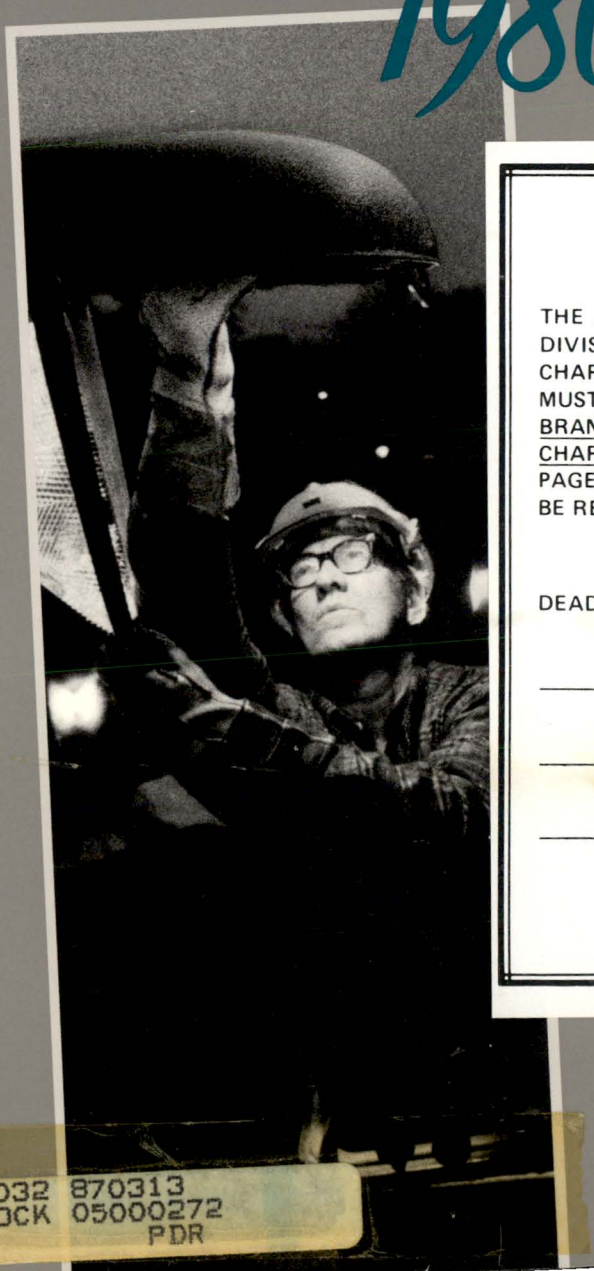
Atlantic Electric

Annual Report

1986



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P.O. Box 1264
1199 Black Horse Pike
Pleasantville, New Jersey 08232
(609) 645-4100

ABOUT THE COMPANY

Atlantic City Electric Company is the official name of the Company as it appears in the Articles of Incorporation. The Company also uses the registered trade name Atlantic Electric in various shareholder and customer publications and in its daily operations.

NOTICE OF ANNUAL MEETING

The 1987 Annual Meeting of Shareholders will be held on Wednesday, April 22, 1987 at the Quail Hill Inn, Smithville, New Jersey. A Notice of Annual Meeting will be mailed in March to those shareholders entitled to vote.

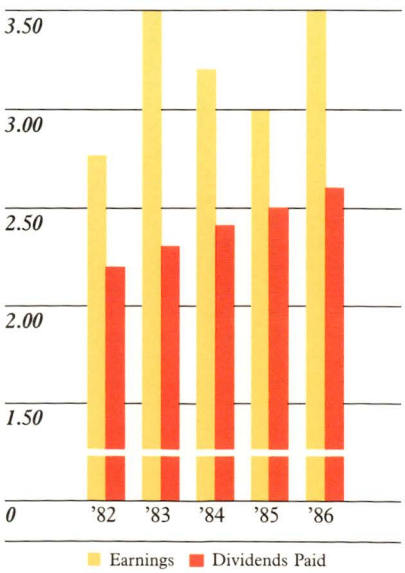
CONTENTS

Financial Highlights

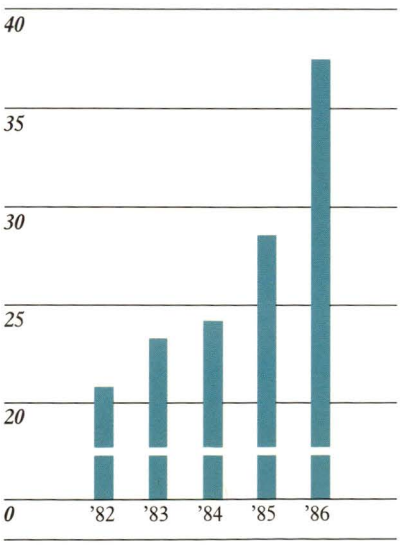
Results of Operations 1986-1984

	1986	% Change 1986-1985	1985	% Change 1985-1984	1984
Electric Operating Revenues (000's)	**$ 582,961**	.6	$ 579,733	5.5	$ 549,531
Operating Expenses (000's)	**$ 487,507**	(.6)	$ 490,327	7.0	$ 458,140
Net Income (000's)	**$ 69,550**	14.9	$ 60,519	(4.4)	$ 63,277
Earnings Per Common Share	**$ 3.50**	16.7	$ 3.00	(6.3)	$ 3.20
Dividends Paid Per Common Share	**$ 2.60**	2.8	$ 2.53	4.5	$ 2.42
Total Assets (000's)	**$1,398,886**	7.6	$1,299,633	6.5	$1,220,503
Cash Construction Expenditures (000's)	**$ 92,283**	(1.8)	$ 94,017	11.1	$ 84,630
Sales of Electricity (KWH) (000's)	**6,521,414**	5.2	6,199,672	2.4	6,053,791
Price Paid Per KWH— (All Customers)	**9.033¢**	(4.7)	9.481¢	5.4	8.999¢
Total Customer Accounts (Year-end)	**407,776**	3.2	395,205	2.9	384,166
Number of Shareholders— Common Stock (Year-end)	**47,133**	(3.1)	48,635	2.5	47,446
Number of Employees (Year-end)	**2,168**	3.3	2,099	4.3	2,012
Book Value	**$ 25.67**	3.7	$ 24.76	2.0	$ 24.27

Earnings and Dividends Paid Per Share of Common Stock
(in dollars)



Market Price Per Share of Common Stock
(year-end in dollars)



To Our Shareholders:

In 1986, we celebrated our first century of service and the results of the year are further cause for celebration—earnings and dividends are up, and the price of electricity is down. It has been one of the Company's best years ever! Per share earnings for 1986 amounted to $3.50, an all-time record, and it represents a substantial increase above the 1985 level of $3.00.

Our fine record of dividend increases continued. For thirty-four consecutive years now, dividends paid per share have increased. In 1986, the dividends paid amounted to $2.60 per share, reflecting the decision by the Directors last June to increase the quarterly dividend rate by one cent, to $.65½.

Our strong financial results derived in large measure from the growth in energy sales. More than 11,600 new customers joined us this past year, and kilowatthour sales increased by 5.2%. Growth was exceptional in both the commercial and residential sectors. Peak demand reached a new level of 1,459 MW, representing a 1.9% increase over the prior record set in 1985.

[l to r]: E.D. Huggard, J.D. Feehan

Future financial performance will continue to depend on both sales and appropriate rate relief. In March 1986, the New Jersey Board of Public Utilities granted us a $13.6 million increase in base rates. We have also been involved in a separate rate proceeding dealing with our 5% share of the new Hope Creek unit, which is jointly owned with Public Service Electric & Gas Company. Hope Creek was completed and joined the other units in the PJM power pool in December 1986.

The BPU has been conducting hearings within a Public Service case to examine the costs of the Hope Creek unit and to fix a level of investment for ratemaking purposes. We understand that the BPU has just issued an oral decision in the Public Service case, recognizing only $4.129 billion of total Hope Creek costs, and disallowing $455 million. We will have to wait until written orders are issued in that case and in ours to determine what the effect on the Company might be. A disallowance by the BPU of some of our Hope Creek costs could result in a rate increase lower than we had requested and, based upon new accounting standards for regulated industries issued in December 1986, a write-down of some portion of our booked investment would result. The accounting standard is not required to be implemented by the Company until 1988 and, in that event, the adjustment would be reflected in a restatement of previously reported retained earnings.

On the positive side, Hope Creek is a new generating unit which successfully completed pre-commercial testing in record time, has been performing well, and will play an important role in our capacity mix for the future.

We expect that the rate decision to be issued shortly by the BPU will result in a net decrease in rates for our customers: An increase for Hope Creek and certain other costs would be offset by decreases due to fuel savings with Hope Creek on-line, lower charges for other fuel and purchased power costs and reduced federal income tax expense as a result of the Tax Reform Act of 1986.

Once again in 1986, about 80% of our energy was provided by coal and nuclear sources. Our diverse mix of fuels and generating units continues to be a significant factor in managing costs: Rates charged our customers have been relatively stable since 1984, and we expect that stability to continue through this coming year.

The Company enjoyed the benefits of improving financial markets in 1986. As the Standard & Poor's 500 index increased by 18% over the year, our stock price showed an increase of 30%. A shareholder buying ATE for $28⅞ at the beginning of

1986 would have seen, by year's end, an increase of about $8.50 in share price. Coupled with the $2.60 of dividends paid, the total return on that initial investment would have been 38%. Interest rates were quite favorable in 1986, and we were able to replace some of our outstanding long term debt with lower-cost new issues.

We have been giving a lot of thought to the changes occurring in our industry. Developments in regulation, competition and alternate energy sources will be the challenges which, if managed properly, can become rewarding opportunities. In the process, we have sharpened our focus on customers, choices and costs.

In the future, strong financial performance will depend on our ability to further increase productivity and manage expenses. We believe that the interests of both customers and shareholders can best be served with a "least-cost" strategy: More intensive conservation and load management, customer-owned generation and cogeneration are key options in our energy future. Combined with a reduced level of investment in new, traditional generating capacity, it should be possible to provide our customers with the energy they require at the lowest reasonable cost. From the shareholders' perspective, we want to assure that future investment by the Company fits into a least-cost system, and that it will earn an appropriate return.

We have come to believe that a holding company structure would provide greater flexibility and better support for this strategy. The proposed holding company, Atlantic Energy, Inc., will have Atlantic City Electric Company as its main subsidiary. Other, unregulated subsidiaries will complement the electric company in developing future power supply, such as cogeneration, and supporting economic vitality in the service area. We also believe that there are additional opportunities for us to enhance earnings through financial investment activities.

Although we believe that diversification will be beneficial, our deployment of resources outside of the core business will be conservative. Diversification will remain related, in large part, to assuring that the people of our service area will have the energy which they need.

Developments of the past year have made full use of the many skills provided by each member of the Board. One of our Directors, Richard M. Dicke, has served on the Board since 1969. Having attained the age of 71, Rick will not be standing for re-election as a Director at this year's Annual Meeting. By that time, Rick will have served on the Board for more than 18 years. His expertise in corporate and securities law is renowned throughout the industry, and we have benefited, in lasting measure, from his unlimited energy and dedication to the success of the Company.

Our newest Director, Richard McGlynn, has been of great assistance since joining us last April, providing the Board with his vast experience and knowledge of regulatory and legal matters. We would also note, with great sadness, the passing of John Miner in January 1987. John was one of our senior Directors, having served on the Board since 1973. His insight and financial advice have been of great value, and we will treasure the contribution which he has made over the years to the Company. We will miss him as a dear friend.

A sense of family binds the people of Atlantic Electric together. Growth and change can be rewarding, particularly for a family which has a common sense of purpose. For us, it is a belief that success is achieved by providing our customers the services they desire. That, in turn, brings added value to your investment and, we trust, pride in your Company.

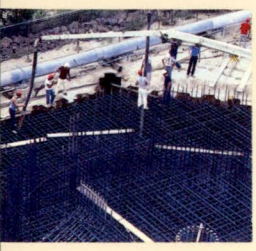
For the Board of Directors,

J. D. Feehan
Chairman of the Board

E. D. Huggard
President and Chief Executive Officer

February 6, 1987

Construction



The 1986 program totalled $109.3 million. Major projects within that program included:

Construction of Hope Creek was completed and was made available for full dispatch to the power pool in December 1986. Hope Creek set a new industry record for the fastest start-up of a boiling water reactor.

The exterior shell for a new 475′ chimney was constructed at the B. L. England Station. It will serve two coal fired and one oil fired unit and will help maintain compliance with emission standards. The structure is expected to be in service in 1988 and when completed, will resemble a lighthouse.

Deepwater Unit #1 was modified to burn both oil and natural gas. The unit now has the capability to switch between fuels based on economics. A new electronic control system was installed during the conversion that will enhance the unit's efficiency.

Modifications made to B. L. England Unit #3 during 1986 are expected to improve the unit's load-tracking capabilities during off-peak times.

In July 1986 the Company began using a computer-aided drafting system for producing drawings. This system will improve drawing clarity, promote standardization and improve productivity.

Operations

A new energy peak demand of 1,459 megawatts occurred on July 7, 1986 representing a 1.9% increase over the 1985 recorded peak. Sales for 1986 were 6.5 billion kilowatt-hours, a 5.2% increase over 1985.

Coal and nuclear generating facilities provided 78% of energy needs in 1986. The continued use of coal and nuclear saved customers an estimated $90 million in fuel costs.

Jointly-owned units combined produced about 20% more energy during 1986 than in 1985. Unit output records were achieved at Keystone and Conemaugh facilities.

The Generating Equipment Maintenance System was instituted in 1986 to streamline maintenance management functions. The system will improve our ability to plan and schedule maintenance projects, check their progress and track their costs.

Administration

A new training center was opened in June. Training activities were consolidated to efficiently provide a broad range of programs including computer literacy, skill development, personal growth and safety in the work place.

President Doug Huggard met with employees at various locations in a series of meetings throughout 1986. Through these sessions, suggestions for improvements in working conditions and performance evaluations were made and implemented.

Employee and Company contributions to the United Way in 1986 exceeded $186,000, representing about a 15% increase over last year.

Through the Good Neighbor Fund, customer and Company donations assisted 1,500 needy families with their heating bills.

Planning and Rates

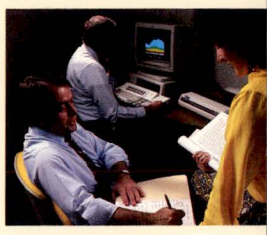
In March 1986, the New Jersey Board of Public Utilities (BPU) granted a $13.6 million increase in base annual revenues. The order allowed an overall rate of return of 11.42% and a return on common equity of 14.1%.

Effective January 1986, the BPU approved reductions in energy adjustment revenues totalling $44 million. The decrease in rates primarily reflected lower projected fuel costs.

Proposed restructuring of Atlantic Electric into a holding company was approved by the BPU in December 1986.

The corporate planning process was further refined in 1986 with the establishment of specific Strategic and Operational Planning Committees. The Strategic Planning Committee coordinates the activities that deal with the nature and the direction of the Company while the Operational Planning Committee concentrates on operational planning and objectives.

Special meetings of the Company's Board of Directors were held during 1986 to evaluate certain strategic planning issues including opportunities for diversification, changes in utility regulation and alternate energy technologies.



