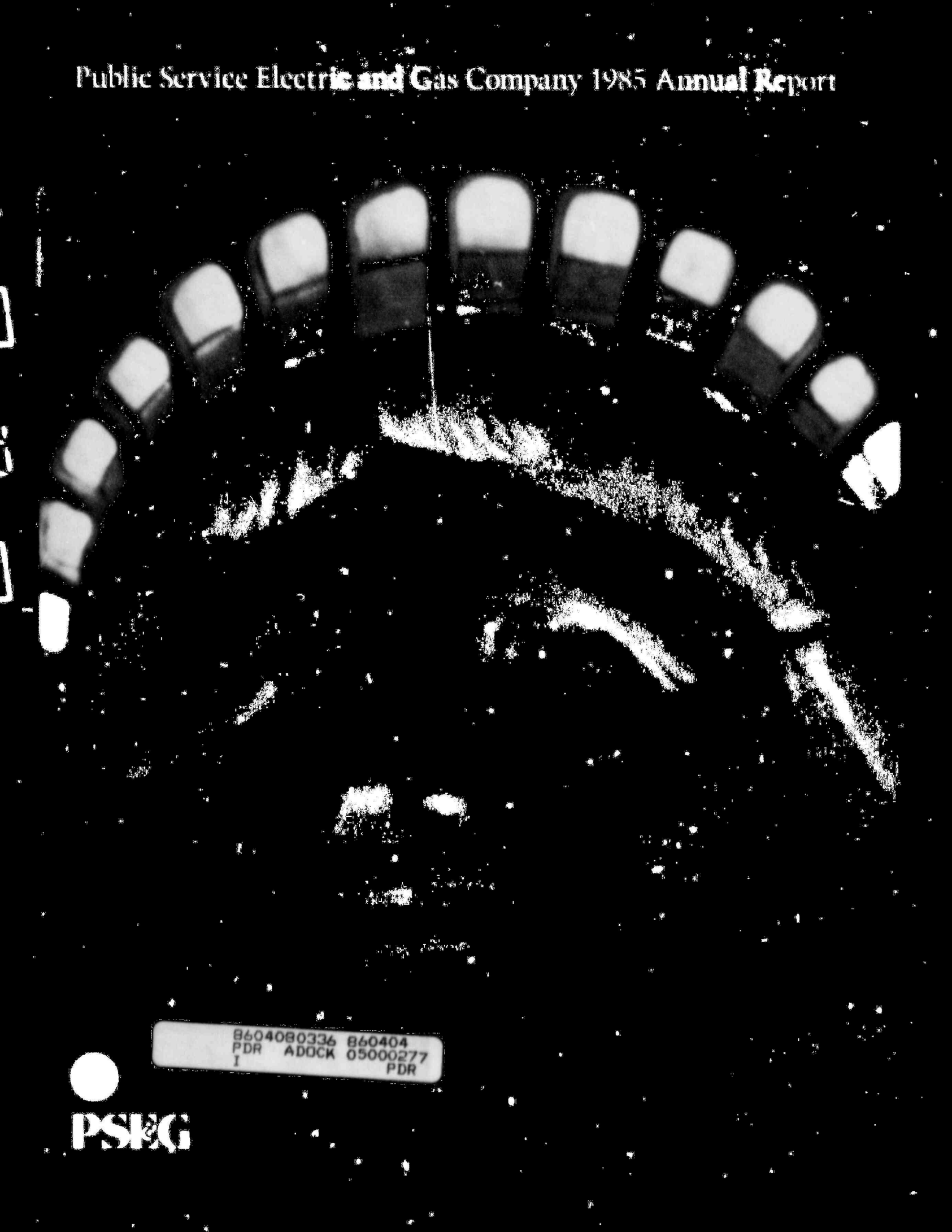
Public Service Electric and Gas Company 1985 Annual Report



PSE&G

Financial Highlights

(Thousands of Dollars where applicable)	1985	1984	% Increase (Decrease)
Electric Sales — Megawatthours	**32,320,508**	31,597,401	2
Gas Sales — Kilotherms	**2,125,674**	2,147,315	(1)
Total Operating Revenues	**$ 4,409,054**	$ 4,196,124	5
Total Operating Expenses	**$ 3,781,268**	$ 3,597,986	5
Earnings Available for Common Stock	**$ 484,550**	$ 429,808	13
Shares of Common Stock (Thousands)			
Average	**122,344**	108,913	12
Year-end	**131,699**	112,563	17
Earnings per Average Share of Common Stock	**$3.96**	$3.95	
Dividends Paid per Share of Common Stock	**$2.81**	$2.70	4
Common Stockholders — Year-end	**231,732**	234,156	(1)
Coverage Ratios			
Fixed Charges	**3.76**	3.61	
Fixed Charges and Preferred Dividends	**2.91**	2.76	
Return on Average Common Equity	**14.03%**	14.43%	
Book Value	**$28.04**	$27.17	3
Year-end Market Price	**31⅛**	26¾	18
Gross Additions to Utility Plant	**$ 1,220,089**	$ 967,365	26
Total Utility Plant at Original Cost	**$10,977,321**	$ 9,870,429	11

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About the Cover:

Public Service Electric and Gas Company joins in celebrating the Centennial of the Statue of Liberty in 1986.

The Company is proud to provide the electricity to light the torch that has been a beacon of hope and a sign of welcome for millions of Americans. And it is proud to have produced a 27-minute film honoring the many immigrants who passed through Ellis Island.

Harold W. Sonn, PSE&G's chairman of the board, serves as chairman of the New Jersey State Campaign for the Liberty Centennial, to raise funds for the restoration of the Statue of Liberty and Ellis Island.

Today, the financial community tends to perceive the utility business as an increasingly uncertain investment. However, conditions of the rest of the 1980s and, for that matter, of the 1990s and beyond must not be viewed with trepidation—if a company is active, flexible and adaptive.

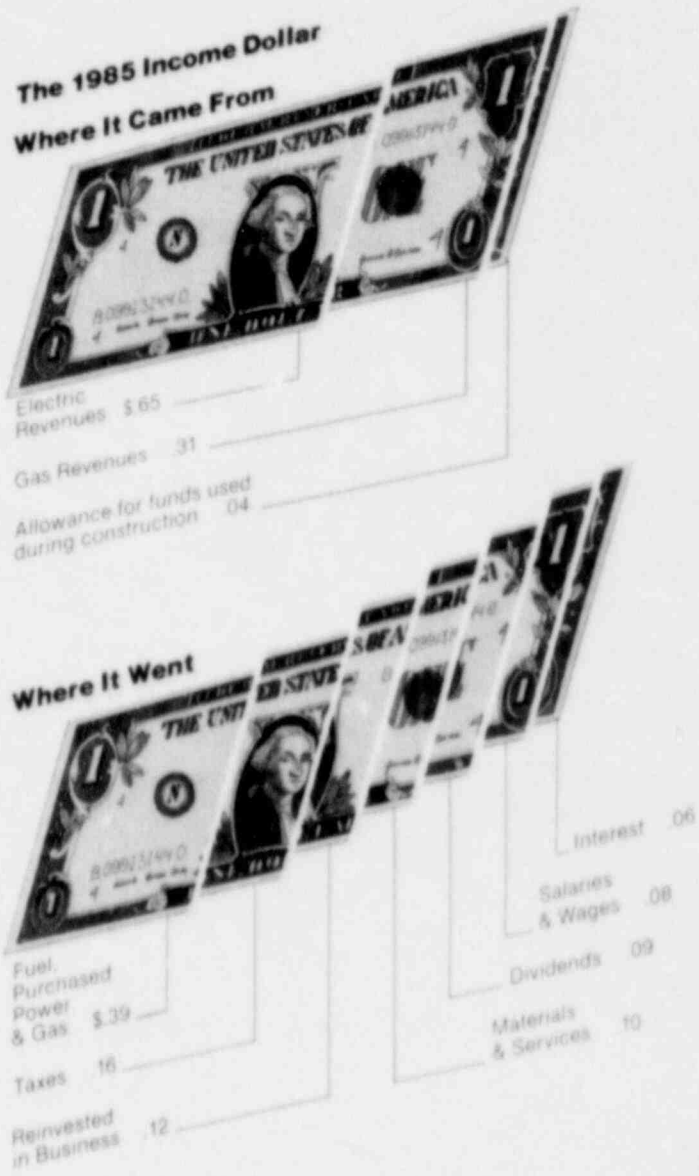
During the 1980s, PSE&G has concentrated on completing the Hope Creek Generating Station, its last major construction project in this century. We will continue focusing on Hope Creek until it is placed in service, which is expected to be later this year.

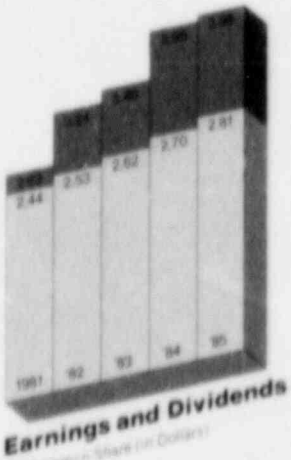
Once this major milestone is reached, PSE&G will be ready for the future, and the holding company will fit this need.

Our service area is relatively mature, with only modest growth projected. PSE&G, like the utility industry, is confronted with formidable, unregulated competition. For example, changes in federal regulation enable natural gas consumers, especially large users, to buy the fuel privately and make their own arrangements for pipeline delivery. The business of a gas distribution utility, such as PSE&G, is changing.

Diversification would provide the Company with the opportunity for growth in earnings without increased rates for electric and gas customers. We feel that the holding company structure offers the best way for diversification and provides a basis for insulating customers from results of unregulated businesses. It allows also for greater freedom for innovation and initiative.

Common stockholders would participate in the benefits and the risks of the Company's investment in non-regulated businesses. The formation of the holding company is described in much greater depth in the Company's proxy statement, and you are encouraged to read it carefully.





Earnings and Dividends

Per Common Share (in Dollars)

■ Earnings
▨ Dividends

Assuming we garner all the necessary approvals, including the endorsement of our holders of Common Stock and $1.40 Dividend Preference Common Stock when we meet in April, the Company would undergo restructuring in May.

While 1985 was a year in which we sharpened our focus on the future, it was also a year in which we paid careful attention to the present.

Earnings per share of Common Stock were $3.96, compared with $3.95 in 1984 when there were 13.4 million fewer shares.

In May, we raised the quarterly dividend by three cents to 71 cents a share. It marked the tenth consecutive year we increased the dividend in line with our policy to raise it on a regular basis. The indicated annual rate is now $2.84 per share.

New Jersey continued to hold worldwide appeal as a place to do business. Many foreign firms have found the state to be an ideal home, and they now account for a sizable portion of its workforce. Developers have excitedly pursued plans along the Hudson River waterfront—New Jersey's Gold Coast—and in other key regions from the Meadowlands to Burlington County.

Milestones marked the year at both our Salem and Hope Creek Generating Stations. In December, Salem 1 broke the national record for annual electric generation by any type of unit—nuclear, coal, oil or gas. Its 277 consecutive days of service was a Company record. Salem 2 returned to operation in May after a long outage because of a problem with its generator, and it performed well for the balance of 1985.

By the end of the year, Hope Creek's construction was virtually completed. The plant began undergoing a series of tests in anticipation of fuel loading in 1986. Plans call for the unit to be placed in commercial operation sometime in the second half of the year.

Hope Creek's cost has been increasing, partly because of scheduling adjustments and partly because of higher labor and other construction charges. We are concentrating on placing the plant in service as quickly as possible, without sacrificing quality, for the benefit of our customers and stockholders. The cost of the plant is now expected to be between $4.15 and $4.3 billion, which is about $400 million in excess of the cost cap contained in the 1982 cost containment agreement for the plant. The final figure will not be known until Hope Creek begins operation, because of numerous clean-up items and testing which must be completed. Based on our present estimate, the cost overruns will result in a reduction in earnings per share of between 5 cents and 8 cents in 1987 under the earnings penalty in the cost containment agreement. The reduction would be less in subsequent years.

In December, we petitioned the New Jersey Board of Public Utilities (BPU) for a $633.6 million, or 14.2%, increase in annual revenues. Nearly 90% of the total is in electric revenues, mostly attributable to the completion of Hope Creek.

The rate increase request also reflects anticipated savings in the cost of fuel, stemming from Hope Creek's operation. By the time we receive a ruling on our application, our existing base rates will have been in effect for over two-and-a-half years. We believe, therefore, that the amount of increase in our petition is reasonable. We anticipate a decision in September when we expect Hope Creek in service.

With the completion of Hope Creek, the Company will end a period of heavy construction expenditures. We do not plan any new large generating units for at least

New Jersey was the first state to reach its fundraising goal for the Statue of Liberty and Ellis Island: $5 million.

the next 15 years. As a result, we should be able to meet our construction costs with funds raised internally. This will reduce pressure on the ratio of earnings to fixed charges, which is used to determine the credit rating of debt and preferred stock, and will limit the need for issuance of new shares of Common Stock.

Through the end of the century, we plan to control increases in our system peak demand by encouraging load management, conservation and cogeneration in our territory. We plan, also, to maintain the reliability and to extend the life of our fossil generating stations. At the same time, we will make every effort to achieve or surpass the modest growth currently forecast for electric and gas sales.

