaries of the Company in 2005 and is expected to render services to the Company's subsidiaries in 2006.

REPORT OF THE COMPENSATION/HUMAN RESOURCES COMMITTEE ON EXECUTIVE COMPENSATION

The Compensation/Human Resources Committee of the Board of Directors (the "Committee") is composed entirely of independent directors. The Committee, together with the other independent members of the Board of Directors, sets the CEO's compensation level after taking into account the annual evaluation of the CEO's performance conducted by the Corporate Governance/Nominating Committee and such other factors as the Committee deems appropriate. The Committee's responsibilities include review of the performance of elected officers and other executives in the context of the administration of the Company's executive compensation programs. The Committee also approves the salaries for the executive officers and the heads of the major subsidiaries, as well as the salaries of the Vice Presidents of the Company. The Committee establishes performance guidelines under the Executive Incentive Compensation Plan, sets awards for the executive officers and the heads of the major subsidiaries pursuant to the Executive Incentive Compensation Plan, approves payments to the Vice Presidents made pursuant to the Executive Incentive Compensation Plan and establishes the structure of compensation and amounts of awards under the shareholder-approved Long-Term Incentive Plan. The Committee also reviews other elements of compensation and benefits and makes recommendations to the Board as appropriate. In order to carry out these responsibilities the Committee employs its own independent compensation consultant and receives input from the Chief Executive Officer and management, as it deems appropriate.

Officer Compensation Philosophy

The objective of the Company's executive compensation program is to attract and retain key executives with a program that compensates executive officers competitively with other companies in the industry and rewards executives for achieving levels of operational excellence and financial results, which increase shareholder value. In this way, the program provides a strong and direct link between compensation and executive performance and short- and long-term Company performance. To be competitive, the Company's compensation policy is to provide a total compensation opportunity comparable to the median compensation levels of energy utility companies of a similar size.

The compensation program for executives consists of three components: (i) base salary, (ii) annual cash incentive awards under Executive Incentive Compensation Plan and (iii) long-term incentive awards under the Long-Term Incentive Plan. The combination of these three elements is intended to balance short- and long-term business performance goals and align executive financial rewards with Company operating results and shareholder return. Total compensation for any specific year may be above the median in the event performance exceeds goals, or below the median if performance falls short of goals.

Annual incentive awards are earned based on the Company's financial and operational plans and results, including annual earnings. For 2005, long-term incentive awards were in the form of performance restricted shares of Common Stock ("Restricted Stock") that will be earned at the end of a three-year performance period to the extent pre-established goals relating to total shareholder returns are met. The executive compensation program for 2005 was structured so that between 33 and 65% of the total compensation opportunity, depending on the responsibility level of the executive, was in the form of performance incentive compensation.

In order to further align the interests of executives with those of the shareholders, the Company adopted stock ownership requirements for executives effective January 1, 2005. Ownership requirements are expressed as a multiple of salary. Officers are given until December 31, 2010, or five years after their election, whichever is

later, to attain the ownership guidelines. The following table is the amount of Common Stock required to be owned by the Company's officers, expressed as a multiple of salary.

Chief Executive Officer	5 times salary
Executive Vice President, Vice Chairman	3 times salary
Senior Vice President	2 times salary
Vice President	1 times salary

Under Section 162(m) of the Internal Revenue Code, a public company is prohibited from deducting for federal income tax purposes compensation in excess of $1 million paid to any of the company's five highest paid executive officers, except if the compensation in excess of $1 million qualifies for an exemption, such as the "performance-based compensation" exemption. The Company's Long-Term Incentive Plan has been designed to allow the Committee to grant options and performance Restricted Stock that will qualify as performance-based compensation. However, the Committee and the Board of Directors retain the discretion under the Long-Term Incentive Plan to design compensation arrangements that do not qualify as "performance-based compensation" within the meaning of Section 162(m) if either determines that such compensation arrangements are in the best interests of the Company. The Restricted Stock awarded in January 2006 which vests solely on the basis of continued employment, rather than performance, will not qualify as performance-based compensation in the year in which it vests. Cash awards under the Company's Executive Incentive Compensation Plan also do not qualify as "performance-based compensation" within the meaning of Section 162(m).

Executive Compensation Plan Review

In 2005, the Committee retained the services of an independent compensation consultant to review all of the Company's compensation plans and make recommendations for plan changes, where appropriate. The review covered base salary and total cash compensation levels, short-term and long-term incentive programs design, employment/severance agreements, retirement benefit plans, deferred compensation plans, and perquisites. Based on the review of its consultant's data, the Committee has taken the following actions commencing in 2006 to further align the interests of the Company's executives and senior management with investors' long-term interests:

- **Modified Peer Group**. The Committee's first step in studying appropriate compensation levels was to ensure that the Committee was comparing the Company's compensation to the appropriate peer group. Commencing in 2006, the Committee modified the Company's peer group with the following results:

	New Peer Group	Old Peer Group
• Expanded peer group	24 companies	20 companies
• Refined the composition of the group to be closer in size to the Company		
• Total assets[1]	$11,226,000,000	$3,457,000,000
• Market capitalization[1]	$ 4,321,000,000	$1,828,000,000
• Reduced the number of gas-only utility companies	1	7

- **Salary Structure.** For 2005, pay levels were determined for executives and senior management based on a review of external market movement in combination with internal equity and performance. For the purpose of setting salaries in 2006 and succeeding years, the Committee's consultants conducted a competitive review of base salaries and total cash compensation for executives and senior management. Based on that review, the Committee established an executive and senior management pay structure to provide consistency in pay across the Company. The pay structure consists of salary grades, which provide a market competitive range of pay for each position. Each executive and member of senior management is placed into the appropriate grade based on market data with consideration given to

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[1] For the year ended 2004, the year used for establishing the peer group, the Company's asset size was $13,349,000,000 and market capitalization was $4,408,000,000.

internal equity. Each pay grade has an associated target short-term and long-term incentive opportunity, expressed as a percent of base salary. These target opportunity levels are also based on competitive market data for the associated salary level. For 2006, the executive and senior management compensation program is structured so between 33 and 75% of total compensation, depending on the responsibility of the executive or member of senior management, is in the form of performance incentive compensation.

- **Annual Incentive Plan.** The Committee did not make any design changes to the Company's Executive Incentive Compensation Plan. The Committee's consultants determined that the plan was in line with industry and best practices in that it includes both financial and operational metrics and is largely quantitative with some qualitative assessment of performance.
- **Long-term Incentive Shift.** In 2005, long-term incentive compensation program awards were in the form of performance Restricted Stock. The performance measure for determining long-term incentive compensation payout was relative total shareholder return. For 2006, the Committee will continue to use performance Restricted Stock but has added time-based vesting of Restricted Stock as another component to aid in executive and senior management retention. Also for 2006, the Committee is changing the performance criteria to earnings growth and free cash flow. The Committee and management believe that these performance criteria are the financial indicators that are most closely tied to stock price and shareholder value. The program is designed so that 67% of the long-term award potential is in performance Restricted Stock and 33% is in the form of time-based Restricted Stock. The performance Restricted Stock vests upon achievement of three-year performance goals and the time-based Restricted Stock vests if the executive remains employed for the full three years. Depending on the extent to which the pre-established performance criteria are satisfied, the participant can earn from 0 to 200% of the target award of performance Restricted Stock. Performance will be determined by measuring average annual performance over the three-year performance period.
- **Benefits and Perquisites.** The Committee's consultants reviewed the Company's current perquisite policies and levels and determined they are conservative as compared to market best practices. Welfare benefits offered to executives and senior management were the same as those offered to the general employee population. In addition, executives received perquisites related to the provision of an automobile for use by the executive or an annual automobile allowance, financial planning and income tax preparation. No changes were made to these policies for 2006.
- **Tally Sheets.** In an effort to understand the total cost of the Company's executive and senior management compensation and benefits programs, the Committee reviewed tally sheets for all of the Company's executives and senior management. Tally sheets provide a snapshot of all elements of remuneration including base salary, annual and long-term incentive opportunity, benefits and perquisites. The tally sheets also outlined the cost to the Company when an executive terminates voluntarily, involuntarily, or as a result of a change in control.
- **Change in Control.** The Committee believes the best time to consider the appropriateness of change of control provisions is when a change of control is not imminent and before the absence of such a plan poses a risk to corporate policy effectiveness. As a result, the Committee considered each cost element of a change in control plan as a percent of market capitalization and found it to be reasonable and consistent with market practice, while still providing fair and adequate protection to executives and senior management. The Committee recognizes the importance of reducing the risk that the fear of job loss will influence executives and members of senior management considering strategic opportunities that may include a change of control of the Company, and avoiding distractions that may result from potential, rumored or actual changes of control. Accordingly, the Committee adopted a Change-in-Control Severance Plan for Certain Executive Officers. Severance benefits are only paid if a change of control occurs and an executive is terminated without cause or by the participant for good reason. Each of the Named Executive Officers has an individual employment agreement with the Company which addresses their respective severance benefits, and, accordingly, is not a participant in the Change-in-Control Severance Plan for Certain Executive Officers.

Modifications were also made to executive retirement benefit plans and deferred compensation plans to bring them into compliance with the provisions of Internal Revenue Code Section 409A.

Factors Considered in Making Compensation Decisions

The CEO makes recommendations for compensation actions for his direct reports, which the Committee individually reviews, discusses, adjusts in its judgment and approves. The Committee also reviews the compensation decisions for senior management who report to the CEO's direct reports. The Committee judgments regarding executive compensation are primarily based on the Committee's assessment of each executive's performance and potential to enhance long-term stockholder value. Key factors affecting the Committee's judgment include: the nature and scope of the executive's responsibilities; the executive's contribution to the Company's financial and operating results; and the executive's effectiveness in leading the Company's initiatives to increase customer satisfaction and shareholder value.

Salary—In setting each executive's 2006 salary, the Committee used input from the Committee's consultant along with management recommendations for individual adjustments. The consultant used published survey sources as well as a review of proxy statements from the new peer group of companies in the energy utility industry. Consistently effective individual performance is a threshold requirement for any salary increase. The CEO recommended base salary adjustments for certain executives using industry market movements as a guideline while also considering the relationship of current pay to market data, performance and internal equity. Following a review and discussion, the Committee approved base salary adjustments for the executives taking into account the recommendations of the CEO. The Committee also developed a recommendation for the 2006 pay increase of the CEO for consideration by the independent members of the Board of Directors for approval.

Short-Term Incentives—For 2005, performance goals established for annual cash bonus awards to the members of the Company's senior management, including the President and Chief Executive Officer, under the Executive Incentive Compensation Plan were based on (1) earnings relative to the corporate plan, (2) cash available for debt reduction, (3) electric system reliability, (4) diversity and (5) safety. For 2005, a target bonus level of 60% of base salary was set for the CEO. For 2005, results related to the performance criteria were as follows: (1) earnings were significantly above target, (2) cash for debt reduction significantly exceeded target, (3) electric system reliability was above target, (4) diversity was at target and (5) safety was below target. Each component was assigned a weighting prior to the performance period. Based on the overall results, the corporate performance was set at 121.6% of target. Corporate performance is used to determine the award level for the CEO.

Long-Term Incentives—Under the Long-Term Incentive Plan, the Committee has instituted a series of Performance Restricted Stock Programs under which executives of the Company have the opportunity to earn Restricted Stock awards based on the extent to which pre-established performance criteria are achieved over generally a three-year performance period. In 2006, the Committee adopted a performance program with a three-year performance period that ends in 2008. The target awards that can be earned by the CEO were established using competitive compensation levels for CEOs consistent with the goal of maintaining compensation at the median level of utility companies of similar size.

In connection with the merger of Pepco and Conectiv, the Committee implemented, effective August 1, 2002, a retention and performance plan entitled Merger Integration Success Program, adopted under the Long-Term Incentive Plan. The Merger Integration Success Program had two components: (1) Restricted Stock grants vesting over three years (20% in 2003, 30% in 2004, and 50% in 2005), provided the executive remained an employee of the Company, and (2) performance Restricted Stock, which was to vest in two equal installments depending on the extent to which operating efficiencies and expense reduction goals were attained through December 31, 2003 and December 31, 2004, respectively. Although these goals were met in 2003, the Committee determined that the shares which would have vested in 2003 would not vest until 2005, and then only if the cost reduction goals were maintained and the Company's financial performance was satisfactory.

For 2005, the cost reduction goals were exceeded and the Company's financial performance had improved as measured by earnings growth, debt reduction and improved credit statistics and the shares vested. The CEO was awarded 9,421 shares of Common Stock.

In 2002, the Pepco Board of Directors granted executives the opportunity to earn awards of Restricted Stock based on the Company's total shareholder return as compared to 20 peer utility companies over a three-year performance period beginning in 2003 and ending in 2005. For the three-year period, total shareholder return was below the threshold level of performance of the plan and accordingly no shares were earned.

Compensation of the Chief Executive Officer

In 2005, the Committee increased Mr. Wraase's salary from $769,000 to $825,000. The amount of the salary increase was set to position Mr. Wraase at a level comparable to the CEOs of the utility company peer group then in effect, with consideration given to the CEO's performance evaluation conducted by the Corporate Governance/Nominating Committee. In making its evaluation, the Corporate Governance/Nominating Committee considered the successes in debt reduction, the Common Stock offering, succession planning and management development, diversity efforts, safety record, emergency response capability, business unit integration, Sarbanes-Oxley compliance, strategic plan implementation, and the overall progress in improving shareholder return.

During 2005, the Committee's consultant reviewed the group of companies used to make executive pay decisions and recommended changes to better align the size and business of peer companies with the Company (see "Executive Compensation Plan Review — Modified Peer Group"). The CEO's compensation was found to be below the 50th percentile of the new peer group and below the 25th percentile of a survey of utility company CEOs, size-adjusted to the Company's fiscal year-end 2004 revenues. In 2005, the Corporate Governance/Nominating Committee's evaluation of the CEO considered the Company's performance in debt reduction, reliability improvements, strategic planning and third-party recognition of the Company's diversity practices. The Corporate Governance/Nominating Committee also recognized the continued success in succession planning and the successful return to the traditional brand names of the Company's utilities. The Corporate Governance/Nominating Committee's 2005 evaluation of CEO performance indicated to the Committee that the CEO should be compensated more closely with the market median. Accordingly, the Committee began to address this shortfall in 2006 through increases in base salary and short- and long-term incentive opportunity. Effective in 2006, a salary of $950,000, a target short-term incentive of 100% of salary, and a target long-term incentive of 200% of salary have been set for Mr. Wraase. Consistent with the other executives, two-thirds of the long-term incentive will be in the form of performance Restricted Stock and one-third will be in the form of Restricted Stock.

In addition to reviewing market data, the Committee also considered the relationship between Mr. Wraase's pay and that of the other Company executives. The Committee believes the relative differences are appropriate. The Committee and the independent members of the Board of Directors have had discussions and made decisions relative to Mr. Wraase's compensation in executive session, without the CEO present.

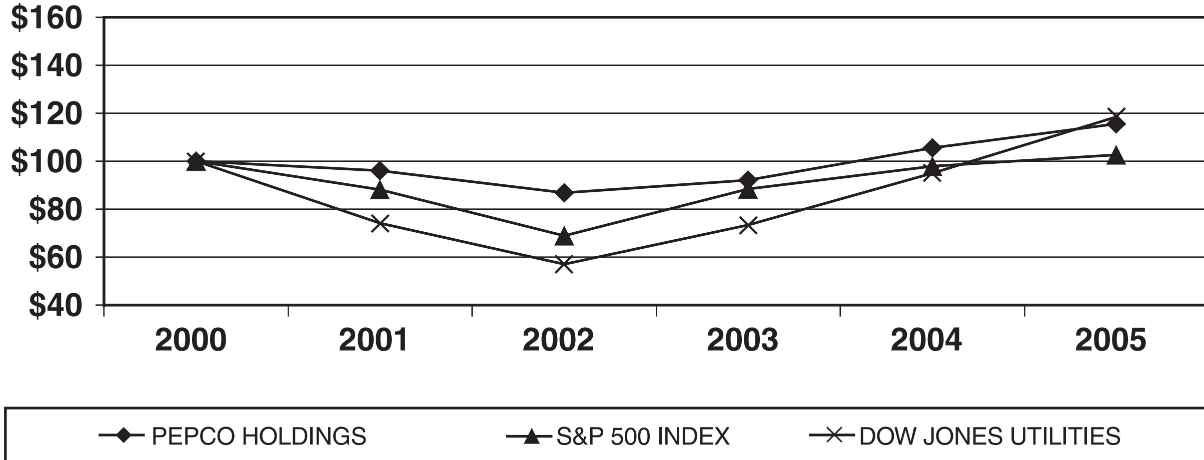
In summary, a substantial portion of Mr. Wraase's potential compensation for 2005 and 2006 is incentive based with the achievement of specific performance results required to earn awards. As a result, the Committee believes his total compensation package meets the Committee's compensation objectives, is in line with the Committee's compensation philosophy, and supports the Company's business strategy.

COMPENSATION/HUMAN RESOURCES COMMITTEE

Richard B. McGlynn, Chairman
George F. MacCormack
Floretta D. McKenzie
Peter F. O'Malley
Frank K. Ross

FIVE-YEAR PERFORMANCE GRAPH 2001-2005

The following chart compares the Company's five-year cumulative total return to shareholders 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.



	Cumulative Total Return					
	2000	2001	2002	2003	2004	2005
Pepco Holdings	$100.00	$96.20	$86.66	$92.21	$105.75	$115.95
S&P 500 Index	$100.00	$88.17	$68.73	$88.41	$ 97.99	$102.80
Dow Jones Utilities	$100.00	$73.87	$56.64	$73.11	$ 95.08	$118.81

AUDIT COMMITTEE REPORT

Among its duties, the Audit Committee is responsible for recommending to the Board of Directors that the Company's financial statements be included in the Company's Annual Report on Form 10-K. The Committee took a number of steps as a basis for making this recommendation for 2005. First, the Audit Committee discussed with PricewaterhouseCoopers LLP, the Company's independent registered public accounting firm for 2005, those matters that PricewaterhouseCoopers LLP is required to communicate to and discuss with the Audit Committee under Statement on Auditing Standards No. 61, as amended (Communication with Audit Committees), which included information regarding the scope and results of the audit. These communications and discussions are intended to assist the Audit Committee in overseeing the financial reporting and disclosure process. Second, the Audit Committee discussed with PricewaterhouseCoopers LLP the firm's independence and received from PricewaterhouseCoopers LLP a letter concerning independence as required by Independent Standards Board No. 1 (Independence Discussions with Audit Committees). This discussion and disclosure informed the Audit Committee of PricewaterhouseCoopers LLP's relationships with the Company and was designed to assist the Audit Committee in considering PricewaterhouseCoopers LLP's independence. Finally, the Audit Committee reviewed and discussed, with the Company's management and with PricewaterhouseCoopers LLP, the Company's audited consolidated balance sheets at December 31, 2005 and 2004, and the Company's consolidated statements of earnings, comprehensive earnings, shareholders' equity and cash flows for the three years ended December 31, 2005, including the notes thereto. Management is responsible for the consolidated financial statements and reporting process, including the system of internal controls and disclosure controls. The independent registered public accounting firm is responsible for expressing an opinion on the conformity of these consolidated financial statements with accounting principles generally accepted in the United States. Based on the discussions with management and PricewaterhouseCoopers LLP concerning the audit, the independence discussions, and the financial statement review and discussions, and such other matters deemed relevant and appropriate by the Audit Committee, the Audit Committee recommended to the Board that these consolidated financial statements be included in the Company's 2005 Annual Report on Form 10-K.

The Audit Committee, in accordance with its charter, conducts an annual evaluation of the performance of its duties. Based on this evaluation, the Committee concluded that it performed effectively in 2005.

AUDIT COMMITTEE

Lawrence C. Nussdorf, Chairman
Terence C. Golden
Richard B. McGlynn
Frank K. Ross

2. RATIFICATION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Audit Committee of the Board of Directors of the Company appointed PricewaterhouseCoopers LLP as independent registered public accounting firm for the Company for the year 2005. The Audit Committee has reappointed the firm for 2006. A representative of PricewaterhouseCoopers LLP is expected to attend the Annual Meeting and will be given the opportunity to make a statement and to respond to appropriate questions.

Although the Company is not required to seek shareholder ratification of this appointment, the Board believes it to be sound corporate governance to do so. If the appointment is not ratified, the Audit Committee will take this fact into consideration when selecting the Company’s independent registered public accounting firm for 2007. Even if the selection is ratified, the Audit Committee may in its discretion direct the appointment of a different independent registered public accounting firm at any time during the year if the Committee determines that a change would be in the best interests of the Company and its shareholders.

Audit Fees

The aggregate fees billed by PricewaterhouseCoopers LLP for professional services rendered for the audit of the Company’s and subsidiaries’ annual financial statements for the 2005 and 2004 fiscal years and the reviews of the financial statements included in the Company’s and subsidiary reporting companies’ 2005 and 2004 Forms 10-Q were $5,354,083 and $6,801,420, respectively. The amount for 2004 includes $543,328 for the 2004 audit that was billed after the 2005 Pepco Holdings proxy statement was filed.

Audit-Related Fees

The aggregate fees billed by PricewaterhouseCoopers LLP for audit-related services rendered for the 2005 and 2004 fiscal years were $170,053 and $586,088, respectively. These services consist of employee benefit plan audits, accounting consultations, internal control reviews, computer systems post-implementation reviews, and attest services for financial reporting not required by statute or regulation.

Tax Fees

The aggregate fees billed by PricewaterhouseCoopers LLP for tax services rendered for the 2005 and 2004 fiscal years were $8,400 and $261,680, respectively. These services consisted of tax compliance, tax advice and tax planning, including advice relating to tax accounting in connection with the 2000, 2001 and 2002 Conectiv tax returns and the 2002 Conectiv Services, Inc. tax return.

All Other Fees

The aggregate fees billed by PricewaterhouseCoopers LLP for all other services other than those covered under “Audit Fees,” “Audit-Related Fees” and “Tax Fees” for the 2005 and 2004 fiscal years were $3,000 and $55,600, respectively. Of the amount for 2005, $1,500 was for a research service subscription renewal for PHI Service Company, and $1,500 was for a research service subscription renewal for Pepco Energy Services, Inc. Of the amount for 2004, $33,300 was for the executive tax services program, $19,300 was for depositions provided in litigation related to the Chalk Point oil spill, $1,500 was for a research service subscription renewal for PHI Service Company and $1,500 was for a research service subscription renewal for Pepco Energy Services, Inc.

All of the services described in “Audit Fees,” “Audit-Related Fees,” “Tax Fees” and “All Other Fees” were approved in advance by the Audit Committee, in accordance with the Audit Committee Policy on the Approval of Services by the Independent Auditor which is attached to this Proxy Statement as Annex A.

What vote is required to ratify the selection of the independent registered public accounting firm?

Ratification of the appointment of the independent registered public accounting firm requires the affirmative vote of the holders of a majority of the Common Stock present and entitled to vote at a meeting of shareholders at which a quorum is present.

How are the votes counted?

Shares, if any, which are the subject of an abstention with regard to the vote on this proposal, will be considered present and entitled to vote, and accordingly will have the same effect as a vote against the proposal. Any shares that are the subject of a "broker non-vote" will not be considered present and entitled to vote and, therefore, will not be included in the denominator when determining whether the requisite percentage of shares has been voted in favor of this matter.

THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE IN FAVOR OF RATIFICATION OF THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM, WHICH IS SET FORTH AS ITEM 2 ON THE PROXY CARD.

SHAREHOLDER PROPOSALS AND DIRECTOR NOMINATIONS

What is the deadline for submission of shareholder proposals for inclusion in the Company's Proxy Statement for the 2007 Annual Meeting?

In order to be considered for inclusion in the Proxy Statement for the 2007 Annual Meeting, shareholder proposals must be received by the Company on or before November 29, 2006.

May a shareholder introduce a resolution for a vote at a future annual meeting?

Under the Company's Bylaws, a shareholder may introduce a resolution for consideration at a future Annual Meeting if the shareholder complies with the advance notice provisions set forth in the Bylaws. These provisions require that for a shareholder to properly bring business before an Annual Meeting, the shareholder must give written notice to the Company's Secretary at 701 Ninth Street, N.W., Washington, D.C. 20068, not less than 100 days nor more than 120 days prior to the date of the meeting (or if the date of the meeting is more than 30 days before or after the anniversary date of the Annual Meeting in the prior year, then the written notice must be received no later than the close of business on the tenth day following the earlier of the date on which notice or public announcement of the date of the meeting was given or made by the Company). The shareholder's notice must set forth a description of the business desired to be brought before the meeting and the reasons for conducting the business at the Annual Meeting, the name and record address of the shareholder, the class and number of shares owned beneficially and of record by the shareholder, and any material interest of the shareholder in the proposed business. The Company will publicly announce the date of its 2007 Annual Meeting at a later date.

May a shareholder nominate or recommend an individual for election as a director of the Company?

Under the Company's Bylaws, a shareholder may nominate an individual for election as a director at a future Annual Meeting by giving written notice of the shareholder's intention to the Company's Secretary at 701 Ninth Street, N.W., Washington, D.C. 20068, not less than 100 days nor more than 120 days prior to the date of the meeting (or if the date of the meeting is more than 30 days before or after the anniversary date of the Annual Meeting in the prior year, then the written notice must be received no later than the close of business on the tenth day following the earlier of the date on which notice or public announcement of the date of the meeting was given or made by the Company). The notice provided to the Secretary must set forth the name and record address of the nominating shareholder and the class and number of shares of capital stock of the Company beneficially owned by such shareholder; and, for each nominee, the nominee's name, age, business address, residence address, principal occupation or employment, the class and number of shares of the Company's capital stock beneficially owned by the nominee, and any other information concerning the nominee that would be required to be included in a proxy statement. The Company will publicly announce the date of its 2007 Annual Meeting at a later date.

A shareholder also may recommend for the consideration of the Corporate Governance/Nominating Committee one or more candidates to serve as a nominee of the Company for election as a director. Any such recommendations for the 2007 Annual Meeting must be submitted in writing to the Secretary of the Company on or before November 29, 2006, accompanied by the information described in the preceding paragraph.

What principles has the Board adopted with respect to Board membership? What are the specific qualities or skills that the Corporate Governance/Nominating Committee has determined are necessary for one or more of the directors to possess?

The Board has approved the following principles with respect to Board membership. The Board should include an appropriate blend of independent and management directors, which should result in independent directors being predominant, and in the views of the Company's management being effectively represented. Accordingly, the number of independent directors should never be less than seven and the management directors should always include the Chief Executive Officer, there should never be more than three management directors, and any management directors other than the Chief Executive Officer should be selected from the Company's Executive Leadership Team.

For independent directors, the Corporate Governance/Nominating Committee seeks the appropriate balance of experience, skills and personal characteristics required of a director. In order to be considered for nomination to the Board, a director candidate should possess most or all of the following attributes: independence, as defined by the NYSE listing standards as currently in effect; integrity; judgment; credibility; collegiality; professional achievement; constructiveness; and public awareness. The independent directors should possess, in aggregate, skill sets that include but are not limited to: financial acumen equivalent to the level of a Chief Financial Officer or senior executive of a capital market, investment or financial services firm; operational or strategic acumen germane to the energy industry, or other industry with similar characteristics (construction, manufacturing, etc.); public and/or government affairs acumen germane to complex enterprises, especially in regulated industries; customer service acumen germane to a service organization with a large customer base; legal acumen in the field(s) of regulatory or commercial law at the partner or chief legal officer level; salient community ties in areas of operation of the Company's enterprises; and corporate governance acumen, gained through service as a senior officer or director of a large publicly held corporation or through comparable academic or other experience. Independent directors are also selected to ensure diversity, in the aggregate, which diversity should include expertise or experience germane to the Company's total business needs, in addition to other generally understood aspects of diversity.

What is the process for identifying and evaluating nominees for director (including nominees recommended by security holders)?

The Corporate Governance/Nominating Committee has developed the following identification and evaluation process which is contained in the Company's Corporate Governance Guidelines and can be found on the Company's Web site (www.pepcoholdings.com) under the link: Corporate Governance:

a. List of Potential Candidates. The Corporate Governance/Nominating Committee develops and maintains a list of potential candidates for Board membership. Potential candidates are recommended by Committee members and other Board members. Shareholders may put forward potential candidates for the Committee's consideration by following submission requirements published in the Company's proxy statement for the previous year's meeting.

b. Candidate Attributes, Skill Sets and Other Criteria. The Committee annually reviews the attributes, skill sets and other qualifications for potential candidates and may modify them from time to time based upon the Committee's assessment of the needs of the Board and the skill sets required to meet those needs.

c. Review of Candidates. All potential candidates are reviewed by the Committee against the current attributes, skill sets and other qualifications established by the Board to determine if a candidate is suitable for Board membership. If a candidate is deemed suitable based on this review, a more detailed review will be performed through examination of publicly available information. This examination will include consideration of the independence requirement for outside directors, the number of boards on which the candidate serves, the possible applicability of restrictions on director interlocks or other requirements or prohibitions imposed by applicable laws or regulations, proxy disclosure requirements, and any actual or potentially perceived conflicts of interest or other issues raised by applicable laws or regulations or the Company's policies or practices.

d. Prioritization of Candidates. The Committee then (i) determines whether any candidate needs to be removed from consideration as a result of the detailed review, and (ii) determines a recommended priority among the remaining candidates for recommendation to and final determination by the Board prior to direct discussion with any candidate.

e. Candidate Contact. Following the Board's determination of a priority-ranked list of approved potential candidates, the Chairman of the Committee or, at his or her discretion, other member(s) of the Board will contact and interview the potential candidates in priority order. When a potential candidate indicates his or her willingness to accept nomination to the Board, no further candidates will be contacted. Subject to a final review of eligibility under the Company's policies and applicable laws and regulations using information supplied directly by the candidate, the candidate will then be nominated.

3. OTHER MATTERS WHICH MAY COME BEFORE THE MEETING

Does the Board of Directors know of any additional matters to be acted upon at the Annual Meeting?

The Board of Directors does not know of any other matter to be brought before the meeting.

If another matter does come before the meeting, how will my proxy be voted?

If any other matter should properly come before the meeting, your signed proxy card, as well as your Internet or telephone proxy, gives the designated proxy holders discretionary authority to vote on such matters in accordance with their best judgment.

How are proxies being solicited and who pays for the costs involved?

The Company will bear the costs of solicitation of proxies, including the reimbursement of banks and brokers for certain costs incurred in forwarding proxy materials to beneficial owners. In addition to the use of the mails, officers, directors and regular employees of the Company may solicit proxies personally, by telephone or facsimile or via the Internet. These individuals will not receive any additional compensation for these activities.

Why was only a single Proxy Statement mailed to households that have multiple holders of Common Stock?