Finance and Accounting

The Company sold $125 million of 8⅞% Series of First Mortgage Bonds due 2016 and $95 million of 8% Series of First Mortgage Bonds due 1996. Some of the proceeds were used to redeem $143.2 million of First Mortgage Bonds of 11½% or greater.

Through redemption and sinking funds in 1986, the Company reduced its embedded cost of debt by about 72 basis points to 8.9% and its embedded cost of preferred stock by about 30 basis points to 7.2%.

On July 2,1986 members of the Company's senior management appeared before the New York Society of Security Analysts to discuss the Company's financial performance and its least cost planning strategy.

During 1986, the first module of the new Cost Center Management System was used to develop portions of the Company's 1987 operation and maintenance budget. Other modules of this accounting information system are being implemented as part of a long-term plan to provide better control of costs.

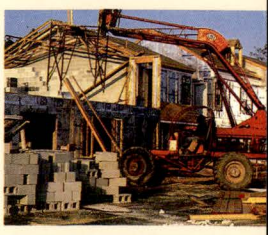
Customer Service

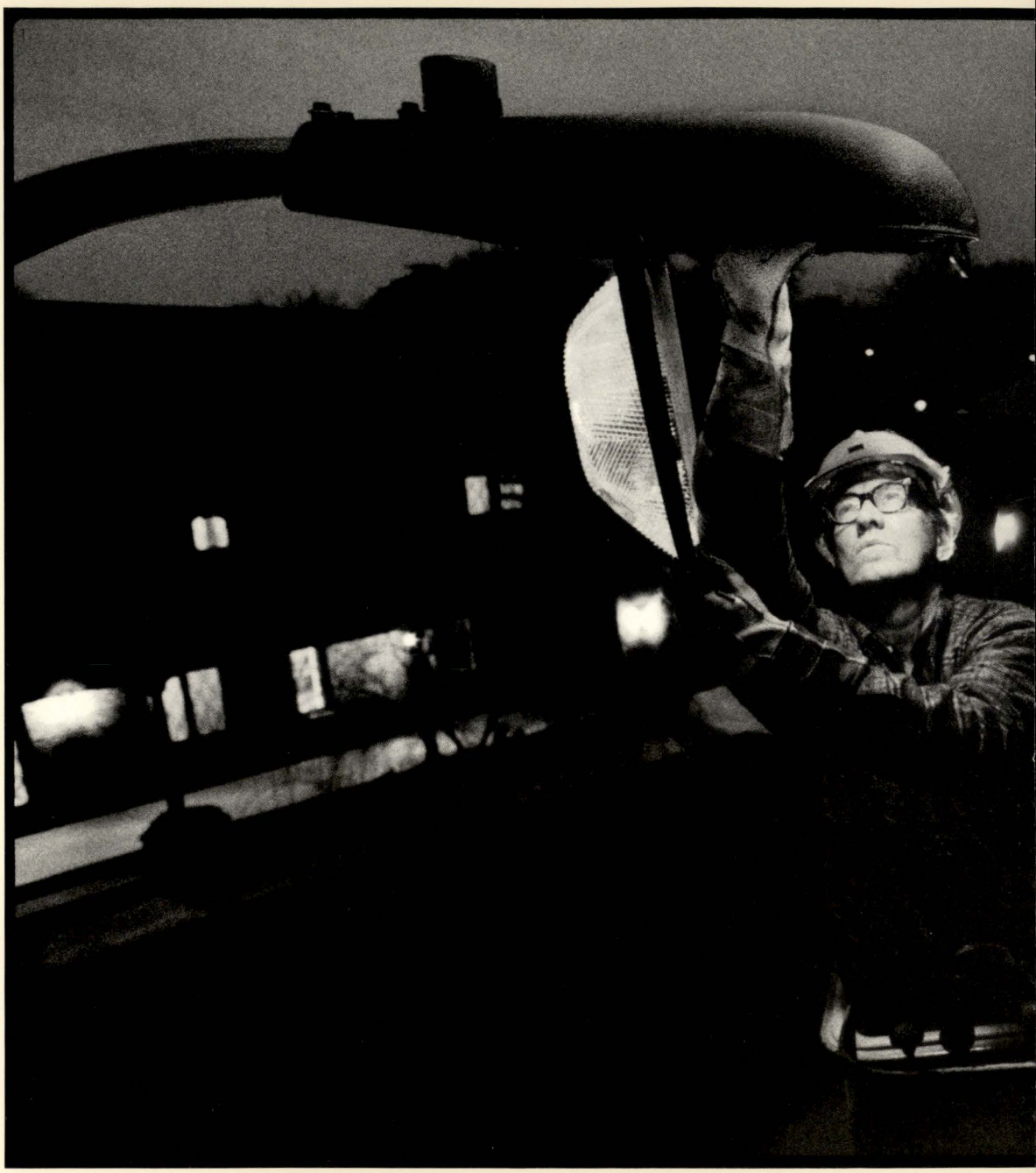
At year end 1986, the total number of customer accounts was approximately 408,000, a 3.2% increase over 1985. The number of Residential and Commercial customers increased 3.2% and 3.1%, respectively, while the number of Industrial customers decreased slightly.

Two additional customer courtesy centers were opened in the service territory in 1986. These locations provide customers with convenience and direct access to Company personnel for handling a full spectrum of customer services.

Conservation and load management programs provided customers with opportunities to control their cost of electricity in 1986. Over 5,200 home energy audits were completed and about 4,700 customers took advantage of customer seal-up programs.

Over 900 employees from all areas of the Customer Service section participated in one of the Company's largest training programs. The motivational program focused on the importance of good customer service in an emerging competitive environment.



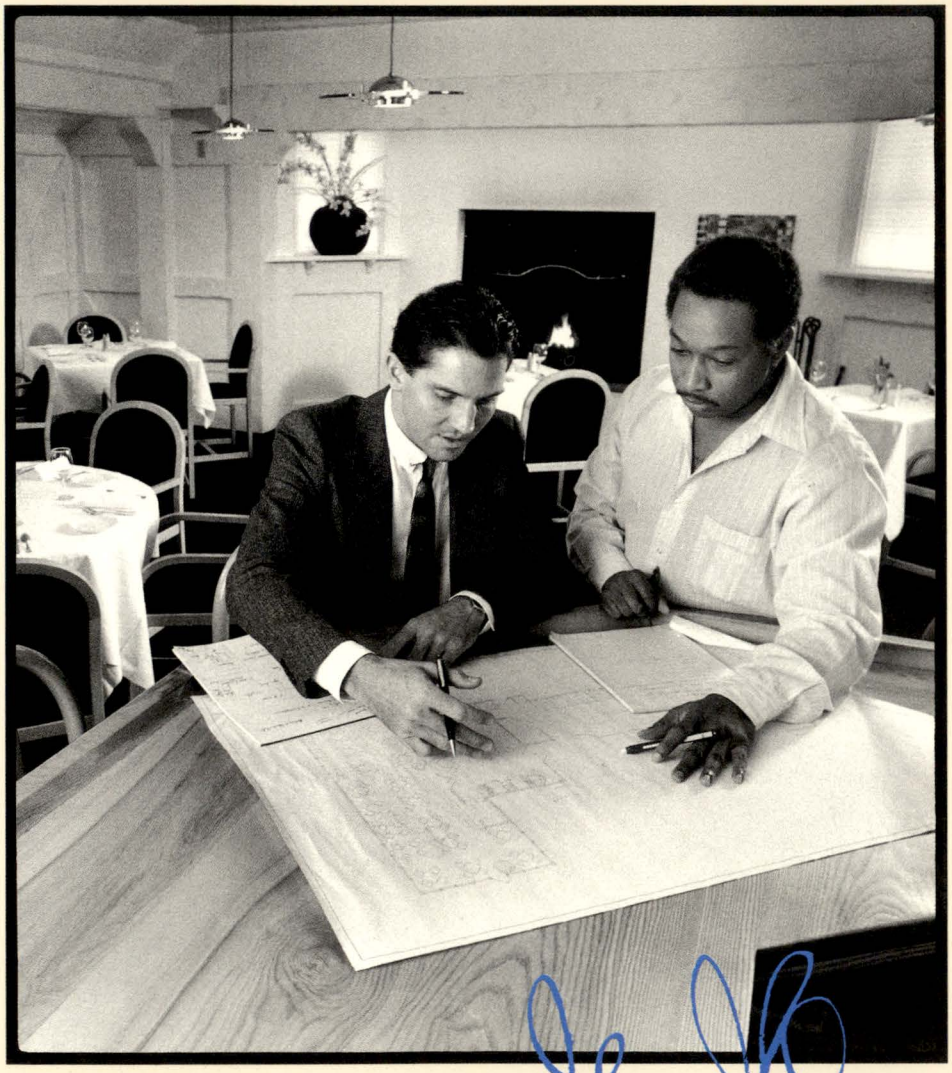


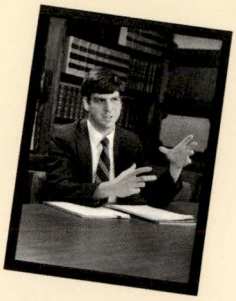
"The familiar images of customer service tell only a part of the story. For us, service is tradition. It's a spirit and commitment to help customers for both the short and long term. That's just good business. Our tradition becomes meaningful through the efforts of all our employees, each one leaving a personal imprint on the service we provide."

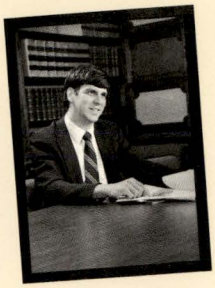
E.D. HUGGARD—*President and Chief Executive Officer*

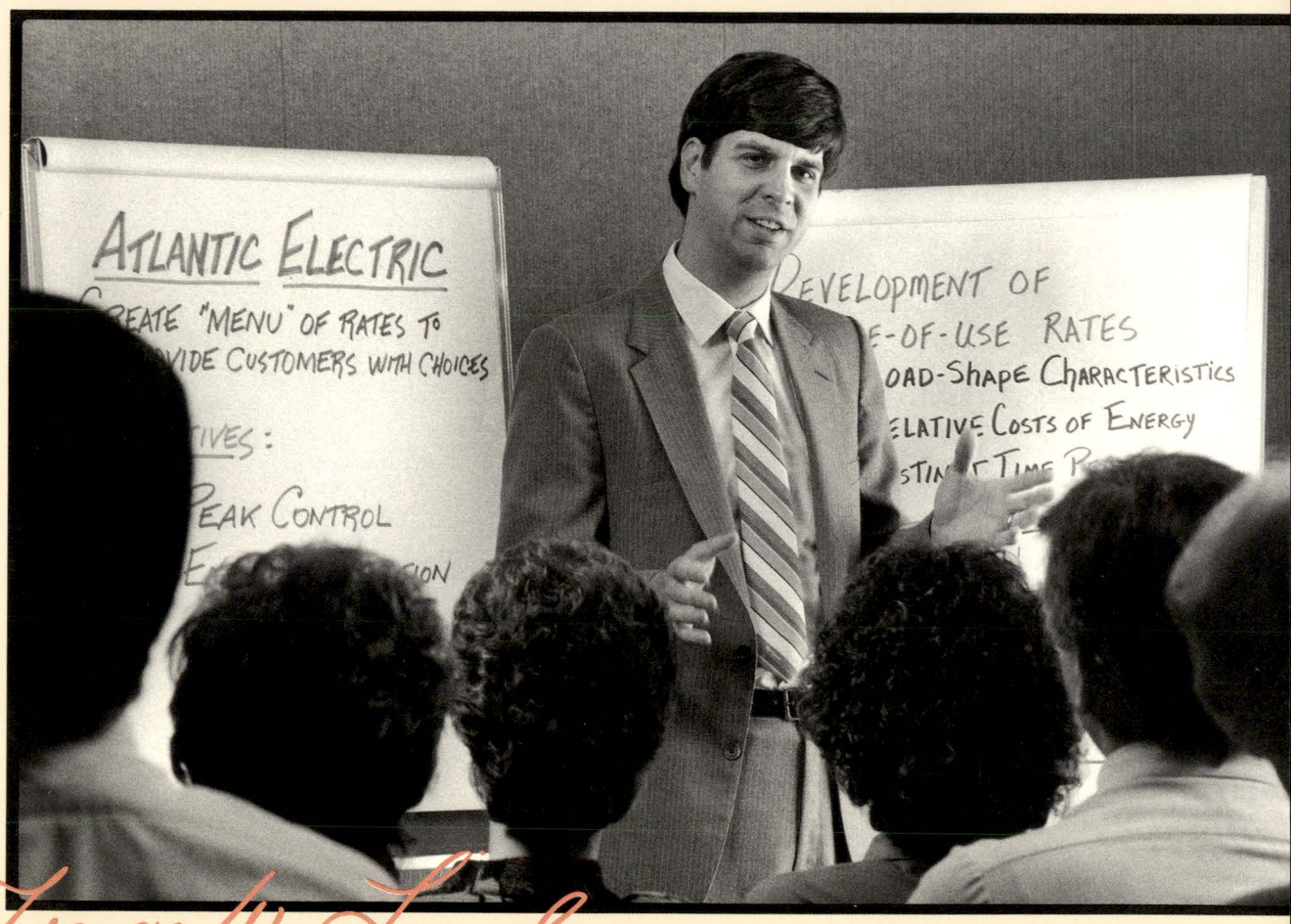
"Every customer is special, with unique needs for service. It's our job to mobilize the people and technical resources necessary to provide quality service. What gives us pride is meeting each customer's standards for getting the job done well."

JOHN J. SIDERAVAGE—*Manager of Transmission and Distribution*









Thomas W. Langley

"Setting electric rates is a complex process. We work to establish rates which provide a fair return. But an important part of the process is to develop a menu of rates, tailored to customer needs. Rate design seeks to give customers a choice, encouraging conservation and off-peak usage to help keep total electricity costs down."

THOMAS W. LANGLEY—*Manager of Rate Design*

"There's a lot of value in cogeneration technology that many of our customers may not be aware of. That's why it's important for us to raise customers' awareness about cogeneration and identify those customers who could enjoy its unique benefits. We're working closely with potential cogenerators to tailor this highly specialized process to fit their energy needs, both now and in the future."

HOWARD SOLGANICK—*Manager of Corporate Planning and Corporate Performance*

"Every day, customers make choices that can affect the cost of electricity for years to come. It's our job to keep customers informed and to involve them in the energy conservation process. By helping customers make thoughtful choices about the way they use energy now, we will be better able to provide them with affordable energy in the future."