Be assured that the dedication of our employees is as strong as ever. That quality was demonstrated repeatedly during 1985. For instance, electric service to more than 239,000 customers was interrupted by Hurricane Gloria's wrath. All service was restored within two days. And then many of the crews who worked around the clock traveled to neighboring utilities to help them restore service to their customers.

Even as we face change, we intend to meet our most important mandate:

To provide our customers, who now number 2 million, with safe, reliable, and economical electric and gas service, to compensate our dedicated employees as fairly as possible, and to give you, our shareholders, a return on your investment that you should expect from a company of PSE&G's dimensions.

As in the past, we are ready for the future. Thank you for your support.

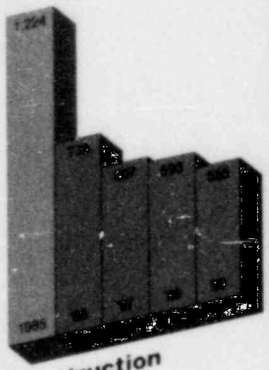
Harold W. Sonn

Harold W. Sonn

Chairman of the Board,
President and Chief Executive Officer

February 10, 1986

Hope Creek Generating Station is scheduled to start operating in the second half of 1986, ending a period of heavy construction. Its cooling tower is the tallest structure in the state.



Construction Financing

(Millions of Dollars)

■ Actual
■ Projected

A Company In Transition

In 1985, PSE&G took several steps to meet the challenges anticipated in the near future. The action reflected the Company's concern for its financial strength and its high-quality service to customers.

Holding company proposed

On July 16, the Company's Board of Directors authorized the formation of a holding company which would own all voting stock of PSE&G, subject to the approval of the New Jersey Board of Public Utilities (BPU) and the Company's stockholders.

Under the proposal, which was endorsed by the BPU in early 1986, a company, to be named Public Service Enterprise Group Incorporated, would be established. The present company, PSE&G, would become a subsidiary of the new holding company and would continue as a regulated electric and gas utility under the laws of the state. Two present subsidiaries of PSE&G—Community Energy Alternatives Incorporated, and Public Service Resources Corporation—also would become subsidiaries of the holding company.

Details about the restructuring appear in the Company's proxy statement. All stockholders are encouraged to read the statement. Holders of Common Stock and $1.40 Dividend Preference Common Stock will be asked to vote on the proposal at the Annual Meeting on April 15, 1986.

Cogeneration subsidiary begins activities

Community Energy Alternatives Incorporated (CEA), formed as a subsidiary of the Company in 1984, began formal operations in 1985. It will participate in the development of cogeneration and small power production projects on an unregulated basis.

CEA's headquarters is in Ridgewood, in Bergen County, and Arthur S. Nislick took office as its first president and chief executive officer on October 1.

Since its formation, CEA has been exploring opportunities to participate in economically sound, technically efficient projects designed to help supply the energy needs of industries, commercial establishments and large residential complexes. CEA intends to consider proposals to join with developers and financial institutions in launching qualifying projects.

Investment subsidiary formed

In 1985, the Company formed Public Service Resources Corporation (PSRC) as an investment subsidiary. The corporation will serve as a vehicle for investing available funds so that they earn a reasonable return that will enhance the overall financial strength of the Company.

PSRC, along with a consortium of other utilities, invested in a communications satellite launched by NASA from the space shuttle Atlantis on November 27. PSRC invested $12.9 million for its share in the satellite, and it will receive rental payments and tax benefits.

Management assessments launched

During the year, there were activities on several fronts that will figure in any restructuring the Company may undergo.

A strategic management group was formed to develop a process which will provide senior management with early identification and effective analysis of strategic options available to the Company. The strategic process will enable PSE&G to seize those opportunities which will improve its core business and define its role as a highly visible participant in directing the future management and use of energy in New Jersey.

A separate program was launched to create a leaner, more efficient organization by reducing levels of management and broadening the span of control. Nearly 200 management positions will be eliminated through reassignment of personnel and attrition.

In addition, a management audit of all Company operations was conducted during the year by Temple, Barker & Sloane, Inc., one of the country's top management consulting firms. The audit was done in line with a 1982 law which requires the BPU to authorize audits of all privately owned electric and gas utilities in the state.

Arthur S. Nislick is the first president of Community Energy Alternatives, which began operations in 1985 as a subsidiary of the Company.

The Financial Picture

Despite adverse pressures from various fronts during the year, the financial results in 1985 placed the Company on firm ground. Throughout the year, the Company sought to provide a solid capital structure and strong credit rating.

Earnings remain stable

Earnings available for Common Stock rose to $484.6 million in 1985, up from $429.8 million in 1984. Earnings per share of Common Stock were $3.96 in 1985, compared with $3.95 in 1984, when there were 13.4 million fewer average shares outstanding.

The increase of 0.3% in earnings per share, or 12.7% in overall earnings, was attributable to the base rate increase, effective March 23, 1984, higher electric sales, and greater Allowance for Funds Used During Construction (AFDC). Operating expenses rose at about the same rate as the previous year, to $3.8 billion from $3.6 billion, or 5.1%.

Reported earnings for the year were reduced by a write-off, after taxes, equal to 10 cents a share, of a portion of replacement energy costs which stemmed from outages at the Peach Bottom and Salem generating stations and for which recovery was disallowed by the New Jersey Board of Public Utilities (BPU). The results also include a write-off, equal to about 3 cents a share, from losses associated with the abandonment of three uranium supply agreements, which were no longer economical.

Total revenues increased 5.1%, to $4.4 billion from $4.2 billion. Electric revenues accounted for 68% of the total, rising to $3.0 billion from $2.8 billion, or 6.5%. Gas revenues made up the other 32% of the total, rising to $1.41 billion from $1.38 billion, or 2.1%.

The higher revenues were buoyed in large measure by an upswing in electric sales to the expanding commercial sector and to service-oriented and high-technology facilities. Overall electric sales rose 2.3% in 1985 over sales recorded a year earlier. Total gas sales, however, declined 1%, an outcome of the switching from gas to oil by some customers with dual-fuel capability and a slowdown in manufacturing activities.

According to the Company's latest financial forecast, electric and gas sales will show modest gains through 1987. The brightest spot will remain the commercial sector, as development unfolds in certain regions of the state, such as the Hudson River waterfront and the Route 1 corridor in Princeton.

For the 1985-87 period, electric sales were forecast to increase, on an average basis, 1.5%, while gas sales were anticipated to grow, on average, 2.1%. Thereafter, through the first decade of the 21st century, growth is expected to remain modest—generally in the 1%-to-2% range—for both electric and gas sales.

As a result of the higher revenues in 1985, New Jersey gross receipts and franchise taxes rose to $557 million from $530 million, an increase of 5.2%.

Dividend increased

The Board of Directors in May increased the quarterly dividend on Common Stock to 71 cents per share, up from 68 cents. It marked the 10th consecutive year the dividend has been raised. The annual rate is now $2.84 per share, up from $2.72.

The increase in the dividend, effective with payments in June, 1985, was in line with the Company's policy of raising dividends on a regular basis and paying a dividend that is sustainable.

Construction costs rise

Construction expenditures, including AFDC, payments for nuclear fuel and advances to subsidiaries, increased to $1.22 billion in 1985 from $964 million in 1984.

Expenditures in 1986 are expected to drop to $739 million, as the Company brings to an end a period of heavy construction spending.

In the five years through 1990, total construction costs are estimated at $3.0 billion, including approximately $240 million of AFDC. Much of the amount will be used to upgrade existing facilities.

Hope Creek has had a targeted cost of $3.795 billion stemming from a cost containment incentive agreement approved in 1983 by the BPU. The agreement had been reached in 1982 with the New Jersey Departments of Energy and the Public Advocate and also designated December, 1986 as the target date for Hope Creek's operation.

There will be an earnings penalty if Hope Creek is completed in excess of the cost cap. Under the agreement, the Company's revenue requirement related to rate base, as determined by the BPU, would be based on the exclusion from rate base of 20% of costs incurred in excess of the cost cap. If the overrun exceeds 10% of the cost cap, the approved rate base would be based on the exclusion of 30% of those expenditures in excess of the 10% overrun.

The agreement also provides for the exclusion of costs relating to certain extraordinary costs from the penalty provision.

The Company's current estimate of the cost of the plant is between $4.15 and $4.3 billion. Based on that estimate, the cost in excess of the cap could result in a reduction of earnings in 1987 of between 5 cents and 8 cents per share of Common Stock under a formula in the agreement. The reduction would decline in subsequent years over the depreciable life of the plant.

It is difficult to predict the final cost of the project as it nears completion because of numerous pre-operational items and imprecision in the timing of tests and power ascension programs which must be adjusted to meet problems as they arise.

Costs at the completion of the project, after fuel is loaded, will include the accrual of AFDC at about $18 million per month and direct costs of about $5 million per month, until the plant is declared in commercial operation.

The Company's first priority is to get the plant completed and operating as quickly as possible without sacrificing quality. Delays would further increase costs.

A goal of the Company has been to raise internally at least half of its total capital requirements. That aim has been met generally in the 1980s.

Now that Hope Creek will be coming on line and construction costs will drop significantly for the remainder of the decade, the Company's goal is to generate all funds internally. This will reduce pressure on the ratio of earnings to fixed charges associated with debt and preferred stock financings, and will limit the need to issue additional shares of Common Stock.

Capital structure shows balance

The principal financial objective of the Company continues to be a conservative capital structure that reflects the increased risk in the utility business. Maintaining this posture will enable the Company to protect its high credit rating and take advantage of financial flexibility.

The Company hopes to achieve interest coverages, before taxes, of at least 4 times. Another objective is to continue reducing its long-term debt ratio, which dropped from 45.8% at the end of 1984 to 42.4% in 1985.

In 1985, the Company purchased on the open market and cancelled a total of more than $70 million of high coupon debt to help reduce interest costs. Additional retirements of high cost debt and preferred stock are anticipated in 1986 through open-market purchases and early redemptions.

During the year, PSE&G ventured for the first time into the European debt market to take advantage of lower interest rates. On December 10, the Company negotiated the sale of $75 million of 9¾%, 10-year First and Refunding Mortgage Bonds, which were sold in Europe. Entry into the Eurobond market will save the Company an estimated $1.5 million in interest costs over the life of the bonds, when compared with the domestic market.

In July, the Company issued $125 million principal amount of 30-year First and Refunding Mortgage Bonds. Interest will be 9½% in each of the first three years, and then the rate will be reset or the bonds will be redeemed at par.

The Company raised $177.8 million through the public offering of 7 million shares of Common Stock in January. During the year, it raised $165.3 million from the sale of 5.9 million shares of Common Stock through its Dividend Reinvestment and Stock Purchase Plan and employee benefits plans.

The Company also generated $159.9 million by selling 6.2 million shares of Common Stock in a rights offering. More than 88% of the shares were purchased through subscription. Holders of Common Stock were issued rights to subscribe to one new share for every 20 shares they owned as of October 16. The subscription price was $25.75, and the offer ended on November 6.

Proceeds from the sale of the stock and bonds were used principally to pay short-term debt incurred as a result of the Company's construction program.

Changes affect reinvested dividends

Major modifications of the Dividend Reinvestment and Stock Purchase Plan became effective with the start of 1986. About 92,000 or one-third of the Company's stockholders participated in the plan in 1985.

First, taxes on dividends reinvested in qualified utility reinvestment plans can no longer be deferred. Congress did not extend the deferment granted through 1985 by the Economic Recovery Tax Act. The change should be considered in tax planning for the year. The Company urges each participant to consult the Internal Revenue Service or a private advisor to determine individual tax consequences.

Second, the Company has eliminated the 5% discount on shares purchased with reinvested dividends. The change, made only after considerable deliberation because of the discount's popularity, is in line with steps taken by other utilities. Since the Company's construction program is winding down, the need for new equity capital has diminished.

The Company is continuing the plan, however, so that stockholders can conveniently purchase shares without paying brokerage commissions. The Company is also now accepting Common Stock certificates, held by stockholders, for deposit and safekeeping in their reinvestment accounts; future dividends on those shares will be reinvested under the plan.

Rate increase is requested

The Company filed a petition in December with the Board of Public Utilities (BPU) for an increase of $633.6 million, or 14.2%, in annual revenues. The request includes an increase of $569.2 million, or 18.8%, in electric rates, and $64.4 million, or 4.5%, in gas rates.

The filing is sizable because it asks that 100% of allowable costs associated with the construction of the Hope Creek Generating Station be included in the rate base.

The Company believes that the amount of the filing attributable to Hope Creek will not be unreasonably burdensome on customers because immediate benefits are derived from the savings in the cost of fuel once the unit begins operation. Nuclear fuel is less expensive than fossil fuels, such as oil, and the petition reflects those savings.

The filing was timed so that a decision by the BPU would coincide with the start of Hope Creek's commercial operation. Generally, the BPU takes about nine months to decide a rate case.

About $81 million of the requested amount would be used to pay additional New Jersey gross receipts and franchise taxes.