Under the rules of the SEC, a company is permitted to deliver a single proxy statement and annual report to any household at which two or more shareholders reside, if the shareholders at the address of the household have the same last name or the company reasonably believes that the shareholders are members of the same family. Accordingly, the Company is sending only one copy of this Proxy Statement and 2005 Annual Report to Shareholders that shared the same last name and address, unless the Company has received instructions to the contrary from one or more of the shareholders.

Under these SEC rules, brokers and banks that hold stock for the account of their customers also are permitted to deliver single copies of proxy statements and annual reports to two or more shareholders that share the same address. If you and other residents at your mailing address own shares of Common Stock through a broker or bank, you may have received a notice notifying you that your household will be sent only one copy of proxy statements and annual reports. If you did not notify your broker or bank of your objection, you may have been deemed to have consented to the arrangement.

If, in accordance with these rules, your household received only a single copy of this Proxy Statement and 2005 Annual Report to Shareholders and you would like to receive a separate copy or you would like to receive separate copies of the Company's proxy statements and annual reports in the future, please contact American Stock Transfer & Trust Company, the Company's transfer agent:

By Telephone:	1-866-254-6502 (toll-free)
In Writing:	American Stock Transfer & Trust Company 6201 15th Avenue Brooklyn, NY 11219-9821

If you own your shares through a brokerage firm or a bank, your notification should include the name of your brokerage firm or bank and your account number.

If you are a record holder of shares of Common Stock who is receiving multiple copies of the Company's shareholder communications at your address and you would like to receive only one copy for your household, please contact American Stock Transfer & Trust Company at the telephone number or address set forth above. If you own your shares through a brokerage firm or a bank, please contact your broker or bank.

Where do I find the Company's Corporate Business Policies, Corporate Governance Guidelines and Committee Charters?

The Company has in place Corporate Business Policies, which in their totality constitute its code of business conduct and ethics. These Policies apply to all directors, employees and others working at the Company and its subsidiaries. The Company's Board of Directors has also adopted Corporate Governance Guidelines and charters for the Company's Audit Committee, Compensation/Human Resources Committee and Corporate Governance/ Nominating Committee which conform to the requirements set forth in the New York Stock Exchange listing standards. The Board of Directors has also adopted charters for the Company's Executive Committee and Finance Committee. Copies of these documents are available on the Company Web site at http://www.pepcoholdings.com/ governance/index.html and also can be obtained by writing to: Ellen Sheriff Rogers, Vice President and Secretary, 701 Ninth Street, N.W., Suite 1300, Washington, D.C. 20068.

Any amendment to, or waiver of, any provision of the Corporate Business Policies with respect to any director or executive officer of the Company will be promptly reported to shareholders through the filing of a Form 8-K with the SEC.

The Letter to Shareholders which begins on the cover page of this document and the Annual Report to Shareholders, including the Business of the Company, Management's Discussion and Analysis and the Consolidated Financial Statements, and other shareholder information included in Annex B to this Proxy Statement are not deemed to be "soliciting material" or to be "filed" with the SEC under or pursuant to the Securities Act of 1933 or the Exchange Act of 1934 and shall not be incorporated by reference or deemed to be incorporated by reference into any filing by the Company under either such Act, unless otherwise specifically provided for in such filing.

ANNEX A

PEPCO HOLDINGS, INC.
AUDIT COMMITTEE

Policy on the Approval of Services
Provided By the Independent Auditor

I. Overview

Under the federal securities laws and the rules of the Securities and Exchange Commission (the "SEC"), the annual consolidated financial statements of Pepco Holdings, Inc. (the "Company") and each of its subsidiaries that has a reporting obligation (a "Reporting Company") under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), must be audited by an "independent" public accountant. Likewise, the quarterly financial statements of the Company and each Reporting Company must be reviewed by an "independent" public accountant.

Under SEC regulations, a public accountant is not "independent" if it provides certain specified non-audit services to an audit client. In addition, a public accountant will not qualify as "independent" unless (i) before the accountant is engaged to provide audit or non-audit services, the engagement is approved by the public company's audit committee or (ii) the engagement to provide audit or non-audit services is pursuant to pre-approved policies and procedures established by the audit committee.

Under the Audit Committee Charter, the Audit Committee of the Company has sole authority (i) to retain and terminate the Company's independent auditors, (ii) to pre-approve all audit engagement fees and terms and (iii) to pre-approve all significant audit-related relationships with the independent auditor. This Policy sets forth the policies and procedures adopted by the Audit Committee with respect to the engagement of the Company's independent auditor to provide audit and non-audit services to the Company and its subsidiaries (as defined by Rule 1-02 (x) of SEC Regulation S-X).

The Audit Committee also serves as the audit committee for each subsidiary of the Company that is a Reporting Company for the purpose of approving audit and non-audit services to be provided by the independent auditor(s) of such Reporting Companies. In this capacity, the Audit Committee has determined that this Policy also shall govern the engagement of the independent auditor for each such Reporting Company.

II. Statement of Principles

The Audit Committee recognizes the importance of maintaining the independence of its external auditor both in fact and appearance. In order to ensure that the independence of the Company's external auditor is not, in the judgment of the Audit Committee, impaired by any other services that the external auditor may provide to the Company and its subsidiaries:

- The Audit Committee shall approve in advance all services—both audit and permitted non-audit services—provided to the Company or any of its subsidiaries by the Company's independent auditor in accordance with the procedures set forth in this Policy.
- The Audit Committee shall not engage the Company's independent auditor to provide to the Company or any of its subsidiaries any non-audit services that are unlawful under Section 10A of the Exchange Act or that would impair the independence of the Company's independent auditor under the standards set forth in Rule 2-01 of SEC Regulation S-X ("Prohibited Non-Audit Services").

III. Approval of Annual Audit Services

The annual audit services provided to the Company and its subsidiaries by the Company's independent auditor shall consist of:

- The audit of the annual consolidated financial statements of the Company and each other Reporting Company and the other procedures required to be performed by the independent auditor to be able to form an opinion on the financial statements.
- Review of the quarterly consolidated financial statements of the Company and each Reporting Company.
- The attestation engagement for the independent auditor's report on management's statement on the effectiveness of the Company's internal control over financial reports.
- Services associated with SEC registration statements, periodic reports and other documents filed with the SEC or issued in connection with securities offerings, including consents and comfort letters provided to underwriters, reviews of registration statements and prospectuses, and assistance in responding to SEC comment letters.

All such audit services must be approved annually by the Audit Committee following a review by the Audit Committee of the proposed terms and scope of the engagement and the projected fees. Any subsequent change of a material nature in the terms, scope or fees associated with such annual audit services shall be approved in advance by the Audit Committee.

Any additional audit services may be pre-approved annually at the meeting at which the annual audit services are approved. If not pre-approved, each additional annual audit service must be approved by the Audit Committee in advance on a case-by-case basis.

IV. Approval of Audit-Related Services

Audit-related services consist of assurance and related services that are reasonably related to the performance of the audit or review of the financial statements of the Company and each Reporting Company, other than the annual audit services described in Section III above. Audit-related services may include, but are not limited to:

- Employee benefit plan audits.
- Due diligence related to mergers and acquisitions.
- Accounting consultations and audits in connection with acquisitions.
- Internal control reviews.
- Attest services related to financial reporting that are not required by statute or regulation.

Audit-related services may be pre-approved annually at the meeting at which the annual audit services are approved. If not pre-approved, each audit-related service must be approved by the Audit Committee in advance on a case-by-case basis.

V. Approval of Tax Services

Tax services consist of professional services rendered by the independent auditor to the Company or any of its subsidiaries for tax compliance, tax advice and tax planning. Tax services may be pre-approved annually at the meeting of the Audit Committee at which the annual audit services are approved. If not pre-approved, each tax service must be approved by the Audit Committee in advance on a case-by-case basis.

VI. Approval of All Other Services

Any other services to be provided by the Company's independent auditor, other than Prohibited Non-Audit Services, may be pre-approved annually at the meeting of the Audit Committee at which the annual audit services are approved. If not pre-approved, each such other service must be approved by the Audit Committee in advance on a case-by-case basis.

VII. Procedures

At the meeting of the Audit Committee to select the independent auditor for the Company and each of the Reporting Companies, the Chief Financial Officer shall submit to the Audit Committee a list of the additional audit services, audit-related services, tax services and other services, if any, that the Company and the Related Companies wish to have pre-approved for the ensuing year. The list shall be accompanied by:

- a written description (which may consist of or include a description furnished to the Company by the independent auditor) of the services to be provided in detail sufficient to enable the Audit Committee to make an informed decision with regard to each proposed service, and, to the extent determinable, an estimate provided by the independent auditor of the fees for each of the services; and
- confirmation of the independent auditor that (i) it would not be unlawful under Section 10A of the Exchange Act for the independent auditor to provide the listed non-audit services to the Company or any of its subsidiaries and (B) none of the services, if provided by the independent auditor to the Company or any of its subsidiaries, would impair the independence of the auditor under the standards set forth in Rule 2-01 of SEC Regulation S-X.

If a type of non-audit service is pre-approved by the Audit Committee, and the Company or any of its subsidiaries subsequently engages the independent auditor to provide that service, the Company's Chief Financial Officer shall report the engagement to the Audit Committee at its next regularly scheduled meeting.

VIII. Delegation

The Audit Committee hereby delegates to the Chairman of the Audit Committee the authority to approve, upon the receipt of the documentation referred to in Section VII above, on a case-by-case basis any non-audit service of the types referred to in Sections IV, V and VI above (i.e. an audit-related, tax or other service) at any time other than at a meeting of the Audit Committee. The Chairman shall report any services so approved to the Audit Committee at its next regularly scheduled meeting. In no circumstances shall the responsibilities of the Audit Committee under this Policy be delegated to the management of the Company or any of its subsidiaries.

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ANNEX B

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Forward-Looking Statements: Except for historical statements and discussions, the statements in this annual report constitute "forward-looking statements" within the meaning of federal securities law. These statements contain management's beliefs based on information currently available to management and on various assumptions concerning future events. Forward-looking statements are not a guarantee of future performance or events. They are subject to a number of uncertainties and other factors, many of which are outside the company's control. Factors that could cause actual results to differ materially from those in the forward-looking statements herein include general economic, business and financing conditions; availability and cost of capital; changes in laws, regulations or regulatory policies; weather conditions; competition; governmental actions; and other presently unknown or unforeseen factors. These uncertainties and factors could cause actual results to differ materially from such statements. Pepco Holdings disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. This information is presented solely to provide additional information to understand further the results and prospects of Pepco Holdings.

GLOSSARY OF TERMS

Term	Definition
ABO	Accumulated benefit obligation
Accounting hedges	Derivatives designated as cash flow and fair value hedges
ACE	Atlantic City Electric Company
ACE Funding	Atlantic City Electric Transition Funding LLC
ACO	Administrative Consent Order
Act	Prescription Drug, Improvement and Modernization Act of 2003
ADITC	Accumulated deferred investment tax credits
AFUDC	Allowance for Funds Used During Construction
Agreement and Plan of Merger	Agreement and Plan of Merger, dated as of February 9, 2001, among PHI, Pepco and Conectiv
Ancillary services	Generally, electricity generation reserves and reliability services
APB	Accounting Principles Board
APBO	Accumulated Postretirement Benefit Obligation
APCA	Air Pollution Control Act
Asset Purchase and Sale Agreement	Asset Purchase and Sale Agreement, dated as of June 7, 2000 and subsequently amended, between Pepco and Mirant (formerly Southern Energy, Inc.) relating to the sale of Pepco's generation assets
Bankruptcy Court	Bankruptcy Court for the Northern District of Texas
Bankruptcy Emergence Date	January 3, 2006, the date Mirant emerged from bankruptcy
BGS	Basic generation service in New Jersey (the supply of energy to customers who have not chosen a competitive supplier)
BGS-FP	BGS-Fixed Price service
BGS-CIEP	BGS-Commercial and Industrial Energy Price service
Bondable Transition Property	Right to collect a non-bypassable transition bond charge from ACE customers pursuant to bondable stranded costs rate orders issued by the NJBPU
BPU Financing Orders	Bondable stranded costs rate orders issued by the NJBPU
BTP	Bondable Transition Property
CAA	Federal Clean Air Act
CAIR	EPA's Clean Air Interstate rule
CAMR	EPA's Clean Air Mercury rule
CBI	Conectiv Bethlehem, LLC
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act of 1980
CESI	Conectiv Energy Supply, Inc.
Circuit Court	U.S. Court of Appeals for the Fifth Circuit
CO_2	Carbon Dioxide
Cooling Degree Days	Daily difference in degrees by which the mean (high and low divided by 2) dry bulb temperature is above a base of 65 degrees Fahrenheit.
Competitive Energy Business	Consists of the business operations of Conectiv Energy and Pepco Energy Services
Conectiv	A wholly owned subsidiary of PHI which is a holding company under PUHCA 2005 and the parent of DPL and ACE
Conectiv Energy	Conectiv Energy Holding Company and its subsidiaries
Conectiv Power Delivery	The trade name under which DPL and ACE formerly conducted their power delivery operations
CRMC	PHI's Corporate Risk Management Committee
CTs	Combustion turbines
CWA	Federal Clean Water Act
DCPSC	District of Columbia Public Service Commission

Term	Definition
DER	Discrete Emission Reduction Credits
District Court	U.S. District Court for the Northern District of Texas
DNREC	Delaware Department of Natural Resources and Environmental Control
DPL	Delmarva Power & Light Company
DPSC	Delaware Public Service Commission
DRP	PHI's Shareholder Dividend Reinvestment Plan
EDECA	New Jersey Electric Discount and Energy Competition Act
EDIT	Excess Deferred Income Taxes
EITF	Emerging Issues Task Force
Energy Act	Energy Policy Act of 2005
EPA	U.S. Environmental Protection Agency
ERISA	Employment Retirement Income Security Act of 1974
Exchange Act	Securities Exchange Act of 1934, as amended
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
Financing Order	Financing Order of the SEC under PUHCA 1935 dated June 30, 2005, with respect to PHI and its subsidiaries
FirstEnergy	FirstEnergy Corp., formerly Ohio Edison
FirstEnergy PPA	PPAs between Pepco and FirstEnergy Corp. and Allegheny Energy, Inc.
First Motion to Reject	The motion Mirant filed with the Bankruptcy Court in August 2003 seeking authorization to reject the PPA-Related Obligations
GCR	Gas Cost Recovery
GPC	Generation Procurement Credit
Heating Degree Days	Daily difference in degrees by which the mean (high and low divided by 2) dry bulb temperature is below a base of 65 degrees Fahrenheit.
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ITC	Investment Tax Credit
Kwh	Kilowatt hour
LEAC Liability	ACE's $59.3 million deferred energy cost liability existing as of July 31, 1999 related to ACE's Levelized Energy Adjustment Clause and ACE's Demand Side Management Programs
LTIP	Pepco Holdings' Long-Term Incentive Plan
March 2005 Orders	Orders entered in March 2005 by the District Court granting Pepco's motion to withdraw jurisdiction over rejection proceedings from the Bankruptcy Court and ordering Mirant to continue to perform the PPA-Related Obligations
Mcf	One thousand cubic feet
MDE	Maryland Department of the Environment
Mirant	Mirant Corporation and its predecessors and its subsidiaries
Mirant Parties	Mirant Corporation and its affiliate Mirant Americas Energy Marketing, LP
Moody's	Moody's Investor Service
MPSC	Maryland Public Service Commission
MTC	Market Transition Charge
NJBPU	New Jersey Board of Public Utilities
NJDEP	New Jersey Department of Environmental Protection
NJPDES	New Jersey Pollutant Discharge Elimination System
New Mirant Common Stock	Common stock of Mirant issued pursuant to the Reorganization Plan

Term	Definition
Normalization provisions	Sections of the Internal Revenue Code and related regulations that dictate how excess deferred income taxes resulting from the corporate income tax rate reduction enacted by the Tax Reform Act of 1986 and accumulated deferred investment tax credits should be treated for ratemaking purposes
NOx	Nitrogen oxide
NPDES	National Pollutant Discharge Elimination System
NSR	New Source Review
NUG	Non-Utility Generation
OCI	Other Comprehensive Income
Panda	Panda-Brandywine, L.P.
Panda PPA	PPA between Pepco and Panda
PARS	Performance Accelerated Restricted Stock
PCI	Potomac Capital Investment Corporation and its subsidiaries
Pepco	Potomac Electric Power Company
Pepco's pre-merger subsidiaries	PCI and Pepco Energy Services
Pepco Energy Services	Pepco Energy Services, Inc. and its subsidiaries
Pepco Holdings or PHI	Pepco Holdings, Inc.
Pepco TPA Claim	Pepco's $105 million allowed, pre-petition general unsecured claim against each of the Mirant Parties
PJM	PJM Interconnection, LLC
POLR	Provider of Last Resort (the supply of energy to customers who have not chosen a competitive supplier)
POM	Pepco Holdings' NYSE trading symbol
PPA	Power Purchase Agreement
PPA-Related Obligations	Mirant's obligations to purchase from Pepco the capacity and energy that Pepco is obligated to purchase under the FirstEnergy PPA and the Panda PPA
Pre-Petition Claims	Unpaid obligations of Mirant to Pepco existing at the time of filing of Mirant's bankruptcy petition consisting primarily of payments due Pepco in respect of the PPA-Related Obligations
PRP	Potentially Responsible Party
PSD	Prevention of Significant Deterioration
PUHCA 1935	Public Utility Holding Company Act of 1935, which was repealed effective February 8, 2006
PUHCA 2005	Public Utility Holding Company Act of 2005, which became effective February 8, 2006
RARC	Regulatory Asset Recovery Charge
Recoverable stranded costs	The portion of stranded costs that is recoverable from ratepayers as approved by regulatory authorities
Regulated electric revenues	Revenues for delivery (transmission and distribution) service and electricity supply service
Reorganization Plan	Mirant's Plan of Reorganization
Retirement Plan	PHI's noncontributory retirement plan
RGGI	Regional Greenhouse Gas Initiative
RI/FS	Remedial Investigation/Feasibility Study
S&P	Standard & Poor's
SEC	Securities and Exchange Commission
Settlement Agreement	Amended Settlement Agreement and Release, dated as of October 24, 2003 between Pepco and the Mirant Parties
SMECO	Southern Maryland Electric Cooperative, Inc.
SMECO Agreement	Capacity purchase agreement between Pepco and SMECO

Term	Definition
SO_2	Sulfur dioxide
SOS	Standard Offer Service (the supply of energy to customers who have not chosen a competitive supplier)
SPEs	Special Purpose Entities as defined in FIN 46R
Standard Offer Service revenue or SOS revenue	Revenue Pepco and DPL, respectively, receive for the procurement of energy for its SOS customers
Starpower	Starpower Communications, LLC
Stranded costs	Costs incurred by a utility in connection with providing service which would be unrecoverable in a competitive or restructured market. Such costs may include costs for generation assets, purchased power costs, and regulatory assets and liabilities, such as accumulated deferred income taxes.
TPAs	Transition Power Agreements for Maryland and the District of Columbia between Pepco and Mirant
Transition Bonds	Transition bonds issued by ACE Funding
Treasury lock	A hedging transaction that allows a company to "lock-in" a specific interest rate corresponding to the rate of a designated Treasury bond for a determined period of time
VaR	Value at Risk
VEBA	Voluntary Employee Beneficiary Association
VRDB	Variable Rate Demand Bonds
VSCC	Virginia State Corporation Commission

CONSOLIDATED FINANCIAL HIGHLIGHTS

	2005	(Restated) 2004 (a)	(Restated) 2003 (a)	(Previously Reported) 2002	(Restated) 2002 (a)	(Previously Reported) 2001	(Restated) 2001 (a)
	(In millions, except per share data)						
Consolidated Operating Results							
Total Operating Revenue	$ 8,065.5	7,223.1	7,268.7	4,324.5	4,324.5	2,371.2	2,371.2
Total Operating Expenses	$ 7,160.1(b)(c)(d)	6,451.0	6,658.0(g)(i)	3,778.9	3,778.6	2,004.8(j)	2,004.7(j)
Operating Income	$ 905.4	772.1	610.7	545.6	545.9	366.4	366.5
Other Expenses	$ 285.5	341.4	433.3(h)	190.4	191.4	105.3	104.8
Preferred Stock Dividend Requirements of Subsidiaries	$ 2.5	2.8	13.9	20.6	20.6	14.2	14.2
Income Before Income Tax Expense and Extraordinary Item	$ 617.4	427.9	163.5	334.6	333.9	246.9	247.5
Income Tax Expense	$ 255.2(e)	167.3(f)	62.1	124.1	124.9	83.5	83.1
Income Before Extraordinary Item	$ 362.2	260.6	101.4	210.5	209.0	163.4	164.4
Extraordinary Item	$ 9.0	—	5.9	—	—	—	—
Net Income	$ 371.2	260.6	107.3	210.5	209.0	163.4	164.4
Redemption Premium on Preferred Stock	$ (.1)	.5	—	—	—	—	—
Earnings Available for Common Stock	$ 371.1	261.1	107.3	210.5	209.0	163.4	164.4
Common Stock Information							
Basic Earnings Per Share of Common Stock Before Extraordinary Item	$ 1.91	1.48	.60	1.61	1.59	1.51	1.52
Basic—Extraordinary Item Per Share of Common Stock	$ .05	—	.03	—	—	—	—
Basic Earnings Per Share of Common Stock	$ 1.96	1.48	.63	1.61	1.59	1.51	1.52
Diluted Earnings Per Share of Common Stock Before Extraordinary Item	$ 1.91	1.48	.60	1.61	1.59	1.50	1.51
Diluted—Extraordinary Item Per Share of Common Stock	$ .05	—	.03	—	—	—	—
Diluted Earnings Per Share of Common Stock	$ 1.96	1.48	.63	1.61	1.59	1.50	1.51
Basic Common Shares Outstanding (Avg.)	189.0	176.8	170.7	131.1	131.1	108.5	108.5
Diluted Common Shares Outstanding (Avg.)	189.3	176.8	170.7	131.1	131.1	108.8	108.8
Cash Dividends Per Share of Common Stock	$ 1.00	1.00	1.00	1.00	1.00	1.165	1.165
Year-End Stock Price	$ 22.37	21.32	19.54	19.39	19.39	22.57	22.57
Book Value per Common Share	$ 18.88	17.74	17.31	17.62	17.49	17.00	16.81
Other Information							
Investment in Property, Plant and Equipment	$11,384.2	11,047.8	10,748.0	10,625.0	10,626.5	4,361.9	4,361.9
Net Investment in Property, Plant and Equipment	$ 7,312.0	7,090.6	6,965.7	7,043.3	7,044.8	2,819.0	2,819.0
Total Assets	$14,017.8	13,350.8	13,369.0	13,368.5	13,406.2	5,395.7	5,400.3
Capitalization							
Short-term Debt	$ 156.4	319.7	518.4	971.1	971.1	350.2	350.2
Long-term Debt	$ 4,202.9	4,362.1	4,588.9	4,287.5	4,287.5	1,602.1	1,602.1
Current Maturities of Long-Term Debt	$ 469.5	516.3	384.9	408.1	408.1	109.2	109.2
Transition Bonds issued by ACE Funding	$ 494.3	523.3	551.3	425.3	425.3	—	—
Capital Lease Obligations due within one year	$ 5.3	4.9	4.4	4.1	4.1	3.3	3.3
Capital Lease Obligations	$ 116.6	122.1	126.8	131.3	131.3	132.2	132.2
Long-Term Project Funding	$ 25.5	65.3	68.6	28.6	28.6	21.7	21.7
Debentures issued to Financing Trust	$ —	—	98.0	—	—	—	—
Trust Preferred Securities	$ —	—	—	290.0	290.0	125.0	125.0
Preferred Stock of Subsidiaries	$ 45.9	54.9	108.2	110.7	110.7	84.8	84.8
Common Shareholders' Equity	$ 3,584.1	3,339.0	2,974.1	2,995.8	2,972.8	1,823.2	1,801.8
Total Capitalization	$ 9,100.5	9,307.6	9,423.6	9,652.5	9,629.5	4,251.7	4,230.3

Note: As a result of the acquisition of Conectiv by Pepco that was completed on August 1, 2002, PHI's 2005, 2004 and 2003 amounts include PHI and its subsidiaries' results for the full year. PHI's 2002 amounts include Conectiv and its subsidiaries post-August 1, 2002 results with Pepco and its pre-merger subsidiaries (PCI and Pepco Energy Services) results for the full year in 2002. The amounts presented for 2001 represent only Pepco and its pre-merger subsidiaries' results.

(a) As discussed in Note (15) to the consolidated financial statements of Pepco Holdings, Pepco Holdings restated its financial statements to reflect the correction of the accounting for certain deferred compensation arrangements and other errors that management deemed to be immaterial.

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

(c) 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.

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

(e) Includes $10.9 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.

(f) Includes a $19.7 million charge related to an IRS settlement. Also includes $13.2 million tax benefit related to issuance of a local jurisdiction's final consolidated tax return regulations.

(g) Includes a charge of $50.1 million ($29.5 million after tax) related to a CT contract cancellation. Also includes a gain of $68.8 million ($44.7 million after tax) on the sale of the Edison Place office building.

(h) Includes an impairment charge of $102.6 million ($66.7 million after tax) related to investment in Starpower Communications, LLC.

(i) Includes the unfavorable impact of $44.3 million ($26.6 million after tax) resulting from trading losses prior to the cessation of proprietary trading.

(j) Includes $55.5 million ($36.1 million after tax) impairment charge related to the write-down of aircraft leasing portfolio.

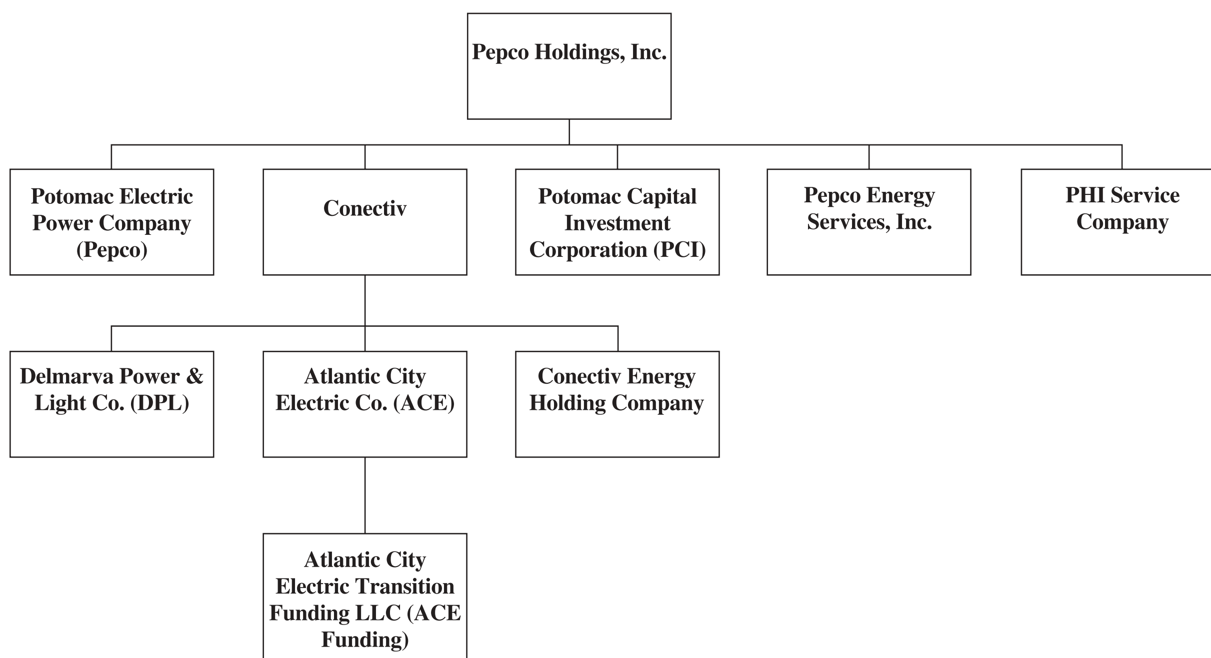
BUSINESS OF THE COMPANY

OVERVIEW

Pepco Holdings, Inc. (PHI or Pepco Holdings) is a public utility holding 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. As a result, DPL and ACE are wholly owned subsidiaries of Conectiv. The following chart shows, in simplified form, the corporate structure of PHI and its principal subsidiaries.



On February 8, 2006, the Public Utility Holding Company Act of 1935 (PUHCA 1935) was repealed and the Public Utility Holding Company Act of 2005 (PUHCA 2005) went into effect. 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). As permitted under FERC regulations promulgated under PUHCA 2005, PHI will give notice to FERC that it will continue, until further notice, to operate pursuant to the authority granted in 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. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—PUHCA Restrictions" for additional information.

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 which was filed with, and approved by, the SEC under PUHCA 1935. The expenses of the service company are charged to PHI and the participating operating subsidiaries in accordance with cost allocation methodologies set forth in the service agreement. PHI expects to continue operating under the service agreement and is evaluating whether to seek FERC approval of the cost allocation methodologies in the service agreement under PUHCA 2005.

For financial information relating to PHI's segments, see Note (3) Segment Information to the consolidated financial statements of PHI. This segment information includes a revision of PHI's segments for 2003 to reflect that, as of January 1, 2004, the formerly separate segments of Pepco Power Delivery and Conectiv Power Delivery were combined to form one operating segment. Each of Pepco, DPL and ACE has one operating segment.

Investor Information

Each of PHI, Pepco, DPL and ACE is a reporting company under the Securities Exchange Act of 1934, as amended (the Exchange Act). The Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to those reports, of each of the companies are made available free of charge on PHI's internet Web site as soon as reasonably practicable after such documents are electronically filed with or furnished to the SEC. These reports may be found at *http://www.pepcoholdings.com/investors*.

The following is a description of each of PHI's two principal areas of operation.

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. In 2005, 2004 and 2003, respectively, PHI's Power Delivery operations produced 58%, 61% and 55% of PHI's consolidated operating revenues (including intercompany transactions) and 74%, 70% and 82% of PHI's consolidated operating income (including income from intercompany transactions).

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 regulated service territory.

Delivery of Electricity and Natural Gas and Default Electricity Supply

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

PHI and its subsidiaries refer to this supply service in each of the jurisdictions generally as Default Electricity Supply.

In the aggregate, the Power Delivery business delivers electricity to more than 1.8 million customers in the mid-Atlantic region and distributes natural gas to approximately 120,000 customers in Delaware.