W.K. CAVENDER, JR.—*Manager of Conservation and Load Management*

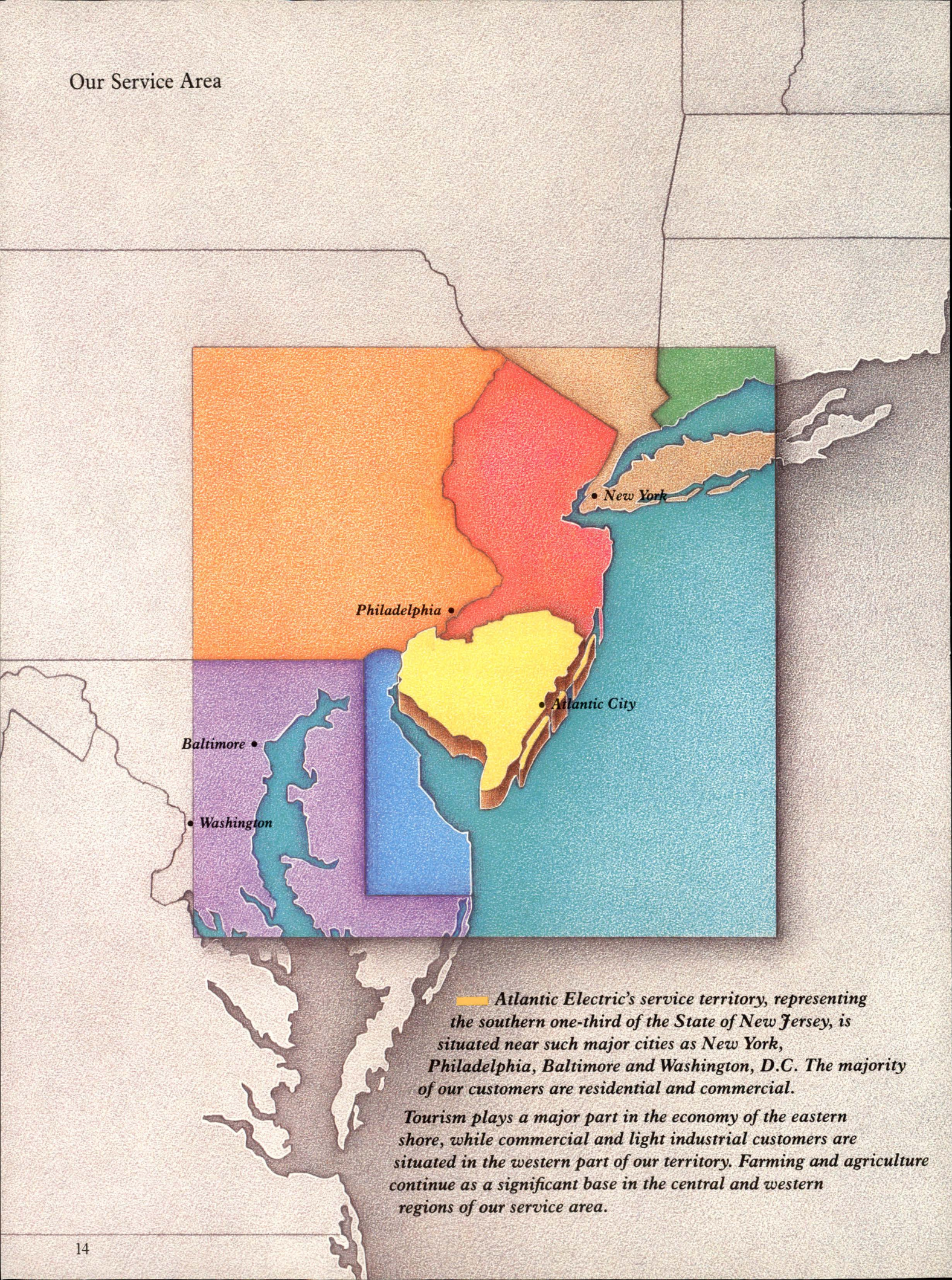
"Our concern for the environment goes beyond the need to meet regulations. As a visible part of the communities we serve, it's important to conduct our operations as any good neighbor should. Our commitment to preserve the environment is a real one—after all, we live here, too."

R.F. DAUGHERTY—*Manager of Environmental Affairs*

"The portrait of a company is painted by its people. Enthusiastic, competent and understanding employees are our greatest resource. Our ability to put the customer at ease by delivering personal service brings a sometimes large and "unknown" entity down to a size where customers can feel comfortable and confident that their service needs will be met."

FERN M. MILLS—*Manager of Customer Inquiry and Billing*

Our Service Area



Atlantic Electric's service territory, representing the southern one-third of the State of New Jersey, is situated near such major cities as New York, Philadelphia, Baltimore and Washington, D.C. The majority of our customers are residential and commercial.

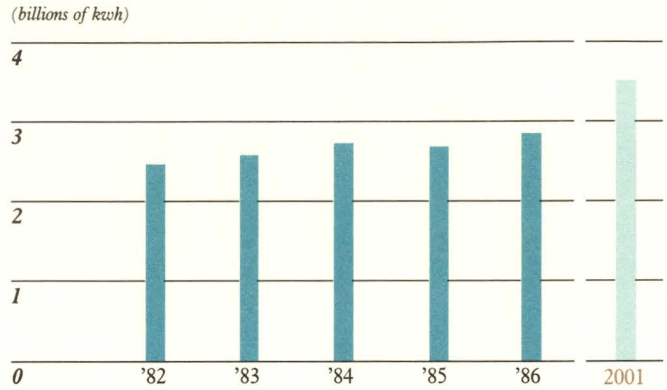
Tourism plays a major part in the economy of the eastern shore, while commercial and light industrial customers are situated in the western part of our territory. Farming and agriculture continue as a significant base in the central and western regions of our service area.

Customers At-A-Glance

Residential

Total residential kilowatt-hour sales increased 7.6% in 1986 and average use per residential customer rose 4.4%. In 1986, the average number of residential customers increased 3% and now comprises over 88% of the Company's total customer accounts. Over 9,700 new residential dwellings were connected in 1986, with the majority located in the coastal area.

	1986	2001	Est. 1986-2001 Annual Growth Rate
Energy (billion kwhrs)	2.839	3.577	1.55%
Peak (Mw)	786	988	1.54%

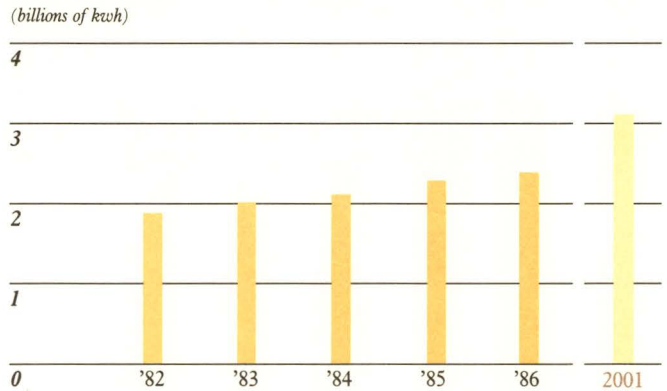


	'82	'83	'84	'85	'86	2001
average customer use (000 kwh)	7.4	7.7	7.9	7.6	8.0	7.4
% of total sales	43	43	44	43	44	45

Commercial

The Company's average number of commercial customers increased 2.5% to 45,359. Overall, commercial sales rose 4.5%. Sales to the eleven hotel casinos increased over 7% from 1985, and represented 5.9% of 1986 total energy sales. Two additional hotel casinos are expected to be in operation by year-end 1987.

	1986	2001	Est. 1986-2001 Annual Growth Rate
Energy (billion kwhrs)	2.401	3.128	1.78%
Peak (Mw)	528	711	2.00%

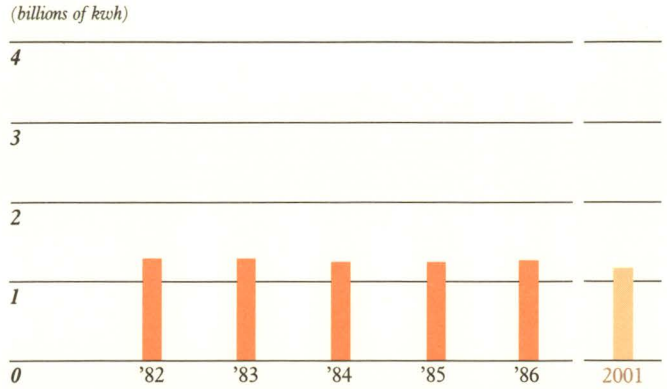


	'82	'83	'84	'85	'86	2001
average customer use (000 kwh)	44.2	46.8	49.3	51.9	52.9	67.7
% of total sales	34	35	35	37	37	40

Industrial & Other

Sales to industrial and other customers increased 1.5% in 1986 from 1985 levels. Industries in the Company's service area include glass, chemicals and allied products, rubber and plastic products, food products, petroleum refining and machinery. The Company's 1,022 industrial customers, whose average use per customer increased slightly in 1986, are located primarily in the inland and western sections of the Company's service territory.

	1986	2001	Est. 1986-2001 Annual Growth Rate
Energy (billion kwhrs)	1.281	1.192	−0.48%
Peak (Mw)	145	124	−1.04%



	'82	'83	'84	'85	'86	2001
average customer use (000 kwh)	1197.0*	1200.4*	1179.7*	1181.3*	1196.7*	1115.2*
% of total sales	23	22	21	20	19	15

*Industrial customers only

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OVERVIEW

The nature of the Company's operations is capital intensive. A significant amount of funds are invested in property and plant to generate, transmit and distribute electric energy service to customers. At December 31, 1986, gross investment in property and plant was approximately $1.5 billion. As a utility, the Company is generally subject to regulation by the New Jersey Board of Public Utilities (BPU). The Company seeks to maintain a level of rates which will allow it to meet daily working capital requirements, long term obligations, and to provide a fair return on investment to its shareholders, while maintaining service reliability.

LIQUIDITY AND CAPITAL RESOURCES

Construction Program

During 1986, cash construction expenditures aggregated $92 million, which is a 2% decrease from the $94 million expenditure level experienced in 1985 and a 9% increase from the level in 1984. A major element of the construction program during the past several years has been the Company's 5% interest in the Hope Creek Generating Station. Cash construction expenditures associated with Hope Creek during 1986, 1985 and 1984 amounted to $17 million, $31 million and $23 million, respectively. The construction program and the forecast of related construction expenditures is reviewed regularly and is designed to meet customers' demand for electric energy service for the present and the future. The current forecast of peak load growth for 1987 through 1991 is 1.4% per year. This forecast reflects a continuing commitment to promote energy conservation among customers, and alternatives to conventional energy supply, including cogeneration. In response to customers' needs, the construction program includes elements to improve or replace existing production plant, and upgrading of the transmission and distribution system.

Financing Program

The Company's financing program is determined by the excess of its total cash requirements over the level of cash generated by its operations. Cash requirements are affected not only by the levels of construction expenditures, but also by requirements associated with normal operations, redemptions, retirements, sinking funds and maturities of outstanding debt and senior equity. Interim financing of cash requirements is accomplished by means of short term debt, which is periodically repaid with the proceeds from permanent financings. The types of permanent financings employed by the Company are determined after consideration of such factors as cost of capital, leverage and long-term capital structure goals. Flexibility in financing needs is complemented by maintaining short-term lines of credit with lending institutions, which aggregated $115 million at December 31, 1986.

The aggregate dollar amounts of major external financings for the past three years are summarized as follows:

(Millions of Dollars)	**1986**	1985	1984
First Mortgage Bonds	**$220.0**	$70.0	$42.2
Common Stock	**.4**	11.2	12.2
Total	**$220.4**	$81.2	$54.4

Financings in 1986 included the sale of two series of First Mortgage Bonds: $125 million of the 8⅞% Series due 2016 and $95 million of the 8% Series due 1996. Portions of the proceeds of these financings were used to redeem outstanding indebtedness which had been issued at higher interest rates. The 1986 Common Stock issuances related to shares issued through the Employee Stock Ownership Plan (ESOP). Effective January 1, 1986 the Company's Dividend Reinvestment and Stock Purchase Plan (DRP) was modified so that shares issued under the DRP would be shares purchased in the open market rather than newly issued shares.

The 1985 financings included the sale of $70 million of 11½% Series of First Mortgage Bonds, $10.8 million of Common Stock issued through the DRP, and $.4 million of Common Stock issued through the ESOP.

In 1984 the Company issued three pollution control series of First Mortgage Bonds: $.85 million of a 10½% Series, $18.2 million of Adjustable Rate Series, and $23.15 million of a separate 10½% Series. Also issued was $11.4 million of Common Stock through the DRP and $.8 million through the ESOP.

The timing and amount of security issuances are guided, in part, by the Company's capital structure goals. Capitalization ratios as of December 31 for the last five years are set forth in the accompanying chart.

Approximately 34% of the cash requirements for construction, maturities, sinking funds, optional retirements and redemptions associated with long term debt and preferred stock, and for other capital purposes during the period 1984-1986 was generated from operations after deductions for dividends and working capital needs, but exclusive of changes in temporary cash investments. Excluding the early retirement of all of the 12⅝% Series First Mortgage Bonds and a portion of the 11⅞% and 11½% Series First Mortgage Bonds in 1986, approximately 46% of cash requirements during the period 1984-1986 were generated internally.

Provisions of the Company's charter, mortgage and debenture agreements can limit, in certain cases, the amount and types of additional financing which may be used. At December 31, 1986 the Company estimates additional funding capacities at $314 million for First Mortgage Bonds, or $373 million for Preferred Stock, or $213 million for unsecured debt. These amounts are not necessarily additive.

RESULTS OF OPERATIONS

The tabulation on pages 38 and 39 includes key historical indicators which may be helpful in evaluating the performance of the Company over the past ten years.

Earnings

Earnings per share of Common Stock, based on the weighted average number of shares outstanding, were $3.50 in 1986, compared to $3.00 in 1985 and $3.20 in 1984. The increase in 1986 earnings per share is primarily attributable to increased sales, while the decrease in earnings per share in 1985 is attributable to increases in operating expenses without corresponding rate relief. In addition, earnings are sensitive to other changes in revenues and expenses as discussed below.

Revenues

Operating revenues increased .6% in 1986 to $583.0 million compared to $579.7 million in 1985. The 1985 level of revenues represented a 5.5% increase compared to 1984. These overall increases reflect the net results of base revenue increases, changes in Levelized Energy Clause revenues and changes in kilowatt-hour sales as shown below:

(Thousands of Dollars)	1986	1985
Base and Unbilled Revenues	$ 7,527	$24,142
Levelized Energy Clauses	(33,849)	(7,039)
Kilowatt-hour Sales	29,550	13,099
Total	$ 3,228	$30,202

Future changes in operating revenues will reflect the timeliness and adequacy of rate relief, general economic conditions in the service area and the results of load management and conservation programs.

Sales

Changes in kilowatt-hour sales are generally due to changes in the average number of customers and average customer use, which is also affected by weather conditions.

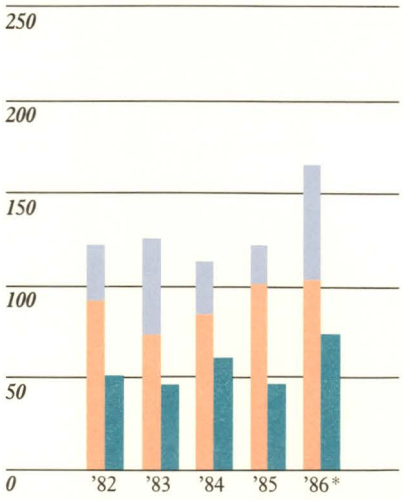
Energy sales statistics, stated as percentage changes from prior years, are shown below:

Customer Class	Increase (Decrease) from Prior Year					
				1985		
		Average			Average	
	Sales	Use	# of Cust.	Sales	Use	# of Cust.
Residential	7.6%	4.4%	3.0%	(.3)%	(2.8)%	2.6%
Commercial	4.5	1.9	2.5	6.9	5.4	1.5
Industrial	1.5	1.3	.2	.6	.1	.5
Other	.8	.8	—	(2.4)	(4.2)	1.8
Total	5.2	2.2	3.0	2.4	—	2.5

The 5.2% and 2.4% increases in total kilowatt-hour sales in 1986 and 1985, respectively, are largely attributable to the number of new customers added to the system. The growth of electricity consumption within the service territory is related to improving economic conditions, enhanced in part by the hotel/casino industry.