Adjustment clauses are revised

Gas customers' bills were reduced, starting in October, after the BPU approved a $35 million decrease under the raw materials adjustment clause. The Company had originally sought a $16 million reduction, but entered into an agreement with the BPU staff and the New Jersey Public Advocate for a larger decrease as the cost of natural gas continued to decline.

The reduction is based on estimated decreases in the projected cost of gas, increased purchases of lower-priced gas on the spot market, anticipated refunds from pipeline suppliers, and general changes in a business that is becoming increasingly deregulated. These conditions have meant good news for customers, especially homeowners, whose bills are now about 4% less than they were in late 1982.

Electric customers' bills rose $137.4 million on an annual basis, commencing in July, under a revision of the levelized energy adjustment clause approved by the BPU. It was the first increase in more than three years. As of the end of 1985, the underrecovered electric energy costs under the clause were $283 million.

When it approved the 1985 change in the energy adjustment clause, the BPU deferred—until the Company's next application for a revision—consideration of $70 million of replacement energy costs associated with certain outages at the Salem Generating Station. The outages involve failures of the electric generators at Salem 1 and 2. One of the outages is now the basis of pending lawsuits against Westinghouse Electric Corporation, the supplier of the station's turbine-generators.

In addition, the BPU disallowed $19.6 million in replacement costs related to certain outages at Peach Bottom and $2.9 million at Salem. These disallowances reduced net income, after taxes, by $12.2 million; the subsequent effect on earnings of the write-off was 10 cents per share of Common Stock.

Review of Operations

Electric Operations

A 2% increase in electric output was recorded in 1985, largely as the result of a growing demand in the commercial sector. Total megawatthours produced, purchased and interchanged amounted to 34.9 million, up from 34.2 million a year earlier.

Records are set

Steamy weather in mid-August resulted in shattered peak load records. An all-time, one-hour peak of 7,721 megawatts occurred on August 15. Only the day before, August 14, the peak load had reached a new high of 7,549 megawatts, breaking the previous mark of 7,422 megawatts on June 11, 1984. Also on August 15, the maximum day's output reached 149,457 megawatthours, up more than 4% from the previous record of 143,558 megawatthours on June 11, 1984.

When the new peak load record was established, the Company had an installed generating capacity of 8,999 megawatts, providing a reserve margin of 16.6%.

The table below shows the Company's forecast for generating capacity, in megawatts, over the next decade, based, in part, on normal weather conditions. The installed capacity, in megawatts, reflects the Hope Creek Generating Station starting in 1987.

Year	Planning Peak Load	Installed Capacity	Percent Reserve
1986	7660	9007	18
1987	7760	10002	29
1988	7820	10041	28
1989	7910	10081	27
1990	8000	10081	25
1991	8100	10081	24
1992	8180	10081	23
1993	8240	10081	22
1994	8280	10221	21
1995	8340	10221	20

Economical fuel mix is sought

The Company continued to reduce its dependence on high-cost oil to produce electricity, reaching in 1985 the lowest amount used since 1948. It relied instead on more economical fuels—nuclear, coal and natural gas.

Comparative fuel costs in 1985 per million British thermal units were: nuclear—$0.82, coal—$1.99, natural gas—$4.05, and oil—$4.73.

During 1985, 2.3 million tons of coal, and 3.4 million barrels of oil were purchased and 394 million therms of natural gas were used for PSE&G's New Jersey electric production facilities. The natural gas displaced the equivalent of 6.5 million barrels of oil, representing a $19.9 million savings. Additional savings of about $3.4 million were realized through spot market purchases of coal and oil.

The average delivered cost of coal purchased in 1985 to generate electricity was $53.05 per ton, 4% lower than in 1984, due to more favorable market conditions and lower contract prices. The average cost of low-sulphur heavy oil to produce electricity was $28.50 per barrel, 8% lower than in 1984, because of soft market conditions which resulted in lower contract and spot prices.

The diversity of the Company's energy output by fuel sources in 1985 is illustrated as follows: nuclear—24%, coal—32%, natural gas—9%, oil—5%, and purchased and interchanged—30%.

Uranium supplies are adequate

The Company has sufficient uranium supplies under contract with producers in the United States and Canada to meet the fuel needs of both the Salem and Hope Creek Generating Stations through 2000.

During 1985, uranium prices stabilized at around $16 a pound, after declining from a high of $24 a pound in mid-1983. Uranium production in the U.S. dropped off as the availability of lower-cost, higher-grade Canadian supplies increased.

In September, the Company terminated a contract with Sequoyah Fuels Corporation, a subsidiary of Kerr-McGee Corporation. The project had been in a standby status since 1980 because open-market prices of uranium had been substantially lower than the contract price. Sequoyah was to have delivered four million pounds of uranium.

In December, the Company terminated its interest in two other uranium ventures, one of which was a project of Philadelphia Electric Company for the Peach Bottom units.

As a result of these three abandonments and prior to regulatory approval, the Company's aggregate net losses of $21.7 million after related tax savings were deferred and are being amortized over a seven-year period commencing in 1985. This amortization reduced net income by approximately $3.1 million in 1985. The reduction in earnings per share of Common Stock for 1985 amounted to

Rigorous programs at the Nuclear Training Center provided the edge in preparing employees to help make Salem 1 the nation's leader in electric generation during 1985.

3 cents after taxes. The Company is seeking regulatory approval to recover these losses in its current base rate case.

Future regulatory action may require a change in the level of annual amortization, or could require the immediate write-off of any remaining unamortized balance existing at that time. Any amount not recovered, in the opinion of management, would not have a material effect on the Company's position or results of operations.

At year's end, there were reports that the United States may consider imposing import quotas on uranium, which could lead to higher prices in the future.

The Company continued, however, to focus on cost-saving measures. An incentive price provision in a new uranium enrichment service contract will lower enrichment costs by an estimated $50 million through 1990. The amount is on top of an estimated $65 million savings stemming from consolidation of a number of previous agreements under the contract, which the Company signed last year with the U.S. Department of Energy. In September, a federal judge in a case to which the Company was not a party ruled that these new contract forms of DOE for the enrichment of uranium are null and void. The parties involved in those proceedings have appealed, and the Company has joined a group of other utilities in seeking to have the decision overturned.

By the end of 1985, the Company had paid the Federal government $79.7 million in fees to fund the eventual transportation and permanent disposal of spent nuclear fuel. The fees were paid in accordance with the Nuclear Waste Policy Act of 1982, which requires utilities to fund the program at a rate of one mill per kilowatthour of nuclear energy produced. The cost to the Company is for its share of energy produced by the Salem and Peach Bottom generating stations.

Purchased power yields savings

During 1985, 30% of the Company's energy output came from the purchase of relatively low-cost power from neighboring electric utilities, mostly through the Pennsylvania-New Jersey-Maryland (PJM) Interconnection and the Allegheny Power System. The purchased energy was generated primarily by coal and thus replaced more costly oil- and gas-fueled generation.

Salem 1 highlights nuclear generation

With Salem Generating Station's Unit 1 leading the nation in electric generation, the Company's nuclear performance showed significant improvement in 1985. The results manifested the Company's basic goals of maintaining safety, demonstrating reliability and upgrading the economic competitiveness of nuclear energy.

Nuclear generation came from four operating units, the ownership of which the Company shares. Two units are at the Salem station, which the Company operates, and two are at the Peach Bottom station in Pennsylvania, which Philadelphia Electric Company operates. PSE&G has a 42.59% interest in Salem, and a 42.49% interest in Peach Bottom. Its share of total output was 8,352,592 megawatthours. If oil had been used to generate this electricity, there would have been an additional cost to customers of about $360 million.

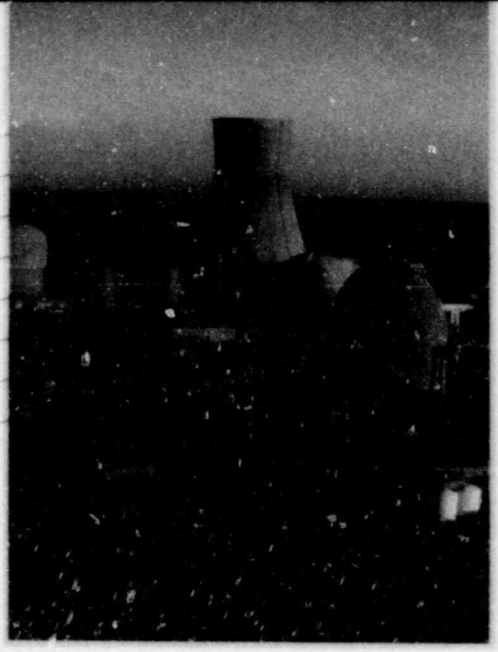
During one period of the year, Salem 1 was on line for 277 consecutive days, breaking its previously longest run of 88 days and establishing a new mark for all PSE&G generating units, regardless of fuel.

On December 16, Salem 1 became the record holder for a year's gross electric power produced in the United States when it reached 8,969,747 megawatthours. The 1079-megawatt unit won the distinction by surpassing a record held by a 1300-megawatt, coal-fired plant, Mountaineer Unit 1 in West Virginia. By year's end, Salem 1 had produced 9,379,960 megawatthours.

The new record for power produced by any type of generating station—nuclear, coal, oil or natural gas—came three days after Salem 1 had established a new record for generation by a nuclear unit. In reaching 8,892,300 megawatthours, it bested a record set by Peach Bottom 2 in 1979.

Salem 2 was returned to service in April after its failed generator was replaced with one that had been purchased for Hope Creek Generating Station's Unit 2, the construction of which had been cancelled in 1981.

Peach Bottom 2 was returned to service in July after refueling and correction of generic piping problems. Peach Bottom 3, the other unit at the station, operated well before it was removed from service in July for refueling and piping work. It was scheduled to return in the first quarter of 1986.



Salem (foreground) and Hope Creek Generating Stations will help PSE&G meet annual peak demands through the next decade.

Hope Creek approaches completion

By year's end, construction work on the Hope Creek Generating Station was essentially completed, while startup, testing and turnover of the plant systems were about 93% completed. The loading of fuel was planned for the first quarter of 1986 and the commercial operation scheduled for the second half of the year.

The present schedule for commercial operation in the second half of 1986 should precede the targeted operation date of December, 1986 which was established in the cost containment agreement.

Achievement of the current schedule will require a continuing dedication to quality and cost control, as well as aggressive licensing, construction and testing schedules. The Company recognizes that there are uncertainties, such as completion costs, with any large construction project, particularly in the nuclear field. The license for a nuclear plant is solely within the discretion of the Nuclear Regulatory Commission (NRC), and hinges on satisfying NRC requirements.

In February 1985, the Company reached accord with the New Jersey Public Advocate to withdraw intervention in proceedings before the NRC's Atomic Safety Licensing Board for the issuance of an operating license for Hope Creek.

In 1985, the first group of Hope Creek's nuclear operators underwent training and received operator licenses from the NRC. A total of 14 reactor operator and 21 senior reactor operator licenses was issued.

The Company agreed to two major independent audits of the Hope Creek project. One was an independent design verification program conducted by Sargent & Lundy, and the other covered general management practices and was performed by Theodore Barry & Associates. Both auditors are nationally recognized engineering and consulting firms.

The results of the audits were favorable and may be helpful in the Company's efforts to obtain an operating license for Hope Creek.

In the Sargent & Lundy audit, Hope Creek's design was considered technically adequate and in line with licensing requirements and standards.

In the Barry report, the project was described as well-managed, comparing very favorably with other projects in the nuclear industry.

Nuclear operations are improved

During the year, the Company's Nuclear Department, which oversees the Salem and Hope Creek Generating Stations, instituted a series of measures to improve controls and reduce costs.

The steps included a realignment of the organization for increased accountability, a reduction in budgets and projected staffing levels, a decrease in the use of outside services, and the implementation of a fixed-bid approach to betterment projects to diminish cost increases associated with plant modification activities.

The Department also initiated measures to enhance long-term planning. The measures are aimed at improving performance of the Company's nuclear units through the reduced length of outages and the elimination of delays in the return to service.

Nuclear training accredited

Major training programs for the Salem Generating Station received accreditation from the Institute of Nuclear Power Operations in 1985. Salem is only the second nuclear station in the nation to win full accreditation.

INPO's accreditation is based on rigorous scrutiny of a nuclear plant's training program. All 55 nuclear utilities in the nation are committed to gaining full accreditation for training operations, which is in line with INPO's mandate to develop and monitor high-level standards to make sure the industry operates its plants safely.

The Company's training of nuclear personnel is based at the Nuclear Training Center in the city of Salem, about eight miles from the Salem and Hope Creek stations. Operators are trained on full-scope simulators that duplicate the control rooms at Salem and Hope Creek.

Distribution systems are improved

During 1985, the Company installed 21 new 13,000-volt power lines, 26,000-volt services to three new or expanding customers, and a high-voltage substation. In addition, the Company installed nearly 40,000 new electric meters, the most in a year since 1966.

The construction of a 43-mile, 500,000-volt transmission line originating at the Hope Creek Generating Station was completed in March. The new line strengthens power distribution reliability in both the Company's system and the Pennsylvania-New Jersey-Maryland (PJM) Interconnection.