Transmission of Electricity and Relationship with PJM

The transmission facilities owned by Pepco, DPL and ACE are interconnected with the transmission facilities of contiguous utilities and as such are part of an interstate power transmission grid over which electricity is transmitted throughout the eastern United States. FERC has designated a number of regional transmission organizations to coordinate the operation and planning of portions of the interstate transmission grid. Pepco, DPL and ACE are members of the PJM Regional Transmission Organization. PJM Interconnection, LLC (PJM) provides transmission planning functions and acts as the independent system operator that coordinates the movement of electricity in all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia. FERC has designated PJM as the sole provider of transmission service in the PJM region. Any entity that wishes to have electricity delivered at any point in the PJM region must obtain transmission services from PJM at rates approved by FERC. In accordance with FERC rules, Pepco, DPL, ACE and the other transmission-owning utilities in the region make their transmission facilities available to PJM and PJM directs and controls the operation of these transmission facilities. In return for the use of their transmission facilities, PJM pays the transmission owners fees approved by FERC.

Distribution of Electricity and Deregulation

Historically, electric utilities, including Pepco, DPL and ACE, were vertically integrated businesses that generated all or a substantial portion of the electric power that they delivered to customers in their service territories over their own distribution facilities. Customers were charged a bundled rate approved by the applicable regulatory authority that covered both the supply and delivery components of the retail electric service. However, legislative and regulatory actions in each of the service territories in which Pepco, DPL and ACE operate have resulted in the “unbundling” of the supply and delivery components of retail electric service and in the opening of the supply component to competition from non-regulated providers. Accordingly, while Pepco, DPL and ACE continue to be responsible for the distribution of electricity in their respective service territories, as the result of deregulation, customers in those service territories now are permitted to choose their electricity supplier from among a number of non-regulated, competitive suppliers. Customers who do not choose a competitive supplier receive Default Electricity Supply on terms that vary depending on the service territory, as described more fully below.

In connection with the deregulation of electric power supply, Pepco, DPL and ACE have divested substantially all of their generation assets, either by selling them to third parties or transferring them to the non-regulated affiliates of PHI that comprise PHI’s Competitive Energy businesses. Accordingly, Pepco, DPL and ACE are no longer engaged in generation operations, except for the limited generation activities of ACE described in the “ACE” section, herein.

Seasonality

The power delivery business is seasonal and weather patterns can have a material impact on operating performance. In the region served by PHI, demand for electricity is generally greater in the summer months associated with cooling and demand for electricity and natural gas is generally greater in the winter months associated with heating, as compared to other times of the year. Historically, the power delivery operations of each of PHI’s utility subsidiaries have generated less revenues and income when weather conditions are milder in the winter and cooler in the summer.

Regulation

The retail operations of PHI's utility subsidiaries, including the rates they are permitted to charge customers for the delivery of electricity and natural gas, are subject to regulation by governmental agencies in the jurisdictions in which they provide utility service. Pepco's electricity delivery operations are regulated in Maryland by the Maryland Public Service Commission (MPSC) and in Washington, D.C. by the District of Columbia Public Service Commission (DCPSC). DPL's electricity delivery operations are regulated in Maryland by the MPSC, in Virginia by the Virginia State Corporation Commission (VSCC) and in Delaware by the Delaware Public Service Commission (DPSC). DPL's natural gas distribution operations in Delaware are regulated by the DPSC. ACE's electric delivery operations are regulated in New Jersey by the New Jersey Board of Public Utilities (NJBPU). The wholesale and transmission operations for both electricity and natural gas of each of PHI's utility subsidiaries are regulated by FERC.

Pepco

Pepco is engaged in the transmission and distribution of electricity in Washington, D.C. and major portions of Prince George's and Montgomery Counties in suburban Maryland. Pepco was incorporated in Washington, D.C. in 1896 and became a domestic Virginia corporation in 1949. Pepco's service territory covers approximately 640 square miles and has a population of approximately 2 million. As of December 31, 2005, Pepco delivered electricity to approximately 747,000 customers, as compared to 737,000 customers as of December 31, 2004. Pepco delivered a total of approximately 27,594,000 megawatt hours of electricity in 2005, compared to approximately 26,902,000 megawatt hours in 2004. In 2005, approximately 30% was delivered to residential customers, 51% to commercial customers, and 19% to United States and District of Columbia government customers.

Under a settlement approved by the MPSC in April 2003, Pepco is required to provide SOS to residential and small commercial customers through May 2008 and to medium-sized commercial customers through May 2006, and was required to provide SOS to large commercial customers through May 2005. Pepco also has an obligation to provide service at hourly priced rates to the largest customers through May 2006. In accordance with the settlement, Pepco purchases the power supply required to satisfy its SOS obligation from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure approved by the MPSC. Pepco is entitled to recover from its SOS customers the cost of the SOS supply plus an average margin of approximately $.002 per kilowatt hour (calculated at the time of the announcement of the contracts, based on total sales to residential and small and large commercial Maryland SOS customers over the twelve months ended December 31, 2003). Because margins vary by customer class, the actual average margin over any given time period depends on the number of Maryland SOS customers from each customer class and the load taken by such customers over the time period. Pepco is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both SOS customers and customers in Maryland who have selected another energy supplier. These delivery rates are capped through December 31, 2006 pursuant to the MPSC order issued in connection with the Pepco acquisition of Conectiv, but are subject to adjustment if FERC transmission rates increase by more than 10%.

Under an order issued by the DCPSC in March 2004, as amended by a DCPSC order issued in July 2004, Pepco is obligated to provide SOS for small commercial and residential customers through May 31, 2011 and for large commercial customers through May 31, 2007. Pepco purchases the power supply required to satisfy its SOS obligation from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure approved by the DCPSC. Pepco is entitled to recover from its SOS customers the costs associated with the acquisition of the SOS supply plus administrative charges that are intended to allow Pepco to recover the administrative costs incurred to provide the SOS. These administrative charges include an average margin for Pepco of approximately $.00248 per kilowatt hour (calculated at the time of the announcement of the contracts, based on total sales to residential and small and large commercial District of Columbia SOS customers over the twelve months ended December 31, 2003). Because margins vary by customer class, the actual average margin

over any given time period depends on the number of District of Columbia SOS customers from each customer class and the load taken by such customers over the time period. Pepco is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both SOS customers and customers in the District of Columbia who have selected another energy supplier. Delivery rates in the District of Columbia generally are capped through July 2007, but are subject to adjustment if FERC transmission rates increase by more than 10%, except that for residential low-income customers, rates generally are capped through July 2009.

For the twelve months ended December 31, 2005, 62% of Pepco's Maryland sales (measured by megawatt hours) were to SOS customers, as compared to 71% in 2004 and 42% of its District of Columbia sales were to SOS customers, as compared to 68% in 2004.

DPL

DPL is engaged in the transmission and distribution of electricity in Delaware and portions of Maryland and Virginia and provides natural gas distribution service in northern Delaware. In Delaware, service is provided in three counties, Kent, New Castle, and Sussex; in Maryland, service is provided in ten counties, Caroline, Cecil, Dorchester, Harford, Kent, Queen Anne's, Somerset, Talbot, Wicomico, and Worchester; and in Virginia, service is provided to two counties, Accomack and Northampton. DPL was incorporated in Delaware in 1909 and became a domestic Virginia corporation in 1979. DPL's electricity distribution service territory covers approximately 6,000 square miles and has a population of approximately 1.28 million. DPL's natural gas distribution service territory covers approximately 275 square miles and has a population of approximately 523,000. As of December 31, 2005, DPL delivered electricity to approximately 510,000 customers and delivered natural gas to approximately 120,000 customers, as compared to 501,000 electricity customers and 118,000 natural gas customers as of December 31, 2004.

In 2005, DPL delivered a total of approximately 14,101,000 megawatt hours of electricity to its customers, as compared to a total of approximately 13,902,000 megawatt hours in 2004. In 2005, approximately 40% of DPL's retail electricity deliveries were to residential customers, 38% were to commercial customers and 22% were to industrial customers. In 2005, DPL delivered approximately 20,700,000 Mcf (one thousand cubic feet) of natural gas to retail customers in its Delaware service territory, as compared to approximately 21,600,000 Mcf in 2004. In 2005, approximately 41% of DPL's retail gas deliveries were sales to residential customers, 27% were sales to commercial customers, 5% were sales to industrial customers, and 27% were sales to customers receiving a transportation-only service.

Under a settlement approved by the DPSC, DPL is required to provide POLR service to customers in Delaware through April 2006. DPL is paid for supplying POLR service to customers in Delaware at fixed rates established in the settlement. DPL obtains all of the energy needed to fulfill its POLR obligations in Delaware under a supply agreement with its affiliate Conectiv Energy, which terminates in April 2006. DPL does not make any profit or incur any loss on the supply component of the POLR supply that it delivers to its Delaware customers. DPL is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both POLR customers and customers who have selected another energy supplier. These delivery rates generally are frozen through April 2006, except that DPL is allowed to file for a one-time transmission rate change during this period. On March 22, 2005, the DPSC issued an order approving DPL as the SOS provider after May 1, 2006, when DPL's current fixed rate POLR obligation ends. DPL will retain the SOS obligation for an indefinite period until changed by the DPSC, and will purchase the power supply required to satisfy its SOS obligations from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure. On October 11, 2005, the DPSC approved a settlement agreement, under which DPL will provide SOS to all customer classes, with no specified termination date for SOS. Two categories of SOS will exist: (i) a fixed price SOS available to all but the largest customers; and (ii) an Hourly Priced Service (HPS) for the largest customers. DPL will purchase the power supply required to satisfy its fixed-price SOS obligation from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure. Power to supply the HPS customers will be

acquired on next-day and other short-term PJM markets. In addition to the costs of capacity, energy, transmission, and ancillary services associated with the fixed-price SOS and HPS, DPL's initial rates will include a component referred to as the Reasonable Allowance for Retail Margin (RARM). Components of the RARM include a fixed annual margin of $2.75 million, plus estimated incremental expenses, a cash working capital allowance, and recovery with a return over five years of the capitalized costs of a billing system to be used for billing HPS customers.

Under a settlement approved by the MPSC in April 2003, DPL is required to provide SOS to residential and small commercial customers through May 2008 and to medium-sized commercial customers through May 2006. In accordance with the settlement, DPL purchases the power supply required to satisfy its market rate SOS obligation from wholesale suppliers under contracts entered into pursuant to a competitive bid procedure approved and supervised by the MPSC. DPL is entitled to recover from its SOS customers the costs of the SOS supply plus an average margin of $.002 per kilowatt hour (calculated at the time of the announcement of the contracts, based on total sales to residential and small and large commercial Maryland SOS customers over the twelve months ended December 31, 2003). Because margins vary by customer class, the actual average margin over any given time period depends on the number of Maryland SOS customers from each customer class and the load taken by such customers over the time period. DPL is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both SOS customers and customers in Maryland who have selected another energy supplier. These delivery rates generally are capped through December 2006, subject to adjustment if FERC transmission rates increase by more than 10%.

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

In October 2004, DPL filed an application with the VSCC for approval to increase the rates that DPL charges its Default Service customers to allow it to recover its costs for power under the 2005 Supply Agreement plus an administrative charge and a margin. A VSCC order issued in November 2004 allowed DPL to put interim rates into effect on January 1, 2005, subject to refund if the VSCC subsequently determined the rates are excessive. The interim rates reflected an increase of 1.0247 cents per kilowatt hour (Kwh) to the fuel rate, which provides for recovery of the entire amount being paid by DPL to Conectiv Energy, but did not include an administrative charge or margin, pending further consideration of this issue. In January 2005, the VSCC ruled that the administrative charge and margin are base rate items not recoverable through a fuel clause. On March 25, 2005, the VSCC approved a settlement resolving all other issues and making the interim rates final.

DPL is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both Default Service customers and customers in Virginia who have selected another energy supplier. These delivery rates generally are frozen until December 31, 2010, except that DPL can propose two changes in delivery rates—one prior to July 1, 2007 and another between July 1, 2007 and December 31, 2010.

In Maryland, DPL sales to SOS customers represented 77% of total sales (measured by megawatt hours) for the twelve months ended December 31, 2005, as compared to 80% in 2004. In Delaware, DPL sales to POLR customers represented 90% of total sales (measured by megawatt hours) for the twelve months ended December 31, 2005, as compared to 89% in 2004. In Virginia, DPL sales to Default Supply customers represented 100% of total sales (measured by megawatt hours) in both 2005 and 2004.

DPL also provides regulated natural gas supply and distribution service to customers in its Delaware natural gas service territory. Large and medium volume commercial and industrial natural gas customers may purchase natural gas either from DPL or from other suppliers. DPL uses its natural gas distribution facilities to transport

gas for customers that choose to purchase natural gas from other suppliers. These customers pay DPL distribution service rates approved by the DPSC. DPL purchases natural gas supplies for resale to its sales service customers from marketers and producers through a combination of long-term agreements and next-day delivery arrangements. For the twelve months ended December 31, 2005, DPL supplied 72.8% of the natural gas that it delivered, compared to 71.8% in 2004.

ACE

ACE is primarily engaged in the transmission and distribution of electricity in a service territory consisting of Gloucester, Camden, Burlington, Ocean, Atlantic, Cape May, Cumberland and Salem counties in southern New Jersey. ACE was incorporated in New Jersey in 1924. ACE's service territory covers approximately 2,700 square miles and has a population of approximately 998,000. As of December 31, 2005, ACE delivered electricity to approximately 532,000 customers in its service territory, as compared to approximately 524,000 customers as of December 31, 2004. ACE delivered a total of approximately 10,080,000 megawatt hours of electricity in 2005 compared to approximately 9,874,000 megawatt hours in 2004. In 2005, approximately 44% was delivered to residential customers, 43% was delivered to commercial customers and 13% was delivered to industrial customers.

In accordance with a process mandated by the NJBPU, electric customers in New Jersey who do not choose another supplier receive BGS from their electric distribution company. Each of New Jersey's electric distribution companies, including ACE, jointly procure the supply to meet their BGS obligations from competitive suppliers selected through two concurrent auctions authorized by the NJBPU for New Jersey's total BGS requirement each February. The winning bidders in the auction are required to supply a specified portion of the BGS customer load with full requirements service, consisting of power supply and transmission service.

ACE provides two types of BGS:

- BGS-Fixed Price (BGS-FP), which is supplied to smaller commercial and residential customers at seasonally-adjusted fixed prices. BGS-FP rates change annually on June 1 and are based on the average BGS price obtained at auction in the current year and two prior years. ACE's BGS-FP load is approximately 2,050 megawatts, which represents approximately 87% of ACE's total BGS load. Approximately one-third of this total load is auctioned off each year for a three-year term.
- BGS-Commercial and Industrial Energy Price (BGS-CIEP), which is supplied to larger customers at hourly PJM real-time market prices for a term of 12 months. ACE's BGS-CIEP load is approximately 300 megawatts, which represents approximately 13% of ACE's BGS load. This total load is auctioned off each year for a one-year term.

As of December 31, 2005, Conectiv Energy served four 100 megawatt blocks of BGS load in the ACE territory.

ACE is paid tariff delivery rates for the delivery of electricity over its transmission and distribution facilities to both BGS customers and customers in its service territory who have selected another energy supplier. ACE is also paid tariff rates established by the NJBPU that compensate it for the cost of obtaining the BGS from competitive suppliers. ACE does not make any profit or incur any loss on the supply component of the BGS it provides to customers.

ACE sales to New Jersey BGS customers represented 78% of total sales (measured by megawatt hours) for the twelve months ended December 31, 2005 and 2004.

In addition to its electricity transmission and distribution operations, as of December 31, 2005, ACE owned the B.L. England electric generating facility (with a generating capacity of 447 megawatts) and a 2.47% undivided interest in the Keystone electric generating facility and a 3.83% undivided interest in the Conemaugh

electric generating facility. The combined generating capacity of these facilities is 555 megawatts. ACE also has contracts with non-utility generators under which ACE purchased 3.8 million megawatt hours of power in 2005. ACE sells the electricity produced by the generating facilities and purchased under the non-utility generator contracts in the wholesale market administered by PJM. During 2005, ACE's generation and wholesale electricity sales operations produced approximately 30% of ACE's operating revenue.

On November 15, 2005, ACE entered into an agreement to sell its undivided interests in the Keystone and Conemaugh generating facilities to Duquesne Light Holdings Inc. for $173.1 million. The sale, subject to approval by the NJBPU, as well as other regulatory agencies and certain other legal conditions, is expected to be completed mid-year 2006. In December 2005, ACE filed testimony with the NJBPU in estimating that its net gains on the sale of the generating stations will be approximately $126.9 million; however, the net gains ultimately realized will be dependent upon the timing of the closing of the sale, transaction costs and other factors. The net gains will be an offset to stranded costs.

ACE is continuing its efforts to sell the B.L. England generating facility. On January 24, 2006, PHI, Conectiv and ACE entered into an administrative consent order (ACO) with the New Jersey Department of Environmental Protection (NJDEP) and the Attorney General of New Jersey, which provides that ACE will permanently cease operation of the B.L. England generating facility by December 15, 2007 if it does not sell the facility before then. The shut-down is contingent upon the receipt by ACE of necessary approvals from applicable regulatory authorities and permits to construct certain electric transmission facilities in southern New Jersey. See "Environmental Matters—Air Quality Regulation."

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

Competitive Energy

PHI's Competitive Energy business provides non-regulated generation, marketing and supply of electricity and natural gas, and related energy management services, in the mid-Atlantic region. In 2005, 2004 and 2003, respectively, PHI's Competitive Energy operations produced 51%, 50% and 55% of PHI's consolidated operating revenues. In 2005 and 2004, respectively, PHI's Competitive Energy operations produced 16% and 19% of PHI's consolidated operating income. In 2003, PHI's Competitive Energy operations incurred an operating loss equal to 20% of PHI's consolidated operating income. PHI's Competitive Energy operations are conducted through subsidiaries of Conectiv Energy and Pepco Energy Services.

Conectiv Energy

Conectiv Energy provides wholesale electric power, capacity, and ancillary services in the wholesale markets administered by PJM and also supplies electricity to other wholesale market participants under long and short-term bilateral contracts. Among its bilateral contracts are the power supply agreements under which Conectiv Energy sells to DPL electricity required by DPL to fulfill its Default Electricity Supply obligations for customers in Delaware and Virginia and for a portion of its Maryland customers. Conectiv Energy also supplies electric power to satisfy a portion of ACE's Default Electric Supply load, as well as Default Electric Supply load to other mid-Atlantic utilities. Other than its Default Electricity Supply sales, Conectiv Energy does not

participate in the retail competitive power supply market. Conectiv Energy obtains the electricity required to meet its power supply obligations from its own generating plants, under bilateral contracts entered into with other wholesale market participants and from purchases in the wholesale market administered by PJM.

Conectiv Energy's generation asset strategy focuses on mid-merit plants with operating flexibility and multi-fuel capability that can quickly change their output level on an economic basis. Like "peak-load" plants, mid-merit plants generally operate during times when demand for electricity rises and prices are higher. However, mid-merit plants usually operate more frequently and for longer periods of time than peak-load plants because of better heat rates. As of December 31, 2005, Conectiv Energy owned and operated mid-merit plants with a combined 2,713 megawatts of capacity, peak-load plants with a combined 639 megawatts of capacity and base-load generating plants with a combined 340 megawatts of capacity. Conectiv Energy also owns three uninstalled combustion turbines with a book value of $57.0 million. Conectiv Energy will determine whether to install these turbines as part of an existing or new generating facility or sell the turbines to a third party based upon market demand and transmission system needs and requirements.

Conectiv Energy also sells natural gas and fuel oil to very large end-users and to wholesale market participants under bilateral agreements. Conectiv Energy obtains the natural gas and fuel oil required to meet its supply obligations through market purchases for next day delivery and under long- and short-term bilateral contracts with other market participants.

Conectiv Energy actively engages in commodity risk management activities to reduce its financial exposure to changes in the value of its assets and obligations due to commodity price fluctuations. A portion of these risk management activities are conducted using instruments classified as derivatives, such as forward contracts, futures, swaps, and exchange-traded and over-the-counter options. Conectiv Energy also manages commodity risk with contracts that are not classified as derivatives. Conectiv Energy has two primary risk management objectives: to manage the spread between the cost of fuel used to operate its electric generation plants and the revenue received from the sale of the power produced by those plants; and to manage the cost of its contracts relating to Default Electricity Supply in order to ensure stable and known minimum cash flows and lock-in favorable prices and margins when they become available. To a lesser extent, Conectiv Energy also engages in market activities in an effort to profit from short-term geographical price differentials in electricity prices among markets.

Conectiv Energy's goal is to hedge economically a targeted portion of both the expected power output of its generation facilities and the expected costs of fuel used to operate those facilities. The hedge goals are approved by PHI's Corporate Risk Management Committee and may change from time to time based on market conditions, and the actual level of coverage may vary from the target depending on the extent to which the company is successful in implementing its hedging strategies. In July 2003, Conectiv Energy entered into an agreement with an international investment banking firm consisting of a series of energy contracts designed to hedge more effectively approximately 50% of Conectiv Energy's generation output and approximately 50% of its supply obligations, with the intention of providing Conectiv Energy with a more predictable earnings stream during the term of the agreement. The agreement will expire in May 2006. For additional discussion of Conectiv Energy's hedging activities, see "Quantitative and Qualitative Disclosures."

Pepco Energy Services

Pepco Energy Services sells retail electricity and natural gas primarily to commercial, industrial and governmental customers primarily in the mid-Atlantic region. Pepco Energy Services also provides integrated energy management services to commercial, industrial and governmental customers, including energy-efficiency contracting, development and construction of "green power" facilities, central plant and other equipment operation and maintenance, and fuel management. Subsidiaries of Pepco Energy Services provide high voltage construction and maintenance services to utilities and other customers throughout the United States and low voltage electric and telecommunication construction and maintenance services in the Washington, D.C. area.

Pepco Energy Services owns peak-load electricity generation plants with approximately 800 megawatts of peak-load capacity, the output of which is sold in the wholesale market administered by PJM.

Pepco Energy Services actively engages in commodity risk management activities to reduce the financial exposure to changes in the value of its supply contracts and sales commitments due to commodity price and volume fluctuations. Certain of these risk management activities are conducted using instruments classified as derivatives, such as forward contracts, futures, swaps, and exchange-traded and over-the-counter options. Pepco Energy Services' primary risk management objective is to manage the spread between its retail electric and natural gas sales commitments and the cost of supply used to service those commitments in order to secure favorable margins. Because of the age and design of Pepco Energy Services' power plants, these facilities have a high variable cost of operation and Pepco Energy Services generally does not hedge the output of these plants. For additional discussion of Pepco Energy Services' hedging activities, see "Quantitative and Qualitative Disclosures."

Competition

The unregulated energy generation, supply and marketing businesses in the mid-Atlantic region are characterized by intense competition at both the wholesale and retail levels. At the wholesale level, Conectiv Energy and Pepco Energy Services compete with numerous non-utility generators, independent power producers, wholesale power marketers and brokers, and traditional utilities that continue to operate generation assets. In the retail energy supply market and in providing energy management services, Pepco Energy Services competes with numerous competitive energy marketers and other service providers. Competition in both the wholesale and retail markets for energy and energy management services is based primarily on price and, to a lesser extent, the range of services offered to customers and quality of service.

Seasonality

Like the Power Delivery business, the power generation, supply and marketing businesses are seasonal and weather patterns can have a material impact on operating performance. Demand for electricity generally is greater in the summer months associated with cooling and demand for electricity and natural gas generally is greater in the winter months associated with heating, as compared to other times of the year. Historically, the competitive energy operations of Conectiv Energy and Pepco Energy Services have produced less revenue when weather conditions are milder than normal. Such weather conditions can also negatively impact income from these operations. Energy management services generally are not seasonal.

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, 2005 of approximately $1.3 billion. For additional information concerning these cross-border lease transactions, see Note (12) "Commitments and Contingencies" to the consolidated financial statements of PHI, "Management's Discussion and Analysis of Financial Condition and Results of Operations—Risk Factors." This activity constitutes a separate operating segment for financial reporting purposes which is designated "Other Non-Regulated."

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESTATEMENT

Pepco Holdings restated its previously reported consolidated financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003, the quarterly financial information for the first three quarters in 2005, and all quarterly periods in 2004, to correct the accounting for certain deferred compensation arrangements. The restatement includes the correction of other errors for the same periods, primarily relating to unbilled revenue, taxes, and various accrual accounts, which were considered by management to be immaterial. These other errors would not themselves have required a restatement absent the restatement to correct the accounting for deferred compensation arrangements. This restatement was required solely because the cumulative impact of the correction, if recorded in the fourth quarter of 2005, would have been material to that period's reported net income. See Note 15 "Restatement" for further discussion.

CONSOLIDATED RESULTS OF OPERATIONS

The accompanying results of operations discussion is for the year ended December 31, 2005, compared to the year ended December 31, 2004. All amounts in the tables (except sales and customers) are in millions.

Operating Revenue

A detail of the components of PHI's consolidated operating revenues is as follows:

	2005	2004	Change
Power Delivery	$4,702.9	$4,377.7	$325.2
Conectiv Energy	2,603.6	2,409.8	193.8
Pepco Energy Services	1,487.5	1,166.6	320.9
Other Non-Regulated	81.9	87.9	(6.0)
Corporate and Other	(810.4)	(818.9)	8.5
Total Operating Revenue	$8,065.5	$7,223.1	$842.4

Power Delivery Business

The following table categorizes Power Delivery's operating revenue by type of revenue.

	2005	2004	Change
Regulated T&D Electric Revenue	$1,618.5	$1,566.6	$ 51.9
Default Supply Revenue	2,753.0	2,514.7	238.3
Other Electric Revenue	69.9	67.8	2.1
Total Electric Operating Revenue	4,441.4	4,149.1	292.3
Regulated Gas Revenue	198.7	169.7	29.0
Other Gas Revenue	62.8	58.9	3.9
Total Gas Operating Revenue	261.5	228.6	32.9
Total Power Delivery Operating Revenue	$4,702.9	$4,377.7	$325.2

Regulated Transmission and Distribution (T&D) Electric Revenue consists of revenue from the transmission and the delivery of electricity to PHI's customers within its service territories at regulated rates.

Default Supply Revenue is the revenue received for Default Electricity Supply. The costs related to the supply of electricity are included in Fuel and Purchased Energy and Other Services Cost of Sales.

Other Electric Revenue consists of utility-related work and services performed on behalf of customers, including other utilities.

Regulated Gas Revenue consists of revenues for on-system natural gas sales and the transportation of natural gas for customers within PHI's service territories at regulated rates.

Other Gas Revenue consists of off-system natural gas sales and the release of excess system capacity.

Electric Operating Revenue

Regulated T&D Electric Revenue	**2005**	**2004**	**Change**
Residential	$ 613.0	$ 597.7	$ 15.3
Commercial	726.8	692.3	34.5
Industrial	36.8	37.4	(.6)
Other (Includes PJM)	241.9	239.2	2.7
Total Regulated T&D Electric Revenue	$1,618.5	$1,566.6	$ 51.9

Regulated T&D Electric Sales (Gwh)	**2005**	**2004**	**Change**
Residential	18,045	17,759	286
Commercial	29,441	28,448	993
Industrial	4,288	4,471	(183)
Total Regulated T&D Electric Sales	51,774	50,678	1,096

Regulated T&D Electric Customers (000s)	**2005**	**2004**	**Change**
Residential	1,591	1,567	24
Commercial	196	193	3
Industrial	2	2	—
Total Regulated T&D Electric Customers	1,789	1,762	27

The Pepco, DPL and ACE service territories are located within a corridor extending from Washington, D.C. to southern New Jersey. These service territories are economically diverse and include key industries that contribute to the regional economic base.

- Commercial activity in the region includes banking and other professional services, government, insurance, real estate, strip malls, casinos, stand alone construction, and tourism.
- Industrial activity in the region includes automotive, chemical, glass, pharmaceutical, steel manufacturing, food processing, and oil refining.

Regulated T&D Revenue increased by $51.9 million primarily due to the following: (i) $19.3 million due to customer growth, the result of a 1.5% customer increase in 2005, (ii) $17.6 million increase as a result of a 14.7% increase in Cooling Degree Days in 2005, (iii) $1.9 million (including $3.3 million in tax pass-throughs) increase due to net adjustments for estimated unbilled revenues recorded in the second and fourth quarters of 2005, reflecting a modification in the estimation process, primarily reflecting higher estimated power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers) and (iv) $21.7 million increase in tax pass-throughs, principally a county surcharge (offset in Other Taxes) offset by (v) $8.6 million other sales and rate variances.

Default Electricity Supply

Default Supply Revenue	**2005**	**2004**	**Change**
Residential	$1,161.7	$ 993.6	$ 168.1
Commercial	994.9	1,060.9	(66.0)
Industrial	134.2	140.7	(6.5)
Other (Includes PJM)	462.2	319.5	142.7
Total Default Supply Revenue	$2,753.0	$2,514.7	$ 238.3

Default Electricity Supply Sales (Gwh)	**2005**	**2004**	**Change**
Residential	17,490	16,775	715
Commercial	15,020	19,203	(4,183)
Industrial	2,058	2,292	(234)
Other	157	226	(69)
Total Default Electricity Supply Sales	34,725	38,496	(3,771)

Default Electricity Supply Customers (000s)	**2005**	**2004**	**Change**
Residential	1,557	1,509	48
Commercial	181	178	3
Industrial	2	2	—
Other	2	2	—
Total Default Electricity Supply Customers	1,742	1,691	51

Default Supply Revenue increased $238.3 million primarily due to the following: (i) $251.9 million due to higher retail energy rates, the result of market-based SOS competitive bid procedures implemented in Maryland in June 2005 and the District of Columbia in February 2005, (ii) $142.2 million increase in wholesale energy revenues resulting from sales of generated and purchased energy into PJM due to higher market prices in 2005, (iii) $44.8 million due to weather (14.7% increase in Cooling Degree Days), (iv) $48.2 million increase due to customer growth, and (v) $8.1 million due to other sales and rate variances, offset by (vi) $245.0 million decrease due primarily to higher commercial customer migration, and (vii) $11.9 million decrease due to net adjustments for estimated unbilled revenues recorded in the second and fourth quarters of 2005, primarily reflecting higher estimated power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers).

Other Electric Revenue increased $2.1 million to $69.9 million from $67.8 million in 2004 primarily due to mutual assistance work related to storm damage in 2005 (offset in Other Operations and Maintenance expense).

Gas Operating Revenue

Regulated Gas Revenue	**2005**	**2004**	**Change**
Residential	$115.0	$100.2	$14.8
Commercial	68.5	56.7	11.8
Industrial	10.6	8.3	2.3
Transportation and Other	4.6	4.5	.1
Total Regulated Gas Revenue	$198.7	$169.7	$29.0

Regulated Gas Sales (Bcf)	**2005**	**2004**	**Change**
Residential	8.4	8.7	(.3)
Commercial	5.6	5.5	.1
Industrial	1.1	1.2	(.1)
Transportation and Other	5.6	6.2	(.6)
Total Regulated Gas Sales	20.7	21.6	(.9)

Regulated Gas Customers (000s)	**2005**	**2004**	**Change**
Residential	111	109	2
Commercial	9	9	—
Industrial	—	—	—
Transportation and Other	—	—	—
Total Regulated Gas Customers	120	118	2

Power Delivery's natural gas service territory is located in New Castle County, Delaware. Several key industries contribute to the economic base as well as to growth.