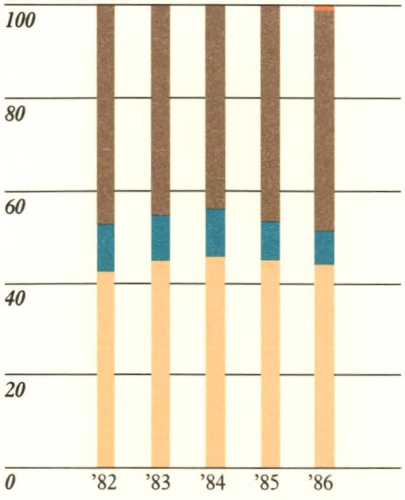
Overall, the combined effects of the changes in sales and rates have resulted in a decrease in revenues per kilowatt-hour of 3.6% in 1986 compared to 1985, and an increase of 2.3% in 1985 compared to 1984.

Cash Requirements and Internal Generation of Funds
(in millions of dollars)



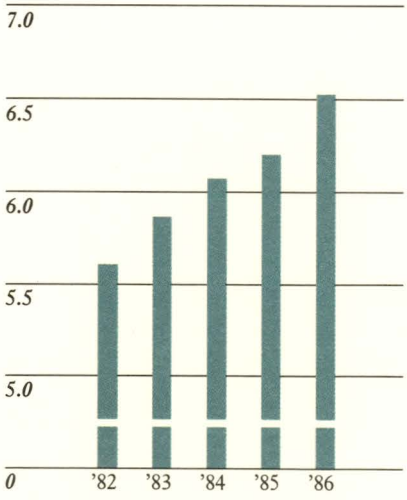
Construction and Other
Maturities, Retirements and Sinking Funds
Internal Cash Generation
* *Excludes certain optional retirements.*

Year-end Capitalization
(in percent)



Common Equity
Preferred Stock
Long term Debt
Short term Debt

Total Energy Sales
(in billions of kilowatt-hours)



Costs and Expenses

Total operating expenses decreased .6% in 1986 compared to 1985. The 1985 operating expenses represented an increase of 7.0% compared to 1984. Excluding depreciation and taxes, operating expenses fell to $328.6 million in 1986, a decrease of 1.3% from 1985, which had increased 6.9% from 1984.

Net Energy Costs reflect the amount of energy produced, the various fuel and purchased power sources used to produce it, as well as the operation of the levelized energy clauses (LEC's). Information on the sources and costs per kilowatt-hour of energy is shown in the accompanying graph and table. During 1986 the Company was in an overrecovery position with respect to the LEC's. For 1985, Net Energy Costs include $5,865,000 of previously Deferred Energy Costs representing fuel costs recovered under the LEC's. In 1984 Net Energy Costs were reduced by $6,969,000 reflecting the deferral of fuel costs incurred in excess of revenues collected under the LEC's effective for that year.

At December 31, 1986, $13,177,000 is shown on the balance sheet as Deferred Energy Revenues associated with the current energy clause, compared to $4,466,000 at December 31, 1985.

The Company's annual fuel, interchange and purchased power costs reflect changes in availability of low-cost generation from Company-owned and purchased sources, as well as changes in the needs of other utilities participating in energy interchange. Certain costs associated with purchased power are deferred on the balance sheet since rates are levelized to collect these costs over the 17-year life of the agreements with Pennsylvania Power & Light Company.

Operation and maintenance costs include the costs of both wholly-owned and jointly-owned generating units. At the Company's wholly-owned units, programs have been instituted to upgrade these facilities to improve efficiency and extend the service life of the generating units.

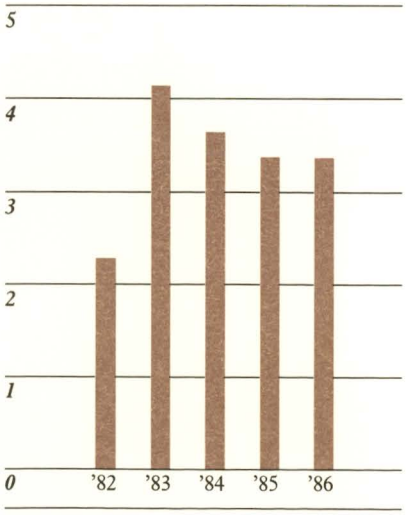
Additionally, operating and maintenance costs are subjected to price increases relating to materials, supplies and services, and include wages and employee benefits.

Changes in depreciation expense generally represent changes in the value and mix of electric utility plant in service and the respective in-service dates.

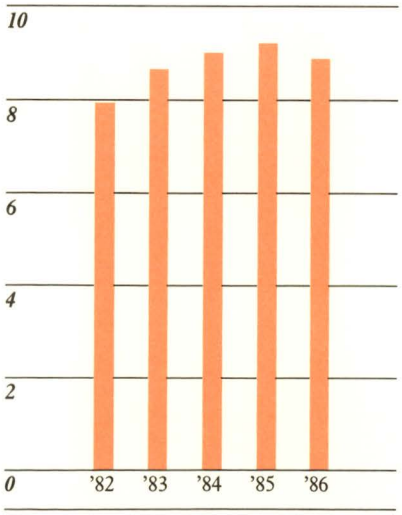
The components of federal income taxes are detailed in the notes to the financial statements.

Interest charges before the allowance for borrowed funds used during construction rose to $46.1 million in 1986 compared to $41.6 million in 1985 and $40.3 million in 1984. These increases reflect net effects of principal amounts and interest rates of debt outstanding in the periods. A total of $332.2 million of long term debt was issued during the 1984-1986 period as described under "Financing Program" above. In the same period, maturities of long term debt included $5 million of 3% Series First Mortgage Bonds and $21 million of 9% Pollution Control Series First Mortgage Bonds in 1984, $10 million of 3¼% Series First Mortgage Bonds in 1985 and $45 million of floating rate notes in 1986. In addition, $63.75 million, $36.675 million and $48.785 million principal amounts, respectively, of the 12⅝%, 11⅞% and 11½% Series of First Mortgage Bonds were retired early in 1986. The decrease in short term interest expense in 1986 from 1985 reflects lower average balances and lower average rates. The increase in short term interest expense in 1985 from 1984 reflects higher average balances offset by lower average rates. The embedded cost of long term debt at December 31, 1986 was 8.9%, compared to 9.6% in 1985

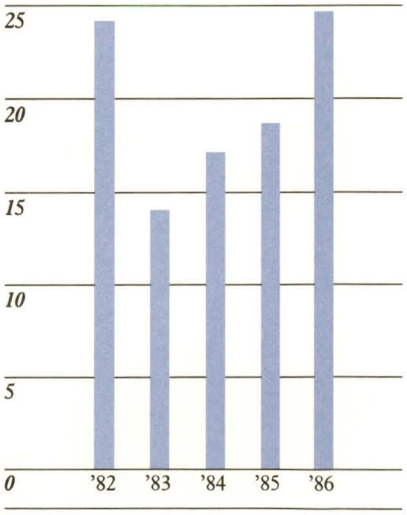
Pre-Tax Interest Coverage Ratio
(times coverage)



Average Annual Price Per Kilowatt-Hour
(in cents)



AFDC as a Percent of Net Income



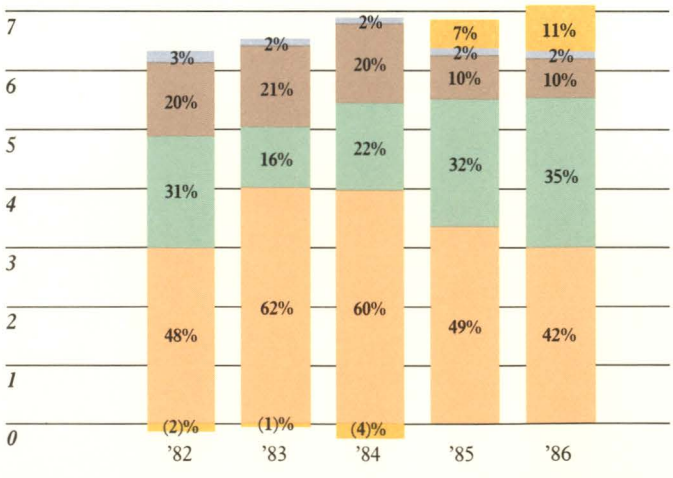
and 9.2% in 1984. The Company expects to use short term debt, but to a lesser degree, to finance the construction and working capital needs on an interim basis, replacing it with long term issues as permanent financing.

The Allowance for Funds Used During Construction (AFDC) including both the Borrowed Funds portion, which is used to reduce interest charges, and the Equity Funds portion, shown under Other Income, was $17.0 million in 1986 compared to $11.2 million in 1985 and $10.8 million in 1984. The increases are due to increases in the average balances of construction work in progress, as well as an increase in the rate from 8.5% to a semi-annually compounded 8.95%. AFDC as a percent of net income for 1986, 1985 and 1984 was 24.5%, 18.5% and 17.0%, respectively.

OUTLOOK

The Company has positioned itself to remain flexible in responding to the external forces that may affect it. This strategy is evident in the diversity of power supply sources, which include investments in both wholly-owned generating facilities, as well as ownership interests in jointly-owned facilities, purchased power contracts and a diversity in fuel mix including coal, nuclear, oil and natural gas. This strategy is also evident in the proposed plans to form a holding company, Atlantic Energy, Inc. This corporate restructuring is expected to allow additional flexibility to take advantage of opportunities which may arise in energy related or other areas, and to respond more quickly to changes which may affect the Company.

Total Sources and Costs of Energy
(in billions of kilowatt-hours)



	'82	'83	'84	'85	'86
Coal	2.35	2.02	2.01	1.95	1.80
Nuclear	.59	.86	.97	1.00	.89
Oil	5.15	5.00	5.66	5.20	4.09
Natural Gas	5.13	6.56	6.93	5.50	3.80
Interchange	5.43	5.21	6.02	3.65	2.48
Yearly Average	*2.38*	*2.54*	*2.43*	*2.17*	*1.81*

cents per kilowatt-hour

There are external forces which the Company may be unable to influence. The ability to raise adequate capital when needed, at the lowest possible cost, depends upon such factors as regulatory treatment of cost of service and the maintenance of good credit ratings.

The recent tax law changes enacted in the Tax Reform Act of 1986 will affect the Company in certain respects, some of which will be unfavorable. For instance, the repeal of the investment tax credit provisions are not favorable to a business such as the Company's which historically invests heavily in plant and equipment. A positive impact is an overall reduction in the corporate income tax rate from the current maximum of 46% to a composite rate of 40% in 1987 and 34% beginning in 1988. Coupled with this is a possible change in accounting for income taxes for financial reporting purposes, principally with respect to deferred income taxes, as proposed by the Financial Accounting Standards Board for implementation in 1987. If adopted in its current form, the proposal would require the Company to record certain deferred tax liabilities previously unrecorded in accordance with rate regulation treatment, and to adjust deferred tax liabilities to be computed at tax rates currently in effect. The Company believes the recording of previously unrecorded deferred tax liabilities would not have a material impact on its financial results because rate regulation should allow recovery of these costs and thus create an offsetting asset. The effect of calculating currently existing deferred tax liabilities at the new rates as enacted by the Tax Reform Act will be lessened because deferred taxes relating to utility plant would be adjusted over the remaining lives of the related assets using an "average rate assumption" as provided in the Tax Reform Act. Other potential deferred tax amount adjustments would be subject to rate treatment, and thus may occur over more than one year. Therefore, the major concern of the Company relating to these changes is the impact on cash flows, since taxes currently payable are expected to increase. In addition, the impact of the Tax Reform Act of 1986 is the subject of a proceeding before the BPU to determine the appropriate amount of decrease in the Company's revenue requirements which should be reflected in customer rates, since overall tax expense is expected to decrease as a result of the Act.

In summary, management believes the Company is ready to meet the challenges and take advantage of the opportunities of the future, but continues to monitor and develop appropriate responses to the changing environment in which the Company operates.

Report of Management

The management of Atlantic City Electric Company is responsible for the financial statements presented herein. These financial statements were prepared by management in conformity with generally accepted accounting principles applicable to public utilities which are consistent in all material respects with the accounting prescribed by the State of New Jersey, Board of Public Utilities and the Federal Energy Regulatory Commission. In preparing the financial statements, management made informed judgments and estimates relating to events and transactions being reported.

The Company has established a system of internal accounting and financial controls and procedures designed to insure that the financial records reflect the transactions of the Company and that assets are safeguarded. This system is examined by management on a continuing basis for effectiveness and efficiency and is reviewed on a regular basis by an internal audit staff that reports directly to the Audit Committee of the Board of Directors.

The financial statements have been examined by Deloitte Haskins & Sells, Certified Public Accountants. The auditors provide an objective, independent review as to management's discharge of its responsibilities insofar as they relate to the fairness of reported operating results and financial condition. Their examination includes procedures believed by them to provide reasonable assurance that the financial statements are not misleading and includes a review of the Company's system of internal accounting and financial controls and a test of transactions.

The Board of Directors has oversight responsibility for determining that management has fulfilled its obligation in the preparation of financial statements and the ongoing examination of the Company's system of internal accounting controls. The Audit Committee, which is composed solely of outside directors, meets regularly with management, Deloitte Haskins & Sells and the internal audit staff to discuss accounting, auditing and financial reporting matters. The Audit Committee reviews the program of audit work performed by the internal audit staff. To insure auditor independence, both Deloitte Haskins & Sells and the internal audit staff have complete and free access to the Audit Committee.