Gas Operations

The Company's gas sendout in 1985 was 2.22 billion therms, a decline of 1.4% from the 1984 mark of 2.25 billion therms. Generally warmer weather, oil competition, and lack of growth in the manufacturing sector contributed to the decrease. The sendout of 17,994,000 therms on January 21, 1985 set a 24-hour record, and the sendout of 382,100,000 therms in January established a monthly mark.

Daily capacity increases

The daily capacity was up by 134,000 therms, to 19,990,000 therms, as of December 31. An additional 215,000 therms of pipeline gas, 322,000 therms of firm storage service, and 145,000 therms of refinery gas more than offset a reduction of 548,000 therms of manufactured gas resulting from the retirement of the West End Gas Plant. The plant was closed as part of an ongoing program to use the most economical sources of gas.

The daily capacity in therms was divided as follows: pipeline natural gas—15,846,000, liquefied petroleum—1,794,000, oil gas—825,000, synthetic natural gas—1,125,000, and refinery gas—400,000.

Supplies are stable

The Company continued to have adequate supplies of gas available to its customers under long-term contracts with interstate pipelines, from wells owned by Energy Development Corporation (EDC), a subsidiary of PSE&G, and through short-term arrangements with other gas companies, pipelines and producers.

These supplies were supplemented by gas purchased from the Exxon Bayway and Amerada-Hess Port Reading refineries, as well as by gas from the Company's own production facilities.

Natural gas purchased for distribution to customers was 2.06 billion therms, compared with 2.15 billion therms in 1984. The average cost was $3.62 per million British thermal units (Btu's), compared with $3.69. Refinery gas purchased totaled 144.5 million therms, compared with 87.0 million therms. Its price averaged $3.49 per million Btu's, against the 1984 average of $4.05. The production of manufactured gas reached 11.2 million therms, compared with 8.5 million therms.

The adequate supply and the stable price reflect the nationwide surplus of gas and the growing competition in the gas industry. In October, the Federal Energy Regulatory Commission issued new regulations designed to provide greater access to

Natural gas facilities are being installed for North Bergen's Roc Harbour development featuring 128 townhouses and 551 condominiums.

interstate pipeline transportaton. As a result, there may eventually be substantial changes in the way natural gas is marketed, which would lead to increased competition.

The Company introduced, in August, a new rate that it will charge for the transportation of gas which large volume customers purchase directly from third parties. A number of customers have made such purchases, arranged for interstate pipelines to transport the gas to PSE&G, and used the Company's transportation service to deliver the gas to their facilities. These direct purchases may result in substantial savings to the customers, largely through the partial avoidance of gross receipts and franchise taxes which represent nearly 14% of the cost of regular gas service.

EDC's levels remain high

Energy Development Corporation (EDC), the Company's exploration and production subsidiary, supplied 8% of the total gas purchased by the Company in 1985. During the previous year, EDC accounted for 6% of the Company's supplies.

Revenues from the sale of natural gas and oil were $94.3 million, up 19.6% from the 1984 figure. Net income fell 8.1% to $9.5 million, due to increased amortization charges.

In 1985, EDC drilled 45 wells, 13% less than last year. Twenty-eight were onshore and 17 were offshore. At year's end, 13 were still being drilled.

Onshore operations took place in the Gulf Coast regions of Texas, Louisiana, Mississippi, Alabama and Florida. Fourteen wells were successful, and 14 were abandoned. Offshore activities included exploratory drilling on 14 lease blocks and development drilling to delineate prior discoveries. Six wells were successful, and 11 were not.

About 48% of EDC's 1985 gas sales was delivered through Gasdel Pipeline System Incorporated, an EDC subsidiary.

Distribution expands

The Company continued in 1985 to install new gas mains and services at record levels. Nearly 300 miles of mains and nearly 275 miles of services were placed throughout the Company's service territory. In addition, some 30,000 new gas meters were installed, the most since the 1950s.

A major project involved the relocation of 18,000 feet of mains and 500 services as part of a sewer construction project in Camden. The Company negotiated an agreement with the Camden County Municipal Utilities Authority to be reimbursed a total of $1.12 million, essentially the overall cost of the Company's work.

Training upgraded

The Company announced that all employees involved in gas appliance service will undergo specially developed, hands-on training to prepare them for work on advanced gas-fired equipment that is now on the market. The program was launched after a pilot study completed in May showed a considerable improvement in service capability among employees.

Service to Customers

In 1985, the Company demonstrated repeatedly its deep concern for the New Jerseyans it serves, as the number of customers reached 2 million for the first time.

Employees meet the test

Electric service to more than 239,000 PSE&G customers was interrupted by Hurricane Gloria during its rampage through the state on September 27. Crews worked around the clock and restored all power within 48 hours.

The Company then responded to appeals for assistance by dispatching 68 crews to areas of Long Island, Connecticut and Massachusetts to help utilities there restore service to their customers.

On Labor Day, electric and gas crews cooperated with firefighters battling a blaze that destroyed 40 acres in the heart of Passaic's industrial section. One volunteer, William Koenemund, who worked in the Company's electric transmission and distribution headquarters in Secaucus, died of a heart attack while fighting the fire as a member of the Secaucus Fire Department. Later, the Company offered bill-paying assistance to customers who were left homeless and jobless by the blaze.

In mid-October, eight gas distribution crews and 20 service personnel answered an appeal from the Brooklyn Union Gas Company. Water from a broken main had entered the gas distribution system, causing widespread outages over a 100-block area and forcing Brooklyn Union to seek restoration assistance from other utilities.

Quality and efficiency emphasized

The Company maintained its aggressive approach

Company crews worked around the clock to restore the electric service of 239,000 customers interrupted by Hurricane Gloria on September 27.

Electric Peak Load and Installed Capacity at Time of Peak

(Millions of Kilowatts)

● Peak Load
■ Installed Capacity

Conservation workshops held at 80 locations attracted about 10,000 low-income electric and gas customers, as part of the Seal-Up and Save program.

in instituting programs and projects to improve the quality and efficiency of service to all customers. The hallmark of the effort remained its "Challenge of Caring" program that was begun in 1983 to emphasize to employees the importance of good customer relations. And PSE&G continued to stay tuned to the thoughts and ideas of customers by supporting, for a third year, three consumer advisory panels.

In 1985, the Company started sending bills in Braille to blind customers. It made arrangements with a number of additional financial institutions to accept bill payments from customers. And it expedited receipt of payments through the mail by adding bar-coding to reply envelopes.

The Company's ongoing effort to assist low-income customers took a creative turn when the Company purchased discounted natural gas from Citizens Energy Corporation (CEC), a Boston-based energy cooperative headed by Joseph P. Kennedy II. CEC's profits were then donated to the Salvation Army, which administers Project Volunteer For Energy, the Company's matching fund program to help qualified needy families pay their utility bills.

Intense collection activities during the year resulted in a sharp reduction in late and unpaid bills. The net write-off of uncollectible accounts in 1985 was $27.6 million, down 31% from the 1984 amount of $40.2 million.

The Company expanded its efforts to prevent energy theft by increasing its investigative staff throughout its service territory. In 1985, 4,204 cases were completed, producing billings of $2.1 million, compared with 3,793 cases completed in 1984, yielding billings of $1.5 million.

During 1985, marketing activities concentrated on sales involving minimal capital investment by the Company and emphasized the benefits of electric and gas to meet energy needs. Overall, the efforts will mean $42 million in additional revenues annually for the Company.

An aggressive advertising campaign encouraged homeowners to switch from oil to natural gas for heating purposes. There were 12,306 residential conversions reported during the year, compared with 11,160 in 1984. Residential gas heating installations in new homes totaled 17,238, compared with 12,190 in the previous year. In addition, 2,154 industrial and commercial customers changed to gas.

In April, the Company received a marketing achievement award from the American Gas Association for its oil-to-gas conversion campaign. The Company was honored for its direct selling, advertising, and personnel training activities and for its cooperation with plumbing and heating contractors.

Electric heating was promoted, in large measure, for new construction. Heat pumps were installed in 2,884 new dwellings. Electric heating installed in industrial and commercial buildings resulted in additional loads of 70,236 kilowatts, compared with 52,427 kilowatts in 1984.

Sales of efficient high-pressure sodium and other vapor lights set a new all-time record, as a result of the Company's dusk-to-dawn lighting promotional activities. There were 10,937 units reported sold, compared with 7,373 in 1984.

Conservation remains strong

New Jersey's residents continued to exhibit their enthusiasm for conservation as a means of saving energy and money.

"Seal-Up and Save" served again as the central theme as the Company carried its message to customers in a variety of ways. For example, some 10,000 low-income electric and gas customers attended special workshops at 80 locations. The workshops were held in cooperation with local community action agencies to outline the benefits of conservation and demonstrate energy-saving measures such as home weatherization.

Under the low-income program, 9,500 weatherization kits were distributed, while the homes of 17,000 customers were weatherized free. In addition, $250,000 was given—for the third consecutive year—to community action agencies for low-income conservation efforts.

Home energy audits increased to 39,850 in 1985 from 27,250 in 1984, while commercial energy audits totaled 1,300, compared with 100 a year earlier.

The Company's energy conservation center in Newark handled more than 180,000 telephone inquiries and 380,000 letters as interest in the subject boomed. During a stretch in August, the center received about 1,100 customer calls daily concerning the Company's offer of free home energy surveys.

"Conservation on Wheels," the Company's mobile energy van, visited various locations during the year, ranging from shopping centers to large companies that gave their employees the time to tour the vehicle. The van attracted 62,000 visitors in 1985, traveling some 6,000 miles.

New activities in 1985 enabled customers having difficulty paying their bills and customers eligible for lifeline credits to take advantage of conservation installations, valued at up to $200, in their homes. About 4,500 have participated.

The Company also offered for the first time, in 1985, $15 discounts on clock-thermostats, and, by year's end, 78,000 customers had requested coupons. The discount program complemented the Company's continuing offer of rebates on the purchase of high efficiency heat pumps and air conditioners. More than 26,000 rebates totaling $2.9 million were made to customers in 1985.

In addition to its own conservation programs, the Company budgeted $140,000 to help underwrite a state-sponsored, cost-benefit study of conservation efforts, and supported, through a $360,000 grant, the newly established New Jersey Energy Conservation Laboratory at Princeton University.

The quality of the Company's conservation activities and efforts was widely recognized in 1985. Both the United States and New Jersey Departments of Energy honored PSE&G with awards for energy conservation innovation. On the local level, the Union County Urban League cited the Company for its low-income conservation programs.

On the Cutting Edge

In 1985, PSE&G engaged in a number of activities to keep pace with rapidly developing and changing technologies that will very likely figure in the Company's future responsibilities as one of the nation's largest electric and gas utilities.

Non-utility generation planned

During the year, the Company signed four agreements to purchase electricity from non-utility generation developers. The contracts will bring to 109.6 megawatts the Company's total supply of non-utility generation. The new projects are:

- The Essex County resource recovery facility, located adjacent to the Essex Generating Station in Newark. It will have a maximum production capacity of 79 megawatts and be fueled by municipal solid waste. The Company expects to begin receiving electricity in 1988.
- The Dundee Dam hydroelectric project, on the Passaic River in Clifton. It will produce 2.1 megawatts, with the first delivery of energy to the Company set for 1986.
- The Great Falls hydroelectric project, on the Passaic River in Paterson. It will produce 11 megawatts and has a startup schedule planned for late 1986.
- A turbo-expander power generating system, located at a gas metering and regulating station in Hamilton Township. The installation, set for operation in 1986, will produce 2.9 megawatts by harnessing the energy that results from a process to reduce the pressure of pipeline natural gas to the desired pressure of the gas for utility distribution.

On June 18, the Company began receiving power generated by a 2.6-megawatt methane gas recovery project at Kinsley's Landfill in Deptford. The landfill gas, composed primarily of methane and carbon dioxide, is produced by the decomposition of solid waste. The recovered gas fuels four diesel engines from which the electricity is obtained.

By the year 2000, the Company anticipates that about 500 megawatts of non-utility generation will be installed throughout its service territory. This will help offset the need to build a new generating unit by then.

Coal-based generation is studied

The Company continued its investigation of new and developing coal-based generation technologies for possible use in its electric power system beyond the year 2000. Studies indicate that coal gasification and fluidized-bed combustion technologies, currently being developed for large-scale electric power production, can offer PSE&G future energy alternatives.