- Commercial activity in the region includes banking and other professional services, government, insurance, real estate, strip malls, stand alone construction and tourism.
- Industrial activity in the region includes automotive, chemical and pharmaceutical.

Regulated Gas Revenue increased by $29.0 million primarily due to a $30.6 million increase in the Gas Cost Rate (GCR) effective November 2004 and 2005, due to higher natural gas commodity costs.

Other Gas Revenue increased by $3.9 million to $62.8 million from $58.9 in 2004 primarily due to increased capacity release revenues compared to the same period last year.

Competitive Energy Businesses

Conectiv Energy

The following table divides Conectiv Energy's operating revenues among its major business activities.

	2005	**2004**	**Change**
Merchant Generation	$ 675.7	$ 684.5	$ (8.8)
Full Requirements Load Service	848.7	960.2	(111.5)
Other Power, Oil and Gas Marketing Services	1,079.2	765.1	314.1
Total Conectiv Energy Operating Revenue	$2,603.6	$2,409.8	$ 193.8

Merchant Generation includes sales of electric power, capacity and ancillary services from its power plants into PJM, tolling arrangements, hedges of generation power and capacity, and fuel-switching activities where the lowest cost fuel is utilized and the more expensive fuel is sold. Excess generation capacity is used to manage risk associated with Full Requirements Load Service.

Full Requirements Load Service includes service provided to affiliated and non-affiliated companies to satisfy Default Energy Supply obligations, other full requirements electric power sales contracts, and related hedges.

Other Power, Oil and Gas Marketing Services consist of all other Conectiv Energy activities not included above. These activities include primarily wholesale gas marketing, oil marketing, a large operating services agreement with an unaffiliated power plant, and the activities of the real-time power desk, which engages in arbitrage between power pools.

Total Conectiv Energy Operating Revenue includes $801.8 million and $820.3 million of affiliate transactions for 2005 and 2004, respectively.

The impact of revenue changes with respect to the Conectiv Energy component of the Competitive Energy business are encompassed within the discussion below under the heading “Conectiv Energy Gross Margin.”

Pepco Energy Services

The following table presents Pepco Energy Services’ operating revenues.

	2005	2004	Change
Pepco Energy Services	$1,487.5	$1,166.6	$320.9

The increase in Pepco Energy Services’ operating revenue of $320.9 million is primarily due to (i) an increase of $228.1 million due to commercial and industrial retail load acquisition by Pepco Energy Services in 2005 at higher prices than in 2004, (ii) an increase of $39.3 million due to higher generation from its Benning and Buzzard Point power plants in 2005 due to warmer weather conditions, and (iii) an increase of $49.5 million due to higher energy services activities in 2005 resulting from contracts signed with customers under which Pepco Energy Services provides services for energy efficiency and high voltage installation projects. As of December 31, 2005, Pepco Energy Services had 2,004 megawatts of commercial and industrial load, as compared to 1,553 megawatts of commercial and industrial load at the end of 2004. In 2005, Pepco Energy Services’ power plants generated 237,624 megawatt hours of electricity as compared to 45,836 in 2004.

Operating Expenses

Fuel and Purchased Energy and Other Services Cost of Sales

A detail of PHI’s consolidated Fuel and Purchased Energy and Other Services Cost of Sales is as follows:

	2005	2004	Change
Power Delivery	$2,720.5	$2,524.2	$196.3
Conectiv Energy	2,344.4	2,130.9	213.5
Pepco Energy Services	1,357.5	1,064.4	293.1
Corporate and Other	(805.7)	(823.3)	17.6
Total	$5,616.7	$4,896.2	$720.5

Power Delivery Business

Power Delivery's Fuel and Purchased Energy costs increased by $196.3 million primarily due to (i) $326.7 million increase for higher average energy costs resulting from Default Electricity Supply contracts implemented in 2005, (ii) $65.6 million increase due to customer growth, (iii) $33.1 million increase for gas commodity purchases, (iv) $25.8 million increase in other sales and rate variances, offset by (v) $254.9 million decrease due to higher customer migration. This expense is primarily offset in Default Supply Revenue.

Competitive Energy Business

Conectiv Energy

The following table divides Conectiv Energy's Fuel and Purchased Energy and Other Services Cost of Sales among its major business activities.

	2005	2004	Change
Merchant Generation	$ 418.6	$ 444.3	$ (25.7)
Full Requirements Load Service	857.7	933.1	(75.4)
Other Power, Oil and Gas Marketing Services	1,068.1	753.5	314.6
Total Conectiv Energy Fuel and Purchased Energy and Other Services Cost of Sales	$2,344.4	$2,130.9	$213.5

The totals presented include $217.7 million and $245.4 million of affiliate transactions for 2005 and 2004, respectively.

The impact of Fuel and Purchased Energy and Other Services Cost of Sales changes with respect to the Conectiv Energy component of the Competitive Energy business are encompassed within the discussion below under the heading "Conectiv Energy Gross Margin."

Conectiv Energy Gross Margin

Management believes that gross margin (Revenue less Fuel and Purchased Energy and Other Services Cost of Sales) is a better comparative measurement of the primary activities of Conectiv Energy than Revenue and Fuel and Purchased Energy by themselves. Gross margin is a more stable comparative measurement and it is used extensively by management in internal reporting. The following is a summary of gross margins by activity type (Millions of dollars):

	December 31,	
	2005	2004
Megawatt Hour Supply (Megawatt Hours)		
Merchant Generation output sold into market	5,595,149	5,161,682
Operating Revenue:		
Merchant Generation	$ 675.7	$ 684.5
Full Requirements Load Service	848.7	960.2
Other Power, Oil, and Gas Marketing	1,079.2	765.1
Total Operating Revenue	$ 2,603.6	$ 2,409.8
Cost of Sales:		
Merchant Generation	$ 418.6	$ 444.3
Full Requirements Load Service	857.7	933.1
Other Power, Oil, and Gas Marketing	1,068.1	753.5
Total Cost of Sales	$ 2,344.4	$ 2,130.9
Gross Margin:		
Merchant Generation	$ 257.1	$ 240.2
Full Requirements Load Service	(9.0)	27.1
Other Power, Oil and Gas Marketing	11.1	11.6
Total Gross Margin	$ 259.2	$ 278.9

Warmer weather during the summer months of 2005 and continued PJM load growth resulted in increased demand for power and higher prices for power, causing higher Merchant Generation output and an increase in the gross margin. The higher gross margin from the sale of generation output was partially offset by negative hedge results.

The 2005 decrease in the Lower Full Requirements Load Service gross margin resulted from higher fuel and energy prices during 2005. Full Requirements Load Service is hedged by both contract purchases with third parties and by the output of the generation plants operated by Conectiv Energy.

Other Power, Oil and Gas Marketing margins decreased because of a one-time gain of $8.7 million on a group of coal contracts in 2004. This was partially offset by higher margin sales for oil marketing ($5.6 million) and gas marketing ($2.0 million) during the fourth quarter of 2005.

Pepco Energy Services

The following table presents Pepco Energy Services' Fuel and Purchased Energy and Other Services cost of sales.

	2005	2004	Change
Pepco Energy Services	$1,357.5	$1,064.4	$293.1

The increase in Pepco Energy Services' fuel and purchased energy and other services cost of sales of $293.1 million resulted from (i) higher volumes of electricity purchased at higher prices in 2005 to serve commercial

and industrial retail customers, (ii) higher fuel and operating costs for the Benning and Buzzard Point power plants in 2005 due to higher electric generation that resulted from warmer weather in 2005, and (iii) higher energy services activities in 2005 resulting from contracts signed with customers under which Pepco Energy Services provides services for energy efficiency and high voltage installation projects.

Other Operation and Maintenance

A detail of PHI's other operation and maintenance expense is as follows:

	2005	2004	Change
Power Delivery	$643.1	$623.9	$19.2
Conectiv Energy	107.7	103.8	3.9
Pepco Energy Services	71.2	71.5	(.3)
Other Non-Regulated	6.1	6.9	(.8)
Corporate and Other	(12.4)	(9.5)	(2.9)
Total	$815.7	$796.6	$19.1

PHI's other operation and maintenance increased by $19.1 million to $815.7 million for the year ended 2005 from $796.6 million for the year ended 2004 primarily due to the following: (i) a $10.3 million increase in employee related costs, (ii) $9.0 million increase in corporate services allocation, (iii) $3.9 million increase due to the write-off of software, (iv) $3.2 million increase due to mutual assistance work related to storm damage in 2005 (offset in Other Electric Revenues), and (v) $2.1 million increase in maintenance expenses, partially offset by (vi) $4.9 million reduction in the uncollectible account reserve to reflect the amount expected to be collected on Pepco's Pre-Petition Claims with Mirant and (vii) a $5.5 million decrease in PJM administrative expenses.

Depreciation and Amortization

PHI's depreciation and amortization expenses decreased by $17.9 million to $422.6 million in 2005 from $440.5 million in 2004. The decrease is primarily due to a $7.6 million decrease from a change in depreciation technique resulting from a 2005 final rate order from the NJBPU and a $4.8 million decrease due to a change in the estimated useful lives of Conectiv Energy's generation assets.

Other Taxes

Other taxes increased by $30.8 million to $342.2 million in 2005 from $311.4 million in 2004 due to higher pass-throughs, mainly as the result of a county surcharge rate increase (primarily offset in Regulated T&D Electric Revenue).

Deferred Electric Service Costs

Deferred Electric Service Costs, which relates only to ACE, increased by $83.9 million to $120.2 million in 2005, from $36.3 million in 2004. At December 31, 2005, DESC represents the net expense or over-recovery associated with New Jersey NUGs, market transition change (MTC) and other restructuring items. The $83.9 million increase represents (i) $77.1 million net over-recovery associated with New Jersey BGS, NUGS, market transition charges and other restructuring items, and (ii) $4.5 million in regulatory disallowances (net of amounts previously reserved) associated with the April 2005 NJBPU settlement agreement. ACE's rates for the recovery of those costs are reset annually and the rates will vary from year to year. At December 31, 2005, ACE's balance sheet included as a regulatory liability an over-recovery of $40.9 million with respect to these items, which is net of a $47.3 million reserve for items disallowed by the NJBPU in a ruling that is under appeal.

Gain on Sales of Assets

Pepco Holdings recorded a Gain on Sales of Assets of $86.8 million for the year ended December 31, 2005, compared to $30.0 million for the year ended December 31, 2004. The $86.8 million gain in 2005 primarily consists of: (i) a $68.1 million gain from the 2005 sale of non-utility land owned by Pepco located at Buzzard Point in the District of Columbia, and (ii) a $13.3 million gain recorded by PCI from proceeds related to the final liquidation of a financial investment that was written off in 2001. The $30.0 million gain in 2004 consists of: (i) a $14.7 million gain from the 2004 condemnation settlement with the City of Vineland relating to the transfer of ACE's distribution assets and customer accounts to the city, (ii) a $6.6 million gain from the 2004 sale of land, and (iii) an $8.3 million gain on the 2004 sale of aircraft investments by PCI.

Gain on Settlement of Claims with Mirant

The Gain on Settlement of Claims with Mirant of $70.5 million represents a settlement (net of customer sharing) with Mirant in the fourth quarter of 2005, of the Pepco TPA Claim ($70 million gain) and a Pepco asbestos claim against the Mirant bankruptcy estate ($.5 million gain).

Other Income (Expenses)

Other expenses (which are net of other income) decreased by $55.9 million to $285.5 million in 2005 from $341.4 million in 2004, primarily due to the following: (i) a decrease in net interest expense of $35.7 million, which primarily resulted from a $23.6 million decrease due to less debt outstanding during the 2005 period and a decrease of $12.8 million of interest expense that was recorded by Conectiv Energy in 2004 related to costs associated with the prepayment of debt related to the Bethlehem mid-merit facility, (ii) an $11.2 million impairment charge on the Starpower investment that was recorded during 2004, (iii) income of $7.9 million received by PCI in 2005 from the sale and liquidation of energy investments, and (iv) income of $3.9 million in 2005 from cash distributions from a joint-owned co-generation facility, partially offset by (v) an impairment charge of $4.1 million in 2005 related to a Conectiv Energy investment in a jointly owned generation project, and (vi) a pre-tax gain of $11.2 million on a distribution from a co-generation joint-venture that was recognized by Conectiv Energy during the second quarter of 2004.

Income Tax Expense

Pepco Holdings' effective tax rate for the year ended December 31, 2005 was 41% as compared to the federal statutory rate of 35%. The major reasons for this difference were state income taxes (net of federal benefit), the flow-through of certain book/tax depreciation differences, and changes in estimates related to tax liabilities of prior tax years subject to audit, partially offset by the flow-through of Deferred Investment Tax Credits and tax benefits related to certain leveraged leases.

Pepco Holdings' effective tax rate for the year ended December 31, 2004 was 39% as compared to the federal statutory rate of 35%. The major reasons for this difference were state income taxes (net of federal benefit), the flow-through of certain book/tax depreciation differences, and the settlement with the IRS on certain non-lease financial assets, partially offset by the flow-through of Deferred Investment Tax Credits and tax benefits related to certain leveraged leases.

Extraordinary Items

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

The accompanying results of operations discussion is for the year ended December 31, 2004, compared to the year ended December 31, 2003. All amounts in the tables (except sales and customers) are in millions.

Operating Revenue

A detail of the components of PHI's consolidated operating revenue is as follows:

	2004	2003	Change
Power Delivery	$4,377.7	$4,015.7	$ 362.0
Conectiv Energy	2,409.8	2,857.5	(447.7)
Pepco Energy Services	1,166.6	1,126.2	40.4
Other Non-Regulated	87.9	100.1	(12.2)
Corporate and Other	(818.9)	(830.8)	11.9
Total Operating Revenue	$7,223.1	$7,268.7	$ (45.6)

Power Delivery Business

The following table categorizes Power Delivery's operating revenue by type of revenue.

	2004	2003	Change
Regulated T&D Electric Revenue	$1,566.6	$1,521.0	$ 45.6
Default Supply Revenue	2,514.7	2,206.1	308.6
Other Electric Revenue	67.8	97.6	(29.8)
Total Electric Operating Revenue	4,149.1	3,824.7	324.4
Regulated Gas Revenue	169.7	150.2	19.5
Other Gas Revenue	58.9	40.8	18.1
Total Gas Operating Revenue	228.6	191.0	37.6
Total Power Delivery Operating Revenue	$4,377.7	$4,015.7	$362.0

Electric Operating Revenue

Regulated T&D Electric Revenue	2004	2003	Change
Residential	$ 597.7	$ 576.2	$ 21.5
Commercial	692.3	674.7	17.6
Industrial	37.4	41.0	(3.6)
Other (Includes PJM)	239.2	229.1	10.1
Total Regulated T&D Electric Revenue	$1,566.6	$1,521.0	$ 45.6

Regulated T&D Electric Sales (Gwh)	2004	2003	Change
Residential	17,759	17,147	612
Commercial	28,448	27,648	800
Industrial	4,471	4,874	(403)
Total Regulated T&D Electric Sales	50,678	49,669	1,009

Regulated T&D Electric Customers (000s)	2004	2003	Change
Residential	1,567	1,547	20
Commercial	193	191	2
Industrial	2	2	—
Total Regulated T&D Electric Customers	1,762	1,740	22

Regulated T&D Electric Sales, as measured on a Gwh basis, increased by 2% in 2004, driven by residential and commercial customer classes. Regulated T&D Revenue increased by $45.6 million primarily due to the following: (i) $14.4 million increase due to growth and average customer usage, (ii) $4.8 million increase due to higher average effective rates, (iii) $9.1 million due to weather, and (iv) $39.9 million increase in tax pass-throughs, principally a county surcharge (offset in Other Taxes expense). These increases were offset by (v) $20.5 million decrease primarily related to PJM network transmission revenue and the impact of customer choice, and (vi) $2.1 million related to a Delaware competitive transition charge that ended in 2003. Cooling Degree Days increased by 11.0% and heating degree days decreased by 6.3% for the year ended December 31, 2004 as compared to the same period in 2003.

Default Electricity Supply

Default Supply Revenue	**2004**	**2003**	**Change**
Residential	$ 993.6	$ 875.2	$118.4
Commercial	1,060.9	946.4	114.5
Industrial	140.7	156.1	(15.4)
Other (Includes PJM)	319.5	228.4	91.1
Total Default Supply Revenue	$2,514.7	$2,206.1	$308.6

Default Electricity Supply Sales (Gwh)	**2004**	**2003**	**Change**
Residential	16,775	16,048	727
Commercial	19,203	18,134	1,069
Industrial	2,292	2,882	(590)
Other	226	94	132
Total Default Electricity Supply Sales	38,496	37,158	1,338

Default Electricity Supply Customers (000s)	**2004**	**2003**	**Change**
Residential	1,509	1,460	49
Commercial	178	175	3
Industrial	2	2	—
Other	2	1	1
Total Default Electricity Supply Customers	1,691	1,638	53

Default Supply Revenue increased $308.6 million primarily due to the following: (i) $109.2 million as the result of higher retail energy rates, the result of effective rate increases in Delaware beginning October 2003 and in Maryland beginning in June and July 2004, (ii) $92.3 million primarily due to a reduction in customer migration in D.C., (iii) $83.1 million increase in wholesale energy prices as the result of higher market prices in 2004, and (iv) $24.4 million increase in average customer usage.

Other Electric Revenue decreased $29.8 million primarily due to a $43.0 million decrease that resulted from the expiration on December 31, 2003 of a contract to supply electricity to Delaware Municipal Electric Corporation (DMEC). This decrease was partially offset by a $14.0 million increase in customer requested work (related costs in Operations and Maintenance expense).

Gas Operating Revenue

Regulated Gas Revenue	2004	2003	Change
Residential	$100.2	$ 88.8	$11.4
Commercial	56.7	47.7	9.0
Industrial	8.3	9.2	(.9)
Transportation and Other	4.5	4.5	—
Total Regulated Gas Revenue	$169.7	$150.2	$19.5

Regulated Gas Sales (Bcf)	2004	2003	Change
Residential	8.7	9.0	(.3)
Commercial	5.5	5.5	—
Industrial	1.2	1.6	(.4)
Transportation and Other	6.2	6.8	(.6)
Total Regulated Gas Sales	21.6	22.9	(1.3)

Regulated Gas Customers (000s)	2004	2003	Change
Residential	109	108	1
Commercial	9	9	—
Industrial	—	—	—
Transportation and Other	—	—	—
Total Regulated Gas Customers	118	117	1

Regulated Gas Revenue increased $19.5 million principally due to the following: (i) $21.0 million increase in the Gas Cost Rate due to higher natural gas commodity costs, effective November 1, 2003, (ii) $8.2 million increase in Gas Base Rates due to higher operating expenses and cost of capital, effective December 9, 2003, and (iii) $2.0 million true up adjustment to unbilled revenues in 2003. These increases were partially offset by (iv) $9.4 million decrease due to 2003 being significantly colder than normal, and (v) $2.9 million reduction related to lower industrial sales. Heating degree days decreased 7.1% for the year ended December 31, 2004 as compared to the same period in 2003.

Other Gas Revenue increased $18.1 million largely related to an increase in off-system sales revenues of $17.3 million. The gas sold off-system was made available by warmer winter weather and reduced customer demand.

Competitive Energy Businesses

Conectiv Energy

The following table divides Conectiv Energy's operating revenues among its major business activities.

	2004	2003	Change
Merchant Generation	$ 684.5	$ 540.2	$ 144.3
Full Requirements Load Service	960.2	1,630.3	(670.1)
Other Power, Oil and Gas Marketing Services	765.1	687.0	78.1
Total Conectiv Energy Operating Revenue	$2,409.8	$2,857.5	$(447.7)

The totals presented include $820.3 million and $822.1 million of affiliate transactions for 2004 and 2003, respectively.

The impact of revenue changes with respect to the Conectiv Energy component of the Competitive Energy business are encompassed within the discussion below under the heading "Conectiv Energy Gross Margin."

Pepco Energy Services

The following table presents Pepco Energy Services' operating revenues.

	2004	2003	Change
Pepco Energy Services	$1,166.6	$1,126.2	$40.4

The increase in Pepco Energy Services' operating revenue of $40.4 million resulted from higher volumes of electricity sold to customers in 2004 at more favorable prices than in 2003, partially offset by a decrease in natural gas revenues.

Operating Expenses

Fuel and Purchased Energy and Other Services Cost of Sales

A detail of PHI's consolidated Fuel and Purchased Energy and Other Services Cost of Sales is as follows:

	2004	2003	Change
Power Delivery	$2,524.2	$2,295.4	$ 228.8
Conectiv Energy	2,130.9	2,696.1	(565.2)
Pepco Energy Services	1,064.4	1,033.1	31.3
Corporate and Other	(823.3)	(820.8)	(2.5)
Total	$4,896.2	$5,203.8	$(307.6)

Power Delivery Business

Power Delivery's Fuel and Purchased Energy costs increased by $228.8 million primarily due to the following: (i) a $212.9 million increase related to higher average energy costs, the result of new Default Supply rates for Maryland beginning in June and July 2004 and for New Jersey beginning in June 2004, and less customer migration primarily in D.C., (ii) $45.1 million higher costs due to the increased cost of electricity supply under the Amended Settlement Agreement and Release with Mirant, effective October 2003, and (iii) a $30.2 million increase for gas commodity purchases, partially offset by (iv) $43.0 million related to the DMEC 2003 contract expiration, and (v) a $14.5 million reserve recorded in September 2003 to reflect a potential exposure related to a pre-petition receivable from Mirant for which Pepco filed a creditor's claim in the bankruptcy proceedings.

Competitive Energy Businesses

Conectiv Energy

The following table categorizes Conectiv Energy's Fuel and Purchased Energy and Other Services Cost of Sales into major profit centers.

	2004	2003	Change
Merchant Generation	$ 444.3	$ 356.5	$ 87.8
Full Requirements Load Service	933.1	1,591.9	(658.8)
Other Power, Oil & Gas Marketing Services	753.5	747.7	5.8
Total Conectiv Energy Fuel and Purchased Energy and Other Services Cost of Sales	$2,130.9	$2,696.1	$(565.2)

Totals presented include $245.4 million and $161.1 million of affiliate transactions for 2004 and 2003, respectively.

The impact of Fuel and Purchased Energy and Other Services Cost of Sales changes for Conectiv Energy's component of the Competitive Energy business is detailed within the discussion below under the heading "Conectiv Energy Gross Margin."

Conectiv Energy Gross Margin

Management believes that gross margin is a better comparative measurement of the primary activities of Conectiv Energy than Revenue and Fuel and Purchased Energy by themselves. Gross margin is a more stable comparative measurement and it is used extensively by management in internal reporting. The following is a summary of gross margins by activity type (Millions of dollars):

	December 31,	
	2004	2003
Megawatt Hour Supply (Megawatt Hours)		
Merchant Generation output sold into market	5,161,682	5,261,878
Operating Revenue:		
Merchant Generation	$ 684.5	$ 540.2
Full Requirements Load Service	960.2	1,630.3
Other Power, Oil, and Gas Marketing	765.1	687.0
Total Operating Revenue	$ 2,409.8	$ 2,857.5
Cost of Sales:		
Merchant Generation	$ 444.3	$ 356.5
Full Requirements Load Service	933.1	1,591.9
Other Power, Oil, and Gas Marketing	753.5	747.7
Total Cost of Sales	$ 2,130.9	$ 2,696.1
Gross Margin:		
Merchant Generation	$ 240.2	$ 183.7
Full Requirements Load Service	27.1	38.4
Other Power, Oil and Gas Marketing	11.6	(60.7)
Total Gross Margin	$ 278.9	$ 161.4

The higher Generation gross margin in 2004 was due to the addition of new more efficient combined cycle generation at Bethlehem (which lowered fuel cost and increased Mwhs sold), unit flexibility (which increased margin by providing quick standard controls over unit running time), increased fuel switching (which generated fuel savings) and nuclear unit outages during the 4th quarter of 2004 (which increased output and price for power in eastern PJM). The higher margins were partially offset by cooler than normal summer weather which resulted in lower unit output in 2004. Conectiv Energy's power plants achieved a substantial portion of the increase ($18.9 million) during the month of December 2004 due to unplanned nuclear outages in the region.

The lower Full Requirements Load Service gross margin resulted from the termination of various full requirements load contracts and related power hedges in 2003 which contained favorable margins. This was partially offset by higher POLR rates in 2004 and lower cost of sales.

Other Power, Oil and Gas Marketing margins increased primarily because 2003 results included proprietary trading losses totaling $44 million. In addition, 2004 contained a substantial coal contract gain.

Pepco Energy Services

The following table presents Pepco Energy Services' Fuel and Purchased Energy and Other Services cost of sales.

	2004	2003	Change
Pepco Energy Services	$1,064.4	$1,033.1	$31.3

The increase in Pepco Energy Services' fuel and purchased energy and other services cost of sales of $31.3 million resulted from higher volumes of electricity purchased in 2004 to serve customers, partially offset by a decrease in volumes of natural gas purchased in 2004 to serve customers.

Other Operation and Maintenance

PHI's other operation and maintenance increased by $25.2 million to $796.6 million in 2004 from $771.4 million in 2003 primarily due to (i) $12.1 million of customer requested work (offset in Other Electric Revenue), (ii) $10.6 million higher electric system operation and maintenance costs, (iii) $9.4 million in Sarbanes-Oxley external compliance costs, and (iv) $12.8 million in severance costs, partially offset by (v) $10.6 million incremental storm costs primarily related to Hurricane Isabel in September 2003.

Depreciation and Amortization

PHI's depreciation and amortization expenses increased by $18.4 million to $440.5 million in 2004 from $422.1 million in 2003 primarily due to a $17.0 million increase attributable to the Power Delivery business resulting from (i) a $12.8 million increase for amortization of New Jersey bondable transition property as a result of additional transitional bonds issued in December 2003, (ii) $3.8 million for the amortization of the New Jersey deferred service costs balance which began in August 2003, and (iii) a $2.4 million increase for amortization of a regulatory tax asset related to New Jersey stranded costs. Additionally, depreciation expense attributable to the Competitive Energy business increased by $5.9 million from 2003 due to a full year of depreciation expense during 2004 at Conectiv Energy's Bethlehem facility.

Other Taxes

Other taxes increased by $39.2 million to $311.4 million in 2004 from $272.2 million in 2003. This increase primarily resulted from a $30.1 million increase attributable to the Power Delivery business due to higher county surcharge pass-throughs of $33.9 million and $3.6 million higher gross receipts/delivery taxes (offset in Regulated T&D Electric Revenue).

Deferred Electric Service Costs

Deferred Electric Service Costs (DESC), which relates only to ACE, increased by $43.3 million to $36.3 million in 2004 from a $7.0 million operating expense credit in 2003. At December 31, 2004, DESC represents the net expense or over-recovery associated with New Jersey NUGs, MTC and other restructuring items. A key driver of the $43.3 million change was $27.5 million for the New Jersey deferral disallowance from 2003. ACE's rates for the recovery of these costs are reset annually and the rates will vary from year to year. On ACE's balance sheet, regulatory assets include an under-recovery of $97.4 million as of December 31, 2004. This amount is net of a $46.1 million write-off on previously disallowed items under appeal.

Impairment Losses

The impairment losses recorded by PHI in 2003 consist of an impairment charge of $53.3 million from the cancellation of a CT contract and an $11.0 million aircraft investments impairment.

Gain on Sales of Assets

During 2004, PHI recorded $30.0 million in pre-tax gains on the sale of assets compared to a $68.8 million pre-tax gain in 2003. The 2004 pre-tax gains primarily consist of (i) a $14.7 million pre-tax gain from the condemnation settlement with the City of Vineland relating to the ACE transfer of distribution assets and customer accounts, (ii) an $8.3 million pre-tax gain on the sale of aircraft investments by PCI, and (iii) a $6.6 million pre-tax gain on the sale of land. The $68.8 million pre-tax gain in 2003 represents the gain on the sale of PHI's office building which was owned by PCI.

Other Income (Expenses)

Other expenses (which are net of other income) decreased $91.9 million to $341.4 million in 2004 from $433.3 million in 2003. The decrease was primarily due to a pre-tax impairment charge of $102.6 million related to PHI's investment in Starpower in 2003, compared to a pre-tax impairment charge of $11.2 million related to Starpower that was recorded in 2004.

Preferred Stock Dividend Requirements of Subsidiaries

Preferred Stock Dividend Requirements decreased by $11.1 million to $2.8 million in 2004 from $13.9 million in 2003. Of this decrease, $6.9 million was attributable to SFAS No. 150, which requires that dividends on Mandatorily Redeemable Serial Preferred Stock declared subsequent to July 1, 2003 be recorded as interest expense. An additional $4.6 million of the decrease resulted from lower dividends in 2004 due to the redemption of the Trust Originated Preferred Securities in 2003.

Income Tax Expense

Pepco Holdings' effective tax rate for 2004 was 39% as compared to the federal statutory rate of 35%. The major reasons for this difference were state income taxes (net of federal benefit), the flow-through of certain book/tax depreciation differences, and the settlement with the IRS on certain non-lease financial assets (which is the primary reason for the higher effective tax rate as compared to 2003), partially offset by the flow-through of Deferred Investment Tax Credits and tax benefits related to certain leveraged leases, and the benefit associated with the retroactive adjustment for the issuance of final consolidated tax return regulations by a taxing authority.

Pepco Holdings' effective tax rate for 2003 was 37% as compared to the federal statutory rate of 35%. The major reasons for this difference were state income taxes (net of federal benefit) and the flow-through of certain book/tax depreciation differences, partially offset by the flow-through of Deferred Investment Tax Credits and tax benefits related to certain leveraged leases.

Extraordinary Item

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

CAPITAL RESOURCES AND LIQUIDITY

This section discusses Pepco Holdings' capital structure, cash flow activity, capital spending plans and other uses and sources of capital for 2005 and 2004.