Auditors' Opinion

Deloitte Haskins+Sells

Certified Public Accountants

One World Trade Center
New York, New York 10048

To the Shareholders and the Board of Directors
of Atlantic City Electric Company:

We have examined the balance sheets of Atlantic City Electric Company as of December 31, 1986 and 1985 and the related statements of income and retained earnings and of cash flows for each of the three years in the period ended December 31, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statements present fairly the financial position of the Company at December 31, 1986 and 1985 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins & Sells

January 30, 1987, except for
the seventh paragraph of Note
11 as to which the date is
February 6, 1987

Statement of Income and Retained Earnings

(Thousands of Dollars)	For the Years Ended December 31 1986	1985	1984
Operating Revenues—Electric	$582,961	$579,733	$549,531
Operating Expenses:			
Energy:			
Fuel	111,384	133,437	178,681
Interchange	19,387	17,272	(15,558)
Deferred Costs	—	5,865	(6,969)
Net Energy	130,771	156,574	156,154
Purchased Power-Exclusive of Fuel	40,887	42,636	28,905
Operations	112,127	90,187	86,866
Maintenance	44,820	43,378	39,247
Depreciation and Amortization	42,515	41,985	38,318
New Jersey Gross Receipts and Franchise Taxes	69,797	71,100	60,769
Federal Income Tax Expense	36,754	36,308	41,227
Other Taxes	9,836	8,159	6,654
Total Operating Expenses	487,507	490,327	458,140
Operating Income	95,454	89,406	91,391
Other Income:			
Allowance for Equity Funds Used During Construction	8,336	5,216	4,821
Miscellaneous Income-Net	3,165	1,502	1,424
Total Other Income	11,501	6,718	6,245
Income Before Interest Charges	106,955	96,124	97,636
Interest Charges:			
Interest on Long Term Debt	46,146	39,604	38,231
Interest on Short Term Debt	408	2,144	2,131
Other Interest Expense	(465)	(163)	(66)
Total Interest Charges	46,089	41,585	40,296
Allowance for Borrowed Funds Used During Construction	(8,684)	(5,980)	(5,937)
Net Interest Charges	37,405	35,605	34,359
Net Income	69,550	60,519	63,277
Retained Earnings at Beginning of Year	169,646	161,629	148,454
	239,196	222,148	211,731
Dividends Declared:			
Cumulative Preferred Stock	5,545	6,282	6,949
Common Stock	47,682	46,220	43,153
Total Dividends Declared	53,227	52,502	50,102
Retained Earnings at End of Year	$185,969	$169,646	$161,629
Earnings for Common Stock:			
Net Income	$ 69,550	$ 60,519	$ 63,277
Less Preferred Dividend Requirements	5,627	6,369	6,968
Balance Available for Common Stock	$ 63,923	$ 54,150	$ 56,309
Average Number of Shares of Common Stock Outstanding (in thousands)	18,266	18,069	17,581
Per Common Share:			
Earnings	$ 3.50	$ 3.00	$ 3.20
Dividends Declared	$ 2.61	$ 2.555	$ 2.45
Dividends Paid	$ 2.60	$ 2.53	$ 2.42

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

(Thousands of Dollars)	For the Years Ended December 31 1986	1985	1984
Net Cash Flows From Operating Activities:			
Net Income	$ 69,550	$ 60,519	$ 63,277
Noncash items affecting operating activities:			
Depreciation and Amortization	42,515	41,985	38,318
Allowance for Funds Used During Construction	(17,020)	(11,196)	(10,758)
Investment Tax Credit Adjustments-Net	4,585	7,261	2,765
Deferred Federal Income Taxes-Net	35,778	16,865	20,304
Net (Increase) Decrease in Working Capital*	10,786	(26,535)	15,044
Other-Net	(201)	2,124	(3,994)
Deferred Energy Costs and Revenues	8,711	22,190	(6,967)
Deferred Purchased Power Costs	(15,700)	(14,680)	(6,530)
Net Cash Flows From Operating Activities	139,004	98,533	111,459
Cash Flows From Investing Activities:			
Additions to Utility Plant	(109,303)	(105,213)	(95,388)
Less Allowance for Funds Used During Construction	17,020	11,196	10,758
Cash Construction Expenditures	(92,283)	(94,017)	(84,630)
Increases in Property Abandonment Costs	(5,922)	(5,215)	—
Investment in Subsidiary Companies	(6,404)	—	—
Other-Net	1,925	(489)	430
Net Cash Flows Used by Investing Activities	(102,684)	(99,721)	(84,200)
Cash Flows From Financing Activities:			
Sale of Long Term Debt	220,000	70,000	42,200
Retirement and Maturity of Long Term Debt	(214,854)	(10,000)	(26,000)
Pollution Control Funds Released (Held) by Trustee	(2,399)	7,718	(5,539)
Proceeds of Short Term Debt	89,100	260,800	132,000
Repayment of Short Term Debt	(76,200)	(260,800)	(132,000)
Common Stock Issued	548	11,515	12,487
Conversion of Preferred Stock	(199)	(353)	(267)
Redemption of Preferred Stock	(9,300)	(11,850)	(2,100)
Dividends on Preferred Stock	(5,545)	(6,282)	(6,949)
Dividends on Common Stock	(47,682)	(46,220)	(43,153)
Debt Costs and Other	(6,146)	905	1,311
Net Cash Flows Provided (Used) by Financing Activities	(52,677)	15,433	(28,010)
Net Increase (Decrease) in Cash And Temporary Investments	$ (16,357)	$ 14,245	$ (751)

*Excluding cash and temporary investments.

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

Balance Sheet

(Thousands of Dollars)	December 31 1986	1985
Assets		
Electric Utility Plant:		
In Service:		
Production	$ 557,257	$ 553,253
Transmission	206,198	200,517
Distribution	367,932	345,177
General	70,709	63,590
Total	1,202,096	1,162,537
Less Accumulated Depreciation	350,873	330,895
Net	851,223	831,642
Construction Work in Progress	282,079	237,310
Land Held for Future Use	5,623	6,849
Electric Utility Plant-Net	1,138,925	1,075,801
Nonutility Property and Investments	11,397	4,298
Pollution Control Construction Funds	5,426	2,871
Current Assets:		
Cash and Working Funds	7,522	5,379
Temporary Cash Investments	—	18,500
Accounts Receivable:		
Utility Service	41,744	42,899
Miscellaneous	13,434	8,386
Allowance for Doubtful Accounts	(1,600)	(1,600)
Unbilled Revenues	24,588	26,401
Fuel (at average cost)	22,899	29,828
Materials and Supplies (at average cost)	17,438	17,223
Prepayments	9,280	8,382
Total Current Assets	135,305	155,398
Deferred Debits:		
Property Abandonment Costs	24,815	19,878
Unrecovered Purchased Power Costs	48,360	32,660
Unamortized Debt Costs	27,240	5,220
Other	7,418	3,507
Total Deferred Debits	107,833	61,265
Total Assets	$1,398,886	$1,299,633

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

(Thousands of Dollars)	December 31 1986	1985
Liabilities and Capitalization		
Capitalization:		
Common Shareholders' Equity:		
Common Stock	$ 54,821	$ 54,771
Premium on Capital Stock	229,788	229,287
Capital Stock Expense	(1,555)	(1,607)
Retained Earnings	185,969	169,646
Total Common Shareholders' Equity	469,023	452,097
Cumulative Preferred Stock Not Subject to Mandatory Redemption	41,154	41,353
Cumulative Preferred Stock Subject to Mandatory Redemption	24,800	34,100
Long Term Debt	494,972	437,462
Total Capitalization	1,029,949	965,012
Current Liabilities:		
Current Portion:		
Cumulative Preferred Stock Subject to Mandatory Redemption	5,050	5,050
Long Term Debt	10,000	45,000
Short Term Debt	12,900	—
Accounts Payable	26,094	28,755
Taxes Accrued	8,817	5,372
Interest Accrued	9,509	12,865
Dividends Declared	13,195	13,224
Customer Deposits	3,408	2,945
Deferred Taxes	14,153	17,747
Deferred Energy Revenues-Net	13,177	4,466
Other	18,463	5,681
Total Current Liabilities	134,766	141,105
Deferred Credits:		
Deferred Investment Tax Credits	69,997	65,412
Deferred Income Taxes	156,242	120,464
Other	7,932	7,640
Total Deferred Credits	234,171	193,516
Commitments and Contingent Liabilities ***(Note 11)***		
Total Liabilities and Capitalization	$1,398,886	$1,299,633

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

Regulation

The accounting policies and rates of the Company are subject to the regulations of the State of New Jersey, Board of Public Utilities (BPU) and in certain respects to the Federal Energy Regulatory Commission (FERC). All significant accounting policies and practices used in the determination of rates are also used for financial reporting purposes. The financial statements are prepared on the basis of the Uniform System of Accounts prescribed by FERC.

Operating Revenues

Revenues are recognized when electric energy services are rendered, and include estimates for amounts unbilled at the end of the period for energy used subsequent to the last billing cycle.

Electric Utility Plant

Property is stated at original cost. Generally the plant is subject to a first mortgage lien. The cost of property additions, including replacement of units of property and betterments, is capitalized. Included in certain additions is an Allowance for Funds Used During Construction (AFDC) which is defined in the applicable regulatory system of accounts as the cost during the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used. AFDC has been calculated using a semi-annually compounded rate of 8.95% for 1986 and 8.5% for 1985 and 1984.

Deferred Energy Costs and Revenues

The Company has a Levelized Energy Clause which is based on projected energy costs and includes a provision for prior period under or over recoveries. The recovery of energy costs is made through levelized monthly charges over the period of projection. Any under or over recoveries are deferred in balance sheet accounts as a current asset or current liability as appropriate. These deferrals are recognized in the Statement of Income during the period in which they are subsequently recovered through the clause.

Depreciation

The Company provides for straight-line depreciation based on the estimated remaining life of transmission and distribution property and, based on the estimated average service life, for all other depreciable property. Depreciation applicable to nuclear plant includes amounts provided for decommissioning. The overall composite rate of depreciation was approximately 3.7% for 1986 and 1985, and 3.6% for 1984. Accumulated depreciation is charged with the cost of depreciable property retired together with removal costs less salvage and other recoveries.

Nuclear Fuel

Fuel costs associated with the Company's participation in jointly-owned nuclear generating stations, including a provision for estimated spent fuel disposal costs, are charged to Fuel Expense based on the units of thermal energy produced.

Federal Income Taxes

The Company provides deferred Federal Income Taxes on all significant current transactions for which the timing of reporting differs for book and tax purposes. Investment tax credits, which are used to reduce current federal income taxes, are deferred on the balance sheet and recognized in book income over the life of the related property.

Retirement Plan

The Company has a noncontributory defined benefit retirement plan covering substantially all employees. The Company's policy is to fund pension costs as accrued. Costs of the plan are determined actuarially under the aggregate cost method.

Property Abandonment Costs

These costs consist principally of the Company's unamortized investment in Hope Creek Unit No. 2, a nuclear generating unit which was cancelled in 1981, offshore nuclear units which were cancelled in 1978, unrecovered nuclear fuel advances associated with uranium supply contracts which were terminated in 1985 and study costs associated with a proposed plant site.

The Hope Creek Unit No. 2 investment is being amortized over a 15-year period that began in 1983. The investment in the offshore nuclear units is being amortized over a 20-year period that began in 1979. Unrecovered nuclear fuel advances are being amortized over 15 years, beginning in 1986. The study costs are being amortized over 10 years beginning in 1986. The unamortized amounts are $11,701,000, $2,542,000, $4,948,000 and $5,484,000, respectively, at December 31, 1986.

Unrecovered Purchased Power Costs

These represent purchased capacity costs, relating to the Company's purchased power agreements with Pennsylvania Power & Light Company, which are not being recovered currently, but for which recovery has been specifically provided in a levelized component of future rates by the BPU.

Other

Debt premium, discount and expenses are amortized over the life of the related debt. Costs associated with debt reacquired by refundings are amortized over the life of the newly issued debt as permitted by the BPU. Gains and losses relating to other reacquired debt are recognized currently.

Certain 1985 and 1984 amounts have been reclassified to conform with 1986 presentations.

NOTE 2. FEDERAL INCOME TAXES

Federal income tax expense is less than the amount computed by applying the statutory rate on book income subject to tax for the following reasons:

	Years Ended December 31		
(Thousands of Dollars)	**1986**	1985	1984
Net Income	**$ 69,550**	$ 60,519	$ 63,277
Federal Income Tax Expense (as below)	**37,911**	36,317	41,876
Book Income Subject to Tax	**$107,461**	$ 96,836	$105,153
Income Tax Computed at the Statutory Rate	**$ 49,432**	$ 44,544	$ 48,370
Items for which deferred taxes are not provided:			
Difference between Tax and Book Depreciation	**2,842**	2,801	(250)
Allowance for Funds Used During Construction	**(7,684)**	(5,029)	(4,832)
Capitalized Overheads	**(1,431)**	(1,209)	(1,221)
Investment Tax Credits	**(2,026)**	(2,178)	(1,842)
Other	**(3,222)**	(2,612)	1,651
Total Federal Income Tax Expense	**$ 37,911**	$ 36,317	$ 41,876
Components of Federal Income Tax Expense:			
Federal Income Taxes Currently Payable	**$ 790**	$ 12,956	$ 15,512
Deferred Federal Income Taxes:			
Liberalized Depreciation	**17,756**	11,899	18,335
Unbilled Revenues	**(834)**	1,415	(616)
Unrecovered Purchased Power Costs	**7,222**	6,753	3,004
Deferred Energy Costs	**—**	(2,551)	3,205
Costs Associated With Reacquired Debt	**10,078**	—	—
Other	**(2,038)**	(1,787)	(1,034)
Deferred Investment Tax Credits	**4,585**	7,261	2,765
Employee Stock Ownership Plan Credits	**352**	371	705
Total Deferred Federal Income Tax Expense	**37,121**	23,361	26,364
Total Federal Income Tax Expense	**37,911**	36,317	41,876
Less Federal Income Taxes Included in Other Income	**1,157**	9	649
Federal Income Taxes Included in Operating Expenses	**$ 36,754**	$ 36,308	$ 41,227

The Company's federal income tax returns for 1981 and prior years have been examined by the Internal Revenue Service (IRS) and the Company's federal income tax liabilities for all years through 1976 have been determined and settled. The IRS has proposed certain deficiencies in taxes for the years 1977 through 1981. The Company has protested the proposed deficiencies and is of the opinion that the final settlement of its federal income tax liabilities for these years will not have a material adverse effect on its results of operations or financial position.

At December 31, 1986 the cumulative amount of deferred income taxes which have not been provided on timing differences, principally depreciation, amounted to approximately $87,000,000 computed at the current statutory rate of 46%.

On October 22, 1986, the Tax Reform Act of 1986 was signed into law. Some of the provisions of the Act, principally those dealing with the repeal of the Investment Tax Credit, impacted the Company's 1986 tax provision. The effects of applying these provisions were recorded by the Company in the fourth quarter of 1986 in accordance with generally accepted accounting principles. The recording of these adjustments did not have a material effect on the Company's results of operations or financial position.

The Financial Accounting Standards Board has issued an exposure draft of a proposed Statement of Financial Accounting Standards entitled "Accounting for Income Taxes." If adopted in its current form, the statement would change the recording methodology relating to deferred income taxes to a liability approach. The principal impact of such a change to the Company would relate to the recording of changes in the tax rates on a current basis, and the recording of deferred tax liabilities not previously recorded. The Company expects the impacts of such a change would be lessened due to rate regulation, and in the opinion of management, would not have a material adverse effect on results of operations or financial position.