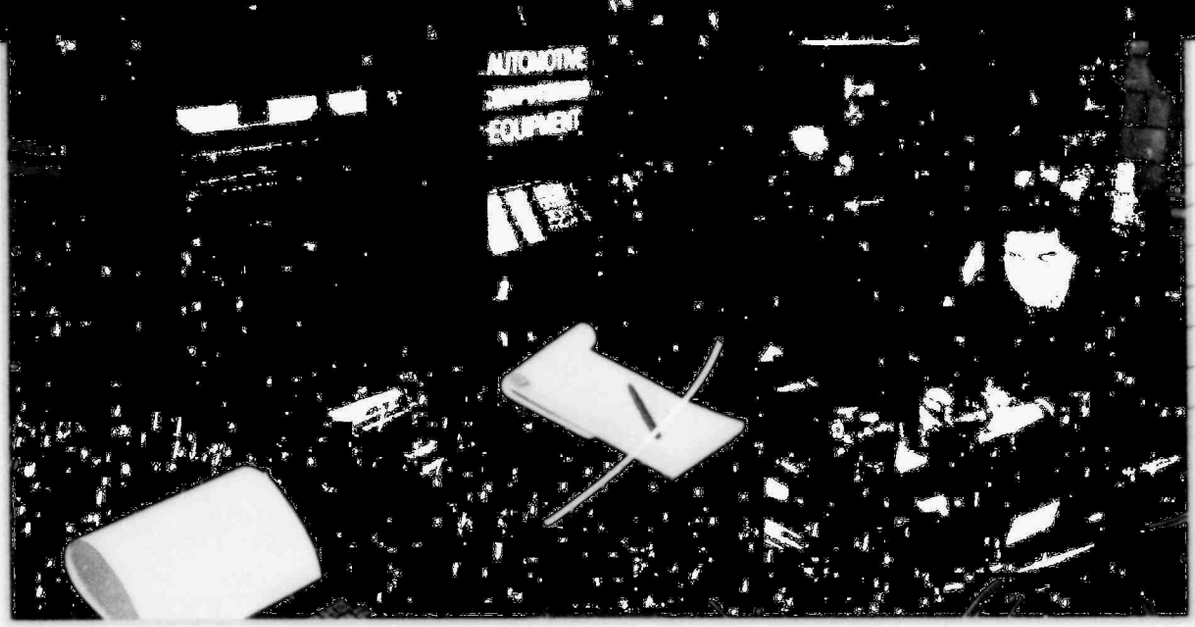
Fossil units to be upgraded

Extending the life of fossil-fired generating units is the subject of an ongoing study that was given increased attention by the Company in 1985. Plans are in the making to maintain the reliability of the fossil steam units in the Company's system and to extend their operating life.

The life extension program is essential since no new generating capacity is planned for the balance of the century. The program will involve the development of turbine/generator ultrasonic inspection and analysis techniques to help determine the remaining operating life expectations of costly components in a generating unit.

Work begins at Merrill Creek

Construction of the Merrill Creek Reservoir was started in September after the acquisition of a number of permits. When completed, the reservoir



The Company will save thousands of dollars annually by conducting its own state-licensed inspection of vehicles.

will help assure acceptable water flow volumes in the Delaware River during low-flow periods by replacing water that evaporates during its use for cooling in electric generating stations.

The reservoir is a project of seven utilities in New Jersey and Pennsylvania which draw power from generating stations on the river.

The project was designed in response to a 1976 order from the Delaware River Basin Commission to replenish water removed from the river.

Mobile data terminals to aid gas service

Plans were completed for installation of an automated gas dispatch system with the signing of a $3.6 million contract with Mobile Data International of Vancouver, Canada. The state-of-the-art system, scheduled to be in operation by early 1987, will displace the decades-old use of two-way radios to assign gas transmission and distribution personnel to customer locations in need of service.

The contract includes the purchase of 769 mobile data terminals to be installed in each of the Company's gas service vehicles and 100 portable data terminals for employees whose work keeps them away from their vehicles for long periods of time.

The system will consolidate the existing 13 dispatch locations throughout the Company's gas service territory. Customers' service orders will be transmitted by computer via radio frequency to screens in the gas service vehicles. Service personnel, after completing the work, will use the terminal keyboard to report job completion information. This will automatically update computerized records of customers.

A key benefit of the system will be its ability to sort customer service orders by priority, location, and type of work, and match the order with the nearest available service employee who can take on the assignment. More than 700 employees will be trained to operate the system.

Vehicle inspection shifts gears

New Jersey's largest private motor vehicle inspection program was launched by the Company in July under a special license from the state. The program will save the Company thousands of dollars annually in manpower needed to drive vehicles to state inspection stations where delays were often encountered.

Some 3,100 vehicles will be inspected yearly under the program. The Company's 250 automotive mechanics have been trained to handle the inspections at 23 field garages. The state will periodically monitor the operation, including the maintenance of master inspection records, the handling of inspection stickers, and the effectiveness of emissions analyzers.

Fiber optics to enhance communications

In early 1985, the Company established a centralized telecommunications department to improve the planning for the movement and processing of information in its various forms through the use of the latest and most economical technologies.

An initial major undertaking was agreement by the Company to permit LightNet, a joint venture of Southern New England Telephone Company and CSX Corporation, to install a segment of its fiber optics telecommunications system along nearly 100 miles of PSE&G's right-of-way. The agreement was approved by the BPU.

LightNet's construction was completed in October. The New Jersey link through PSE&G territory is part of a 5,000-mile fiber optics network.

One feature in the agreement provides PSE&G with dedicated capacity within the fiber optics system. The telecommunications department is developing plans to use the capacity for more

reliable communications service between the Company's headquarters in Newark and the Salem and Hope Creek Generating Stations. It is also planning to integrate communications systems into a single digital network incorporating voice, data, image, text, and graphic services. The eventual use of private facilities will enable the Company to reduce overall communications costs.

Research: Robots to fuel cells

Through its subsidiary, the PSE&G Research Corporation, the Company examined the prospects of a variety of technologies that may help enhance its operations in years to come.

Total research and development costs for 1985 were $18.9 million, which were partially offset by $2.8 million in sales and reimbursements. Of the balance, $3.2 million were spent for internal studies and $12.9 million for research by utility-sponsored organizations.

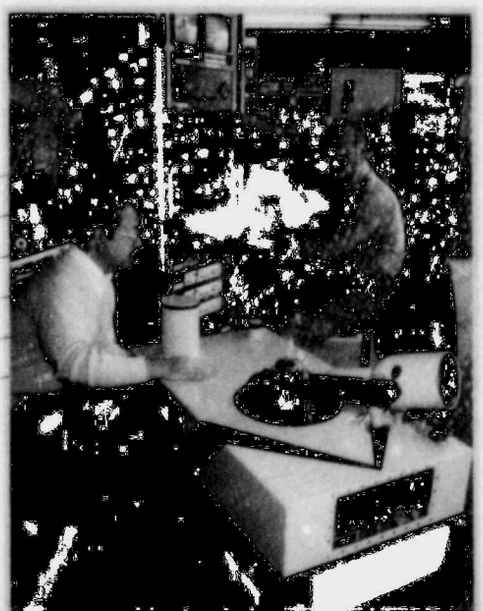
Commercially available robotic devices were tested at the Salem and Hope Creek Generating Stations to gauge their usefulness in carrying out routine inspection, surveillance and maintenance tasks. The aim of the research is to have robots do work in controlled radiation areas of the nuclear plants to minimize personnel radiation exposure. To expand its knowledge, the Company has joined with other organizations to form a national utility robotics users group that will investigate more extensively the applications of the devices.

The Company also joined other utilities and the Electric Power Research Institute (EPRI) to study the benefits of heating homes by using thermal storage equipment. Under the program, less costly off-peak electricity is used to produce heat at night. The heat is then stored in a specially designed furnace until needed during the day by the homeowner. Widespread use of the process could help utilities reduce the need for daytime generating capacity. Two PSE&G employees volunteered their homes for the test, which covers the 1985-86 heating season.

In response to several transformer failures in the industry, a two-year research effort was initiated at Rensselaer Polytechnic Institute to study the dielectric behavior of circulating transformer oil. The research is being underwritten by PSE&G and EPRI and will focus on the build-up of harmful electric charge potential in insulating material in the transformers.

The Company began testing two 40-kilowatt fuel cell power plants in 1985. One unit was installed at Alcan Building Products in Woodbridge and began operating in January. Preliminary results showed that it has operated well, with 75% availability and a combined thermal and electrical efficiency of 76%, about twice the rate of the best fossil-fueled generating station. It produced an average electrical output of 37 kilowatts.

The other unit was installed at Princeton University and placed in service in October. Both will be tested for 8,000 operating hours. The fuel cells use natural gas as a fuel and, through an electrochemical process, produce electricity and thermal energy in the form of hot water. The study is part of a nationwide program sponsored by the Gas Research Institute and the U.S. Department of Energy.



Robots were tested in 1985 for possible use in routine work at the Salem and Hope Creek stations.

In the Public Eye

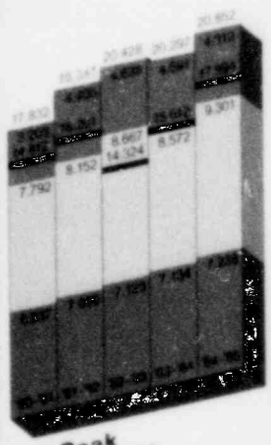
New Jersey remained a strong economic magnet for business in 1985, and PSE&G continued to play a key role in attracting new companies to the state and encouraging existing ones to expand.

Development is widespread

The Company worked closely with a number of agencies on all levels of government, particularly the New Jersey Department of Commerce and Economic Development, and the results were again outstanding.

Numerous foreign businesses established operations in New Jersey to a level where they now employ more than 130,000 persons, or 4% of the state's employable population. The state maintained its appeal to high technology firms and now ranks third in the nation in the number of patents issued. Many prominent companies announced in 1985

Development boomed in many regions of the Company's service territory, and PSE&G had a key role in assisting new and expanding businesses.



Gas Peak Sendout and Daily Capacity at Time of Peak

(Millions of Therms)

● 24-Hour Peak Sendout

▩ Manufactured Gas

▨ Winter Shortage Natural Gas

▩ High Load Factor Natural Gas

The newly renovated Second Sun, an energy information center at the site of Salem and Hope Creek stations, continued to attract thousands of visitors.

corporate or administrative office expansions in excess of 100,000 square feet. During the year, the state experienced an overall job gain of 4%, placing it above the national average.

The development boom continued in certain highly attractive areas, such as the Hudson River waterfront, the Meadowlands, the Princeton-Route 1 corridor and the Burlington County region.

A clear illustration of the intense development under way in the state is in builder projections for an 18-mile stretch along the Hudson: 24 million square feet of office space, 28,000 residential units, 1.5 million square feet of retail space, 2,500 hotel rooms and 10 marinas—all resulting in as many as 80,000 new jobs.

The trend to rejuvenate the state's inner cities was unabated in 1985 as a number of companies took advantage of PSE&G's innovative area development electric rate. Companies which move into or expand in 10 communities are eligible for a discounted rate. The communities are: Newark, Jersey City, Paterson, Elizabeth, Camden, Trenton, East Orange, Hoboken, Union City, and Plainfield.

The area development rate augments the state's enterprise zone program, which permits municipalities to offer tax incentives, grants and low-income business loans to retain or attract companies. In 1985, the program's first full year, five zones—Newark, Camden, Trenton, Plainfield and Bridgeton—attracted $125 million in private investments and the creation of 8,300 permanent jobs. By year's end, five more had been designated: Jersey City, Kearny, Elizabeth, Orange and a joint zone of Vineland and Millville.

To assist developers in finding business locations, the Company and the state produced a "New Jersey Map." The map delineates economic development factors such as major railway lines, highways and exchanges, and other important site location features.

Community service continues

A proud tradition of community involvement by the Company and its employees was continued in 1985. Representatives of the Company participated in a wide range of civic and cultural activities. Through an internal program, all employees were encouraged to serve as volunteers in organizations in their home communities and in the municipalities in which they work.

In the educational arena, about 140,000 teachers and students attended workshops and programs and received various energy reference materials.

Various Company programs, including those conducted by Community Affairs and Speakers' Bureau representatives, reached nearly 322,000 persons. The Second Sun, the energy information center at the Salem and Hope Creek Generating Stations, underwent renovation and attracted 18,400 visitors. About 2,300 persons toured the Company's other generating stations.

Employee orientation improved

More than 13,000 persons worked for the Company in 1985, and their dedication remained the backbone of dependable and reliable service to customers.

In 1985, a two-day orientation program for new employees was introduced to help set a positive, motivating tone as they begin their careers. The program focused on performance expectations, job standards, safety considerations, and relationships with supervisors and colleagues.

Changes in organization

Frank P. Librizzi retired as Vice President—Production on March 2, 1985 after more than 38 years of service.

The Board of Directors elected Corbin A. McNeill, Jr. as Vice President—Nuclear and redesignated Richard A. Uderitz, formerly Vice President—Nuclear, as Vice-President—Production, both effective March 18, 1985.

William E. Scott, Senior Executive Vice President, retired on May 1, 1985, after 13 years of service.

Upon the retirement of Robert J. Selbach as Vice President—Transmission and Distribution, after more than 38 years of service, the Board of Directors redesignated Rudolph D. Stys as Vice President—Transmission and Distribution, effective June 1, 1985.

On June 29, 1985, Robert M. Crockett retired as Vice President—Fuel Supply after more than 37 years of service. The Board of Directors elected Robert F. Steinke, Vice President—Fuel Supply, effective June 29, 1985.

James B. Kandel, Jr., a Senior Vice President of the Company since July 1, 1974 died suddenly on June 15, 1985. The Board of Directors and the management of the Company deeply regret the loss of this distinguished and able executive officer.

Financial Statement Responsibility

The management of Public Service Electric and Gas Company is responsible for the preparation, integrity and objectivity of the financial statements of the Company. The financial statements are prepared in accordance with generally accepted accounting principles applied on a consistent basis and reflect estimates based upon the judgement of management where appropriate. Management believes that the financial statements present fairly and consistently the Company's financial position and results of operations. Information in other parts of this Annual Report is consistent with these financial statements.