Capital Structure

The components of Pepco Holdings' capital structure are shown below as of December 31, 2005 and 2004 in accordance with GAAP. The table also shows the following adjustments to components of the capital structure made for the reasons discussed in the footnotes to the table: (i) the exclusion from debt of the Transition Bonds issued by ACE Funding, and (ii) the treatment of the Variable Rate Demand Bonds (VRDBs) issued by certain of PHI's subsidiaries as long-term, rather than short-term, debt obligations (Millions of dollars):

	2005			
	Per Balance Sheet	Adjustments	As Adjusted	As Adjusted %
Common Shareholders' Equity	$3,584.1	$ —	$3,584.1	41.8%
Preferred Stock of Subsidiaries (a)	45.9	—	45.9	.5%
Long-Term Debt	4,202.9	156.4 (b)	4,359.3	50.8%
Transition Bonds issued by ACE Funding	494.3	(494.3)(c)	—	—
Long-Term Project Funding	25.5	—	25.5	.3%
Capital Lease Obligations	116.6	—	116.6	1.4%
Capital Lease Obligations due within one year	5.3	—	5.3	.1%
Short-Term Debt	156.4	(156.4)(b)	—	—
Current Maturities of Long-Term Debt	469.5	(29.0)(d)	440.5	5.1%
Total	$9,100.5	$(523.3)	$8,577.2	100.0%

	2004			
	Per Balance Sheet	Adjustments	As Adjusted	As Adjusted %
Common Shareholders' Equity	$3,339.0	$ —	$3,339.0	38.1%
Preferred Stock of Subsidiaries (a)	54.9	—	54.9	.6%
Long-Term Debt	4,362.1	158.4 (b)	4,520.5	51.7%
Transition Bonds issued by ACE Funding	523.3	(523.3)(c)	—	—
Long-Term Project Funding	65.3	—	65.3	.7%
Capital Lease Obligations	122.1	—	122.1	1.4%
Capital Lease Obligations due within one year	4.9	—	4.9	.1%
Short-Term Debt	319.7	(158.4)(b)	161.3	1.8%
Current Maturities of Long-Term Debt	516.3	(28.1)(d)	488.2	5.6%
Total	$9,307.6	$(551.4)	$8,756.2	100.0%

(a) Consists of Serial Preferred Stock and Redeemable Serial Preferred Stock issued by subsidiaries of PHI.

(b) In accordance with GAAP, the VRDBs are included in short-term debt on the Balance Sheet of PHI because they are payable on demand by the holder. However, under the terms of the VRDBs, when demand is made for payment by the holder (specifically, when the VRDBs are submitted for purchase by the holder), the VRDBs are remarketed by a remarketing agent on a best efforts basis and the remarketing resets the interest rate at market rates. Due to the creditworthiness of the issuers, PHI expects that any VRDBs submitted for purchase will be successfully remarketed. Because of these characteristics of the VRDBs, PHI, from a debt management standpoint, views the VRDBs (which have nominal maturity dates ranging from 2009 to 2031) as Long-Term Debt and, accordingly, the adjustment reduces Short-Term Debt and increases Long-Term Debt by an amount equal to the principal amount of the VRDBs.

(c) Adjusted to exclude Transition Bonds issued by ACE Funding. Because repayment of the Transition Bonds is funded solely by charges collected from ACE's customers and is not a general obligation of ACE or PHI, PHI excludes the Transition Bonds from capitalization from a debt management standpoint.
(d) Adjusted to exclude the current maturities of Transition Bonds issued by ACE Funding.

In 2003, PHI established a goal of reducing its total debt and preferred stock outstanding by $1 billion by the end of 2007 to improve PHI's interest coverage ratios and to achieve a ratio of consolidated equity to total capitalization (excluding Transition Bonds issued by ACE Funding) in the mid-40% range. Because the net proceeds of $278 million from a public offering of PHI common stock in 2004 was not contemplated in the original $1 billion debt reduction plan, PHI raised its debt reduction goal to $1.3 billion by 2007.

PHI expects to meet its debt reduction goal through a combination of internally generated cash, equity issuances through the Shareholder Dividend Reinvestment Plan (DRP), and asset dispositions. (See "Risk Factors" for a description of factors that could cause PHI to not meet this goal.)

The total debt and preferred stock reduction achieved through year end 2005 is $1.14 billion.

Set forth below is a summary of the equity and long-term debt financing activity during 2005 for Pepco Holdings and its subsidiaries.

Pepco Holdings issued 1,228,505 shares of common stock under the DRP and various benefit plans. The proceeds from the issuances were added to PHI's general funds.

Pepco Holdings issued $250 million of floating rate unsecured notes due 2010. The net proceeds of $248.5 million were used to repay commercial paper issued to fund the redemptions of Conectiv debt.

Pepco issued $175 million of 5.40% senior secured notes due 2035. The net proceeds of $172.8 million, plus additional funds, were used to pay at maturity and redeem higher interest rate securities of $175 million.

DPL issued $100 million of unsecured notes due in 2015. The net proceeds of $98.9 million, plus additional funds, were used to redeem higher interest rate securities of $100 million.

Proceeds from Sale of Claims with Mirant

In December 2005, Pepco received proceeds of $112.9 million for the sale of the Pepco TPA Claim and the Pepco asbestos claim against the Mirant bankruptcy estate. After customer sharing, Pepco recorded a pre-tax gain of $70.5 million related to the settlement of these claims.

Sale of Buzzard Point Property

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.

Financial Investment Liquidation

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

Working Capital

At December 31, 2005, Pepco Holdings' current assets on a consolidated basis totaled $2.2 billion and its current liabilities totaled $2.4 billion. At December 31, 2004, Pepco Holdings' current assets totaled $1.7 billion and its current liabilities totaled $1.9 billion.

PHI's working capital deficit results in large part from the fact that, in the normal course of business, PHI's utility subsidiaries acquire energy supplies for their customers before the supplies are delivered to, metered and billed to customers. Short-term financing is used to meet liquidity needs. Short-term financing is also used, at times, to fund temporary redemptions of long-term debt, until long-term replacement financings are completed.

At December 31, 2005, Pepco Holdings' cash and cash equivalents and its restricted cash, totaled $144.5 million, of which $112.8 million was net cash collateral held by subsidiaries of PHI engaged in Competitive Energy and Default Electricity Supply activities (none of which was held as restricted cash). At December 31, 2004, Pepco Holdings' cash and cash equivalents and its restricted cash totaled $71.5 million, of which $21 million was net cash collateral held by subsidiaries of PHI engaged in Competitive Energy and Default Electricity Supply activities (of which $7.6 million was held as restricted cash). See "Capital Requirements—Contractual Arrangements with Credit Rating Triggers or Margining Rights" for additional information.

A detail of PHI's short-term debt balance and its current maturities of long-term debt and project funding balance follows:

	As of December 31, 2005 (Millions of dollars)									
Type	**PHI Parent**	**Pepco**	**DPL**	**ACE**	**ACE Funding**	**Conectiv Energy**	**PES**	**PCI**	**Conectiv**	**PHI Consolidated**
Variable Rate Demand Bonds	$ —	$ —	$104.8	$22.6	$ —	$—	$29.0	$ —	$ —	$156.4
Floating Rate Note	—	—	—	—	—	—	—	—	—	—
Commercial Paper	—	—	—	—	—	—	—	—	—	—
Total Short-Term Debt	$ —	$ —	$104.8	$22.6	$ —	$—	$29.0	$ —	$ —	$156.4
Current Maturities of Long-Term Debt and Project Funding	$300.0	$ 50.0	$ 22.9	$65.0	$29.0	$—	$ 2.6	$ —	$ —	$469.5

	As of December 31, 2004 (Millions of dollars)									
Type	**PHI Parent**	**Pepco**	**DPL**	**ACE**	**ACE Funding**	**Conectiv Energy**	**PES**	**PCI**	**Conectiv**	**PHI Consolidated**
Variable Rate Demand Bonds	$ —	$ —	$104.8	$22.6	$ —	$—	$31.0	$ —	$ —	$158.4
Floating Rate Note	50.0	—	—	—	—	—	—	—	—	50.0
Commercial Paper	78.6	—	—	32.7	—	—	—	—	—	111.3
Total Short-Term Debt	$128.6	$ —	$104.8	$55.3	$ —	$—	$31.0	$ —	$ —	$319.7
Current Maturities of Long-Term Debt and Project Funding	$ —	$100.0	$ 2.7	$40.0	$28.1	$—	$ 5.5	$60.0	$280.0	$516.3

Cash Flow Activity

PHI's cash flows for 2005, 2004, and 2003 are summarized below.

	Cash Source (Use)		
	2005	2004	2003
	(Millions of dollars)		
Operating Activities	$ 986.9	$ 715.7	$ 662.4
Investing Activities	(333.9)	(417.3)	(252.7)
Financing Activities	(561.0)	(359.1)	(370.7)
Net change in cash and cash equivalents	$ 92.0	$ (60.7)	$ 39.0

Operating Activities

Cash flows from operating activities are summarized below for 2005, 2004, and 2003.

	Cash Source (Use)		
	2005	2004	2003
	(Millions of dollars)		
Net Income	$371.2	$260.6	$107.3
Non-cash adjustments to net income	156.5	521.9	643.8
Changes in working capital	459.2	(66.8)	(88.7)
Net cash provided by operating activities	$986.9	$715.7	$662.4

Net cash provided by operating activities increased by $271.2 million in 2005 as compared to 2004. A $110.6 million increase in net income in 2005 as compared to 2004 is a result of improved operating results at PHI's regulated utilities. Other increases in operating activities include the following: (i) Pepco's receipt of $112.9 million in proceeds in December 2005 for the sale of the Pepco TPA Claim and the Pepco asbestos claim against the Mirant bankruptcy estate, (ii) a decrease of approximately $29 million in interest paid on debt obligations in 2005 as compared to 2004 due to a decrease in outstanding debt, (iii) an increase in power broker payables in 2005 as a result of higher electricity prices, and (iv) an increase from $21 million to $112.8 million in the cash collateral held in connection with Competitive Energy activities.

Cash flows from operating activities increased by $53.3 million to $715.7 million in 2004 from $662.4 million in 2003. The $53.3 million increase was largely the result of improved operating results at PHI's Regulated utilities. Regulated T&D Electric experienced 2% growth in Gwh sales in 2004, and Regulated T&D Revenue increased by $45.6 million primarily due to customer growth and increased average usage, higher average effective rates, and favorable warmer weather.

The Power Delivery business produced over 80% of consolidated cash from operations in 2005, 2004 and 2003.

Investing Activities

The most significant items included in cash flows related to investing activities during 2005, 2004, and 2003 are summarized below.

	Cash Source (Use)		
	2005	2004	2003
	(Millions of dollars)		
Capital expenditures	$(467.1)	$(517.4)	$(598.2)
Cash proceeds from sale of:			
Starpower investment	—	29.0	—
Marketable securities, net	—	19.4	156.6
Office building and other properties	84.1	46.4	147.7
All other investing cash flows, net	49.1	5.3	41.2
Net cash used by investing activities	$(333.9)	$(417.3)	$(252.7)

Net cash used by investing activities decreased by $83.4 million in 2005 compared to 2004. The decrease is primarily due to a $50.3 million decrease in capital expenditures, net proceeds of $73.7 million received from the sale of non-utility land in 2005, and proceeds of $33.8 million received by PCI from the sale of an energy investment and from the final liquidation of a financial investment that was written off in 2001.

In 2004, capital expenditures decreased $80.8 million to $517.4 million from $598.2 million in 2003. The decrease was primarily due to lower construction expenditures for Conectiv Energy, offset by an increase in Power Delivery capital requirements to upgrade electric transmission and distribution systems.

In 2004, PHI sold its 50% interest in Starpower for $29 million in cash. Additionally in 2004, PCI continued to liquefy its marketable securities portfolio and PHI received proceeds from the sale of aircraft and land.

In 2003, PCI liquidated its marketable securities portfolio. Additionally, in 2003, PHI received cash proceeds of $147.7 million from the sale by PCI of an office building known as Edison Place (which serves as headquarters for PHI and Pepco).

Financing Activities

	Cash Source (Use)		
	2005	2004	2003
	(Millions of dollars)		
Common stock dividends	$(188.9)	$ (176.0)	$ (170.7)
Common stock issuances	33.2	318.0	32.8
Preferred stock redemptions	(9.0)	(53.3)	(197.5)
Long-term debt issuances	532.0	650.4	1,136.9
Long-term debt redemptions	(755.8)	(1,214.7)	(692.2)
Short-term debt, net	(161.3)	136.3	(452.7)
Other	(11.2)	(19.8)	(27.3)
Net cash used in financing activities	$(561.0)	$ (359.1)	$ (370.7)

Net cash used by financing activities increased by $201.9 million in 2005 as compared to 2004.

Common stock dividend payments were $188.9 million in 2005, $176.0 million in 2004 and $170.7 million in 2003. The increase in common dividends paid in 2005 and 2004 was due to the issuance of 14,950,000 shares of common stock in September 2004 and issuances of 1,228,505 and 1,471,936 shares in 2005 and 2004, respectively, of common stock under the DRP.

Preferred stock redemptions in 2005 totaled $9.0 million and included the following: (i) in October 2005, Pepco redeemed 22,795 shares of its $2.44 Series 1957 Serial Preferred Stock at $1.1 million, 74,103 shares of its $2.46 Series 1958 Serial Preferred Stock at $3.7 million, and 13,148 shares of its $2.28 Series 1965 Serial Preferred Stock at $.7 million, (ii) in August 2005, ACE redeemed 160 shares of its 4.35% Serial Preferred Stock at $.02 million, and (iii) in December 2005, DPL redeemed all of the 35,000 shares of its 6.75% Serial Preferred Stock outstanding at $3.5 million.

In 2005, Pepco Holdings issued $250 million of floating rate unsecured notes due 2010. The net proceeds, plus additional funds, were used to repay commercial paper issued to fund the redemption of $300 million of Conectiv debt.

In September 2005, Pepco used the proceeds from the June 2005 issuance of $175 million in senior secured notes to fund the retirement of $100 million in first mortgage bonds at maturity as well as the redemption of $75 million in first mortgage bonds prior to maturity.

In 2005, DPL issued $100 million of unsecured notes due 2015 to redeem $100 million of higher rate securities.

In December 2005, Pepco paid down $50 million of its $100 million bank loan due December 2006.

In 2005, ACE retired at maturity $40 million of medium-term notes.

In 2005, PCI redeemed $60 million of Medium-Term Notes.

Described above are $525 million of the $532 million total 2005 long-term debt issuances and $725 million of the $755.8 million total 2005 long-term debt redemptions.

As a result of the 2004 common stock issuance, Pepco Holdings received $278.5 million of proceeds, net of issuance costs of $10.3 million. The proceeds in combination with short-term debt were used to prepay in its entirety the $335 million Conectiv Bethlehem term loan.

In 2004, Pepco redeemed all of the 900,000 shares of $3.40 series mandatorily redeemable preferred stock then outstanding for $45 million, and 165,902 shares of $2.28 series preferred stock for $8.3 million.

In 2004, Pepco Holdings redeemed $200 million of variable rate notes at maturity.

In 2004, Pepco issued $275 million of secured senior notes with maturities of 10 and 30 years, the net proceeds of which were used to redeem higher interest rate securities of $210 million and to repay short-term debt. Pepco borrowed $100 million under a bank loan due in 2006, and proceeds were used to redeem mandatorily redeemable preferred stock and repay short-term debt. DPL issued $100 million of unsecured notes that mature in 2014, the net proceeds of which were used to redeem trust preferred securities and repay short-term debt. ACE issued $54.7 million of insured auction rate tax-exempt securities and $120 million of secured senior notes which mature in 2029 and 2034, respectively; the net proceeds of $173.2 million were used to redeem higher interest rate securities. Conectiv redeemed $50 million of Medium-Term Notes, and PCI redeemed $86 million of Medium-Term Notes in 2004. In 2004, redemptions of mandatorily redeemable trust preferred securities included $70 million for DPL and $25 million for ACE.

Described above are $649.7 million of the $650.4 million total 2004 long-term debt issuances and $1,149.2 million of the $1,214.7 million total 2004 long-term debt redemptions.

In 2003, Pepco Holdings issued $700 million of unsecured long-term debt with maturities ranging from 1 year to 7 years, the net proceeds of which were used to repay short-term debt. Pepco issued $200 million of

secured senior notes, and proceeds were used to refinance $125 million trust preferred securities and repay short-term debt. Pepco redeemed $50 million of First Mortgage Bonds at maturity, $140 million of First Mortgage Bonds, and $15 million of Medium-Term Notes during 2003. DPL issued $33.2 million of tax-exempt bonds having maturities ranging from 5 to 35 years, the net proceeds of which were used to refinance higher interest debt of $33 million. DPL also redeemed $85 million of First Mortgage Bonds at maturity and $32 million of higher interest rate securities. ACE redeemed $40 million of First Mortgage Bonds and $30 million Medium-Term Notes at maturity, and redeemed $58 million of higher interest rate securities. ACE Funding issued $152 million of Transition Bonds with maturities ranging from 8 to 17 years, the net proceeds of which were used to recover the stranded costs associated with an ACE generation asset and transaction costs. PCI redeemed $141 million of Medium-Term Notes in 2003. Conectiv redeemed $50 million of Medium-Term Notes. Also, in 2003, redemptions of mandatorily redeemable trust preferred securities included $125 million for Pepco, and $70 million for ACE.

Described above are $1,085.2 million of the $1,136.9 million total 2003 long-term debt issuances and $647 million of the $692.2 million total 2003 long-term debt redemptions.

Subsequent Financing

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

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

Capital Requirements

Construction Expenditures

Pepco Holdings’ construction expenditures for the year ended December 31, 2005 totaled $467.1 million of which $432.1 million was related to the Power Delivery businesses and the remainder related to Conectiv Energy and Pepco Energy Services.

For the five-year period 2006 through 2010, approximate construction expenditures are projected as follows:

	For the Year					
	2006	**2007**	**2008**	**2009**	**2010**	**Total**
Total	$571	$505	$500	$480	$492	$2,548
Power Delivery related	$535	$477	$470	$454	$469	$2,405

These amounts include estimated costs for environmental compliance by PHI’s subsidiaries. Pepco Holdings expects to fund these expenditures through internally generated cash from the Power Delivery businesses.

Dividends

Pepco Holdings’ annual dividend rate on its common stock is determined by the Board of Directors on a quarterly basis and takes into consideration, among other factors, current and possible future developments that may affect PHI’s income and cash flows. PHI’s Board of Directors declared quarterly dividends of 25 cents per share of common stock payable on March 31, 2005, June 30, 2005, September 30, 2005 and December 31, 2005.

On January 26, 2006, Pepco Holdings declared a dividend on common stock of 26 cents per share payable March 31, 2006, to shareholders of record March 10, 2006.

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

Pepco's articles of incorporation and DPL's certificate and articles of incorporation each contain provisions restricting the amount of dividends that can be paid on common stock when preferred stock is outstanding if the applicable company's capitalization ratio is less than 25%. For this purpose, the capitalization ratio is equal to (i) common stock capital plus surplus, divided by (ii) total capital (including long-term debt) plus surplus. In addition, DPL's certificate and articles of incorporation and ACE's certificate of incorporation each provide that, if preferred stock is outstanding, no dividends may be paid on common stock if, after payment, the applicable company's common stock capital plus surplus would be less than the involuntary liquidation value of the outstanding preferred stock. Pepco has no shares of preferred stock outstanding. Currently, the restriction in the ACE charter does not limit its ability to pay dividends.

Pension Funding

Pepco Holdings has a noncontributory retirement plan (the Retirement Plan) that covers substantially all employees of Pepco, DPL and ACE and certain employees of other Pepco Holdings' subsidiaries.

As of the 2005 valuation, the Retirement Plan satisfied the minimum funding requirements of the Employment Retirement Income Security Act of 1974 (ERISA) without requiring any additional funding. However, PHI's funding policy with regard to the Retirement Plan is to maintain a funding level in excess of 100% of its accumulated benefit obligation (ABO). In 2005 and 2004, PHI made discretionary tax-deductible cash contributions to the Retirement Plan in accordance with its funding policy as described below.

In 2005, the ABO for the Retirement Plan increased over 2004, due to the accrual of an additional year of service for participants and a decrease in the discount rate used to value the ABO obligation. The change in the discount rate reflected the continued decline in long-term interest rates in 2005. The Retirement Plan assets achieved returns in 2005 below the 8.50% level assumed in the valuation. As a result of the combination of these factors, in December 2005 PHI contributed $60 million (all of which was funded by ACE) to the Retirement Plan. The contribution was made to ensure that under reasonable assumptions, the funding level at year end would be in excess of 100% of the ABO. In 2004, PHI contributed a total of $10 million (all of which was funded by Pepco) to the Retirement Plan. Assuming no changes to the current pension plan assumptions, PHI projects no funding will be required under ERISA in 2006; however, PHI may elect to make a discretionary tax-deductible contribution, if required to maintain its assets in excess of ABO for the Retirement Plan.

Contractual Obligations And Commercial Commitments

Summary information about Pepco Holdings' consolidated contractual obligations and commercial commitments at December 31, 2005, is as follows:

Obligation	Total	Contractual Maturity Less than 1 Year	1-3 Years	3-5 Years	After 5 Years
	(Millions of dollars)				
Variable rate demand bonds	$ 156.4	$ 156.4	$ —	$ —	$ —
Long-term debt	5,170.3	467.1	1,178.4	614.1	2,910.7
Interest payments on debt	2,787.9	280.1	468.6	384.7	1,654.5
Capital leases	213.9	15.8	30.9	30.4	136.8
Operating leases	561.0	38.3	77.2	78.0	367.5
Non-derivative fuel and purchase power contracts (a)	7,406.8	1,823.7	1,705.0	754.3	3,123.8
Total	$16,296.3	$2,781.4	$3,460.1	$1,861.5	$8,193.3

(a) Excludes the PPA Related Obligations that are part of the back-to-back agreement that was entered into with Mirant (See "Relationship with Mirant Corporation" for additional information) and excludes ACE's BGS load supply.

Third Party Guarantees, Indemnifications and Off-Balance Sheet Arrangements

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

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

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

1. Pepco Holdings has contractual commitments for performance and related payments of Conectiv Energy and Pepco Energy Services to counterparties related to routine energy sales and procurement obligations, including requirements under BGS contracts entered into with ACE.
2. Subsidiaries of Pepco Holdings have guaranteed residual values in excess of fair value related to certain equipment and fleet vehicles held through lease agreements. As of December 31, 2005, obligations under the guarantees were approximately $7.1 million. Assets leased under agreements subject to residual value guarantees are typically for periods ranging from 2 years to 10 years. Historically, payments under the guarantees have not been made by the guarantor as, under normal conditions, the contract runs to full term at which time the residual value is minimal. As such, Pepco Holdings believes the likelihood of payment being required under the guarantee is remote.
3. Other guarantees consist of:
    - Pepco Holdings has guaranteed payment of a bond issued by a subsidiary of $14.9 million. Pepco Holdings does not expect to fund the full amount of the exposure under the guarantee.

- Pepco Holdings has guaranteed a subsidiary building lease of $3.4 million. Pepco Holdings does not expect to fund the full amount of the exposure under the guarantee.
- PCI has guaranteed facility rental obligations related to contracts entered into by Starpower. As of December 31, 2005, the guarantees cover the remaining $2.4 million in rental obligations.

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

Energy Contract Net Asset Activity

The following table provides detail on changes in net asset or liability position of the Competitive Energy business with respect to energy commodity contracts from one period to the next:

Roll-forward of Mark-to-Market Energy Contract Net Assets
For the Year Ended December 31, 2005
(Dollars are pre-tax and in millions)

	Proprietary Trading (1)	Other Energy Commodity (2)	Total
Total Marked-to-Market (MTM) Energy Contract Net Assets at December 31, 2004	$ .9	$ 25.7	$ 26.6
Total change in unrealized fair value excluding reclassification to realized at settlement of contracts	.1	36.2	36.3
Reclassification to realized at settlement of contracts	(1.0)	(124.6)	(125.6)
Effective portion of changes in fair value—recorded in Other Comprehensive Income (OCI)	—	121.9	121.9
Ineffective portion of changes in fair value—recorded in earnings	—	.3	.3
Changes in valuation techniques and assumptions	—	—	—
Purchase/sale of existing contracts or portfolios subject to MTM	—	.4	.4
Total MTM Energy Contract Net Assets at December 31, 2005	$—	$ 59.9	$ 59.9

Detail of MTM Energy Contract Net Assets at December 31, 2005 (see above)	Total
Current Assets (other current assets)	$ 173.3
Noncurrent Assets (other assets)	65.1
Total MTM Energy Assets	238.4
Current Liabilities (other current liabilities)	(114.2)
Noncurrent Liabilities (other liabilities)	(64.3)
Total MTM Energy Contract Liabilities	(178.5)
Total MTM Energy Contract Net Assets	$ 59.9

Notes:

(1) Includes all contracts held for proprietary trading since the discontinuation of that activity in 2003.

(2) Includes all SFAS No. 133 hedge activity and non-proprietary trading activities marked-to-market through earnings.

The following table provides the source of fair value information (exchange-traded, provided by other external sources, or modeled internally) used to determine the carrying amount of the Competitive Energy business' total mark-to-market energy contract net assets. The table also provides the maturity, by year, of the Competitive Energy business' mark-to-market energy contract net assets, which indicates when the amounts will settle and either generate cash for, or require payment of cash by, PHI.

PHI uses its best estimates to determine the fair value of the commodity and derivative contracts that its Competitive Energy business hold and sell. The fair values in each category presented below reflect forward prices and volatility factors as of December 31, 2005 and are subject to change as a result of changes in these factors:

Maturity and Source of Fair Value of Mark-to-Market Energy Contract Net Assets As of December 31, 2005 (Dollars are pre-tax and in millions)

	Fair Value of Contracts at December 31, 2005				
	Maturities				
Source of Fair Value	2006	2007	2008	2009 and Beyond	Total Fair Value
Proprietary Trading					
Actively Quoted (i.e., exchange-traded) prices	$ —	$ —	$—	$—	$ —
Prices provided by other external sources	—	—	—	—	—
Modeled	—	—	—	—	—
Total	$ —	$ —	$—	$—	$ —
Other Energy Commodity, net (1)					
Actively Quoted (i.e., exchange-traded) prices	$ 88.4	$ 45.5	$ 9.9	$ .4	$ 144.2
Prices provided by other external sources (2)	(68.6)	(52.1)	(1.9)	(1.0)	(123.6)
Modeled (3)	39.3	—	—	—	39.3
Total	$ 59.1	$ (6.6)	$ 8.0	$ (.6)	$ 59.9

Notes:

(1) Includes all SFAS No. 133 hedge activity and non-proprietary trading activities marked-to-market through AOCI or on the Statement of Earnings, as required.

(2) Prices provided by other external sources reflect information obtained from over-the-counter brokers, industry services, or multiple-party on-line platforms.

(3) The modeled hedge position is a power swap for 50% of the POLR obligation in the DPL territory. The model is used to approximate the forward load quantities. Pricing is derived from the broker market.

Contractual Arrangements with Credit Rating Triggers or Margining Rights

Under certain contractual arrangements entered into by PHI's subsidiaries in connection with competitive energy and other transactions, the subsidiary may be required to provide cash collateral or letters of credit as security for its contractual obligations if the credit ratings of the subsidiary are downgraded one or more levels. In the event of a downgrade, the amount required to be posted would depend on the amount of the underlying contractual obligation existing at the time of the downgrade. As of December 31, 2005, a one-level downgrade in the credit rating of PHI and all of its affected subsidiaries would have required PHI and such subsidiaries to provide aggregate cash collateral or letters of credit of up to approximately $181 million. An additional approximately $328 million of aggregate cash collateral or letters of credit would have been required in the event

of subsequent downgrades to below investment grade. PHI believes that it and its utility subsidiaries maintain adequate short-term funding sources in the event the additional collateral or letters of credit are required. See "Sources of Capital—Short-Term Funding Sources."

Many of the contractual arrangements entered into by PHI's subsidiaries in connection with competitive energy activities include margining rights pursuant to which the PHI subsidiary or a counterparty may request collateral if the market value of the contractual obligations reaches levels in excess of the credit thresholds established in the applicable arrangements. Pursuant to these margining rights, the affected PHI subsidiary may receive, or be required to post, collateral due to energy price movements. As of December 31, 2005, Pepco Holdings' subsidiaries engaged in competitive energy activities and default supply activities were in receipt of (a net holder of) cash collateral in the amount of $112.8 million in connection with their competitive energy activities.

Environmental Remediation Obligations

PHI's accrued liabilities as of December 31, 2005 include approximately $22.3 million, of which $5.6 million is expected to be incurred in 2006, for potential cleanup and other costs related to sites at which an operating subsidiary is a PRP, is alleged to be a third-party contributor, or has made a decision to clean up contamination on its own property. The principal environmental remediation obligations as of December 31, 2005, were:

- $6.8 million, of which $1.0 million is expected to be incurred in 2006, payable by DPL in accordance with a consent agreement reached with DNREC during 2001, for remediation, site restoration, natural resource damage compensatory projects and other costs associated with environmental contamination that resulted from an oil release at the Indian River power plant. That plant was sold on June 22, 2001.
- ACE's entry into a sale agreement in 2000 (which was subsequently terminated) for the B.L. England and Deepwater generating facilities (ACE transferred the Deepwater generating facility to Conectiv Energy on February 29, 2004) triggered the applicability of the New Jersey Industrial Site Recovery Act requiring remediation at these facilities. When the prospective purchaser of these generating facilities terminated the agreement of sale in accordance with the agreement's termination provisions, ACE decided to continue the environmental investigation process at these facilities. ACE and Conectiv Energy are continuing the investigation with oversight from NJDEP. ACE anticipates that it will incur approximately $2.2 million in environmental remediation costs, of which $860,000 is expected to be incurred in 2006, associated with the B.L. England generating facility. Conectiv Energy anticipates that it will incur approximately $6.0 million in environmental remediation costs, of which $690,000 is expected to be incurred in 2006, associated with the Deepwater generating facility.
- As a result of a December 7, 2003 oil spill at the B.L. England generating facility, $811,000 was accrued in December 2003 for estimated clean up, remediation, restoration, and potential NJDEP natural resources damage assessments. As of December 31, 2005, ACE has spent $611,000 for clean up, remediation, and restoration. The remaining liability of $200,000 is anticipated to cover future restoration efforts to be monitored for three years ending in May 2007. The NJDEP natural resource damage assessments, if any, have not been determined at this time.
- DPL expects to incur costs of approximately $2.6 million in connection with a site located in Wilmington, Delaware, to remediate residual material from the historical operation of a manufactured gas plant. Approximately $2.0 million is expected to be incurred in 2006.
- Pepco expects to incur approximately $1.3 million for long-term monitoring in connection with a pipeline oil release, of which $140,000 is expected to be incurred in 2006.

Sources Of Capital

Pepco Holdings' sources to meet its long-term funding needs, such as capital expenditures, dividends, and new investments, and its short-term funding needs, such as working capital and the temporary funding of long-term funding needs, include internally generated funds, securities issuances and bank financing under new or

existing facilities. PHI's ability to generate funds from its operations and to access capital and credit markets is subject to risks and uncertainties. See "Risk Factors" for a discussion of important factors that may impact these sources of capital.