NOTE 3. RATE MATTERS

Base Rate Case Decisions

During the four year period ended December 31, 1986 base rate case decisions of the New Jersey Board of Public Utilities (BPU) are shown below:

Date of Petition	Amount Requested	Date Effective	Amount Approved	Increase In Revenue	Test Year
	(millions)		*(millions)*		
January 1983	$30.8	October 7, 1983	$24.5	4.5%	September 30, 1982
October 1983	25.3	August 17, 1984	—	—	December 31, 1983
October 1984	24.1	February 13, 1985	24.0	4.3%	September 30, 1982
April 1985	63.3	April 3, 1986	13.6	2.1%	September 30, 1985

The October 1983 increase relates to the first half of the purchase of 125 megawatts of capacity and related energy from Pennsylvania Power & Light Company (PP&L) under two Capacity and Energy Sales Agreements (the PP&L Agreements), which commenced with the start of commercial operation of PP&L's Susquehanna Unit 1. The February 1985 increase relates to the second half of the Company's agreements with PP&L and commenced with the start of commercial operation of PP&L's Susquehanna Unit 2. The PP&L Agreements provide for the purchase by the Company of capacity and energy from the Susquehanna Units through September 30, 1991, and then from certain PP&L coal-fired units through September 30, 2000. Through September 30, 1991, the estimated costs to be incurred by the Company for purchases of capacity and associated energy from the Susquehanna Units will exceed the levelized costs to be recovered by the Company from its customers. Such unrecovered costs will be accumulated and deferred. Such costs are included in the balance sheet as Unrecovered Purchased Power Costs along with a related provision for deferred taxes. The level of rates approved by the BPU is designed to enable the Company to recover these deferred costs and associated carrying charges during the balance of the 17-year period. The stipulation provided that any difference between actual costs incurred by the Company under the agreements and the estimated costs on which the increased rates were based will be recognized in future base rate proceedings if such costs are found to be reasonable. The BPU order prescribes a revenue reduction formula in the event that the Susquehanna Units fail to meet a combined minimum performance standard established by the stipulation which could subject the Company, under the most adverse circumstances, to a revenue reduction not to exceed $15,000,000 per unit per year.

In August 1984, the BPU denied the Company's October 1983 request for the $25,300,000 increase in base rates. The BPU, in denying rate relief, made several adjustments to the Company's requested rate base, test year operating income and rate of return, providing for an overall rate of return of 11.35% and a return on common equity of 14.30%. Prior to the BPU decision, the Company had been authorized to earn an overall rate of return of 11.7% and a return on common equity of 15.0%. In November 1985 the decision by the BPU was affirmed by the New Jersey Superior Court. The Company subsequently filed a request with the New Jersey Supreme Court for review of the appellate ruling. This request was denied on March 23, 1986.

In April 1985, the Company filed a petition requesting a net increase of $91,850,000 to be implemented in two phases. The first phase request, for $63,316,000, related to increased operations and maintenance costs, and capital investment, and was based upon a test year of September 30, 1985. In April 1986, the BPU issued an Order relating to the first phase granting the Company an increase in annual revenues of $13,587,000. The BPU order reflects an overall rate of return of 11.42%, with a return on common equity of 14.10%. The second phase request, for a net increase of $28,534,000, relates to the Company's 5% ownership in the Hope Creek Generating Station, and would become effective upon commercial operation of the unit.

In March 1986, the Company filed revised testimony in its second phase with respect to Hope Creek and other matters. The Company requested a net increase in annual revenues of $34.9 million, of which approximately $32.2 million related to costs associated with the Hope Creek Station. In April 1986, the Company updated its second phase request to reflect certain of the decisions set forth in the BPU's Order in the first phase, resulting in an updated request for a net increase of $36.4 million, with approximately $33.6 million of such amount related to Hope Creek. As of December 31, 1986, the Company had expended $236 million, including AFDC, for Hope Creek. For purposes of applying the provisions of a cost containment agreement approved by the BPU in 1983, the Company currently projects its share of the final cost of Hope Creek to be approximately $240 million, including AFDC, compared with an estimate of the targeted costs of approximately $202.2 million. The cost containment agree-

ment provides for a graduated disallowance of a return on reasonable project costs in excess of the targeted amount. The amount requested by the Company for Hope Creek reflects the estimated effects of the provisions of the cost containment agreement. Hearings in the second phase rate request commenced in mid-April 1986. As discussed more fully in Note 11, the BPU has also examined in a separate proceeding, in which the Company was granted intervenor status, the reasonableness of costs associated with the Hope Creek project. The BPU has issued an interim accounting order to permit the Company to defer the operating costs of Hope Creek and a related return on the plant costs until a final BPU decision resolving the issues concerning Hope Creek. The Company cannot predict the final cost of Hope Creek which will ultimately be allowed for ratemaking purposes, or the outcome of these proceedings, or their ultimate effect on the Company. The Company has requested that changes to its customer rates be synchronized to implement all changes expected resulting from these proceedings and its energy clause proceeding, as discussed below, and expects a BPU Order in February 1987.

The Company has evaluated the impact of the Tax Reform Act of 1986 and its effect on tax expense and related revenue requirements. The Company expects the overall impact of the Act to reduce revenue requirements, primarily as a result of the decrease in corporate tax rates, offset in part by the elimination of the investment tax credit, the capitalization of construction interest and the taxation of unbilled revenues and contributions in aid of construction. The Company has submitted data on this impact to the BPU for their consideration.

Energy Clauses

The Company's energy clauses are reviewed annually by the BPU and the most recent decisions are shown above:

Date of Petition	Amount Requested	Date Effective	Amount Approved
	(millions)		*(millions)*
October 1983	$ 28.1	January 20, 1984	$ 28.1
October 1984	25.4	February 13, 1985	4.8
September 1985	(37.1)	January 1, 1986	(44.0)

As part of the February 1985 energy clause approval, $1,639,000 of the costs associated with an extended outage of Salem Unit 1 during 1983 were excluded from recovery, and $4,298,000 of Deferred Energy Costs were reclassified to Unrecovered Purchased Power Costs. The Company also agreed to defer $7,500,000 of Deferred Energy Costs, relating to costs associated with certain nuclear unit outages in 1984.

As part of the January 1986 energy clause approval, the Company agreed to expense $3,975,000 of replacement power costs associated with maintenance and repair outages at Peach Bottom Unit 2 and Salem Unit 2. Also, the Company agreed to increase the 1985 deferral of $7,500,000 of Deferred Energy Costs to $12,179,000. These costs represent the Company's pro rata impact of BPU findings in proceedings related to other co-owners with respect to replacement power costs associated with certain outages at the Salem Nuclear Generating Station, and are subject to later review by the BPU.

In September 1986, the Company filed petitions with the BPU requesting a reduction of $14.9 million in annual energy clause revenues. This reduction reflects lower fuel costs experienced in 1986 and projected fuel costs for 1987. The Company had originally requested that the change be effective for service rendered on and after January 1, 1987, but has requested that changes to its customer rates be synchronized to implement all changes, as discussed above, at one date.

NOTE 4. RETIREMENT BENEFITS

The cost to the Company in providing a retirement plan for its employees was $4,300,000, $6,465,000 and $7,555,000 in 1986, 1985 and 1984, respectively. Approximately 80% of these costs were charged to operating expense and the remainder, which was associated with construction labor, was charged to the cost of new utility plant.

The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8% for 1986 and 1985. The Company's Plan is in compliance with the Employee Retirement Income Security Act of 1974 as amended.

A comparison of accumulated plan benefits and plan net assets (including purchased annuity contract amounts) for the Company's Plan, as of the most recent actuarial valuation dates, is as follows:

	January 1	
(Thousands of Dollars)	1986	1985
Actuarial present value of accumulated plan benefits:		
Vested	$ 96,849	$ 84,563
Nonvested	2,045	4,459
Total	$ 98,894	$ 89,022
Net Assets available for benefits	$146,473	$121,778

In December 1985 the Financial Accounting Standards Board adopted an accounting standard which will require the Company to modify the financial accounting and reporting for its retirement plan beginning in 1987. The Company believes the adoption of this new standard will not have a material adverse effect on its results of operations or financial position.

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for retired employees. Substantially all of the Company's employees may become eligible for those benefits if they reach retirement age while working for the Company. Benefits have been provided through insurance companies and other plan providers whose premiums and related plan costs are based on the benefits paid during the year. The cost of these premiums and related plan costs expensed in providing those benefits totalled $1,537,000 for 1986, $992,000 for 1985 and $845,000 for 1984.

In December 1986, the Company established a trusteed plan to begin funding for these post-employment benefits. The Company made an initial contribution of $2,900,000 to the trust. Funding on behalf of active employees is based on the aggregate cost method over their service lives and is equivalent to normal cost. For current retirees, funding is based on current actual experience and amortization of expected benefits over the remaining life expectancy of the retiree group. The actuarial present value of accumulated post-employment benefits under the plans was $23,700,000 at January 1, 1986.

NOTE 5. JOINTLY-OWNED GENERATING STATIONS

The Company participates with other utilities in the construction and operation of several electric production facilities.

The amounts shown represent the Company's share of each plant at December 31, and includes an allowance for funds used during construction.

Station	Energy Source	Company's Share	Electric Plant in Service		Construction Work in Progress		Generation	
			1986	1985	**1986**	1985	**1986**	1985
			(Thousands of Dollars)				*(MWH)*	
Keystone	Coal	2.47%	**$ 8,074**	$ 7,306	**$ 285**	$ 976	**286,415**	258,436
Conemaugh	Coal	3.83	**12,558**	12,355	**1,100**	210	**402,874**	400,790
Peach Bottom	Nuclear	7.51	**91,690**	91,010	**4,285**	2,490	**878,791**	420,469
Salem	Nuclear	7.41	**162,960**	160,977	**4,006**	2,605	**919,915**	1,039,420
Hope Creek	Nuclear	5.00	**—**	—	**236,055**	203,656	**53,766**	—

The Hope Creek Station completed its power ascension program and was released to the Pennsylvania-New Jersey-Maryland power pool for dispatch on December 20, 1986. Public Service Electric & Gas Company, the operator of the station, has not declared the unit commercial, pending receipt of a BPU Order.

The operators of the Salem and Peach Bottom Nuclear Generating Stations entered into contracts with the United States Department of Energy for spent nuclear fuel disposal, requiring the payment of fees related to the Company's ownership interests in the stations. Current recovery of these spent nuclear fuel disposal costs is provided as part of the Company's energy clause.

The Company provides its own financing during the construction period for its share of the jointly-owned plants and includes its share of direct operations and maintenance expenses in its Statement of Income.

NOTE 6. INVESTMENTS IN OPERATING SUBSIDIARIES

The Company's investment in Deepwater Operating Company (Deepwater), a wholly-owned subsidiary which operates generating and process steam units owned by the Company, was $3,291,000 at December 31, 1986 and 1985, respectively. The principal asset of Deepwater is working capital in which the equity of the Company is fairly represented by its investment. The net production costs of Deepwater are included in the Company's accounts classified as to operation, maintenance and taxes.

The Company's investment in Atlantic Housing, Inc., a wholly-owned subsidiary, was $6,404,000 at December 31, 1986 and $1,000 at December 31, 1985. Atlantic Housing, Inc. was inactive during 1985, and in 1986 made an investment in a commercial real estate property.

NOTE 7. COMMON STOCK

As of December 31, 1986 and 1985, the Company's Common Stock included 25,000,000 authorized shares of Common Stock ($3 par value).

Shares Issued and Outstanding:	1986	1985	1984
Beginning of Year	18,257,009	17,821,346	17,250,882
Dividend Reinvestment and Stock Purchase Plan	—	408,999	525,118
Employee Stock Ownership Plan	9,665	14,306	36,009
Conversion of Preferred Stock	6,981	12,358	9,337
End of Year	18,273,655	18,257,009	17,821,346
At $3 Par Value	$54,820,965	$54,771,027	$53,464,038

Premium on Capital Stock was credited in 1986 and 1985 with $501,000 and $10,209,000, respectively, representing the excess of proceeds over the par value of shares of Common Stock issued, sold and converted. At December 31, 1986 there were 47,514 shares of Common Stock authorized for issuance pursuant to the Employee Stock Ownership Plan and 40,394 shares of Common Stock reserved for the conversion of 5⅞% Convertible Series of Preferred Stock.

NOTE 8. CUMULATIVE PREFERRED STOCK

The Company has authorized 799,979 shares of Cumulative Preferred Stock, $100 Par Value, 2,000,000 shares of No Par Preferred Stock and 3,000,000 shares of Preference Stock, No Par Value. Unissued shares may, or may not, possess mandatory redemption characteristics upon issuance. In certain circumstances, if dividends on issued Preferred Stock are in arrears, voting rights for the election of a majority of the Board of Directors becomes operative.

NOTE 8(A).

Cumulative Preferred Stock Not Subject To Mandatory Redemption:

$100 Par Value-Cumulative and Non-participating shares issued and outstanding:	December 31 1986	December 31 1985	Current Redemption Price Per Share
	(Thousands of Dollars)		
Series:			
4% 77,000 Shares	$ 7,700	$ 7,700	$105.50
4.10% 72,000 Shares	7,200	7,200	101.00
4.35% 15,000 Shares	1,500	1,500	101.00
4.35% 36,000 Shares	3,600	3,600	101.00
4.75% 50,000 Shares	5,000	5,000	101.00
5% 50,000 Shares	5,000	5,000	100.00
5⅞% Convertible Series:			
11,535 Shares (1986)	1,154	—	101.50
13,530 Shares (1985)	—	1,353	
7.52% 100,000 Shares	10,000	10,000	104.89
Total	$41,154	$41,353	

Cumulative Preferred Stock Not Subject to Mandatory Redemption is redeemable solely at the option of the Company upon payment of the redemption price plus accumulated and unpaid dividends to the date fixed for redemption. Premium on such Preferred Stock was $93,000 at December 31, 1986 and 1985.

The 5⅞% Convertible Series, of which 1,995 and 3,531 shares were converted in 1986 and 1985, respectively, is convertible, subject to adjustment in certain events, into Common Stock at the rate of 3.5 shares of Common Stock for each share of Preferred.

NOTE 8(B).

Cumulative Preferred Stock Subject To Mandatory Redemption:

Shares Issued and Outstanding:	Par Value	December 31 1986 (Thousands of Dollars)	December 31 1985 (Thousands of Dollars)	Current Redemption Price Per Share	Refunding Restricted Prior to
Series:					
9.96% 96,000 Shares (1986)	$100	$ 9,600	$ —	$105.70	
104,000 Shares (1985)		—	10,400		
$8.25 82,500 Shares (1986)	None	8,250	—	106.35	November 1, 1987
87,500 Shares (1985)		—	8,750		
$9.45 120,000 Shares (1986)	None	12,000	—	103.15	November 1, 1989
200,000 Shares (1985)		—	20,000		
		29,850	39,150		
Less portion due within one year		5,050	5,050		
Total		$24,800	$34,100		

On February 1, 1985, the Company redeemed 8,000 shares of its 8.40% Preferred Stock Series through the operation of the sinking fund and optional redemption provisions at a redemption price of $100 per share. On August 2, 1985 the Company reacquired all of the remaining shares (92,000) of this series, with an aggregate par value of $9,200,000 for $9,177,000.

On August 1 of each year, 8,000 shares of the 9.96% Series must be redeemed through the operation of a sinking fund at a redemption price of $100 per share. At the option of the Company, an additional 8,000 shares may be redeemed on any sinking fund date, without premium, up to 40,000 shares in the aggregate. The Company redeemed 8,000 and 16,000 shares at par, in 1986 and 1985, respectively, through the operation of the sinking fund and optional redemption provisions. As of December 31, 1986 the Company had redeemed the maximum 40,000 shares.

On November 1 of each year, 2,500 shares of the $8.25 No Par Preferred Stock Series must be redeemed through the operation of a sinking fund at a redemption price of $100 per share. At the option of the Company, not more than an additional 2,500 shares may be redeemed on any sinking fund date without premium. The Company redeemed 5,000 and 2,500 shares at par in 1986 and 1985, respectively.