The Company maintains a system of internal accounting controls to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management's authorization and recorded properly. The system is designed to permit preparation of financial statements in accordance with generally accepted accounting principles. The concept of reasonable assurance recognizes that the costs of a system of internal controls should not exceed the related benefits.

Management believes the effectiveness of this system is enhanced by a program of continuous and selective training of employees. In addition, management has communicated to all employees its Policies on Business Conduct, Company Assets and Internal Control.

The Internal Auditing Department of the Company conducts audits and appraisals of accounting and other operations and evaluates the effectiveness of cost and other controls.

The firm of Deloitte Haskins & Sells, independent certified public accountants, is engaged to examine the Company's financial statements and issue an opinion thereon. Their examination is conducted in accordance with generally accepted auditing standards and includes a review of internal accounting controls and tests of transactions.

The Board of Directors carries out its responsibility of financial overview through the Audit Committee, currently consisting of six directors who are not employees of the Company. The Audit Committee meets periodically with management as well as with representatives of the internal auditors and the independent certified public accountants. The Committee reviews the work of each to ensure that their respective responsibilities are being carried out, and discusses related matters. Both audit groups have full and free access to the Audit Committee.

Statements of Income

(Thousands of Dollars) For the Years Ended December 31,	1985	1984	1983
Operating Revenues			
Electric	**$3,000,564**	$2,816,241	$2,570,457
Gas	**1,408,490**	1,379,883	1,392,475
Total Operating Revenues	**4,409,054**	4,196,124	3,962,932
Operating Expenses			
Operation			
Fuel for Electric Generation and Interchanged Power — net	**965,966**	872,805	868,977
Gas Purchased and Materials for Gas Produced	**824,648**	822,583	858,018
Other	**546,267**	527,371	503,568
Maintenance	**291,437**	269,974	238,766
Depreciation and Amortization of Utility Plant	**222,963**	211,188	201,787
Amortization of Property Losses (note 4)	**55,263**	58,975	49,040
Taxes			
Federal Income Taxes (note 1)	**266,379**	255,304	191,033
New Jersey Gross Receipts Taxes	**557,270**	529,654	513,760
Other	**51,075**	50,132	44,033
Total Operating Expenses	**3,781,268**	3,597,986	3,468,982
Operating Income	**627,786**	598,138	493,950
Other Income			
Allowance for Funds Used During Construction — Equity	**127,397**	104,803	85,591
Equity in Earnings of Subsidiaries (note 2)	**9,627**	9,098	7,061
Miscellaneous — net	**587**	3,768	5,544
Total Other Income	**137,611**	117,669	98,196
Income Before Interest Charges	**765,397**	715,807	592,146
Interest Charges (note 8)			
Long-Term Debt	**276,227**	256,689	228,189
Short-Term Debt	**5,788**	5,428	3,480
Other	**7,278**	17,650	13,699
Total Interest Charges	**289,293**	279,767	245,368
Allowance for Funds Used During Construction — Debt	**(68,448)**	(53,989)	(43,001)
Net Interest Charges	**220,845**	225,778	202,367
Net Income	**544,552**	490,029	389,779
Dividends on Cumulative Preferred Stock and $1.40 Dividend Preference Common Stock	**60,002**	60,221	58,234
Earnings Available for Common Stock	**$ 484,550**	$ 429,808	$ 331,545
Shares of Common Stock Outstanding			
End of Year	**131,698,517**	112,563,068	102,857,989
Average for Year	**122,344,270**	108,913,276	97,467,431
Earnings per Average Share of Common Stock	**$3.96**	$ 3.95	$ 3.40
Dividends Paid per Share of Common Stock	**$2.81**	$ 2.70	$ 2.62

See Summary of Significant Accounting Policies and Notes to Financial Statements.

Balance Sheets

Assets

(Thousands of Dollars) December 31,	1985	1984
Utility Plant — Original cost		
Electric Plant	**$ 5,268,113**	$4,994,717
Gas Plant	**1,290,330**	1,222,468
Common Plant	**264,106**	250,372
Nuclear Fuel	**120,888**	105,140
Utility Plant in Service	**6,943,437**	6,572,697
Less Accumulated Depreciation and Amortization	**2,502,594**	2,320,140
Net Utility Plant in Service	**4,440,843**	4,252,557
Construction Work in Progress	**3,997,772**	3,255,914
Plant Held for Future Use	**36,112**	41,818
Net Utility Plant	**8,474,727**	7,550,289
Other Property and Investments		
Nonutility Property, net of accumulated depreciation — 1985, $670; 1984, $831	**13,672**	12,889
Investments in and Advances to Subsidiaries (note 2)	**250,598**	234,799
Total Other Property and Investments	**264,270**	247,688
Current Assets		
Cash (note 3)	**13,667**	4,702
Working Funds	**24,716**	27,481
Pollution Control Escrow Funds	**30,466**	127,103
Accounts Receivable, net of allowance for doubtful accounts — 1985, $20,733; 1984, $16,470	**386,518**	364,850
Unbilled Revenues	**210,416**	165,529
Fuel, at average cost	**224,069**	276,206
Materials and Supplies, at average cost	**75,551**	57,611
Prepayments	**21,572**	11,445
Total Current Assets	**986,975**	1,034,927
Deferred Debits (note 4)		
Property Losses (note 7)		
Atlantic Project	**215,232**	230,292
Hope Creek Unit 2	**174,076**	197,206
LNG Project	**48,823**	59,400
Uranium Projects	**31,623**	
Other	**3,862**	5,605
Underrecovered Electric Energy and Gas Fuel Costs — net	**264,039**	307,461
Unrecovered Nuclear Fuel Disposal Costs		3,656
Unamortized Debt Expense	**23,426**	24,120
Total Deferred Debits	**761,081**	827,740
Total	**$10,487,053**	$9,660,644

See Summary of Significant Accounting Policies and Notes to Financial Statements.

Capitalization and Liabilities

(Thousands of Dollars) December 31,	1985	1984
Capitalization (see statements, pages 31-33)		
Common Equity		
Common Stock	**$ 2,508,945**	$2,005,923
Premium on Capital Stock	**557**	557
Paid-In Capital	**26,185**	26,185
Retained Earnings	**1,232,849**	1,098,219
Total Common Equity	**3,768,536**	3,130,884
Preferred Stock Without Mandatory Redemption	**554,994**	554,994
Preferred Stock With Mandatory Redemption	**65,000**	137,750
Long-Term Debt	**3,164,641**	3,103,343
Other Long-Term Obligations (note 8)	**58,337**	122,947
Total Capitalization	**7,611,508**	7,049,918
Current Liabilities		
Preferred Stock to be redeemed within one year	**72,750**	1,750
Long-Term Debt and Other Obligations due within one year	**57,895**	3,084
Commercial Paper (note 5)	**107,000**	185,000
Accounts Payable	**287,290**	233,829
New Jersey Gross Receipts Taxes Accrued	**545,802**	547,341
Deferred Income Taxes on Unbilled Revenues (note 1)	**96,791**	76,143
Other Taxes Accrued	**25,139**	16,303
Interest Accrued	**84,065**	86,887
Gas Purchases Accrued	**87,669**	108,237
Other	**70,662**	65,007
Total Current Liabilities	**1,435,063**	1,323,581
Deferred Credits		
Accumulated Deferred Income Taxes (note 1)		
Depreciation and Amortization	**579,541**	507,605
Property Losses		
Atlantic Project	**90,485**	96,821
Hope Creek Unit 2	**69,105**	81,487
LNG Project	**18,725**	23,885
Uranium Projects	**13,106**	
Deferred Electric Energy and Gas Fuel Costs — net	**121,458**	141,178
Unamortized Debt Expense	**7,791**	8,203
Other	**(27,110)**	(22,978)
Accumulated Deferred Investment Tax Credits (note 1)	**547,169**	417,978
Other	**20,212**	32,966
Total Deferred Credits	**1,440,482**	1,287,145
Commitments and Contingent Liabilities (note 7)		
Total	**$10,487,053**	$9,660,644

Statements of Changes in Financial Position

(Thousands of Dollars) For the Years Ended December 31,	1985	1984	1983
Funds Provided			
Net Income	**$ 544,552**	$ 490,029	$ 389,779
Add (Deduct) Items not affecting Working Capital			
Depreciation and Amortization	**329,938**	299,865	294,628
Recovery (Deferral) of Electric Energy and Gas Fuel Costs—net	**43,422**	(211,336)	(162,797)
Provision for Deferred Income Taxes—net (note 1)			
Depreciation and Amortization	**71,936**	69,125	79,935
Property Losses	**(10,772)**	4,392	(19,915)
Deferred Electric Energy and Gas Fuel Costs	**(19,720)**	96,931	76,842
Other	**(4,544)**	(14,031)	6,107
Investment Tax Credits—net	**131,358**	94,457	33,718
Allowance for Funds Used During Construction (AFDC)	**(195,845)**	(158,792)	(128,592)
Equity in Earnings of Subsidiaries	**(9,627)**	(9,098)	(7,061)
Other	**(9,042)**	5,724	3,583
Total Funds from Operations	**871,656**	667,266	566,227
Net Funds from Financings			
Long-Term Debt	**199,118**	421,610	161,081
Preferred Stock			29,739
Common Stock	**499,905**	213,492	181,276
Increase in Obligations Under Capital Leases	**548**	5,910	2,924
Total Funds from Financings	**699,571**	641,012	375,020
Total Funds Provided	**$1,571,227**	$1,308,278	$ 941,247
Funds Applied			
Additions to Utility Plant, excluding AFDC	**$1,024,244**	$ 808,573	$ 765,217
Cash Dividends	**406,805**	355,276	313,989
Investments in and Advances to Subsidiaries—net	**6,172**	(9,061)	9,080
Reductions of Long-Term Debt and Other Obligations	**202,855**	7,054	58,002
Reductions of Preferred Stock	**72,750**		
LNG Project Abandonment (note 4)			
Reduction in Investments and Advances		(69,313)	
Deferral of Loss		69,313	
Uranium Projects Abandonments (note 4)			
Reduction in Utility Plant	**(37,108)**		
Deferral of Losses	**37,108**		
Miscellaneous	**17,835**	33,025	10,278
Total Funds Applied	**1,730,661**	1,194,867	1,156,566
Changes in Working Capital — Increase (Decrease)			
Short-Term Debt	**(47,811)**	18,885	(157,999)
Cash and Equivalents	**(90,437)**	116,767	(45,778)
Accounts Receivable and Unbilled Revenues	**66,555**	(38,252)	9,755
Fuel	**(52,137)**	54,444	(40,155)
Other Current Assets	**28,067**	4,214	11,440
Accounts Payable and Other Accrued Liabilities	**(35,726)**	(26,910)	12,298
Accrued Taxes	**(27,945)**	(15,737)	(4,880)
Net Increase (Decrease) in Working Capital	**(159,434)**	113,411	(215,319)
Total Funds Applied and Changes in Working Capital	**$1,571,227**	$1,308,278	$ 941,247

See Summary of Significant Accounting Policies and Notes to Financial Statements.

Statements of Retained Earnings

(Thousands of Dollars) For the Years Ended December 31,	1985	1984	1983
Balance January 1	**$1,098,219**	$ 963,617	$ 888,262
Add Net Income	**544,552**	490,029	389,779
Total	**1,642,771**	1,453,646	1,278,041
Deduct			
Cash Dividends			
Preferred Stock, at required rates	**58,121**	58,317	56,353
$1.40 Dividend Preference Common Stock	**1,881**	1,881	1,881
Common Stock [A]	**346,803**	295,078	255,755
Total Cash Dividends	**406,805**	355,276	313,989
Capital Stock Expenses	**3,117**	151	435
Total Deductions	**409,922**	355,427	314,424
Balance December 31	**$1,232,849**	$1,098,219	$ 963,617

A. Restrictions on the payment of dividends are contained in the Charter, certain of the indentures supplemental to the Company's Mortgage, and certain debenture bond indentures. However, none of these restrictions presently limits the payment of dividends out of current earnings. The amount of retained earnings free of these restrictions at December 31, 1985 was $1,222,849,000.

See Summary of Significant Accounting Policies and Notes to Financial Statements.