Internally Generated Cash

The primary source of Pepco Holdings' internally generated funds is the cash flow generated by its regulated utility subsidiaries in the Power Delivery business. Additional sources of funds include cash flow generated from its non-regulated subsidiaries and the sale of non-core assets.

Short-Term Funding Sources

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 fund temporarily long-term capital requirements.

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, up to $275 million, and up to $250 million, respectively. The commercial paper can be issued with maturities up to 270 days from the date of issue. The commercial paper programs of PHI, Pepco, DPL, and ACE are backed by a $1.2 billion credit facility.

Long-Term Funding Sources

The sources of long-term funding for PHI and its subsidiaries are the issuance of debt and equity securities and borrowing under long-term credit agreements. Proceeds from long-term financings are used primarily to fund long-term capital requirements, such as capital expenditures and new investments, and to repay or refinance existing indebtedness.

PUHCA Restrictions

Because Pepco Holdings is a public utility holding company that was registered under the Public Utility Holding Company Act of 1935 (PUHCA 1935), it was required to obtain Securities and Exchange Commission (SEC) approval to issue securities. PUHCA 1935 also prohibited Pepco Holdings from borrowing from its subsidiaries. Under an SEC Financing Order dated June 30, 2005 (the Financing Order), Pepco Holdings is authorized to issue equity, preferred securities and debt securities in an aggregate amount not to exceed $6 billion through an authorization period ending June 30, 2008, subject to a ceiling on the effective cost of these funds. Pepco Holdings is also authorized to enter into guarantees to third parties or otherwise provide credit support with respect to obligations of its subsidiaries of up to $3.5 billion. Of this amount, only $1.75 billion may be on behalf of subsidiaries engaged in energy marketing activities. As permitted under FERC regulations promulgated under the newly effective Public Utility Holding Company Act of 2005 (PUHCA 2005), Pepco Holdings will give notice to FERC that it will continue to operate pursuant to the authority granted in the Financing Order until further notice.

Under the Financing Order, Pepco Holdings is limited to issuing no more than an aggregate of 20 million shares of common stock under the DRP and employee benefit plans during the period ending June 30, 2008.

The Financing Order requires that, in order to issue debt or equity securities, including commercial paper, Pepco Holdings must maintain a ratio of common stock equity to total capitalization (consisting of common stock, preferred stock, if any, long-term debt and short-term debt for this purpose) of at least 30 percent. At December 31, 2005, Pepco Holdings' common equity ratio for purposes of the Financing Order was 40.1 percent. The Financing Order also requires that all rated securities issued by Pepco Holdings be rated "investment grade"

by at least one nationally recognized rating agency. Accordingly, if Pepco Holdings' common equity ratio were less than 30 percent or if no nationally recognized rating agency rated a security investment grade, Pepco Holdings could not issue the security without first obtaining an amendment to the Financing Order from FERC.

If an amendment to the Financing Order or other FERC authority pursuant to the Federal Power Act or FERC regulations is required to enable Pepco Holdings or any of its subsidiaries to effect a financing, there is no certainty that such an amendment or authority could be obtained nor certainty as to the timing of FERC action.

The foregoing financing limitations also generally apply to Pepco, DPL, ACE and certain other Pepco Holdings' subsidiaries.

Money Pool

Under the Financing Order, Pepco Holdings has received SEC authorization under PUHCA 1935, which will continue until June 30, 2008 under PUHCA 2005, to establish the Pepco Holdings system money pool. The money pool is a cash management mechanism used by Pepco Holdings to manage the short-term investment and borrowing requirements of the PHI subsidiaries that participate in the money pool. Pepco Holdings may invest in but not borrow from the money pool. Eligible subsidiaries with surplus cash may deposit those funds in the money pool. Deposits in the money pool are guaranteed by Pepco Holdings. Eligible subsidiaries with cash requirements may borrow from the money pool. Borrowings from the money pool are unsecured. Depositors in the money pool receive, and borrowers from the money pool pay, an interest rate based primarily on Pepco Holdings' short-term borrowing rate. Pepco Holdings deposits funds in the money pool to the extent that the pool has insufficient funds to meet the borrowing needs of its participants, which may require Pepco Holdings to borrow funds for deposit from external sources. Consequently, Pepco Holdings' external borrowing requirements fluctuate based on the amount of funds required to be deposited in the money pool.

REGULATORY AND OTHER MATTERS

Relationship with Mirant Corporation

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

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

Transition Power Agreements

As part of the Asset Purchase and Sale Agreement, Pepco and Mirant entered into Transition Power Agreements for Maryland and the District of Columbia, respectively (collectively, the TPAs). Under the TPAs,

Mirant was obligated to supply Pepco with all of the capacity and energy needed to fulfill Pepco's SOS obligations during the rate cap periods in each jurisdiction immediately following deregulation, which in Maryland extended through June 2004 and in the District of Columbia extended until January 22, 2005.

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

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

Power Purchase Agreements

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

Pepco Pre-Petition Claims

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Regulatory Recovery of Mirant Bankruptcy Losses

If Mirant were ultimately successful in rejecting the PPA-Related Obligations or on its alternative claims to recover payments made to Pepco related to the PPA-Related Obligations and Pepco's corresponding claims against the Mirant bankruptcy estate are not recovered in full, Pepco would seek authority from the MPSC and the DCPSC to recover its additional costs. Pepco is committed to working with its regulatory authorities to achieve a result that is appropriate for its shareholders and customers. Under the provisions of the settlement agreements approved by the MPSC and the DCPSC in the deregulation proceedings in which Pepco agreed to divest its generation assets under certain conditions, the PPAs were to become assets of Pepco's distribution business if they could not be sold. Pepco believes that these provisions would allow the stranded costs of the PPAs that are not recovered from the Mirant bankruptcy estate to be recovered from Pepco's customers through its distribution rates. If Pepco's interpretation of the settlement agreements is confirmed, Pepco expects to be able

to establish the amount of its anticipated recovery from customers as a regulatory asset. However, there is no assurance that Pepco's interpretation of the settlement agreements would be confirmed by the respective public service commissions.

Pepco's Notice of Administrative Claims

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

Mirant's Fraudulent Transfer Claim

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

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

The SMECO Agreement

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

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

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

On December 1, 2005, Mirant filed both a motion with the Bankruptcy Court seeking to reject the SMECO Agreement and a complaint against Pepco and SMECO seeking to recover payments made to SMECO after the entry of the Bankruptcy Court's November 22, 2005 order holding that the SMECO Agreement is a lease of real property. On December 15, 2005, Pepco filed a motion with the District Court to withdraw jurisdiction of this

matter from the Bankruptcy Court. The motion to withdraw and Mirant's underlying motion and complaint have been stayed pending a decision of the Court of Appeals in the appeals described above.

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

Rate Proceedings

Delaware

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

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

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

On September 20, 2005, the DPSC issued an order approving DPL's request that the rate increase go into effect on May 1, 2006; subject to refund and pending evidentiary hearings. The order also suspends effectiveness of various proposed tariff rule changes until the case is concluded. The discovery process commenced on October 21,

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

District of Columbia and Maryland

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

Federal Energy Regulatory Commission

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

Restructuring Deferral

Pursuant to orders issued by the NJBPU under New Jersey Electric Discount and Energy Competition Act (EDECA), beginning August 1, 1999, ACE was obligated to provide BGS to retail electricity customers in its

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

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

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

Divestiture Cases

District of Columbia

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

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

ADITC balance ($5.3 million as of December 31, 2005) in each case as those balances exist as of the later of the date a DCPSC order is issued and all rights to appeal have been exhausted or lapsed, or the date the DCPSC order becomes operative.

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

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

Maryland

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

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

Default Electricity Supply Proceedings

District of Columbia

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

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

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

Delaware

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

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

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

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

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

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

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

Maryland

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

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

Virginia

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

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

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

New Jersey

On October 12, 2005, the NJBPU, following the evaluation of proposals submitted by ACE and the other three electric distribution companies located in New Jersey, issued an order reaffirming the current BGS auction

process for the annual period from June 1, 2006 through May 2007. The NJBPU order maintains the current size and make up of the Commercial and Industrial Energy Pricing class (CIEP) and approved the electric distribution companies' recommended approach for the CIEP auction product, but deferred a decision on the level of the retail margin funds.

Proposed Shut Down of B.L. England Generating Facility

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

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

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

ACE Auction of Generation Assets

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

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

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

Any sale of B.L. England will not affect the stranded costs associated with the plant that already have been securitized. If B.L. England is sold, ACE anticipates that, subject to regulatory approval in Phase II of the proceeding described above, approximately $9.1 million of additional assets may be eligible for recovery as stranded costs. The net gains on the sale of the Keystone and Conemaugh generating stations will be an offset to

stranded costs associated with the shutdown of B. L. England or will be offset through other ratemaking adjustments. Testimony filed by ACE with the NJBPU in December 2005 estimated net gains of approximately $126.9 million; however, the net gains ultimately realized will be dependent upon the timing of the closing of the sale of Keystone and Conemaugh generating stations, transaction costs and other factors.

Federal Tax Treatment of Cross-Border Leases

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

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

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

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

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

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

In July 2005, the FASB released a Proposed Staff Position paper that would amend SFAS No. 13 and require a lease to be repriced and the book value adjusted when there is a change or probable change in the

timing of tax benefits. Under this proposal, a material change in the timing of cash flows under PHI's cross-border leases as the result of a settlement with the IRS or a change in tax law also would require an adjustment to the book value. If adopted in its proposed form, the application of this guidance could result in a material adverse effect on PHI's financial condition, results of operations, and cash flows, even if a resolution with the IRS or a change in tax law is limited to a deferral of the tax benefits realized by PCI from its leases.

IRS Mixed Service Cost Issue

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

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

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

CRITICAL ACCOUNTING POLICIES

General

The SEC has defined a company's most critical accounting policies as the ones that are most important to the portrayal of its financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Critical estimates represent those estimates and assumptions that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, such as Statement of Position 94-6, "Disclosure of Certain Significant Risks and Uncertainties," requires management to make certain estimates and assumptions that affect the reported amounts of assets and 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 and the need/amount for reserves of future receipts from Mirant (see "Relationship with Mirant Corporation"), 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, and the judgment involved with assessing the probability of recovery of regulatory assets. Additionally, PHI is subject to legal, regulatory, and other proceedings and claims that arise in the ordinary course of our business. Pepco Holdings records an estimated liability for these proceedings and claims based upon the probable and reasonably estimable criteria contained in SFAS No. 5, "Accounting for Contingencies." Although Pepco 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.

Goodwill Impairment Evaluation

Pepco Holdings believes that the estimates involved in its goodwill impairment evaluation process represent "Critical Accounting Estimates" because (i) they may be susceptible to change from period to period because management is required to make assumptions and judgments about the discounting of future cash flows, which are inherently uncertain, (ii) actual results could vary from those used in Pepco Holdings' estimates and the impact of such variations could be material, and (iii) the impact that recognizing an impairment would have on Pepco Holdings' assets and the net loss related to an impairment charge could be material.

The provisions of SFAS No. 142, "Goodwill and Other Intangible Assets," require the evaluation of goodwill for impairment at least annually and more frequently if events and circumstances indicate that the asset might be impaired. 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. The goodwill generated in the transaction by which Pepco acquired Conectiv in 2002 was allocated to Pepco Holdings' Power Delivery segment. In order to estimate the fair value of its Power Delivery segment, Pepco Holdings discounts the estimated future cash flows associated with the segment using a discounted cash flow model with a single interest rate that is commensurate with the risk involved with such an investment. The estimation of fair value is dependent on a number of factors, including but not limited to interest rates, future growth assumptions, operating and capital expenditure requirements and other factors, changes in which could materially impact the results of impairment testing. Pepco Holdings tested its goodwill for impairment as of July 1, 2005. This testing concluded that Pepco Holdings' goodwill balance was not impaired. A hypothetical decrease in the Power Delivery segment's forecasted cash flows of 10 percent would not have resulted in an impairment charge.

Long-Lived Assets Impairment Evaluation

Pepco Holdings believes that the estimates involved in its long-lived asset impairment evaluation process represent "Critical Accounting Estimates" because (i) they are highly susceptible to change from period to period because management is required to make assumptions and judgments about undiscounted and discounted future cash flows and fair values, which are inherently uncertain, (ii) actual results could vary from those used in Pepco Holdings' estimates and the impact of such variations could be material, and (iii) the impact that recognizing an impairment would have on Pepco Holdings' assets as well as the net loss related to an impairment charge could be material.

SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets,” requires that certain long-lived assets must be tested for recoverability whenever events or circumstances indicate that the carrying amount may not be recoverable. An impairment loss may only be recognized if the carrying amount of an asset is not recoverable and the carrying amount exceeds its fair value. The asset is deemed not to be recoverable when its carrying amount exceeds the sum of the undiscounted future cash flows expected to result from the use and eventual disposition of the asset. In order to estimate an asset’s future cash flows, Pepco Holdings considers historical cash flows. Pepco Holdings uses its best estimates in making these evaluations and considers various factors, including forward price curves for energy, fuel costs, legislative initiatives, and operating costs. The process of determining fair value is done consistent with the process described in assessing the fair value of goodwill, which is discussed above.

Derivative Instruments

Pepco Holdings believes that the estimates involved in accounting for its derivative instruments represent “Critical Accounting Estimates” because (i) the fair value of the instruments are highly susceptible to changes in market value and interest rate fluctuations, (ii) there are significant uncertainties in modeling techniques used to measure fair value in certain circumstances, (iii) actual results could vary from those used in Pepco Holdings’ estimates and the impact of such variations could be material, and (iv) changes in fair values and market prices could result in material impacts to Pepco Holdings’ assets, liabilities, other comprehensive income (loss), and results of operations. See Note 2, “Summary of Significant Accounting Policies—Accounting for Derivatives” to the consolidated financial statements of PHI for information on PHI’s accounting for derivatives.

Pepco Holdings and its subsidiaries use derivative instruments primarily to manage risk associated with commodity prices and interest rates. SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended, governs the accounting treatment for derivatives and requires that derivative instruments be measured at fair value. 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, an internal model is used to interpolate broker quality price information. The same valuation methods are used to determine the value of non-derivative, commodity exposure for risk management purposes.

Pension and Other Postretirement Benefit Plans

Pepco Holdings believes that the estimates involved in reporting the costs of providing pension and other postretirement benefits represent “Critical Accounting Estimates” because (i) they are based on an actuarial calculation that includes a number of assumptions which are subjective in nature, (ii) they are dependent on numerous factors resulting from actual plan experience and assumptions of future experience, and (iii) changes in assumptions could impact Pepco Holdings’ expected future cash funding requirements for the plans and would have an impact on the projected benefit obligations, the reported pension and other postretirement benefit liability on the balance sheet, and the reported annual net periodic pension and other postretirement benefit cost on the income statement. In terms of quantifying the anticipated impact of a change in assumptions, Pepco Holdings estimates that a .25% change in the discount rate used to value the benefit obligations could result in a $5 million impact on its consolidated balance sheets and statements of earnings. Additionally, Pepco Holdings estimates that a .25% change in the expected return on plan assets could result in a $4 million impact on the consolidated balance sheets and statements of earnings and a .25% change in the assumed healthcare cost trend rate could result in a $.5 million impact on its consolidated balance sheets and statements of earnings. Pepco Holdings’ management consults with its actuaries and investment consultants when selecting its plan assumptions.

Pepco Holdings follows the guidance of SFAS No. 87, “Employers’ Accounting for Pensions,” and SFAS No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions,” when accounting for these benefits. Under these accounting standards, assumptions are made regarding the valuation of benefit obligations

and the performance of plan assets. In accordance with these standards, the impact of changes in these assumptions and the difference between actual and expected or estimated results on pension and postretirement obligations is generally recognized over the working lives of the employees who benefit under the plans rather than immediately recognized in the statement of earnings. Plan assets are stated at their market value as of the measurement date, which is December 31.

Regulation of Power Delivery Operations

The requirements of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," apply to the Power Delivery businesses of Pepco, DPL, and ACE. Pepco Holdings believes that the judgment involved in accounting for its regulated activities represent "Critical Accounting Estimates" because (i) a significant amount of judgment is required (including but not limited to the interpretation of laws and regulatory commission orders) to assess the probability of the recovery of regulatory assets, (ii) actual results and interpretations could vary from those used in Pepco Holdings' estimates and the impact of such variations could be material, and (iii) the impact that writing off a regulatory asset would have on Pepco Holdings' assets and the net loss related to the charge could be material.

Unbilled Revenue

Unbilled revenue represents an estimate of revenue earned from services rendered by Pepco Holdings' utility operations that have not yet been billed. Pepco Holdings' utility operations calculate unbilled revenue using an output based methodology. This methodology is based on the supply of electricity or gas distributed to customers. Pepco Holdings believes that the estimates involved in its unbilled revenue process represent "Critical Accounting Estimates" because management is required to make assumptions and judgments about input factors such as customer sales mix and estimated power line losses (estimates of electricity expected to be lost in the process of its transmission and distribution to customers), all of which are inherently uncertain and susceptible to change from period to period, the impact of which could be material.

New Accounting Standards

SFAS No. 154

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

SFAS No. 155

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

SAB 107 and SFAS No. 123R

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

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

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

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

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

FIN 47

Pepco Holdings adopted FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47), on December 31, 2005. A conditional asset retirement obligation refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity applies even though uncertainty exists about the time and/or method of settlement. FIN 47 requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation, when incurred, if the fair value of the liability can be reasonably estimated. Uncertainty about the timing and/or method of settlement of the conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists.

In adopting FIN 47, Pepco Holdings identified that it has asset retirement obligations to (1) remove retired underground storage tanks located in multiple locations, (2) cap and monitor an ash disposal site, (3) remove asbestos at one generating station and (4) remove thermal equipment installed under contract with a Delaware court house at the termination of the contract. As a result of these obligations, during 2005 Pepco Holdings recorded both a conditional asset retirement obligation of $1.5 million and a de minimis transition liability. Accretion expense for 2005 which relates to the Power Delivery segment has been recorded as a regulatory asset.

EITF 04-13

In September 2005, the FASB ratified EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" (EITF 04-13), which addresses circumstances under which two or more exchange transactions involving inventory with the same counterparty should be viewed as a single exchange transaction for the purposes of evaluating the effect of APB Opinion 29. EITF 04-13 is effective for new

arrangements entered into, or modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006 (April 1, 2006 for Pepco Holdings). EITF 04-13 would not affect Pepco Holdings' net income, overall financial condition, or cash flows, but rather could result in certain revenues and costs, including wholesale revenues and purchased power expenses, being presented on a net basis. Pepco Holdings is in the process of evaluating the impact of EITF 04-13 on its Consolidated Statements of Earnings presentation of purchases and sales.

RISK FACTORS

The businesses of PHI and its subsidiaries are subject to numerous risks and uncertainties, including the events or conditions identified below. The occurrence of one or more of these events or conditions could have an adverse effect on the business of PHI and its subsidiaries, including, depending on the circumstances, their financial condition, results of operations and cash flows.

PHI and its subsidiaries are subject to substantial governmental regulation. If PHI or any of its subsidiaries receives unfavorable regulatory treatment, PHI's business could be negatively affected.

PHI's Power Delivery businesses are subject to regulation by various federal, state and local regulatory agencies that significantly affects their operations. Each of Pepco, DPL and ACE is regulated by state public service commissions in its service territories, with respect to, among other things, the rates it can charge retail customers for the supply and distribution of electricity (and additionally for DPL the supply and distribution of gas). In addition, the rates that the companies can charge for electricity transmission are regulated by FERC. The companies cannot change supply, distribution, or transmission rates without approval by the applicable regulatory authority. While the approved distribution and transmission rates are intended to permit the companies to recover their costs of service and earn a reasonable rate of return, the profitability of the companies is affected by the rates they are able to charge. In addition, if the costs incurred by any of the companies in operating its transmission and distribution facilities exceed the allowed amounts for costs included in the approved rates, the financial results of that company, and correspondingly, PHI, will be adversely affected.

PHI's subsidiaries also are required to have numerous permits, approvals and certificates from governmental agencies that regulate their businesses. PHI believes that its subsidiaries have obtained or sought renewal of the material permits, approvals and certificates necessary for their existing operations and that their businesses are conducted in accordance with applicable laws; however, PHI is unable to predict the impact of future regulatory activities of any of these agencies on its business. Changes in or reinterpretations of existing laws or regulations, or the imposition of new laws or regulations, may require PHI's subsidiaries to incur additional expenses or to change the way they conduct their operations.

PHI's business could be adversely affected by the Mirant bankruptcy.

In 2000, Pepco sold substantially all of its electricity generation assets to Mirant. As part of the sale, Pepco entered into several ongoing contractual arrangements with Mirant and certain of its subsidiaries. On July 14, 2003, Mirant and most of its subsidiaries filed a voluntary petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the Northern District of Texas. Depending on the outcome of the proceedings related to the bankruptcy, the Mirant bankruptcy could adversely affect PHI's business. See "Relationship with Mirant Corporation" for additional information.

Pepco may be required to make additional divestiture proceeds gain-sharing payments to customers in the District of Columbia and Maryland.

Pepco currently is involved in regulatory proceedings in Maryland and the District of Columbia related to the sharing of the net proceeds from the sale of its generation-related assets. The principal issue in the proceedings is whether Pepco should be required to share with customers the excess deferred income taxes and accumulated deferred investment tax credits associated with the sold assets and, if so, whether such sharing

would violate the normalization provisions of the Internal Revenue Code and its implementing regulations. Depending on the outcome of the proceedings, Pepco could be required to make additional gain-sharing payments to customers and payments to the IRS in the amount of the associated accumulated deferred investment tax credits, and Pepco might be unable to use accelerated depreciation on District of Columbia and Maryland allocated or assigned property. See "Regulatory and Other Matters" for additional information.

The operating results of PHI's Power Delivery and Competitive Energy businesses fluctuate on a seasonal basis and can be adversely affected by changes in weather.

PHI's Power Delivery and Competitive Energy businesses are seasonal and weather patterns can have a material impact on their operating performance. Demand for electricity is generally greater in the summer months associated with cooling and demand for electricity and gas is generally greater in the winter months associated with heating as compared to other times of the year. Historically, the competitive energy operations of Conectiv Energy and Pepco Energy Services have produced less revenues when weather conditions are milder than normal. Such weather conditions can also negatively impact income from these operations. Energy management services generally are not seasonal.

The facilities of PHI's subsidiaries may not operate as planned or may require significant maintenance expenditures, which could decrease their revenues or increase their expenses.

Operation of generation, transmission and distribution facilities involves many risks, including the breakdown or failure of equipment, accidents, labor disputes and performance below expected levels. Older facilities and equipment, even if maintained in accordance with sound engineering practices, may require significant capital expenditures for additions or upgrades to keep them operating at peak efficiency, to comply with changing environmental requirements, or to provide reliable operations. Natural disasters and weather-related incidents, including tornadoes, hurricanes and snow and ice storms, also can disrupt generation, transmission and distribution delivery systems. Operation of generation, transmission and distribution facilities below expected capacity levels can reduce revenues and result in the incurrence of additional expenses that may not be recoverable from customers or through insurance. Furthermore, if PHI's operating subsidiaries are unable to perform their contractual obligations for any of these reasons, they may incur penalties or damages.

The transmission facilities of PHI's Power Delivery business are interconnected with the facilities of other transmission facility owners whose actions could have a negative impact on the operations of PHI's subsidiaries.

The transmission facilities of Pepco, DPL and ACE are directly interconnected with the transmission facilities of contiguous utilities and, as such, are part of an interstate power transmission grid. FERC has designated a number of regional transmission operators to coordinate the operation of portions of the interstate transmission grid. Each of Pepco, DPL and ACE is a member of PJM, which is the regional transmission operator that coordinates the movement of electricity in all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia. Pepco, DPL and ACE operate their transmission facilities under the direction and control of PJM. PJM and the other regional transmission operators have established sophisticated systems that are designed to ensure the reliability of the operation of transmission facilities and prevent the operations of one utility from having an adverse impact on the operations of the other utilities. However, the systems put in place by PJM and the other regional transmission operators may not always be adequate to prevent problems at other utilities from causing service interruptions in the transmission facilities of Pepco, DPL or ACE. If any of Pepco, DPL or ACE were to suffer such a service interruption, it could have a negative impact on its and PHI's business.

The cost of compliance with environmental laws is significant and new environmental laws may increase the expenses of PHI and its subsidiaries.

The operations of PHI's subsidiaries, both regulated and unregulated, are subject to extensive federal, state and local environmental statutes, rules and regulations, relating to air quality, water quality, spill prevention,

waste management, natural resources, site remediation, and health and safety. These laws and regulations require PHI's subsidiaries to make capital expenditures and to incur other expenditures to, among other things, meet emissions standards, conduct site remediation and perform environmental monitoring. PHI's subsidiaries also may be required to pay significant remediation costs with respect to third party sites. If PHI's subsidiaries fail to comply with applicable environmental laws and regulations, even if caused by factors beyond their control, such failure could result in the assessment of civil or criminal penalties and liabilities and the need to expend significant sums to come into compliance.

In addition, PHI's subsidiaries incur costs to obtain and comply with a variety of environmental permits, licenses, inspections and other approvals. If there is a delay in obtaining any required environmental regulatory approval, or if PHI's subsidiaries fail to obtain, maintain or comply with any such approval, operations at affected facilities could be halted or subjected to additional costs.

New environmental laws and regulations, or new interpretations of existing laws and regulations, could impose more stringent limitations on the operations of PHI's subsidiaries or require them to incur significant additional costs. PHI's current compliance strategy may not successfully address the relevant standards and interpretations of the future.

Failure to retain and attract key skilled professional and technical employees could have an adverse effect on the operations of PHI.

Implementation of PHI's strategy is dependent on its ability to recruit, retain and motivate employees. Competition for skilled employees in some areas is high and the inability to retain and attract these employees could adversely affect PHI's business, operations, and financial condition.

PHI's Competitive Energy businesses are highly competitive.

The unregulated energy generation, supply and marketing businesses in the mid-Atlantic region are characterized by intense competition at both the wholesale and retail levels. PHI's Competitive Energy businesses compete with numerous non-utility generators, independent power producers, wholesale and retail energy marketers, and traditional utilities. This competition generally has the effect of reducing margins and requires a continual focus on controlling costs.

PHI's Competitive Energy businesses rely on some transmission, storage, and distribution assets that they do not own or control to deliver wholesale and retail electricity and natural gas and to obtain fuel for their generation facilities.

PHI's Competitive Energy businesses depend upon electric transmission facilities, natural gas pipelines, and gas storage facilities owned and operated by others. The operation of their generation facilities also depends upon coal, natural gas or diesel fuel supplied by others. If electric transmission, natural gas pipelines, or gas storage are disrupted or capacity is inadequate or unavailable, the Competitive Energy businesses' ability to buy and receive and/or sell and deliver wholesale and retail power and natural gas, and therefore to fulfill their contractual obligations, could be adversely affected. Similarly, if the fuel supply to one or more of their generation plants is disrupted and storage or other alternative sources of supply are not available, the Competitive Energy businesses' ability to operate their generating facilities could be adversely affected.

Changes in technology may adversely affect PHI's Power Delivery and Competitive Energy businesses.

Research and development activities are ongoing to improve alternative technologies to produce electricity, including fuel cells, micro turbines and photovoltaic (solar) cells. It is possible that advances in these or other alternative technologies will reduce the costs of electricity production from these technologies, thereby making the generating facilities of PHI's Competitive Energy businesses less competitive. In addition, increased conservation efforts and advances in technology could reduce demand for electricity supply and distribution,

which could adversely affect PHI's Power Delivery and Competitive Energy businesses. Changes in technology also could alter the channels through which retail electric customers buy electricity, which could adversely affect PHI's Power Delivery business.

PHI's risk management procedures may not prevent losses in the operation of its Competitive Energy businesses.

The operations of PHI's Competitive Energy businesses are conducted in accordance with sophisticated risk management systems that are designed to quantify risk. However, actual results sometimes deviate from modeled expectations. In particular, risks in PHI's energy activities are measured and monitored utilizing value-at-risk models to determine the effects of potential one-day favorable or unfavorable price movements. These estimates are based on historical price volatility and assume a normal distribution of price changes and a 95% probability of occurrence. Consequently, if prices significantly deviate from historical prices, PHI's risk management systems, including assumptions supporting risk limits, may not protect PHI from significant losses. In addition, adverse changes in energy prices may result in economic losses in PHI's earnings and cash flows and reductions in the value of assets on its balance sheet under applicable accounting rules.

The commodity hedging procedures used by PHI's Competitive Energy businesses may not protect them from significant losses caused by volatile commodity prices.

To lower the financial exposure related to commodity price fluctuations, PHI's Competitive Energy businesses routinely enter into contracts to hedge the value of their assets and operations. As part of this strategy, PHI's Competitive Energy businesses utilize fixed-price, forward, physical purchase and sales contracts, tolling agreements, futures, financial swaps and option contracts traded in the over-the-counter markets or on exchanges. Each of these various hedge instruments can carry a unique set of risks in their application to PHI's energy assets. PHI must apply judgment in determining the application and effectiveness of each hedge instrument. Changes in accounting rules, or revised interpretations to existing rules, may cause hedges to be deemed ineffective. This could have material earnings implications for the period or periods in question. Conectiv Energy's objective is to hedge a portion of the expected power output of its generation facilities and the costs of fuel used to operate those facilities so it is not completely exposed to spot energy price movements. Hedge targets are approved by PHI's Corporate Risk Management Committee and may change from time to time based on market conditions. Conectiv Energy generally establishes hedge targets annually for the next three succeeding 12-month periods. Within a given 12 month horizon, the actual hedged positioning any month may be outside of the targeted range, even if the average for a 12 month period falls within the stated range. Management exercises judgment in determining which months present the most significant risk, or opportunity, and hedge levels are adjusted accordingly. Since energy markets can move significantly in a short period of time, hedge levels may also be adjusted to reflect revised assumptions. Such factors may include, but are not limited to, changes in projected plant output, revisions to fuel requirements, transmission constraints, prices of alternate fuels, and improving or deteriorating supply and demand conditions. In addition, short-term occurrences, such as abnormal weather, operational events, or intra-month commodity price volatility may also cause the actual level of hedging coverage to vary from the established hedge targets. These events can cause fluctuations in PHI's earnings from period to period. Due to the high heat rate of the Pepco Energy Services generation facilities, Pepco Energy Services generally does not enter into wholesale contracts to lock in the forward value of its plants. To the extent that PHI's Competitive Energy businesses have unhedged positions or their hedging procedures do not work as planned, fluctuating commodity prices could result in significant losses. Conversely, by engaging in hedging activities, PHI may not realize gains that otherwise could result from fluctuating commodity prices.