On November 1, 1986, and annually thereafter, 40,000 shares of the $9.45 No Par Preferred Stock Series must be redeemed through the operation of a sinking fund at a redemption price of $100 per share. At the option of the Company, not more than an additional 40,000 shares may be redeemed on any sinking fund date, without premium, up to 50,000 shares in the aggregate. The Company redeemed 80,000 shares at par in 1986.

The annual minimum sinking fund provisions of the above series aggregate $5,050,000 each year from 1987 through 1989 and $1,050,000 for 1990 and 1991.

NOTE 9. LONG TERM DEBT

(Thousands of Dollars)	December 31 1986	1985
First Mortgage Bonds:		
4½% Series due (January 1) 1987	$ 10,000	$ 10,000
3⅞% Series due (April 1) 1988	10,000	10,000
4½% Series due (April 1) 1989	2,775	2,775
4½% Series due (March 1) 1991	10,000	10,000
4½% Series due (July 1) 1992	10,350	10,350
4⅜% Series due (March 1) 1993	9,540	9,540
11⅞% Series due (November 1) 1993	13,325	50,000
5⅛% Series due (February 1) 1996	9,980	9,980
8% Series due (November 1) 1996	95,000	—
8⅞% Series due (September 1) 2000	19,000	19,000
8% Series due (May 1) 2001	27,000	27,000
7½% Series due (April 1) 2002	20,000	20,000
7¾% Series due (June 1) 2003	29,976	29,976
7⅝% Pollution Control Series due (January 1) 2005	6,500	6,500
6⅜% Pollution Control Series due (December 1) 2006	2,500	2,500
12⅝% Series due (January 1) 2010	—	63,750
11⅝% Pollution Control Series due (May 1) 2011	39,000	39,000
10½% Pollution Control Series B due (July 15) 2012	850	850
Adjustable Rate Pollution Control Series A due (April 15) 2014 (7¼% Until 4-15-87)	18,200	18,200
10½% Pollution Control Series C due (July 15) 2014	23,150	23,150
11½% Series due (October 1) 2015	21,215	70,000
8⅞% Series due (May 1) 2016	125,000	—
Total	503,361	432,571
Debentures:		
5¼% Sinking Fund Debentures due (February 1) 1996	2,267	2,267
7¼% Sinking Fund Debentures due (May 1) 1998	2,619	2,619
Total	4,886	4,886
Notes-Variable Rate Notes due (April 30) 1986	—	45,000
Unamortized Premium and Discount-Net	(3,275)	5
Total	504,972	482,462
Less portion due within one year	10,000	45,000
Total	$494,972	$437,462

On January 1, 1986 the Company redeemed $6,000,000 principal amount of the 12⅝% Series bonds through the operation of the sinking fund and optional redemption provisions. On June 12, 1986 the Company redeemed all of the remaining principal amount, $57,750,000, at a redemption price of 109.92%. The aggregate costs of the reacquisition were $3,288,000, net of related income taxes. These costs, including unamortized debt expenses related to the issuance of the debt and other expenses, and the related deferred income taxes, are being amortized over thirty years beginning in June 1986.

On November 5, 1986 the Company tendered for all of the outstanding principal of the $50,000,000, 11⅞% Series due 1993 and the $70,000,000, 11½% Series due 2015 at redemption prices of 112.570% and 121.125% of the principal amount, respectively. At December 31, 1986 principal amounts of $36,675,000 and $48,785,000, respectively, were reacquired. The aggregate cost of these redemptions was $8,750,000, net of related income taxes. These costs, including unamortized debt expenses related to the issuances of the debt and other expenses, and the related deferred income taxes, are being amortized over ten years beginning in November 1986.

In January 1987, the Company reacquired an additional $300,000 principal amount of the 11⅞% Series relative to the November 5, 1986 tender.

Deposits in sinking funds for retirement of debentures are required on February 1 of each year through 1995 for the 5¼% Debentures, and on May 1 of each year through 1997 for the 7¼% Debentures in amounts in each case sufficient to redeem $100,000 principal amount plus, at the election of the Company, up to an additional $100,000

principal amount in each year. By December 31, 1986 the Company had reacquired and cancelled $1,133,000 and $981,000 principal amount of the 5¼% and 7¼% Debentures, respectively, toward its requirements for 1987 and subsequent periods.

Regular redemption prices on a face value per bond basis are currently in effect for each series of First Mortgage Bonds except for certain pollution control series in which regular redemption is restricted by agreement prior to specified dates. Also, certain pollution control series contain future sinking fund requirements. Redemption of certain series of the First Mortgage Bonds are restricted prior to specified dates if the redemption is for the purpose or in anticipation of refunding through the direct or indirect use of funds borrowed by the Company at effective interest costs to the Company of less than specified rates.

Current sinking fund requirements of $750,000 in connection with certain First Mortgage Bonds outstanding may be satisfied by certification of property additions as provided for in the related mortgage indentures.

The aggregate amount of debt maturities, in addition to sinking fund requirements, of all long term debt outstanding at December 31, 1986 are $10,000,000 in 1987 and 1988, $2,775,000 in 1989 and $10,000,000 in 1991. No outstanding long term debt matures in 1990.

NOTE 10. SHORT TERM DEBT AND COMPENSATING BALANCES

As of December 31, 1986, the Company had bank lines of credit available for use of $115,000,000. The Company is required, with respect to $14,000,000 of these credit lines, to maintain average compensating balances of $455,000. These compensating balances are maintained in demand deposits which are not legally restricted. The Company is in compliance with such compensating balance arrangements. With respect to the remaining available credit lines, the Company pays commitment fees (generally ¼%) for which charges amounted to $248,000 for 1986, $235,000 for 1985 and $242,000 for 1984. The Company had $12,900,000 of short term debt outstanding at December 31, 1986, consisting of $8,500,000 of commercial paper, and $4,400,000 of notes payable. The notes payable represent two separate pollution control financings at respective interest rates of 4.7% and 5.5%. These notes will mature in July 1987. The Company expects to refinance these short term borrowings on a long term basis during 1987. The Company had no outstanding short term debt at December 31, 1985 or 1984. Additional information regarding short term debt follows:

(Thousands of Dollars)	1986	1985	1984
For the year ended—			
Maximum amount of total short term debt at any month-end:			
Commercial Paper	$10,500	$55,700	$35,000
Notes Payable to Banks	$ 5,000	$10,000	—
Average amount of short term debt (based on daily outstanding balances):			
Commercial Paper	$ 2,256	$19,905	$17,519
Notes Payable to Banks	$ 123	$ 4,239	$ 301
Weighted daily average interest rates on short term debt:			
Commercial Paper	6.3%	7.9%	10.6%
Notes Payable to Banks	6.8%	8.1%	9.2%

NOTE 11. COMMITMENTS AND CONTINGENCIES

Construction Program

Total cash construction expenditures for 1987 are estimated at approximately $109,783,000, which includes $17,611,000 for jointly-owned facilities. Current commitments for the construction of major production and transmission facilities amount to approximately $52,577,000 of which it is estimated approximately $16,771,000 will be expended in 1987. These amounts exclude allowance for funds used during construction and customer contributions.

Insurance Programs

The Company is a member of certain insurance programs which provide coverage for property damage to members' nuclear generating plants. Facilities at the Peach Bottom, Salem and Hope Creek Stations are insured against property damage losses up to $1.16 billion per site under these programs.

In addition, the Company is a member of an insurance program which provides insurance coverage for the cost of

replacement power during prolonged outages of nuclear units caused by certain specific conditions. Under the property and replacement power insurance programs, the Company could be assessed retrospective premiums in the event the insurers' losses exceed their reserves. As of December 31, 1986, the maximum amount of retrospective premiums the Company could be assessed for losses during the current policy year was $9.05 million under these programs.

In the event of a nuclear incident at any of the facilities covered by the federal government's third-party liability indemnification program, the Company could be assessed up to $2.34 million per incident, but not more than $4.67 million in a calendar year, in the event more than one incident is experienced.

The Company is also a member of several industry-owned mutual insurance companies providing various other liability insurance coverages as part of the Company's overall insurance programs. As of December 31, 1986, under these policies the maximum amount of retrospective premiums the Company could be assessed for losses during the current policy year was $6.8 million.

Purchase Power Agreements

The Company has an arrangement for a limited term purchase of energy and capacity from Allegheny Power System which is subject to annual extensions. The Company also has agreements to purchase certain capacity and energy output from units of Pennsylvania Power & Light Company.

Hope Creek Nuclear Generating Station

The Company owns 5% of the Hope Creek Nuclear Generating Station, along with Public Service Electric & Gas Company (PSE&G), which owns the other 95% of the unit. In July 1983, the BPU approved an Agreement between the Company, PSE&G, the New Jersey Department of Energy and the New Jersey Department of the Public Advocate which establishes a program to contain the continuing construction costs of Hope Creek. The cost containment agreement established a targeted in-service date of December 1986 and a targeted cost of $3.7952 billion and provides for penalties for overruns based on the final cost of the unit. The Company's portion of the targeted cost is approximately $202 million. However, the targeted amount may be subject to adjustment due to changes in the regulatory treatment of Construction Work In Progress and the Allowance for Funds Used During Construction, as well as changes due to certain extraordinary events not contemplated by the parties in 1983. At December 31, 1986 the Company's costs associated with Hope Creek amounted to approximately $236 million. In 1985, the Company filed a petition with the BPU to recognize Hope Creek in its rate base. In late 1986, a separate proceeding involving Hope Creek was conducted by the BPU to examine.the reasonableness of the total costs of the unit. On February 6, 1987, the BPU issued an oral decision involving PSE&G, ruling that a total of $455.2 million of costs associated with the Hope Creek project would be disallowed for ratemaking purposes.

Pending issuance of a written order in the PSE&G case, as well as a ruling in our separate proceeding, the Company cannot predict the outcome of these proceedings or their effects on the Company.

Nuclear Plant Outages

The BPU has deferred consideration of $12,179,000 of replacement power costs associated with certain nuclear outages relating to generator failures at Salem Station pending the development of the record on such outages in the next energy clause adjustment proceeding of the operator of the station, Public Service Electric & Gas Company. The co-owners of the station have instituted litigation against the supplier of the affected equipment. The Company cannot predict the outcome of this matter or its ultimate effect on the Company.

Nuclear Fuel

The Company's contractual liability to purchase nuclear fuel from Pearl Fuel Corporation for Salem and Hope Creek Generating Stations as of December 31, 1986 was approximately $29,700,000. Under certain conditions of termination, the Company will be required to purchase all nuclear fuel then existing at a price which will allow Pearl Fuel Corporation to recover its net investment costs. Nuclear fuel requirements for Peach Bottom Generating Station are being provided by the operating company through a fuel purchase contract. The Company is responsible for payment of its share of fuel consumed and related operating costs and interest expense. These costs are included in fuel expense.

Accounting Standards

In December 1986 the Financial Accounting Standards Board issued a new accounting standard entitled "Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs", which is an amendment to existing accounting standards for regulated enterprises, such as the Company and is effective for fiscal years beginning after December 15, 1987. This standard alters current accounting for the types of events enumerated and requires the Company to reduce the carrying value of certain assets on the balance sheet, principally the unamortized costs of abandoned plant projects. The effects of such an adjustment would not be material in relation to the Company's financial position. Additionally, the new standard will affect the accounting for the Hope Creek Generating Station depending upon the outcome of those proceedings as discussed above. Depending on the outcome of the proceedings, the new standard could require the Company to recognize a loss on any disallowed costs based on prudency or recognize a loss for any costs on which a return is not allowed. The Company cannot predict the ultimate impact of the new standard.

NOTE 12. LEASES

The Company has certain obligations which, in accordance with criteria established by the Financial Accounting Standards Board (FASB), are capital leases, but are accounted for as operating leases in accordance with the ratemaking treatment. An accounting standard issued by the FASB requires that the Company record such leases on its balance sheet beginning in 1987. Recording capital leases would not have a material effect on assets or liabilities, and would not affect income, since the total amortization of the leased assets and the interest on the lease obligation would equal the rental expense currently allowed for ratemaking purposes.

Rentals charged to operating expenses were as follows:

(Thousands of Dollars)	1986	1985	1984
Nuclear Fuel	$14,872	$11,800	$ 8,457
Other	4,033	4,511	4,759
Total	$18,905	$16,311	$13,216

The future minimum rental commitments under all noncancelable lease agreements are not significant.

NOTE 13. QUARTERLY FINANCIAL RESULTS (UNAUDITED)

Quarterly financial data, reflecting all adjustments necessary in the opinion of the Company for fair presentation of such amounts, are as follows:

Quarter	Operating Revenues	Operating Income	Net Income	Earnings For Common Stock	Earnings Per Share
(Thousands of Dollars Except Per Share Amounts)					
1986					
1st	$136,520	$20,339	$13,316	$11,868	$ .65
2nd	134,433	20,858	14,480	13,033	.71
3rd	179,310	37,826	31,008	29,575	1.62
4th	132,698	16,431	10,746	9,447	.52
	$582,961	$95,454	$69,550	$63,923	$3.50
1985					
1st	$140,491	$19,104	$12,658	$10,962	$ .61
2nd	134,214	15,683	8,866	7,176	.40
3rd	180,411	35,630	27,815	26,283	1.45
4th	124,617	18,989	11,180	9,729	.53
	$579,733	$89,406	$60,519	$54,150	$3.00(1)

(1) The individual quarters may not add to the total due to the increasing average number of Common shares outstanding at the end of each quarter.

The revenues of the Company are subject to seasonal fluctuations due to increased sales and higher residential rates during the summer months.

Where should I send inquiries concerning my investment in Atlantic City Electric Company?

The Company staffs an Investor Records Department which serves as recordkeeping agent, dividend disbursing agent and also as Transfer Agent for Common and Preferred Stocks. Correspondence concerning such matters as the replacement of dividend checks or stock certificates, address changes, transfer of Common and Preferred Stock certificates, Dividend Reinvestment and Stock Purchase Plan inquiries or any general information about the Company should be addressed to:

Atlantic City Electric Company
Investor Records Department
P.O. Box 1334, 1199 Black Horse Pike
Pleasantville, New Jersey 08232
Telephone (609) 645-4506 or (609) 645-4507

Ms. S. M. Dodd, Secretary, is the corporate officer responsible for all investor services—Mr. R. E. Moeller is Manager of Investor Services and Mrs. M. T. Lindsay is Supervisor of Shareholder Recordkeeping.

Does the Company have a Dividend Reinvestment and Stock Purchase Plan?

Yes. The Plan allows shareholders and employees to automatically invest their cash dividends and/or optional cash payments in shares of the Company's Common Stock. Holders of record of Common Stock interested in enrolling in the Plan should contact the Investor Records Department. See the address above.

Where is the Company's stock listed?

Common Stock and 5⅞% Cumulative Convertible Preferred Stock are listed on the New York Stock Exchange. The Company's Common Stock is also listed on the Pacific and Philadelphia Stock Exchanges. The trading symbol of the Company's Common Stock is ATE; however, newspaper listings generally use AtCyEl.

The high and low sales prices of the Common Stock as reported in the Wall Street Journal as New York Stock Exchange—Composite Transactions for the periods indicated were as follows:

	1986		1985	
	High	Low	High	Low
First Quarter	36¼	28¼	25¼	23¾
Second Quarter	38⅞	32½	29¾	24¾
Third Quarter	46⅝	33⅞	29¼	25⅝
Fourth Quarter	41⅜	37	29¾	26

Is additional information about the Company available?