Independent Accountants' Opinion

Deloitte Haskins Sells

Certified Public Accountants
Gateway One
Newark, New Jersey 07102

To the Stockholders and Board of Directors of Public Service Electric and Gas Company:

We have examined the balance sheets and statements of capital stock and long-term debt of Public Service Electric and Gas Company as of December 31, 1985 and 1984 and the related statements of income, retained earnings, and changes in financial position for each of the three years in the period ended December 31, 1985. 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, such financial statements present fairly the financial position of Public Service Electric and Gas Company at December 31, 1985 and 1984 and the results of its operations and the changes in its financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins + Sells

February 10, 1986

Statements of Capital Stock

December 31,	Outstanding Shares (note A)	Current Redemption Price Per Share	Certain Refundings Restricted Prior to	1985	1984
				(Thousands of Dollars)	(Thousands of Dollars)
Nonparticipating Cumulative Preferred Stock (note B)					
With Mandatory Redemption					
$100 par value — Series					
12.25%	227,500	$106.00		**$ 22,750**	$ 24,500
13.44%	500,000	113.44	4/1/86	**50,000**	50,000
12.80%	350,000	112.80	10/1/87	**35,000**	35,000
11.62% (300,000 shares issued in 1985)	300,000	111.62	9/1/88	**30,000**	30,000
Less amount to be redeemed within one year				**72,750**	1,750
Preferred Stock with Mandatory Redemption				**$ 65,000**	$ 137,750
Without Mandatory Redemption					
$25 par value — Series					
9.75%	1,600,000	$ 25.75		**$ 40,000**	$ 40,000
8.70%	2,000,000	26.50		**50,000**	50,000
$100 par value — Series					
4.08%	250,000	103.00		**25,000**	25,000
4.18%	249,942	103.00		**24,994**	24,994
4.30%	250,000	102.75		**25,000**	25,000
5.05%	250,000	103.00		**25,000**	25,000
5.28%	250,000	103.00		**25,000**	25,000
6.80%	250,000	102.00		**25,000**	25,000
9.62%	350,000	104.50		**35,000**	35,000
7.40%	500,000	101.00		**50,000**	50,000
7.52%	500,000	101.00		**50,000**	50,000
8.08%	150,000	101.00		**15,000**	15,000
7.80%	750,000	101.00		**75,000**	75,000
7.70%	600,000	104.64		**60,000**	60,000
8.16%	300,000	106.86		**30,000**	30,000
Preferred Stock without Mandatory Redemption (no changes in 1984 and 1983)				**$ 554,994**	$ 554,994
Dividend Preference Common Stock and Common Stock					
$1.40 Dividend Preference Common Stock (no par) — 1,343,999 shares authorized, issued and outstanding; current redemption price $35.00 per share (note C)					
Common Stock (no par) — authorized 150,000,000 shares (note D); issued and outstanding at December 31, 1985, 131,698,517 shares and at December 31, 1984, 112,563,068 shares (19,135,449 shares issued for $503,022,000 in 1985, 9,075,079 shares issued for $213,583,000 in 1984, and 8,013,393 shares issued for $141,461,000 in 1983)				**$2,508,945**	$2,005,923

Notes:

A. In addition, there are 1,472,558 shares of $100 par value and 6,400,000 shares of $25 par value Cumulative Preferred Stock which are authorized and unissued, and which upon issuance may or may not provide for mandatory sinking fund redemption.

B. If dividends upon any shares of Preferred Stock are in arrears in an amount equal to the annual dividend thereon, voting rights for the election of a majority of the Board of Directors become operative and continue until all accumulated and unpaid dividends thereon have been paid, whereupon all such voting rights cease, subject to being again revived from time to time.

The Company is required to purchase or redeem a specified minimum number of shares of Cumulative Preferred Stock with mandatory redemption annually commencing on the effective dates shown below. Such redemptions are cumulative. The Company may annually redeem, at its option, an aggregate of up to twice the number of shares shown for each such series. All such redemptions are at a redemption price of $100 per share. A redemption of shares of any series also requires payment of all accumulated and unpaid dividends to the date fixed for redemption.

Series	Minimum Shares Redeemable Annually	Effective Date of Mandatory Redemption	Aggregate Number of Shares Purchased and Redeemed During the Years		
			1985	1984	1983
12.25%	17,500	2/1/80	**17,500**	17,500	3,806
13.44%	25,000	3/31/87			
12.80%	17,500	9/30/88			
11.62%	15,000	9/30/89			

Preferred Stock without mandatory redemption is subject to redemption solely at the option of the Company upon payment of the applicable redemption price plus accumulated and unpaid dividends to the date fixed for redemption.

The statement reflects the planned redemption in 1986 of all shares of the Preferred Stock of the 12.25% Series and the 13.44% Series. As a result the annual dividend requirement and the embedded dividend costs will drop to $7,966,000 and 12.37%, respectively, for Preferred Stock with mandatory redemption. The annual dividend requirement and embedded dividend cost for Preferred Stock without mandatory redemption were $40,629,000 and 7.38%, respectively.

C. Each share of $1.40 Dividend Preference Common Stock is entitled to cumulative dividends, to two votes, and, on liquidation or dissolution, to twice as much as each share of Common Stock. There were no changes in outstanding shares in 1985, 1984, or 1983.

D. Includes 5,229,628 shares of Common Stock reserved for possible issuance under the Company's Dividend Reinvestment and Stock Purchase Plan, Tax Reduction Act Employee Stock Ownership Plan, Employee Stock Purchase Plan, Thrift and Tax-Deferred Savings Plan and Payroll-Based Employee Stock Ownership Plan.

See Summary of Significant Accounting Policies and Notes to Financial Statements.

Statements of Long-Term Debt

(Thousands of Dollars) December 31,	1985	1984
First and Refunding Mortgage Bonds (note A)		
Series Maturity Date		
4⅜% November 1, 1986	**$ 50,000**	$ 50,000
4⅞% September 1, 1987	**60,000**	60,000
4⅜% August 1, 1988	**60,000**	60,000
5⅛% June 1, 1989	**50,000**	50,000
4¾% September 1, 1990	**50,000**	50,000
4⅜% August 1, 1992	**40,000**	40,000
4⅜% June 1, 1993	**40,000**	40,000
4¾% September 1, 1994	**60,000**	60,000
4¾% September 1, 1995	**60,000**	60,000
6¼% June 1, 1997	**75,000**	75,000
7 % June 1, 1998	**75,000**	75,000
7⅜% April 1, 1999	**75,000**	75,000
9⅛% March 1, 2000	**98,000**	98,000
8⅜% A May 15, 2001	**69,300**	69,300
7⅜% B November 15, 2001	**80,000**	80,000
7½% C April 1, 2002	**125,000**	125,000
8½% D March 1, 2004	**90,000**	90,000
12 % E October 1, 2004	**9,730**	10,730
8¾% F April 1, 2006	**60,000**	60,000
8.45% G September 1, 2006	**60,000**	60,000
8¼% H June 1, 2007	**125,000**	125,000
8⅛% I September 1, 2007	**59,900**	59,900
9⅜% J November 1, 2008	**100,000**	100,000
9⅜% K July 1, 2009	**100,000**	100,000
12 % L November 1, 2009	**119,750**	125,000
12⅛% M June 1, 2010	**87,500**	100,000
15⅞% N August 1, 1991	**100,000**	100,000
14⅜% O September 1, 2012	**43,300**	100,000
12¼% P December 1, 2012	**98,500**	100,000
12⅝% Q August 1, 1993	**100,000**	100,000
9½% R July 1, 2015	**125,000**	
9¾% S January 14, 1996 (note B)	**75,000**	
8 % June 1, 2037	**7,463**	7,463
5 % June 1, 2037	**7,538**	7,538
Pollution Control Series		
6.30% A October 1, 2006	**14,300**	14,300
6.90% B September 1, 2009	**42,620**	42,620
6.90% C September 1, 2009	**2,990**	2,990
12½% D April 1, 2012	**23,500**	23,500
9⅞% E June 1, 2013	**64,000**	64,000
10½% F July 1, 2014	**150,000**	150,000
10⅜% G September 1, 2014	**150,000**	150,000
10½% H November 1, 2014	**130,400**	130,400
10⅜% I November 1, 2012	**4,600**	4,600
Total First and Refunding Mortgage Bonds	**$3,018,391**	$2,895,341

(Thousands of Dollars)	1985	1984
Debenture Bonds unsecured		
Maturity Date		
5¾% June 1, 1991	**$ 35,787**	$ 36,778
7¼% December 1, 1993	**25,380**	26,449
9 % November 1, 1995	**49,345**	51,075
7⅛% August 15, 1996	**52,152**	54,058
8¾% November 1, 1996	**38,198**	39,724
6 % July 1, 1998	**18,195**	18,195
Total Debenture Bonds	**219,057**	226,279
Total Long-Term Debt		
Principal amount outstanding (notes C and D)	**3,237,448**	3,121,620
Less amount due within one year (note E)	**55,250**	306
Long-Term Debt excluding amount due within one year	**3,182,198**	3,121,314
Net Unamortized Discount	**(17,557)**	(17,971)
Long-Term Debt less Net Unamortized Discount	**$3,164,641**	$3,103,343

Notes:

A. The Company's Mortgage, securing the First and Refunding Mortgage Bonds, constitutes a direct first mortgage lien on substantially all property and franchises.

B. This series was issued January 14, 1986 and the proceeds were used to refinance Commercial Paper which was outstanding at December 31, 1985 and reclassified to Long-Term Debt to reflect the issuance of these bonds.

C. At December 31, 1985 the annual interest requirement on Long-Term Debt was $288,680,000 of which $271,865,000 was the requirement for First and Refunding Mortgage Bonds. The embedded interest cost on Long-Term Debt was 9.17%.

D. At December 31, 1985, the Company had unexercised commitments under a Credit Agreement with 12 domestic banks for issuance of revolving loans up to an aggregate amount of $200,000,000 at any time to May 1, 1986. The Company may terminate the commitments, in whole or in part, without penalty or premium. Under the agreement, any borrowings outstanding at May 1, 1986 are convertible, at the Company's option, into three year term loans. The Company is required to pay a commitment fee on any unused portion. The Company has the right, with the consent of the banks, to extend the agreement on a year-to-year basis.

E. The aggregate principal amount of requirements for sinking funds and maturities for each of the five years following December 31, 1985 are as follows:

Year	Sinking Funds	Maturities	Total
		(Thousands of Dollars)	
1986	$ 5,250	$ 50,000	$ 55,250
1987	10,312	60,000	70,312
1988	11,450	60,000	71,450
1989	11,450	50,000	61,450
1990	11,450	50,000	61,450
	$49,912	$270,000	$319,912

For sinking fund purposes, certain First and Refunding Mortgage Bond issues require annually the retirement of $21,400,000 principal amount of bonds or the utilization of bondable property additions at 60% cost. The portion expected to be met by property additions has been excluded from the table above. Also, the Company may, at its option, retire additional amounts up to $6,200,000 annually through sinking funds of certain debenture bonds. The election of any such option is included in long-term debt due within one year.

See Summary of Significant Accounting Policies and Notes to Financial Statements

Summary of Significant Accounting Policies

Accounting Principles

Financial statements are presented in accordance with generally accepted accounting principles (GAAP). As a result of accounting requirements imposed under rate-making decisions by the Board of Public Utilities of the State of New Jersey (BPU) and the Federal Energy Regulatory Commission (FERC), the applications of GAAP by the Company differ in certain respects from applications by non-regulated businesses. The Company is under jurisdiction of the FERC and the BPU and maintains its accounts in accordance with their prescribed Uniform Systems of Accounts, which are the same.

Utility Plant and Related Depreciation and Amortization

Additions to utility plant and replacements of units of property are capitalized at cost. The cost of maintenance, repairs and replacements of minor items of property is charged to appropriate expense accounts. At the time units of depreciable properties are retired or otherwise disposed of, the original cost less net salvage value is charged to accumulated depreciation.

For financial reporting purposes, depreciation is computed under the straight-line method. Depreciation is based on estimated average remaining lives of the several classes of depreciable property. Depreciation applicable to nuclear plant includes estimated costs of decommissioning. Amortization of leasehold improvements and capital lease assets is based on the term of the lease. These estimates are reviewed on a regular basis and necessary adjustments are made as approved by the BPU. Depreciation provisions stated in percentages of original cost of depreciable property are 3.52% in 1985, and 3.53% in 1984 and 1983.

Amortization of Nuclear Fuel

Nuclear energy burnup costs are charged to fuel expense on the basis of the number of units of thermal energy produced as they relate to total thermal units expected to be produced over the life of the fuel. The rate calculated for fuel used at all of the Company's nuclear units includes a provision of one mill per kilowatt-hour of nuclear generation for spent fuel disposal costs.

Investments in Subsidiaries

The Company's investments in its subsidiaries (all wholly-owned), which in the aggregate are not significant as defined by the Securities and Exchange Commission, are reported in the accompanying financial statements on the equity method of accounting. The carrying value of investments in subsididaries is reported under Other Property and Investments in the Balance Sheets, and under the equity method of accounting is adjusted for earnings or losses of such subsidiaries as reported under Other Income in the Statements of Income. The Company believes that its financial position and results of operations are best reflected without consolidation of these subsidiaries.

Revenues and Fuel Costs

Revenues are recorded based on services rendered to customers during each accounting period. The Company records unbilled revenues representing the amount customers will be billed for services rendered from the time meters were last read to the end of the respective accounting period.

The Company projects the costs of fuel for electric generation, purchased and interchanged power, gas purchased and materials for gas produced for twelve-month periods.

Adjustment clauses in the Company's rate structure allow the recovery of fuel costs over those included in the Company's base rates through levelized monthly charges. Any under or over-recoveries, along with interest in the case of an overrecovery, are deferred and included in operations in the period in which they are reflected in rates.

Income Taxes

The Company and its subsidiaries file a consolidated Federal income tax return and income taxes are allocated, for reporting purposes, to the Company and its subsidiaries based on taxable income or loss of each (except for the effects of the LNG abandonment discussed in note 4).