Acts of terrorism could adversely affect PHI's businesses.

The threat of, or actual acts of, terrorism may affect the operations of PHI and its subsidiaries in unpredictable ways and may cause changes in the insurance markets, force PHI and its subsidiaries to increase security measures and cause disruptions of fuel supplies and markets. If any of PHI's infrastructure facilities,

such as its electric generation, fuel storage, transmission or distribution facilities, were to be a direct target, or an indirect casualty, of an act of terrorism, its operations could be adversely affected. Instability in the financial markets as a result of terrorism also could affect the ability of PHI and its subsidiaries to raise needed capital.

The insurance coverage of PHI and its subsidiaries may not be sufficient to cover all casualty losses that they might incur.

PHI and its subsidiaries currently have insurance coverage for their facilities and operations in amounts and with deductibles that they consider appropriate. However, there is no assurance that such insurance coverage will be available in the future on commercially reasonable terms. In addition, some risks, such as weather related casualties, may not be insurable. In the case of loss or damage to property, plant or equipment, there is no assurance that the insurance proceeds, if any, received will be sufficient to cover the entire cost of replacement or repair.

PHI and its subsidiaries may be adversely affected by economic conditions.

Periods of slowed economic activity generally result in decreased demand for power, particularly by industrial and large commercial customers. As a consequence, recessions or other downturns in the economy may result in decreased revenues and cash flows for PHI's Power Delivery and Competitive Energy businesses.

The IRS challenge to cross-border energy sale and lease-back transactions entered into by a PHI subsidiary could result in loss of prior and future tax benefits.

PCI maintains a portfolio of cross-border energy sale-leaseback transactions, which as of December 31, 2005, had a book value of approximately $1.3 billion and from which PHI currently derives approximately $55 million per year in tax benefits in the form of interest and depreciation deductions. All of PCI's cross-border energy leases are with tax indifferent parties and were entered into prior to 2004. On February 11, 2005, the Treasury Department and IRS issued a notice informing taxpayers that the IRS intends to challenge the tax benefits claimed by taxpayers with respect to certain of these transactions. 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 leases have been under examination by the IRS as part of the normal PHI tax audit. On May 4, 2005, the IRS issued a Notice of Proposed Adjustment to PHI that challenges the tax benefits realized from interest and depreciation deductions claimed by PHI with respect to these leases for the tax years 2001 and 2002. The tax benefits claimed by PHI with respect to these leases from 2001 through December 31, 2005 were approximately $230 million. The ultimate outcome of this issue is uncertain; however, if the IRS prevails, PHI would be subject to additional taxes, along with interest and possibly penalties on the additional taxes, which could have a material adverse effect on PHI's results of operations and cash flows.

In addition, a disallowance, rather than a deferral, of tax benefits to be realized by PHI from these leases will require PHI to adjust the book value of its leases and record a charge to earnings equal to the repricing impact of the disallowed deductions. Such a change would likely have a material adverse effect on PHI's results of operations for the period in which the charge is recorded.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Regulatory and Other Matters" for additional information.

Pending tax legislation could result in a loss of future tax benefits from cross-border energy sale and lease-back transactions entered into by a PHI subsidiary.

On November 18, 2005, the U.S. Senate passed The Tax Relief Act of 2005 (S.2020) which would apply passive loss limitation rules to leases with foreign tax indifferent parties effective for taxable years beginning

after December 31, 2005, even if the leases were entered into on or prior to March 12, 2004. On December 8, 2005, the U.S. House of Representatives passed the Tax Relief Extension Reconciliation Act of 2005 (H.R. 4297), which does not contain any provision which would modify the current treatment of leases with tax indifferent parties. Enactment into law of a bill that is similar to S.2020 in its current form could result in a material delay of the income tax benefits that PCI would receive in connection with its cross-border energy leases and thereby adversely affect PHI's cash flow. 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.

In July 2005, the FASB released a Proposed Staff Position paper that would amend SFAS No. 13 and require a lease to be repriced and the book value adjusted when there is a change or probable change in the timing of tax benefits. Adoption of this Proposed Staff Position Paper and enactment of a bill that is similar to S.2020 could result in a material adverse effect on PHI's results of operations and cash flows.

See "Regulatory and Other Matters" for additional information.

IRS Revenue Ruling 2005-53 on Mixed Service Costs could require PHI to incur additional tax and interest payments in connection with the IRS audit of this issue for the tax years 2001 through 2004 (IRS Revenue Ruling 2005-53).

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

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

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

PHI believes that the $121 million tax payment is a reasonable estimate, based on current information, of the additional taxes that will be due once a new method of tax accounting is adopted. For the 2001 through 2004 period currently under audit by the IRS, there is a risk that the IRS could successfully challenge the tax accounting method utilized in 2001 through 2004, and assert additional taxes above the $121 million payment. If the IRS were to be successful in this contention, PHI would be responsible for the additional taxes above the $121 million amount, as well as interest on the additional taxes.

PHI and its subsidiaries are dependent on their ability to successfully access capital markets. An inability to access capital may adversely affect their business.

PHI and its subsidiaries rely on access to both short-term money markets and longer-term capital markets as a source of liquidity and to satisfy their capital requirements not satisfied by the cash flow from their operations. Capital market disruptions, or a downgrade in credit ratings of PHI or its subsidiaries, could increase the cost of borrowing or could adversely affect their ability to access one or more financial markets. In addition, a reduction in PHI's credit ratings could require PHI or its subsidiaries to post additional collateral in connection with some of its wholesale marketing and financing activities. Disruptions to the capital markets could include, but are not limited to:

- recession or an economic slowdown;
- the bankruptcy of one or more energy companies;
- significant increases in the prices for oil or other fuel;
- a terrorist attack or threatened attacks; or
- a significant transmission failure.

In accordance with the requirements of the Sarbanes-Oxley Act of 2002 and the SEC rules thereunder, PHI's management is responsible for establishing and maintaining internal control over financial reporting and is required to assess annually the effectiveness of these controls. The inability to certify the effectiveness of these controls due to the identification of one or more material weaknesses in these controls also could increase the financing costs of PHI and its subsidiaries or could adversely affect their ability to access one or more financial markets.

PHI's future defined benefit plan funding obligations are affected by its assumptions regarding the valuation of its benefit obligations and the performance of plan assets; actual experience which varies from the assumptions could result in an obligation of PHI to make significant unplanned cash contributions to the plan.

PHI follows the guidance of SFAS No. 87, "Employers' Accounting for Pensions," in accounting for pension benefits under the Retirement Plan, a non-contributory defined benefit plan. In accordance with these accounting standards, PHI makes assumptions regarding the valuation of benefit obligations and the performance of plan assets. Changes in assumptions, such as the use of a different discount rate or expected return on plan assets, affect the calculation of projected benefit obligations, accumulated benefit obligation (ABO), reported pension liability on PHI's balance sheet, and reported annual net periodic pension benefit cost on PHI's statement of earnings.

Furthermore, if actual pension plan experience is different from that which is expected, the ABO could be greater than the fair value of pension plan assets. If this were to occur, PHI could be required to recognize an additional minimum liability as prescribed by SFAS No. 87. The liability would be recorded as a reduction to common equity through a charge to Other Comprehensive Income (OCI), and would not affect net income for the year. The charge to OCI would be restored through common equity in future periods when the fair value of plan assets exceeded the accumulated benefit obligation. PHI's funding policy is to make cash contributions to the pension plan sufficient for plan assets to exceed the ABO, and avoid the recognition of an additional minimum liability.

Use of alternative assumptions could also impact the expected future cash funding requirements for the pension plan if PHI's defined benefit plan did not meet the minimum funding requirements of ERISA.

PHI's cash flow, ability to pay dividends and ability to satisfy debt obligations depend on the performance of its operating subsidiaries. PHI's unsecured obligations are effectively subordinated to the liabilities and the outstanding preferred stock of its subsidiaries.

PHI is a holding company that conducts its operations entirely through its subsidiaries, and all of PHI's consolidated operating assets are held by its subsidiaries. Accordingly, PHI's cash flow, its ability to satisfy its obligations to creditors and its ability to pay dividends on its common stock are dependent upon the earnings of the subsidiaries and the distribution of such earnings to PHI in the form of dividends. The subsidiaries are separate and distinct legal entities and have no obligation to pay any amounts due on any debt or equity securities issued by PHI or to make any funds available for such payment. Because the claims of the creditors and preferred stockholders of PHI's subsidiaries are superior to PHI's entitlement to dividends, the unsecured debt and obligations of PHI are effectively subordinated to all existing and future liabilities of its subsidiaries and to the rights of the holders of preferred stock to receive dividend payments.

Energy companies are subject to adverse publicity, which may render PHI and its subsidiaries vulnerable to negative regulatory and litigation outcomes.

The energy sector has been among the sectors of the economy that have been the subject of highly publicized allegations of misconduct in recent years. In addition, many utility companies have been publicly criticized for their performance during recent natural disasters and weather related incidents. Adverse publicity of this nature may render legislatures, regulatory authorities, and other government officials less likely to view energy companies such as PHI and its subsidiaries in a favorable light, and may cause PHI and its subsidiaries to be susceptible to adverse outcomes with respect to decisions by such bodies.

Provisions of the Delaware General Corporation Law and PHI's organizational documents may discourage an acquisition of PHI.

The Delaware General Corporation Law and PHI's organizational documents both contain provisions that could impede the removal of PHI's directors and discourage a third party from making a proposal to acquire PHI. As a Delaware corporation, PHI is subject to the business combination law set forth in Section 203 of the Delaware General Corporation Law, which could have the effect of delaying, discouraging or preventing an acquisition of PHI. PHI has a staggered board of directors that is divided into three classes of equal size, with one class elected each year for a term of three years. At the 2005 Annual Meeting, the shareholders approved an amendment to PHI's Certificate of Incorporation that will eliminate the staggered board over a two-year period. As a result, beginning with the 2007 Annual Meeting, all of the directors will be elected for one-year terms.

GENERAL INFORMATION ABOUT RISK MANAGEMENT

As of March 2003, Conectiv Energy ceased all proprietary trading activities, which generally consist of the entry into contracts to take a view of market direction, capture market price change, and put capital at risk. PHI's competitive energy segments are no longer engaged in proprietary trading; however, the market exposure under certain contracts entered into prior to cessation of proprietary trading activities was not eliminated due to the illiquid market environment to execute such elimination. Some of these contracts remained in place through December 2005.

The competitive energy segments actively engage in commodity risk management activities to reduce their financial exposure to changes in the value of their assets and obligations due to commodity price fluctuations. Certain of these risk management activities are conducted using instruments classified as derivatives under SFAS 133. In addition, the competitive energy segments also manage commodity risk with contracts that are not classified as derivatives. The competitive energy segments' primary risk management objectives are to manage the spread between the cost of fuel used to operate their electric generation plants and the revenue received from

the sale of the power produced by those plants and manage the spread between retail sales commitments and the cost of supply used to service those commitments in order to ensure stable and known minimum cash flows and fix favorable prices and margins when they become available. To a lesser extent, Conectiv Energy also engages in market activities in an effort to profit from short-term geographical price differentials in electricity prices among markets. PHI collectively refers to these energy market activities, including its commodity risk management activities, as "other energy commodity" activities and identifies this activity separately from that of the discontinued proprietary trading activity.

PHI's risk management policies place oversight at the senior management level through the Corporate Risk Management Committee which has the responsibility for establishing corporate compliance requirements for the competitive energy segments' energy market participation. PHI uses a value-at-risk (VaR) model to assess the market risk of its competitive energy segments' other energy commodity activities and its remaining proprietary trading contracts. PHI also uses other measures to limit and monitor risk in its commodity activities, including limits on the nominal size of positions and periodic loss limits. VaR represents the potential mark-to-market loss on energy contracts or portfolios due to changes in market prices for a specified time period and confidence level. PHI estimates VaR using a delta-gamma variance / covariance model with a 95 percent, one-tailed confidence level and assuming a one-day holding period. Since VaR is an estimate, it is not necessarily indicative of actual results that may occur.

Value at Risk Associated with Energy Contracts
For the Year Ended December 31, 2005
(Millions of dollars)

	Proprietary Trading VaR (1)	VaR for Competitive Energy Activity (2)
95% confidence level, one-day holding period, one-tailed(3)		
Period end	$0	$17.0
Average for the period	$0	$ 9.7
High	$0	$23.1
Low	$0	$ 2.9

Notes:

(1) Includes all remaining proprietary trading contracts entered into prior to cessation of this activity prior to March 2003.

(2) This column represents all energy derivative contracts, normal purchase and sales contracts, modeled generation output and fuel requirements and modeled customer load obligations for both the discontinued proprietary trading activity and the ongoing other energy commodity activities.

(3) As VaR calculations are shown in a standard delta or delta/gamma closed form 95% 1-day holding period 1-tail normal distribution form, traditional statistical and financial methods can be employed to reconcile prior Form 10-K and Form 10-Q VaRs to the above approach. In this case, 5-day VaRs divided by the square root of 5 equal 1-day VaRs; and 99% 1-tail VaRs divided by 2.326 times 1.645 equal 95% 1-tail VaRs. Note that these methods of conversion are not valid for converting from 5-day or less holding periods to over 1-month holding periods and should not be applied to "non-standard closed form" VaR calculations in any case.

For additional quantitative and qualitative information on the fair value of energy contracts see Note (13) "Use of Derivatives in Energy and Interest Rate Hedging Activities" to the consolidated financial statements of Pepco Holdings.

The competitive energy segments' portfolio of electric generating plants includes "mid-merit" assets and peaking assets. Mid-merit electric generating plants are typically combined cycle units that can quickly change

their megawatt output level on an economic basis. These plants are generally operated during times when demand for electricity rises and power prices are higher. The competitive energy segments dynamically (economically) hedge both the estimated plant output and fuel requirements as the estimated levels of output and fuel needs change. Dynamic (or economic) hedge percentages include the estimated electricity output of and fuel requirements for the competitive energy segment's generation plants that have been economically hedged and any associated financial or physical commodity contracts (including derivative contracts that are classified as cash flow hedges under SFAS 133, other derivative instruments, wholesale normal purchase and sales contracts, and load service obligations).

During the fourth quarter of 2005, Conectiv Energy revised its energy commodity hedging targets to reflect several factors, including improving market conditions that are predicted for the eastern portion of the PJM power market. Conectiv Energy intends to maintain a forward 36 month program with targeted ranges for hedging energy and capacity margins as follows:

Month	Target Range
1-12	50-100%
13-24	25-75%
25-36	0-50%

The primary purpose of the hedging program is to improve the predictability and stability of generation margins by selling forward a portion of its projected plant output, and buying forward a portion of its projected fuel supply requirements. Within each period, hedged values can vary significantly above or below the average reported values.

As of December 31, 2005, Conectiv Energy was within the established target ranges for each of the forward twelve month periods. The projected amount of on peak output hedged on average was 91%, 66% and 18% for the 1-12 month, 13-24 month and 25-36 month forward periods respectively. While Conectiv Energy attempts to place hedges that are expected to generate energy margins at or near its forecasted gross margin levels, the volumetric percentages vary significantly by month and often do not capture the peak pricing hours and the related high margins that can be realized. As a result the percentage of on peak output hedged does not represent the amount of expected value hedged.

Not all of Conectiv Energy's Merchant Generation gross margins can be hedged such as ancillary services and fuel switching. Also the hedging of locational value and capacity can be limited. These margins can be material to Conectiv Energy.

This table provides information on the competitive energy segment's credit exposure, net of collateral, to wholesale counterparties.

Schedule of Credit Risk Exposure on Competitive Wholesale Energy Contracts
(Millions of dollars)

	December 31, 2005				
Rating (1)	Exposure Before Credit Collateral (2)	Credit Collateral (3)	Net Exposure	Number of Counterparties Greater Than 10% *	Net Exposure of Counterparties Greater Than 10%
Investment Grade	$440.8	$147.1	$293.7	1	$64.8
Non-Investment Grade	7.1	1.0	6.1		
No External Ratings	29.2	15.6	13.6		
Credit reserves			$ 2.4		

(1) Investment Grade—primarily determined using publicly available credit ratings of the counterparty. If the counterparty has provided a guarantee by a higher-rated entity (e.g., its parent), it is determined based upon the rating of its guarantor. Included in "Investment Grade" are counterparties with a minimum Standard & Poor's or Moody's rating of BBB- or Baa3, respectively.

(2) Exposure before credit collateral—includes the MTM energy contract net assets for open/unrealized transactions, the net receivable/payable for realized transactions and net open positions for contracts not subject to MTM. Amounts due from counterparties are offset by liabilities payable to those counterparties to the extent that legally enforceable netting arrangements are in place. Thus, this column presents the net credit exposure to counterparties after reflecting all allowable netting, but before considering collateral held.

(3) Credit collateral—the face amount of cash deposits, letters of credit and performance bonds received from counterparties, not adjusted for probability of default, and, if applicable, property interests (including oil and gas reserves).

* Using a percentage of the total exposure.

QUANTITATIVE AND QUALITATIVE DISCLOSURES

Market Risk

Market risk represents the potential loss arising from adverse changes in market rates and prices. Certain of Pepco Holdings financial instruments are exposed to market risk in the form of interest rate risk, equity price risk, commodity risk, and credit and nonperformance risk. Pepco Holdings management takes an active role in the risk management process and has developed policies and procedures that require specific administrative and business functions to assist in the identification, assessment and control of various risks. Management reviews any open positions in accordance with strict policies in order to limit exposure to market risk.

Interest Rate Risk

Pepco Holdings and its subsidiaries floating rate debt is subject to the risk of fluctuating interest rates in the normal course of business. Pepco Holdings manages interest rates through the use of fixed and, to a lesser extent, variable rate debt. The effect of a hypothetical 10% change in interest rates on the annual interest costs for short-term and variable rate debt was approximately $3.2 million as of December 31, 2005.

Commodity Price Risk

Pepco Holdings is at risk for a decrease in market liquidity to levels that affect its capability to execute its commodity participation strategies. PHI believes the commodity markets to be sufficiently liquid to support its market participation.

Credit and Nonperformance Risk

Certain of PHI's subsidiaries' agreements may be subject to credit losses and nonperformance by the counterparties to the agreements. However, PHI anticipates that the counterparties will be able to fully satisfy their obligations under the agreements. PHI's 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. As of December 31, 2005, credit exposure to wholesale energy counterparties was weighted 94% with investment grade counterparties, 4% with counterparties without external credit quality ratings, and 2% with non-investment grade counterparties.

FORWARD-LOOKING STATEMENTS

Some of the statements contained in this Annual Report are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act and are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. These statements include declarations regarding Pepco Holdings' intents, beliefs

and current expectations. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of such terms or other comparable terminology. Any forward-looking statements are not guarantees of future performance, and actual results could differ materially from those indicated by the forward-looking statements. Forward-looking statements involve estimates, assumptions, known and unknown risks, uncertainties and other factors that may cause PHI's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements.

The forward-looking statements contained herein are qualified in their entirety by reference to the following important factors, which are difficult to predict, contain uncertainties, are beyond Pepco Holdings' control and may cause actual results to differ materially from those contained in forward-looking statements:

- Prevailing governmental policies and regulatory actions affecting the energy industry, including with respect to allowed rates of return, industry and rate structure, acquisition and disposal of assets and facilities, operation and construction of plant facilities, recovery of purchased power expenses, and present or prospective wholesale and retail competition;
- Changes in and compliance with environmental and safety laws and policies;
- Weather conditions;
- Population growth rates and demographic patterns;
- Competition for retail and wholesale customers;
- General economic conditions, including potential negative impacts resulting from an economic downturn;
- Growth in demand, sales and capacity to fulfill demand;
- Changes in tax rates or policies or in rates of inflation;
- Potential changes in accounting standards or practices;
- Changes in project costs;
- Unanticipated changes in operating expenses and capital expenditures;
- The ability to obtain funding in the capital markets on favorable terms;
- Restrictions imposed by Federal and/or state regulatory commissions;
- Legal and administrative proceedings (whether civil or criminal) and settlements that influence PHI's business and profitability;
- Pace of entry into new markets;
- Volatility in market demand and prices for energy, capacity and fuel;
- Interest rate fluctuations and credit market concerns; and
- Effects of geopolitical events, including the threat of domestic terrorism.

Any forward-looking statements speak only as to the date of this Annual Report and Pepco Holdings undertakes no obligation to update any forward-looking statements to reflect events or circumstances after the date on which such statements are made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for Pepco Holdings to predict all of such factors, nor can Pepco Holdings assess the impact of any such factor on its business or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement.

The foregoing review of factors should not be construed as exhaustive.

Management's Report on Internal Control Over Financial Reporting

The management of Pepco Holdings is responsible for establishing and maintaining adequate internal control over financial reporting. Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed its internal control over financial reporting as of December 31, 2005 based on the framework in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its assessment, the management of Pepco Holdings concluded that its internal control over financial reporting was effective as of December 31, 2005.

Management's assessment of the effectiveness of its internal controls over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in its report which is included herein.

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of
Pepco Holdings, Inc.:

We have completed integrated audits of Pepco Holdings, Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of earnings, comprehensive earnings, shareholders' equity and cash flows present fairly, in all material respects, the financial position of Pepco Holdings, Inc. and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note 15 to the consolidated financial statements, the Company restated its financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial

reporting as of December 31, 2005 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

Washington, DC
March 13, 2006

PEPCO HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS

For the Year Ended December 31,	2005	(Restated) 2004	(Restated) 2003
(In millions, except per share data)			
Operating Revenue			
Power Delivery	$4,702.9	$4,377.7	$4,015.7
Competitive Energy	3,288.2	2,755.5	3,135.8
Other	74.4	89.9	117.2
Total Operating Revenue	8,065.5	7,223.1	7,268.7
Operating Expenses			
Fuel and purchased energy	4,904.4	4,258.3	4,626.2
Other services cost of sales	712.3	637.9	577.6
Other operation and maintenance	815.7	796.6	771.4
Depreciation and amortization	422.6	440.5	422.1
Other taxes	342.2	311.4	272.2
Deferred electric service costs	120.2	36.3	(7.0)
Impairment losses	—	—	64.3
Gain on sales of assets	(86.8)	(30.0)	(68.8)
Gain on settlement of claims with Mirant	(70.5)	—	—
Total Operating Expenses	7,160.1	6,451.0	6,658.0
Operating Income	905.4	772.1	610.7
Other Income (Expenses)			
Interest and dividend income	16.0	8.7	17.3
Interest expense	(337.6)	(373.3)	(372.8)
(Loss) Income from equity investments	(2.2)	14.4	(.9)
Impairment loss on equity investments	(4.1)	(11.2)	(102.6)
Other income	50.8	29.3	41.9
Other expenses	(8.4)	(9.3)	(16.2)
Total Other Expenses	(285.5)	(341.4)	(433.3)
Preferred Stock Dividend Requirements of Subsidiaries	2.5	2.8	13.9
Income Before Income Tax Expense and Extraordinary Item	617.4	427.9	163.5
Income Tax Expense	255.2	167.3	62.1
Income Before Extraordinary Item	362.2	260.6	101.4
Extraordinary Item (net of income taxes of $6.2 million and $4.1 million for the years ended December 31, 2005 and 2003, respectively)	9.0	—	5.9
Net Income	$ 371.2	$ 260.6	$ 107.3
Earnings Per Share of Common Stock			
Basic Before Extraordinary Item	$ 1.91	$ 1.48	$ .60
Basic—Extraordinary Item	$ .05	$ —	$ .03
Basic Earnings Per Share of Common Stock	$ 1.96	$ 1.48	$ .63
Diluted Before Extraordinary Item	$ 1.91	$ 1.48	$ .60
Diluted—Extraordinary Item	$ .05	$ —	$ .03
Diluted Earnings Per Share of Common Stock	$ 1.96	$ 1.48	$ .63

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

PEPCO HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

For the Year Ended December 31, *(Millions of dollars)*	2005	(Restated) 2004	(Restated) 2003
Net income	$371.2	$260.6	$107.3
Other comprehensive earnings (losses)			
Unrealized gains (losses) on commodity derivatives designated as cash flow hedges:			
Unrealized holding gains (losses) arising during period	117.1	(20.9)	45.0
Less: reclassification adjustment for gains included in net earnings	76.1	33.4	18.9
Net unrealized gains (losses) on commodity derivatives	41.0	(54.3)	26.1
Realized gains on Treasury lock transaction	11.7	11.7	11.7
Unrealized gains (losses) on interest rate swap agreements designated as cash flow hedges:			
Unrealized holding gains (losses) arising during period	1.5	(4.5)	3.4
Less: reclassification adjustment for gains (losses) included in net earnings	1.1	(9.6)	(5.6)
Net unrealized gains on interest rate swaps	.4	5.1	9.0
Unrealized (losses) gains on marketable securities:			
Unrealized holding (losses) gains arising during period	—	(3.6)	6.1
Less: reclassification adjustment for gains included in net earnings	—	.8	.3
Net unrealized (losses) gains on marketable securities	—	(4.4)	5.8
Minimum pension liability adjustment	(5.2)	(6.9)	—
Other comprehensive earnings (losses), before income taxes	47.9	(48.8)	52.6
Income tax expense (benefit)	18.7	(19.5)	22.4
Other comprehensive earnings (losses), net of income taxes	29.2	(29.3)	30.2
Comprehensive earnings	$400.4	$231.3	$137.5

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

PEPCO HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS *(Millions of dollars)*	December 31, 2005	(Restated) December 31, 2004
CURRENT ASSETS		
Cash and cash equivalents	$ 121.5	$ 29.5
Restricted cash	23.0	42.0
Accounts receivable, less allowance for uncollectible accounts of $40.6 million and $43.7 million, respectively	1,363.1	1,122.8
Fuel, materials and supplies—at average cost	340.1	268.4
Unrealized derivative receivables	185.7	90.3
Prepaid expenses and other	118.3	119.5
Total Current Assets	2,151.7	1,672.5
INVESTMENTS AND OTHER ASSETS		
Goodwill	1,431.3	1,430.5
Regulatory assets	1,202.0	1,335.0
Investment in finance leases held in Trust	1,297.9	1,218.7
Prepaid pension expense	208.9	165.7
Other	414.0	437.8
Total Investments and Other Assets	4,554.1	4,587.7
PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment	11,384.2	11,047.8
Accumulated depreciation	(4,072.2)	(3,957.2)
Net Property, Plant and Equipment	7,312.0	7,090.6
TOTAL ASSETS	$14,017.8	$13,350.8

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

PEPCO HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

LIABILITIES AND SHAREHOLDERS' EQUITY	December 31, 2005	(Restated) December 31, 2004
(In millions, except share data)		
CURRENT LIABILITIES		
Short-term debt	$ 156.4	$ 319.7
Current maturities of long-term debt	469.5	516.3
Accounts payable and accrued liabilities	1,002.2	664.8
Capital lease obligations due within one year	5.3	4.9
Taxes accrued	322.9	56.7
Interest accrued	84.6	90.1
Other	358.4	287.8
Total Current Liabilities	2,399.3	1,940.3
DEFERRED CREDITS		
Regulatory liabilities	594.1	391.9
Income taxes	1,935.0	1,953.3
Investment tax credits	51.0	55.7
Other postretirement benefit obligations	284.2	279.5
Other	284.9	263.4
Total Deferred Credits	3,149.2	2,943.8
LONG-TERM LIABILITIES		
Long-term debt	4,202.9	4,362.1
Transition Bonds issued by ACE Funding	494.3	523.3
Long-term project funding	25.5	65.3
Capital lease obligations	116.6	122.1
Total Long-Term Liabilities	4,839.3	5,072.8
COMMITMENTS AND CONTINGENCIES (NOTE 12)		
PREFERRED STOCK OF SUBSIDIARIES		
Serial preferred stock	21.5	27.0
Redeemable serial preferred stock	24.4	27.9
Total preferred stock	45.9	54.9
SHAREHOLDERS' EQUITY		
Common stock, $.01 par value—authorized 400,000,000 shares—issued 189,817,723 shares and 188,327,510 shares, respectively	1.9	1.9
Premium on stock and other capital contributions	2,586.3	2,552.7
Accumulated other comprehensive loss	(22.8)	(52.0)
Retained earnings	1,018.7	836.4
Total Shareholders' Equity	3,584.1	3,339.0
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$14,017.8	$13,350.8

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,	2005	(Restated) 2004	(Restated) 2003
(Millions of dollars)			
OPERATING ACTIVITIES			
Net income	$ 371.2	$ 260.6	$ 107.3
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	422.6	440.5	422.1
Gain on sale of assets	(86.8)	(30.0)	(68.8)
Gain on settlement of claims with Mirant	(70.5)	—	—
Proceeds from sale of claims with Mirant	112.9	—	—
Gain on sale of other investment	(8.0)	—	—
Extraordinary item	(15.2)	—	(10.0)
Rents received from leveraged leases under income earned	(79.3)	(76.4)	(72.4)
Impairment losses	4.1	11.2	166.9
Deferred income taxes	(51.6)	217.5	197.0
Investment tax credit adjustments	(5.1)	(8.0)	(5.3)
Prepaid pension expense	(43.2)	.9	(17.3)
Energy supply contracts	(11.3)	(12.3)	(21.6)
Other deferred charges	17.0	3.9	59.1
Other deferred credits	(29.1)	(25.4)	(5.9)
Changes in:			
Accounts receivable	(153.7)	(171.0)	49.0
Regulatory assets and liabilities	76.1	(11.3)	(75.1)
Prepaid expenses	10.3	22.0	(23.1)
Materials and supplies	(71.7)	9.2	(18.0)
Accounts payable and accrued liabilities	327.5	120.4	(59.1)
Interest and taxes accrued	270.7	(36.1)	37.6
Net Cash Provided By Operating Activities	986.9	715.7	662.4
INVESTING ACTIVITIES			
Investment in property, plant and equipment	(467.1)	(517.4)	(598.2)
Proceeds from/changes in:			
Sale of office building and other properties	84.1	46.4	147.7
Sale of Starpower investment	—	29.0	—
Proceeds from combustion turbine contract cancellation	—	—	52.0
Proceeds from sale of marketable securities	—	117.6	715.2
Purchase of marketable securities	—	(98.2)	(558.6)
Purchases of other investments	(2.1)	(.3)	(11.0)
Proceeds from sale of other investments	33.8	15.1	11.5
Net investment in receivables	(7.1)	2.9	(43.2)
Changes in restricted cash	19.0	(17.8)	31.0
Net other investing activities	5.5	5.4	.9
Net Cash Used In Investing Activities	(333.9)	(417.3)	(252.7)
FINANCING ACTIVITIES			
Dividends paid on preferred stock of subsidiaries	(2.5)	(2.8)	(4.6)
Dividends paid on common stock	(188.9)	(176.0)	(170.7)
Common stock issued to the Dividend Reinvestment Plan	27.5	29.2	31.2
Redemption of debentures issued to financing trust	—	(95.0)	—
Redemption of Trust Preferred Stock of subsidiaries	—	—	(195.0)
Redemption of preferred stock of subsidiaries	(9.0)	(53.3)	(2.5)
Redemption of variable rate demand bonds	(2.0)	—	—
Issuance of common stock	5.7	288.8	1.6
Issuances of long-term debt	532.0	650.4	1,136.9
Redemption of long-term debt	(755.8)	(1,119.7)	(692.2)
(Repayments) issuances of short-term debt, net	(161.3)	136.3	(452.7)
Cost of issuances and financings	(9.0)	(26.7)	(14.6)
Net other financing activities	2.3	9.7	(8.1)
Net Cash Used In Financing Activities	(561.0)	(359.1)	(370.7)
Net Increase (Decrease) In Cash and Cash Equivalents	92.0	(60.7)	39.0
Cash and Cash Equivalents at Beginning of Year	29.5	90.2	51.2
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 121.5	$ 29.5	$ 90.2
NON-CASH ACTIVITIES			
Excess accumulated depreciation transferred to regulatory liabilities	$ 131.0	—	—
Sale of financed project account receivables	$ 50.0	—	—
Supplemental Disclosure of Cash Flow Information			
Cash paid for interest (net of capitalized interest of $3.8 million, $2.9 million and $11.3 million, respectively) and paid (received) for income taxes:			
Interest	$ 328.4	$ 356.9	$ 390.3
Income taxes	$ 44.1	$ (19.9)	$ (144.1)

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

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

(In millions, except share data)	Common Stock Shares	Common Stock Par Value	Premium on Stock	Capital Stock Expense	Accumulated Other Comprehensive (Loss) Earnings	Retained Earnings
BALANCE, DECEMBER 31, 2002 (AS REPORTED)	169,982,361	$ 1.7	$2,212.0	$ (3.2)	$(52.9)	$ 838.2
RESTATEMENT	—	—	—	—	—	(23.0)
BALANCE, DECEMBER 31, 2002 (RESTATED)	169,982,361	$ 1.7	$2,212.0	$ (3.2)	$(52.9)	$ 815.2
Net Income (RESTATED)	—	—	—	—	—	107.3
Other comprehensive income	—	—	—	—	30.2	—
Dividends on common stock ($1.00/sh.)	—	—	—	—	—	(170.7)
Issuance of common stock:						
Original issue shares	80,665	—	1.6	—	—	—
DRP original shares	1,706,422	—	31.2	—	—	—
Release of restricted stock	—	—	.1	(.1)	—	—
Reacquired Conectiv and Pepco PARS	—	—	1.7	—	—	—
BALANCE, DECEMBER 31, 2003 (RESTATED)	171,769,448	$ 1.7	$2,246.6	$ (3.3)	$(22.7)	$ 751.8
Net Income (RESTATED)	—	—	—	—	—	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 (RESTATED)	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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) ORGANIZATION

Pepco Holdings, Inc. (Pepco Holdings or PHI) is a diversified energy company that, through its operating subsidiaries, is engaged 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 February 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 a merger between DPL and ACE. As a result, DPL and ACE are wholly owned subsidiaries of Conectiv.