The annual report to the Securities and Exchange Commission on Form 10-K and other reports containing financial data are available to shareholders. Specific requests should be addressed to Mr. R. E. Moeller, Manager of Investor Services, or the Investor Records Department, at the address shown.

Who is the trustee and interest paying agent for the Company's Bonds and Debentures?

First Mortgage Bond recordkeeping and interest disbursing are performed by Irving Trust Company, One Wall Street, New York, New York 10015. Debenture recordkeeping and interest disbursing are performed by First Fidelity Bank, N.A., 765 Broad Street, Newark, New Jersey 07101.

When are dividends paid?

The proposed record dates and payable dates for dividends on Common Stock are as follows:

Record Dates	Payable Dates
March 19, 1987	April 15, 1987
June 18, 1987	July 15, 1987
September 17, 1987	October 15, 1987
December 17, 1987	January 15, 1988

The following table indicates dividends paid in 1986 and 1985 on Common Stock:

	1986	1985
First Quarter	$ .645	$ .62
Second Quarter	$ .645	$ .62
Third Quarter	$ .655	$ .645
Fourth Quarter	$ .655	$ .645
Annual Total	$2.60	$2.53

Dividends paid on Common Stock in 1986 and 1985 were fully taxable.

Summary Financial and Statistical Review 1986-1976

	1986	1985	1984	1983
Facilities for Service				
Total Utility Plant (Thousands)	$1,489,798	$1,406,696	$1,309,670	$1,226,165
Additions to Utility Plant (Thousands)	$ 109,303	$ 105,213	$ 95,388	$ 83,673
Pole Miles of Transmission and Distribution Lines	7,015	6,977	6,958	6,925
Generating Capacity (Kilowatts) (a) (b)	1,660,700	1,605,700	1,594,200	1,594,200
Maximum Utility System Demand—kw	1,459,000	1,432,000	1,298,800	1,346,700
Capacity Reserve at Time of Peak (% of Instal. Gen.)	12.1%	10.8%	18.5%	15.5%
Energy Supply (Thousands of kwh):				
Net Generation	5,912,834	5,817,254	6,237,724	5,913,196
Purchased and Interchanged—Net	1,185,666	1,049,393	393,175	579,488
Total System Load	7,098,500	6,866,647	6,630,899	6,492,684
Electric Sales (Thousands of kwh)				
Residential	2,839,114	2,638,121	2,646,813	2,545,351
Commercial	2,401,199	2,298,895	2,150,464	2,019,468
Industrial	1,222,981	1,204,971	1,197,392	1,225,637
All Others	58,120	57,685	59,122	60,978
Total	6,521,414	6,199,672	6,053,791	5,851,434
Residential Electric Service (Average per Customer)				
Amount of Electricity used during the year (kwh)	7,982	7,643	7,866	7,715
Revenue for a year's service	$ 780.43	$ 778.77	$ 783.47	$ 735.66
Revenue per Kilowatt-hour	9.78¢	10.19¢	9.96¢	9.54¢
Customer Data (Average)				
Residential With Electric Heating	72,640	68,871	65,261	62,272
Residential Without Electric Heating	283,062	276,305	271,207	267,642
Total Residential	355,702	345,176	336,468	329,914
Commercial	45,359	44,256	43,615	43,152
Industrial	1,022	1,020	1,015	1,021
Other	554	554	544	549
Total Customers	402,637	391,006	381,642	374,636
Total Service Locations	430,565	417,625	407,277	398,526
Operating Revenues (Thousands)				
Energy Revenues:				
Residential	$ 277,601	$ 268,814	$ 263,612	$ 242,705
Commercial	211,023	209,880	190,435	175,520
Industrial	78,404	80,392	79,123	76,109
All Others	10,152	10,315	10,405	10,133
Total Energy Revenues	577,180	569,401	543,575	504,467
Unbilled Revenues—Net	(1,813)	3,076	(1,340)	5,671
Other Electric Revenue	7,594	7,256	7,296	7,004
Total	$ 582,961	$ 579,733	$ 549,531	$ 517,142
Investor Information				
Net Income	$ 69,550	$ 60,519	$ 63,277	$ 66,152
Average Number of Shares Outstanding (Thousands)	18,266	18,069	17,581	16,923
Earnings per Average Common Share	$ 3.50	$ 3.00	$ 3.20	$ 3.48
Total Assets (Year End)	$1,398,886	$1,299,633	$1,220,503	$1,139,978
Long Term Debt and Cumulative Preferred Stock Subject to Mandatory Redemption (Year End)	$ 534,822	$ 521,612	$ 473,462	$ 459,366
Dividends Declared on Common Stock	$ 2.61	$ 2.555	$ 2.45	$ 2.32
Dividend Payout Ratio	74%	84%	76%	66%
Book Value Per Share (Year End)	$ 25.67	$ 24.76	$ 24.27	$ 23.58
Price Earnings Ratio (Year End)	11	10	8	7
Times Fixed Charges Earned (before income taxes)	3.33	3.33	3.61	4.11
Shareholders and Employees (Year End)				
Common Shareholders	47,133	48,635	47,446	48,299
Employees	2,168	2,099	2,012	1,995

(a) Excludes capacity allocated to a large industrial customer.

(b) Includes unit purchase of capacity under contracts with Pennsylvania Power & Light Company (commencing in 1983) and Delmarva Power & Light Company (from 1980 through 1984).

(c) Net income and earnings calculations include the cumulative effect of an accounting change. Financial ratio is computed excluding the cumulative effect.

1982	1981	1980	1979	1978	1977	1976
$1,153,321	$1,064,928	$ 962,052	$ 870,075	$ 802,473	$ 753,269	$ 710,343
$ 126,893	$ 123,318	$ 97,330	$ 72,773	$ 58,073	$ 48,733	$ 41,702
6,918	6,910	6,879	6,831	6,786	6,735	6,696
1,531,200	1,524,600	1,431,600	1,384,700	1,414,700	1,414,700	1,334,700
1,264,200	1,263,800	1,261,700	1,192,600	1,177,400	1,176,000	1,030,300
17.4%	17.1%	11.9%	13.9%	16.7%	16.9%	22.8%
5,676,118	5,302,023	5,533,178	5,397,338	5,625,988	5,293,019	4,918,906
466,667	946,241	643,106	464,143	130,037	224,169	324,196
6,142,785	6,248,264	6,176,284	5,861,481	5,756,025	5,517,188	5,243,102
2,415,292	2,480,225	2,514,738	2,411,732	2,377,202	2,221,250	2,070,766
1,894,535	1,849,863	1,769,208	1,580,384	1,586,097	1,478,559	1,392,029
1,218,520	1,279,724	1,286,205	1,255,304	1,250,636	1,220,260	1,143,170
63,770	65,555	63,753	60,799	60,705	58,866	57,667
5,592,117	5,675,367	5,633,904	5,308,219	5,274,640	4,978,935	4,663,632
7,444	7,751	8,003	7,849	7,951	7,653	7,320
$ 644.77	$ 670.66	$ 536.99	$ 439.92	$ 406.18	$ 378.36	$ 349.64
8.66¢	8.65¢	6.71¢	5.61¢	5.11¢	4.94¢	4.78¢
59,319	56,100	52,225	48,339	44,387	40,318	37,581
265,124	263,904	261,988	258,941	254,592	249,927	245,296
324,443	320,004	314,213	307,280	298,979	290,245	282,877
42,885	43,219	43,267	43,219	42,672	42,033	41,170
1,018	1,032	1,041	1,048	1,034	1,047	1,071
627	634	654	667	673	676	681
368,973	364,889	359,175	352,214	343,358	334,001	325,799
391,989	386,046	379,242	371,362	362,131	352,205	343,147
$ 209,191	$ 214,614	$ 168,733	$ 135,178	$ 121,440	$ 109,818	$ 98,904
154,792	156,624	115,973	88,819	80,539	73,354	66,354
71,255	82,908	60,512	47,590	42,185	40,885	36,438
9,255	9,700	7,836	6,624	5,973	5,630	5,406
444,493	463,846	353,054	278,211	250,137	229,687	207,102
(6,795)	—	—	—	—	—	—
6,480	5,837	5,337	4,895	4,921	5,308	4,925
$ 444,178	$ 469,683	$ 358,391	$ 283,106	$ 255,058	$ 234,995	$ 212,027
$ 49,055(c)	$ 46,988	$ 38,538	$ 34,307	$ 30,064	$ 27,358	$ 30,796
15,116	13,034	12,372	11,980	10,791	10,630	9,747
$ 2.76(c)	$ 3.03	$ 2.62	$ 2.36	$ 2.21	$ 2.06	$ 2.60
$1,077,969	$1,013,789	$ 879,795	$ 779,026	$ 699,861	$ 662,614	$ 633,058
$ 462,470	$ 447,389	$ 394,288	$ 324,848	$ 329,781	$ 330,120	$ 320,636
$ 2.24	$ 2.08	$ 1.93	$ 1.79	$ 1.70	$ 1.62	$ 1.58
80%	67%	73%	75%	76%	79%	60%
$ 22.45	$ 22.40	$ 22.22	$ 21.63	$ 21.27	$ 20.71	$ 20.25
8	6	6	7	8	11	9
2.27(c)	2.84	3.03	3.62	3.62	3.17	3.14
48,790	48,424	47,762	48,194	44,490	43,826	42,516
2,022	2,035	1,968	1,903	1,797	1,739	1,714

This Annual Report has been prepared for the purpose of providing general and statistical information concerning the Company and not in connection with any sale, offer for sale or solicitation of an offer to buy any securities.

Board of Directors

ELEANOR S. DANIEL
Self-employed, Vice President and director of several real estate corporations

RICHARD M. DICKE
Counselor-at-law, partner of the law firm of Simpson, Thacher & Bartlett

JOHN D. FEEHAN
Chairman of the Board of the Company

JOS. MICHAEL GALVIN, JR.
President and Chief Executive Officer of Salem County Memorial Hospital

GERALD A. HALE
President of HHH, Inc., an investment and management company

MATTHEW HOLDEN, JR.
Professor of Government and Foreign Affairs, University of Virginia

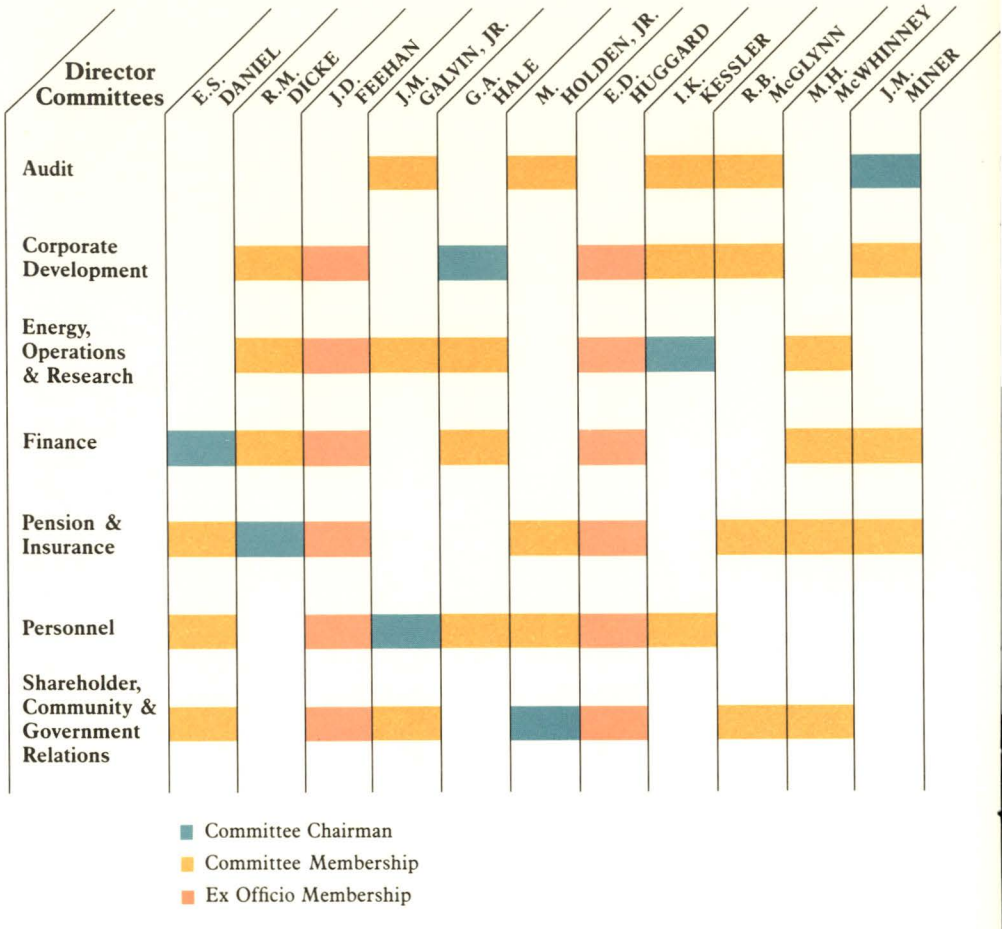
E. DOUGLAS HUGGARD
President and Chief Executive Officer of the Company

IRVING K. KESSLER
Retired, Former Executive Vice President, RCA Corporation

RICHARD B. McGLYNN
Counselor-at-Law, Attorney with the firm of Stryker, Tams & Dill

MADELINE H. McWHINNEY
President of Dale, Elliott & Company, a management consulting firm providing services to the banking industry

JOHN M. MINER
Financial Consultant



Officers

	Years of Service		Years of Service		Years of Service
E. DOUGLAS HUGGARD President and Chief Executive Officer	31	**JOHN M. CARDEN** Vice President—Administrative Services	19	**JOSEPH T. KELLY, JR.** Vice President—Interconnection Operations	36
JERROLD L. JACOBS Senior Vice President—Utility Operations	25	**LANCE E. COOPER** Vice President—Control and Assistant Treasurer	4	**BERTRAM LeMUNYON** Vice President—Power Delivery	27
MICHAEL A. JARRETT Senior Vice President—Corporate Services	11	**SABRINA M. DODD** Corporate Secretary	1	**HENRY K. LEVARI, JR.** Vice President—Corporate Planning	15
BRIAN A. PARENT Senior Vice President—Planning and Rates	19	**THOMAS E. FREEMAN** Vice President—Human Resources	6	**J. DAVID McCANN** Vice President, Treasurer and Assistant Secretary	14
J. G. SALOMONE Senior Vice President—Finance and Accounting	10	**MEREDITH I. HARLACHER, JR.** Vice President—Customer Service	21	**HENRY C. SCHWEMM, JR.** Vice President—Production	17

Front row [l to r]:
M. Holden
M.H. McWhinney
J.M. Galvin, Jr.
R.B. McGlynn

Back row [l to r]:
I.K. Kessler
G.A. Hale
E.D. Huggard
J.D. Feehan
R.M. Dicke
J.M. Miner
E.S. Daniel

Design: Mueller & Wister, Inc.
Major Photography: Kelly/Mooney

ATLANTIC ELECTRIC
P.O. Box 1264
1199 Black Horse Pike
Pleasantville, NJ 08232

BULK RATE
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