On February 8, 2006, the Public Utility Holding Company Act of 1935 (PUHCA 1935) was repealed and the Public Utility Holding Company Act of 2005 (PUHCA 2005) went into effect. 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). As permitted under FERC regulations promulgated under PUHCA 2005, PHI will give notice to FERC that it will continue, until further notice, to operate pursuant to the authority granted in 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.

PHI Service Company, a subsidiary service company of PHI, provides a variety of support services, including legal, accounting, tax, financial reporting, treasury, purchasing and information technology services to Pepco Holdings and its operating subsidiaries. These services are provided pursuant to a service agreement among PHI, PHI Service Company, and the participating operating subsidiaries that was filed with, and approved by, the SEC under PUHCA 1935. 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. PHI expects to continue operating under 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. Together the three companies constitute a single segment for financial reporting purposes. 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

PHI and its subsidiaries refer to this supply service in each of the jurisdictions generally as Default Electricity Supply.

The rates each company is permitted to charge for the wholesale transmission of electricity are regulated by FERC.

The profitability of the Power Delivery business depends on its ability to recover costs and earn a reasonable return on its capital investments through the rates it is permitted to charge.

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, 2005 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, the proportionate interests in jointly owned electric plants are consolidated.

In accordance with the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 46R (revised December 2003), entitled "Consolidation of Variable Interest Entities," 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, 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, and judgment involved with assessing the probability of recovery of regulatory assets. 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 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.

Also, 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 that resulted in lower depreciation expense of approximately $5.3 million.

Revenue Recognition

Regulated Revenue

The Power Delivery businesses recognize revenues from the supply and delivery of electricity and gas upon delivery to the customer, including amounts for services rendered but not yet billed (unbilled revenue). Pepco Holdings recorded amounts for unbilled revenue of $198.2 million and $227.4 million as of December 31, 2005 and 2004, respectively. These amounts are included in the "accounts receivable" line item in the accompanying Consolidated Balance Sheets. Pepco Holdings utility operations calculate unbilled revenue using an output based methodology. This methodology is based on the supply of electricity or gas distributed to customers. The unbilled revenue process requires management to make assumptions and judgments about input factors such as customer sales mix and estimated power line losses, 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 by the respective companies 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 revenues for the supply and delivery of electricity and gas upon delivery to the customer, including amounts for services rendered, 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. Revenues for Pepco Energy Services' energy efficiency construction business are recognized using the percentage-of-completion method of revenue recognition which recognizes revenue as work is completed on the contract, and revenues from its operation and maintenance and other products and services contracts are recognized when earned. Revenues 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).

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, 2005 and 2004, are as follows:

	2005	2004
	(Millions of dollars)	
Securitized stranded costs	$ 823.5	$ 887.7
Deferred energy supply costs	18.3	109.1
Deferred recoverable income taxes	150.5	162.2
Deferred debt extinguishment costs	80.9	78.3
Unrecovered purchased power contract costs	18.2	22.6
Deferred other postretirement benefit costs	17.5	20.0
Other	93.1	55.1
Total regulatory assets	$1,202.0	$1,335.0

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

	2005	2004
	(Millions of dollars)	
Deferred income taxes due to customers	$ 73.2	$ 71.0
Deferred energy supply costs	40.9	—
Regulatory liability for Federal and New Jersey tax benefit	37.6	40.7
Generation Procurement Credit, customer sharing commitment and other	76.5	26.1
Accrued asset removal costs	244.2	254.1
Excess depreciation reserve	121.7	—
Total regulatory liabilities	$594.1	$391.9

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). A customer surcharge is collected by ACE to fund principal and interest payments on the Transition Bonds. The stranded costs are amortized over the life of the Transition Bonds, which mature between 2010 and 2023.

Deferred Energy Supply Costs: The regulatory asset balances primarily represent deferred costs related to the provision of BGS and other restructuring related costs incurred by ACE as well as deferred fuel costs for DPL's gas business. All deferrals receive a return, with ACE deferrals recovered over the next 8 years and DPL's deferred fuel costs recovered annually. The regulatory liability balance at December 31, 2005 relates to ACE and reflects net over recovery associated with New Jersey BGS, NUGS, Market transition charges, and other restructuring items.

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

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

Unrecovered Purchased Power Contract Costs: Represents deferred costs related to purchase power contracts at 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.

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) and Customer Sharing Commitment: Pepco's settlement agreements related to its December 2000 generation 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 Standard Offer Service electricity supply to customers in Maryland and the District of Columbia that has not yet been distributed to customers. Pepco is currently distributing the customers' share of profits monthly to customers in a billing credit. The GPC increased by $42.3 million in December 2005 due to the settlement of the Pepco TPA claim against the Mirant bankruptcy estate.

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 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 will be amortized over 8.25 years, beginning June 2005.

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 CRMC monitors interest rate fluctuation, commodity price fluctuation, and credit risk exposure. The CRMC 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 Sheet 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. Derivatives that were used for Conectiv Energy's discontinued proprietary trading activities were marked-to-market through earnings.

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 other hedging 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 as provided under the guidance of 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 risk. These options are normally marked-to-market through current earnings because of the difficulty in qualifying options for hedge accounting treatment. Option premiums are deferred as prepaid expenses or other liabilities until the exercise period of the option is realized. 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, an internal model is 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 on 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 sales 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 electric load service. 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. 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, steps are taken to reduce or increase hedges. Portfolio-level hedging includes the use of accounting hedges (derivatives designated as cash flow 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 fuel adjustment clause approved by the DPSC and are deferred under SFAS No. 71 until recovered. At December 31, 2005, DPL's Balance Sheet included a deferred derivative receivable of $21.6 million, offset by a $21.6 million regulatory liability.

Pepco Energy Services purchases electric and natural gas futures, swaps and forward contracts to hedge price risk in connection with the purchase of physical natural gas and electricity for delivery to customers in future months. Pepco Energy Services accounts for its futures and swap contracts as cash flow hedges of forecasted transactions. 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.

Conectiv Bethlehem, LLC (CBI), a subsidiary of Conectiv Energy, entered into an interest rate swap agreement for the purpose of managing its overall borrowing rate and limiting its interest rate risk associated with debt it incurred. CBI hedged 75% of the interest rate payments for its variable rate debt. CBI formally designated its interest rate swap agreement as a cash flow hedge. CBI repaid all of its external debt and settled its interest rate swap agreement ($6.8 million gain) in September 2004.

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. Approximately 72.9% of PCI's fixed rate debt for its Medium Term Note program has been swapped into variable rate debt. 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 (SO2) and Nitrous Oxide (NOX) are allocated to generation owners by the Environmental Protection Agency (EPA) based on Federal programs designed to regulate the emissions from power plants. The EPA allotments have no cost basis to the generation owners. Depending on the run-time of a 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. Allowances from EPA allocation are added to current inventory each year at a zero basis. Additional purchased allowances are recorded at cost. Allowances sold or consumed at the power plants are expensed at a weighted-average cost. This cost tends to be relatively low due to the zero-basis allowances. Pepco Holdings has a committee established 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 in 2002.

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

Balance, December 31, 2003	$1,432.3
Less: Adjustment to pre-merger tax reserve	(1.8)
Balance December 31, 2004	$1,430.5
Add: Adjustment to pre-merger tax reserve	.8
Balance, December 31, 2005	$1,431.3

Goodwill Impairment Evaluation

The provisions of SFAS No. 142 require the evaluation of goodwill for impairment at least annually or more frequently if events and circumstances indicate that the asset might be impaired. Examples of such events and circumstances include an adverse action or assessment by a regulator, a significant adverse change in legal factors or in the business climate, and unanticipated competition. SFAS No. 142 indicates that if the fair value of a reporting unit is less than its carrying value, including goodwill, an impairment charge may be necessary. During 2005, Pepco Holdings tested its goodwill for impairment as of July 1, 2005. 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.

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

Cash and Cash Equivalents

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

Restricted Cash

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

Prepaid Expenses and Other

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

Accounts Receivable and Allowance for Uncollectible Accounts

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

Capitalized Interest and Allowance for Funds Used During Construction

In accordance with the provisions of SFAS No. 34, "Capitalization of Interest Cost," the cost of financing the construction of Pepco Holdings' non-regulated subsidiaries' electric generating plants is capitalized. Other

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

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

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

Leasing Activities

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

Amortization of Debt Issuance and Reacquisition Costs

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

Pension and Other Postretirement Benefit Plans

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

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

Severance Costs

In 2004, PHI's Power Delivery business reduced its work force through a combination of retirements and targeted reductions. This reduction plan met the criteria for the accounting treatment provided under SFAS No. 88, "Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," and SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities,"

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

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

Property, Plant and Equipment

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

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

Asset Retirement Obligations

Pepco Holdings adopted SFAS No. 143, "Accounting for Asset Retirement Obligations," on January 1, 2003 and FIN 47 as of December 31, 2005. This statement and related interpretation establish the accounting and reporting standards for measuring and recording asset retirement obligations. Based on the implementation of SFAS No. 143, $244.2 million of accrued asset removal costs ($179.2 million for DPL and $65.0 million for Pepco) at December 31, 2005, and $254.1 million of accrued asset removal costs ($176.9 million for DPL and $77.2 million for Pepco) at December 31, 2004, are reflected as regulatory liabilities in the accompanying Consolidated Balance Sheets. Commission-approved depreciation rates for ACE do not contain components for the recovery of removal cost; therefore, the recording of asset retirement obligations for ACE associated with accruals for removal cost is not required. Additionally, in 2005, Pepco Holdings recorded conditional asset retirement obligations of approximately $1.5 million. Accretion expense for 2005, which relates to the regulated Power Delivery segment, has been recorded as a regulatory asset.

Stock-Based Compensation

Pepco Holdings accounts for its stock-based employee compensation under the intrinsic value method of expense recognition and measurement prescribed by APB Opinion No. 25, "Accounting for Stock Issued to

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

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

Accumulated Other Comprehensive Loss

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

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

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

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

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

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

Financial Investment Liquidation

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

Income Taxes

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

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

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

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

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

FIN 46R

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

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

Other Non-Current Assets

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

Other Current Liabilities

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

Other Deferred Credits

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

New Accounting Standards

SFAS No. 154

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

SFAS No. 155

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

SAB 107 and SFAS No. 123R

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

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

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

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

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

EITF 04-13

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

(3) 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, 2005 as Power Delivery, Conectiv Energy, Pepco Energy Services, and Other Non-Regulated. Intercompany (intersegment) revenues and expenses are not eliminated at the segment level for purposes of presenting segment financial results. Elimination of these intercompany amounts is accomplished for PHI's consolidated results through the "Corporate and Other" column. Segment financial information for the years ended December 31, 2005, 2004, and 2003, is as follows.

	Year Ended December 31, 2005 (Millions of dollars)					
		Competitive Energy Segments				
	Power Delivery	Conectiv Energy	Pepco Energy Services	Other Non-Regulated	Corp. & Other (a)	PHI Cons.
Operating Revenue	$ 4,702.9	$2,603.6(b)	$1,487.5	$ 81.9	$ (810.4)	$ 8,065.5
Operating Expense (g)	4,032.1 (b)(e)	2,499.7	1,445.1	(5.0)(f)	(811.8)	7,160.1
Operating Income	670.8	103.9	42.4	86.9	1.4	905.4
Interest Income	8.3	31.9	2.5	112.3	(139.0)	16.0
Interest Expense	175.0	58.7	5.6	146.1	(47.8)	337.6
Other Income	20.2	3.6	1.7	7.9	2.7	36.1
Preferred Stock Dividends	2.6	—	—	—	(.1)	2.5
Income Taxes	228.6(c)	32.6	15.3	13.1	(34.4)	255.2
Extraordinary Item (net of income tax of $6.2 million)	9.0(d)	—	—	—	—	9.0
Net Income (loss)	302.1	48.1	25.7	47.9	(52.6)	371.2
Total Assets	8,720.3	2,227.6	511.6	1,404.0	1,154.3	14,017.8
Construction Expenditures	$ 432.1	$ 15.4	$ 11.3	$ —	$ 8.3	$ 467.1

Note:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(4) LEASING ACTIVITIES

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

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

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

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

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

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

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

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

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

Lease Commitments

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

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

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

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

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

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

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is comprised of the following:

At December 31, 2005	Original Cost	Accumulated Depreciation	Net Book Value
	(Millions of dollars)		
Generation	$ 1,795.1	$ 558.4	$1,236.7
Distribution	5,985.5	2,219.9	3,765.6
Transmission	1,773.5	680.4	1,093.1
Gas	339.5	100.7	238.8
Construction work in progress	364.1	—	364.1
Non-operating and other property	1,126.5	512.8	613.7
Total	$11,384.2	$4,072.2	$7,312.0

At December 31, 2004	Original Cost	Accumulated Depreciation	Net Book Value
	(Millions of dollars)		
Generation	$ 1,847.6	$ 520.4	$1,327.2
Distribution	5,712.9	2,193.7	3,519.2
Transmission	1,653.1	648.9	1,004.2
Gas	326.7	93.8	232.9
Construction work in progress	409.8	—	409.8
Non-operating and other property	1,097.7	500.4	597.3
Total	$11,047.8	$3,957.2	$7,090.6

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

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

Gain on Sale of Assets

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

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

Jointly Owned Plant

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

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

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

(6) PENSIONS AND OTHER POSTRETIREMENT BENEFITS

Pension Benefits

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

Other Postretirement Benefits

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Plan Assets

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

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

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

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

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

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

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

Cash Flows

Contributions—Retirement Plan

Pepco Holdings' funding policy with regard to the Retirement Plan is to maintain a funding level in excess of 100% with respect to its accumulated benefit obligation (ABO). PHI's Retirement Plan currently meets the

minimum funding requirements of ERISA without any additional funding. In 2005 and 2004, PHI made discretionary tax-deductible cash contributions to the plan of $60.0 million and $10.0 million, respectively, in line with its funding policy. Assuming no changes to the current pension plan assumptions, PHI projects no funding will be required under ERISA in 2006; however, PHI may elect to make a discretionary tax-deductible contribution, if required to maintain its plan assets in excess of its ABO.

Contributions—Other Postretirement Benefits

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

Expected Benefit Payments

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

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

(7) DEBT

LONG-TERM DEBT

The components of long-term debt are shown below.

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

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

NOTE: Schedule is continued on next page.

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

NOTE: Schedule is continued on next page.

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

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

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

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

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

SHORT-TERM DEBT

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

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

Commercial Paper

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

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

Floating Rate Note

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

Variable Rate Demand Bonds

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

Credit Facility

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

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

(8) INCOME TAXES

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

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

Provision for Income Taxes

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

Reconciliation of Consolidated Income Tax Expense

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

Components of Consolidated Deferred Tax Liabilities (Assets)

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

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

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

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

Non Financial Lease Asset

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

Taxes Other Than Income Taxes

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

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

(9) PREFERRED STOCK OF SUBSIDIARIES

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

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

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

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

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

Stock-Based Compensation

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

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

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

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

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

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

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

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

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

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

The maximum number of share award opportunities granted under the Merger Integration Success Program during 2002 was 241,075. The fair value per share on grant date was $19.735. Of those shares, 96,427 were restricted and have time-based vesting over three years: 20% vested in 2003, 30% vested in 2004, and 50% vested in 2005. The remaining 144,648 shares are performance-based award opportunities that may be earned based on the extent to which operating efficiencies and expense reduction goals were attained through December 31, 2003 and 2004, respectively. Although the goals were met in 2003, it was determined that 63,943 shares, including shares reallocated from participants who did not meet performance goals as well as shares reflecting accrued dividends for the period August 1, 2002 to December 31, 2003, granted to certain executives, would not vest until 2005, and then only if the cost reduction goals were maintained and Pepco Holdings' financial performance were satisfactory. A total of 9,277 shares of common stock vested under this program on December 31, 2003 for other eligible employees. On March 11, 2005, 70,315 shares, including reinvested dividends, vested for the performance period ending on December 31, 2004. A total of 44,644 shares, including reinvested dividends, vested on March 7, 2006, for the original performance period ended December 31, 2003, that was extended to December 31, 2005.

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

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

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

Dividend Restrictions

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

Calculations of Earnings Per Share of Common Stock

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

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

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

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

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

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

(a) Plan was terminated in 2005.

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

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

(11) FAIR VALUES OF FINANCIAL INSTRUMENTS

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

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

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

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

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

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

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

(12) COMMITMENTS AND CONTINGENCIES

REGULATORY AND OTHER MATTERS

Relationship with Mirant Corporation

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

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

Transition Power Agreements

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

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

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

Power Purchase Agreements

Under agreements with FirstEnergy Corp., formerly Ohio Edison (FirstEnergy), and Allegheny Energy, Inc., both entered into in 1987, Pepco was obligated to purchase 450 megawatts of capacity and energy from FirstEnergy annually through December 2005 (the FirstEnergy PPA). Under the Panda PPA, entered into in

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

Pepco Pre-Petition Claims

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

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

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

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

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

In January 2005, Mirant filed in the Bankruptcy Court a motion seeking to reject certain of its ongoing obligations under the Asset Purchase and Sale Agreement, including the PPA-Related Obligations (the Second

Motion to Reject). In March 2005, the District Court entered orders granting Pepco's motion to withdraw jurisdiction over these rejection proceedings from the Bankruptcy Court and ordering Mirant to continue to perform the PPA-Related Obligations (the March 2005 Orders). Mirant has appealed the March 2005 Orders to the Court of Appeals.

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

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

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

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

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

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

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

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

Regulatory Recovery of Mirant Bankruptcy Losses

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

Pepco's Notice of Administrative Claims

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

Mirant's Fraudulent Transfer Claim

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

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

The SMECO Agreement

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

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

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

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

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

Rate Proceedings

Delaware

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

As authorized by the April 16, 2002 settlement agreement in Delaware relating to the acquisition of Conectiv by Pepco (the Delaware Merger Settlement Agreement), on May 4, 2005, DPL filed with the DPSC a proposed increase of approximately $6.2 million in electric transmission service revenues, or about 1.1% of total Delaware retail electric revenues. This revenue increase covers the Delaware retail portion of the increase in the

"Delmarva zonal" transmission rates on file with FERC under the PJM Open Access Transmission Tariff (OATT) and other transition PJM charges. This level of revenue increase will decrease to the extent that competitive suppliers provide the supply portion and its associated transmission service to retail customers. In that circumstance, PJM would charge the competitive retail supplier the PJM OATT rate for transmission service into the Delmarva zone and DPL's charges to the retail customer would exclude as a "shopping credit" an amount equal to the SOS supply charge and the transmission and ancillary charges that would otherwise be charged by DPL to the retail customer. DPL began collecting this rate change for service rendered on and after June 3, 2005, subject to refund pending final approval by the DPSC.

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

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

District of Columbia and Maryland

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

Federal Energy Regulatory Commission

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

Restructuring Deferral

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

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

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

power plants with contracts to sell ACE approximately 397 megawatts of electricity, were filed on October 3, 2005. The NJBPU Staff filed briefs on December 12, 2005. ACE filed its reply briefs on January 30, 2006.

Divestiture Cases

District of Columbia

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

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

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

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

Maryland

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

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

Default Electricity Supply Proceedings

District of Columbia

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

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

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

Delaware

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

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

include a fixed annual margin of $2.75 million, plus estimated incremental expenses, a cash working capital allowance, and recovery with a return over five years of the capitalized costs of a billing system to be used for billing HPS customers.

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

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

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

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

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

Maryland

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

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

Virginia

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

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

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

New Jersey

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

Proposed Shut Down of B.L. England Generating Facility

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

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

In a January 24, 2006 Administrative Consent Order (ACO) among PHI, Conectiv, ACE, the New Jersey Department of Environmental Protection (NJDEP) and the Attorney General of New Jersey, ACE agreed to shut down and permanently cease operations at the B.L. England generating facility by December 15, 2007 if ACE

does not sell the plant. The shut-down of the B.L. England generating facility will be subject to necessary approvals from the relevant agencies and the outcomes of the auction process, discussed under "ACE Auction of Generating Assets," below.

ACE Auction of Generation Assets

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

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

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

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

Federal Tax Treatment of Cross-Border Leases

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

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

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

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

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

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

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

IRS Mixed Service Cost Issue

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

On the same day as the Revenue Ruling was issued, the Treasury Department released regulations that, if adopted in their current form, would require Pepco, DPL, and ACE to change their method of accounting with respect to capitalizable construction costs for income tax purposes for all future tax periods beginning in 2005.

Under these regulations, Pepco, DPL, and ACE will have to capitalize and depreciate a portion of the construction costs that they have previously deducted and include the impact of this adjustment in taxable income over a two-year period beginning with tax year 2005. PHI is continuing to work with the industry to determine an alternative method of accounting for capitalizable construction costs acceptable to the IRS to replace the method disallowed by the proposed regulations.

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

General Litigation

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

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

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

Environmental Litigation

PHI, through its subsidiaries, is subject to regulation by various federal, regional, state, and local authorities with respect to the environmental effects of its operations, including air and water quality control, solid and hazardous waste disposal, and limitations on land use. In addition, federal and state statutes authorize governmental agencies to compel responsible parties to clean up certain abandoned or unremediated hazardous

waste sites. PHI's subsidiaries may incur costs to clean up currently or formerly owned facilities or sites found to be contaminated, as well as other facilities or sites that may have been contaminated due to past disposal practices. Although penalties assessed for violations of environmental laws and regulations are not recoverable from customers of the operating utilities, environmental clean-up costs incurred by Pepco, DPL and ACE would be included by each company in its respective cost of service for ratemaking purposes.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) Subsidiaries of Pepco Holdings have guaranteed residual values in excess of fair value related to certain equipment and fleet vehicles held through lease agreements. As of December 31, 2005, obligations under the guarantees were approximately $7.1 million. Assets leased under agreements subject to residual value

guarantees are typically for periods ranging from 2 years to 10 years. Historically, payments under the guarantees have not been made by the guarantor as, under normal conditions, the contract runs to full term at which time the residual value is minimal. As such, Pepco Holdings believes the likelihood of payment being required under the guarantee is remote.

(3) Other guarantees consist of:

- Pepco Holdings has guaranteed payment of a bond issued by a subsidiary of $14.9 million. Pepco Holdings does not expect to fund the full amount of the exposure under the guarantee.
- Pepco Holdings has guaranteed a subsidiary building lease of $3.4 million. Pepco Holdings does not expect to fund the full amount of the exposure under the guarantee.
- PCI has guaranteed facility rental obligations related to contracts entered into by Starpower. As of December 31, 2005, the guarantees cover the remaining $2.4 million in rental obligations.

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

Contractual Obligations

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

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

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

Conectiv Energy's 2003 loss includes the unfavorable impact of net trading losses of $26.6 million that resulted from a dramatic rise in natural gas futures prices during February 2003, net of an after tax gain of $15 million on the sale of a purchase power contract in February 2003. As of March 2003, Conectiv Energy ceased all proprietary trading activities, which generally consisted of the entry into contracts to take a view of market direction, capture market price change, and put capital at risk. PHI's Competitive Energy businesses are no longer engaged in proprietary trading; however, the market exposure under certain contracts entered into prior to

cessation of proprietary trading activities was not completely eliminated because perfectly offsetting contractual positions were not available in the market at that time. These contracts will remain in place until they are terminated and their values are realized.

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

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

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

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

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

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

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

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

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

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

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

(14) EXTRAORDINARY ITEMS

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

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

(15) RESTATEMENT

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

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

(16) QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

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

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

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

(a) Relates to ACE's electric distribution rate case settlement that was accounted for in the first quarter of 2005. This resulted in ACE's reversal of $9.0 million in after tax accruals related to certain deferred costs that are now deemed recoverable. This amount is classified as an extraordinary gain since the original accrual was part of an extraordinary charge in conjunction with the accounting for competitive restructuring in 1999.
(b) Includes $8.3 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.
(c) Includes $68.1 million gain ($40.7 million after tax) from sale of non-utility land owned by Pepco at Buzzard Point.
(d) Includes $70.5 million ($42.2 million after tax) gain (net of customer sharing) from the settlement of the Pepco TPA Claim and the Pepco asbestos claim against the Mirant bankruptcy estate.
(e) Includes $13.3 million gain ($8.9 million after tax) related to PCI's liquidation of a financial investment that was written off in 2001.
(f) Includes $2.6 million in income tax expense related to the mixed service cost issue under IRS Ruling 2005-53.
(g) Includes tax benefit of $13.2 million related to a local jurisdiction's final consolidated tax return regulations, which are retroactive to 2001.
(h) Includes an $11.2 million pre-tax impairment charge ($7.3 million after tax) to reduce the value of PHI's investment in Starpower Communications, LLC to $28 million. Also includes $11.2 million pre-tax gain ($6.6 million after tax) from the disposition of a joint venture associated with the Vineland co-generation facility.
(i) Includes $12.8 million pre-tax loss ($7.7 million after tax) associated with the prepayment of the debt incurred by Conectiv Bethlehem, LLC.
(j) Includes a $14.7 million pre-tax ($8.6 million after tax) gain from the condemnation settlement associated with the transfer of Vineland distribution assets.
(k) Includes a $19.7 million charge related to an IRS Settlement.

(17) SUBSEQUENT EVENTS

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

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

BOARD OF DIRECTORS AND OFFICERS

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Washington, D.C.

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Hunton & Williams
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Vice Chairman and General
Counsel
Pepco Holdings, Inc.

Dennis R. Wraase[3]
Chairman of the Board,
President and Chief
Executive Officer
Pepco Holdings, Inc.

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Dennis R. Wraase
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President and Chief
Executive Officer

William T. Torgerson
Vice Chairman and General
Counsel

Thomas S. Shaw
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Chief Operating Officer
(President and Chief
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Beverly L. Perry
Senior Vice President
Government Affairs and
Public Policy

William J. Sim
Senior Vice President
(President and
Chief Executive Officer,
Potomac Electric Power
Company and Atlantic City
Electric Company)

William H. Spence
Senior Vice President
(President, PHI Competitive
Businesses)

Ronald K. Clark
Vice President and Controller

Kenneth P. Cohn
Vice President and
Chief Information 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

James S. Potts
Vice President, Safety and
Environment

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

David M. Velazquez
Vice President, Strategic
Planning

Karen G. Almquist
Assistant Treasurer and
Assistant Secretary

Donna J. Kinzel
Assistant Treasurer

Allen E. Webb
Assistant Controller

Kathy A. White
Assistant Controller

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 Dr. McKenzie 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

Common Stock and All Series of Preferred Stock (Atlantic City Electric Company and Delmarva Power & Light Company)

In writing:
American Stock Transfer & Trust Company
6201 15th Avenue
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, 2005, 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 as listed in the left column.

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

In writing:
The Bank of New York
P. O. Box 11265
Church Street Station
New York, NY 10286

By telephone:
Toll Free: 1-800-548-5075

Delmarva Power & Light Company Bonds

In writing:
JP Morgan Chase Bank
Institutional Trust Service
4 New York Plaza, 15th Floor
New York, NY 10004

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 9, 2005, 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 13, 2006.

Stock Market Information

2005	**High**	**Low**	**Dividend**	**2004**	**High**	**Low**	**Dividend**
1st Quarter	$23.25	$20.26	$.25	**1st Quarter**	$21.71	$19.08	$.25
2nd Quarter	$24.20	$20.50	$.25	**2nd Quarter**	$20.70	$16.94	$.25
3rd Quarter	$24.46	$21.87	$.25	**3rd Quarter**	$20.70	$17.90	$.25
4th Quarter	$23.89	$20.36	$.25	**4th Quarter**	$21.68	$19.88	$.25

(Close on December 30, 2005: $22.37)
(Close on December 31, 2004: $21.32)
Number of Shareholders at December 30, 2005: 73,154

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