Deferred income taxes are provided for differences between book and taxable income to the extent permitted for rate-making purposes.

Investment tax credits are deferred and amortized over the useful lives of the related property including nuclear fuel.

Allowance for Funds Used During Construction

Allowance for funds used during construction (AFDC) is a cost accounting procedure whereby the cost of financing construction (interest and equity costs) is transferred from the income statement to construction work in progress (CWIP) in the balance sheet. The rate of 8½% used for calculating AFDC was within the limits set by FERC.

As a result of BPU rate orders, the Company is allowed to include a portion of CWIP in rate base on which a current return is permitted to be recovered through operating revenues. The amounts of CWIP included in rate base were $375 million at the end of 1983 and $550 million at the end of 1984 and 1985. No AFDC is accrued on the amounts of CWIP which are included in rate base.

Pension Plan

The Company has a non-contributory trusteed pension plan covering substantially all employees completing one year of service. The Company's policy is to fund pension costs accrued. Company contributions include current service costs and amounts required to fund prior service costs over a 35-year period beginning January 1, 1967.

Notes to Financial Statements

1. Federal Income Taxes

A reconciliation of reported Net Income with pre-tax income and of Federal income tax expense with the amount computed by multiplying pre-tax income by the statutory Federal income tax rate of 46% is as follows:

(Thousands of Dollars)	1985	1984	1983
Net Income	**$544,553**	$490,029	$389,779
Federal income taxes included in:			
Operating income			
Current provision	**75,214**	18,384	6,015
Provision for deferred income taxes—net [A]	**57,549**	140,378	151,300
Investment tax credits—net	**133,616**	96,542	33,718
Total included in operating income	**266,379**	255,304	191,033
Miscellaneous other income—net	**4,118**	3,246	4,825
Total Federal income tax provisions	**270,497**	258,550	195,858
Subtotal	**815,050**	748,579	585,637
Equity in earnings of subsidiaries	**(9,627)**	(9,098)	(7,061)
Pre-tax income	**$805,423**	$739,481	$578,576
Tax expense at the statutory rate	**$370,495**	$340,161	$266,145

Adjustments to pre-tax income, computed at the statutory rate, for which deferred taxes are not provided under current rate-making policies:

Tax depreciation under book depreciation	**$ 33,077**	$ 29,122	$ 27,806
Allowance for funds used during construction	**(90,089)**	(73,044)	(59,152)
Overhead costs capitalized	**(18,083)**	(15,992)	(13,810)
Other	**9,927**	8,774	3,853
Subtotal	**(65,168)**	(51,140)	(41,303)
Amortization of deferred tax items	**(34,830)**	(30,471)	(28,984)
Subtotal	**(99,998)**	(81,611)	(70,287)
Total Federal income tax provisions	**$270,497**	$258,550	$195,858

A. The provision for deferred income taxes represents the tax effects of the following items:

Current Liabilities			
Unbilled revenues	**$ 20,648**	$ (16,039)	$ 8,331
Deferred Credits			
Property losses	**(10,772)**	4,392	(19,915)
Additional tax depreciation and amortization	**72,108**	65,780	78,830
New Jersey Gross Receipts Taxes			(5,838)
Deferred fuel costs—net	**(19,720)**	96,931	76,842
Nuclear Plant Decommissioning Costs	**(5,765)**	(5,587)	(5,408)
Nuclear Fuel Disposal Costs	**2,891**	(7,243)	20,433
Loss on reacquired debt	**(412)**	(415)	(417)
Other	**(1,429)**	2,559	(1,558)
Subtotal	**36,901**	156,417	142,969
Total	**$ 57,549**	$140,378	$151,300

Deferred income taxes are provided for differences between book and taxable income to the extent permitted for rate-making purposes. At December 31, 1985 the cumulative net amount of income tax timing differences for which deferred income taxes have not been provided was approximately $1.3 billion. The related deferred income taxes, at the current statutory rate of 46%, would be approximately $600 million. The Company expects to continue to recover through rates the taxes due as such timing differences reverse.

As a result of Internal Revenue Service (IRS) audits for taxable years 1976 through 1980, the IRS has proposed an increase in taxable income which would increase the current tax liability by $72 million. This proposed liability is primarily the result of including unbilled revenues as taxable income in the year estimated services were provided. The taxability of unbilled revenues is an industry issue. The Company has appealed the tax assessments related to unbilled revenues, and the IRS has suspended any action on the appeal pending the outcome of various court cases involving other utilities. Deferred taxes have been provided for such unbilled revenues and, if the Company is unsuccessful in its appeal, there would be little effect on earnings.

2. Investments in and Advances to Subsidiaries

Investments in and advances to subsidiaries are summarized as follows:

(Thousands of Dollars) December 31,	1985	1984	1983
Energy Development Corporation			
Investment	**$ 66,134**	$ 56,639	$ 46,366
Advances	**167,348**	173,865	183,737
	233,482	230,504	230,103
Other Subsidiaries	**17,116**	4,295	73,972
Total	**$250,598**	$234,799	$304,075

Energy Development Corporation (EDC) is engaged in exploration activities to obtain supplies of natural gas. The majority of the Company's gas purchases from EDC are below FERC published ceiling prices. During 1985, 1984 and 1983, EDC provided approximately 8%, 6% and 3%, respectively, of the total gas received by the Company. EDC's revenues from sales of gas to the Company amounted to $74.7 million, $67.6 million and $45.0 million, respectively, for those years.

Currently, Other Subsidiaries consists principally of Public Service Resources Corporation and Mulberry Street Urban Renewal Corporation. On December 18, 1984, the Company announced the abandonment of the unused liquefied natural gas terminal in Rossville, Staten Island, New York, owned by its wholly-owned subsidiary, Energy Terminal Services Corporation. See Note 4—Abandonment of LNG Project. The majority of the LNG property was sold in 1985.

3. Compensating Balances

Cash consists primarily of compensating balances under informal arrangements with various banks to compensate them for services and to support lines of credit of $202 million at December 31, 1985 and December 31, 1984. There are no legal restrictions placed on the withdrawal or other use of these bank balances. In addition, at December 31, 1985 and December 31, 1984, the Company had lines of credit of $35.0 million which were compensated for by fees.

4. Deferred Items

Abandonment of Atlantic Project

In December 1978, the Company cancelled the Atlantic nuclear plant project. The BPU authorized the Company to recover a portion of the costs of the project over a period of 20 years commencing in April 1980. Such costs are being recovered at the rate of $15.1 million annually, less related taxes of $6.3 million. No return is being earned on the unrecovered balance.

Abandonment of Hope Creek Unit No. 2

In December 1981, the Company abandoned the construction of Hope Creek Nuclear Generating Station Unit No. 2. In March 1982, the BPU authorized the transfer of $112 million of Hope Creek 2 costs to Hope Creek 1 and the recovery of all after-tax abandonment costs for Hope Creek 2 from customers through the electric levelized energy adjustment clause. The recovery is over 15 years on an accelerated method and commenced in June 1982. During 1986, the amount to be recovered is estimated to be $27.9 million, less related taxes of $11.4 million. No return is being earned on the unrecovered balance.

Abandonment of LNG Project

In December 1984, the Company abandoned its investment in certain facilities for the storage of liquefied natural gas of its wholly-owned subsidiaries, Energy Terminal Services Corporation (ETSC) and Energy Pipeline Corporation (EPC). As a result of this abandonment and prior to regulatory approval, the Company's investment of approximately $69.3 million, less tax savings of $27.9 million or the net amount of $41.4 million, was deferred and is being amortized over a seven-year period commencing in 1984 at a rate which will reduce net income by approximately $6 million per year during that period.

Abandonments of Uranium Projects

In September 1985, the Company terminated a 1976 uranium supply agreement with Sequoyah Fuels Corporation (Sequoyah), a subsidiary of Kerr-McGee Corporation. Under the agreement, as amended, Sequoyah was to have provided up to 4.2 million pounds of uranium and the Company had advanced $27.4 million as of September 30, 1985 to finance the related mining facilities which had not been recovered through the purchase of uranium. The project had been in a stand-by status since 1980 because of the availability of uranium on the open market at prices which were substantially less than those applicable under the contract. This price disparity is expected to continue for the foreseeable future.

In December 1985, Philadelphia Electric Company terminated its Lee Mine uranium supply project, in which the Company had participated as a co-owner of Peach Bottom Generating Station. In addition, the Company terminated the Homestake Mining Company contract, dated February 25, 1976, for the exploration and development of uranium. The total loss of these projects when combined with the Sequoyah loss amounts to $37.1 million.

As a result of the abandonments and prior to regulatory approval, the Company's net unrecovered advances of $21.7 million, after related tax savings, were deferred and are being amortized over a seven-year period commencing in 1985. This amortization will result in a charge against net income of approximately $3.1 million per year. The reduction in earnings per share for the year 1985 is 3¢.

Future regulatory action with respect to the abandonments of the LNG and Uranium Projects may require a change in the level of annual amortization, or could require the immediate write-off of any remaining unamortized balance existing at that time. Any amount not recovered, in the opinion of management, would not have a material effect on the financial position or results of operations of the Company. The recovery of the losses and any return on the unamortized balances will be determined in the current rate proceeding.

Underrecovered Electric Energy and Gas Fuel Costs—net

Recoveries of electric energy and gas fuel costs are determined by the BPU. At December 31, 1985, underrecoveries under the electric Levelized Energy Adjustment Clause (LEAC) were $283.3 million, while overrecoveries under the gas Raw Materials Adjustment Clause (RMAC) amounted to $19.2 million. Earnings are not directly affected by increases or decreases in the costs of fuel or interchanged power, because such costs are adjusted monthly to match amounts recovered through revenues. However, the carrying of underrecovered fuel costs ultimately increases financing costs.

Electric

On July 11, 1985, the BPU authorized an increase in the LEAC of $137.4 million on an annual basis commencing July 11, 1985, deferred consideration until the next LEAC proceeding of $70.0 million of replacement energy costs related to the Salem generator failures referred to below, and disallowed the recovery of $22.5 million of replacement energy costs which had been contested in the most recent proceeding. This LEAC rate is presently scheduled to be in effect for an 18-month period. The $22.5 million disallowance reduced 1985 net income by $12.2 million, net of tax, or approximately 10¢ per share of Common Stock.

A major reason for the large underrecoveries during the preceding LEAC period was extended outages at the Salem Generating Station, Units 1 and 2 and Peach Bottom Generating Station, Units 2 and 3 in which the Company shares ownership. These outages include an outage resulting from reactor trip breaker failures and failure of the electric generators at Salem, and outages as a result of intergranular stress corrosion pipe cracking (a generic problem with boiling water reactors) at Peach Bottom.

Gas

On September 26, 1985, the BPU approved a Stipulation that had been entered into by the Company, BPU Staff, and Public Advocate of New Jersey which will reduce revenues under the RMAC by $35 million for the period October 1985 through September 1986, including a one-time credit to customers' bills reflecting an $11.3 million reduction in gas costs which was implemented in October 1985. The reduction is based on estimated decreases in the projected cost of gas, increased purchases of lower cost gas on the spot market, the return of an overrecovery and associated interest related to the RMAC period that ended September 30, 1984, and anticipated refunds from pipeline suppliers.

Unamortized Debt Expense

These costs, associated with the issuance or reacquisition of debt, are deferred and amortized over the lives of the related issue. Amounts shown in the balance sheets consist principally of costs associated with the Company's tender offer for its 12% Series E Mortgage Bonds which mature in October 2004. The Company expects to amortize $1.1 million of these costs in 1986.

5. Bank Loans and Commercial Paper

Bank loans represent the Company's unsecured promissory notes issued under credit arrangements with various banks and have a term of eleven months or less.

Commercial paper represents the Company's unsecured bearer promissory notes sold to dealers at a discount with a term of nine months or less. Certain information regarding short-term debt follows:

(Thousands of Dollars)	1985	1984	1983
Balance at end of year	**$107,000**	$185,000	$153,000
Maximum amount outstanding at any month end	**$157,500**	$185,000	$161,900
Average daily outstanding	**$ 72,400**	$ 55,300	$ 37,004
Weighted average annual interest rate	**7.91%**	9.80%	9.40%
Weighted average interest rate for commercial paper outstanding at year-end	**8.09%**	8.26%	9.87%

6. Pension Plan

Information on accumulated plan benefits and net assets of the Company's pension plan are as follows:

(Thousands of Dollars) December 31,	1985	1984
Actuarial present value of accumulated plan benefits		
Vested	**$490,486**	$418,516
Nonvested	**75,322**	61,632
	$565,808	$480,148
Assumed rate of return	**8.5%**	9.5%
Market value of Plan Net Assets	**$647,087**	$515,000

Pension costs for the past three years were charged as follows:

(Thousands of Dollars)	1985	1984	1983
Operating Expenses	**$52,155**	$55,294	$56,360
Utility Plant	**14,743**	13,296	12,109
Total Pension Costs	**$66,898**	$68,590	$68,459

In December 1985 the Financial Accounting Standards Board issued Statement No. 87—Employers' Accounting for Pensions which requires future changes for the accounting and reporting of pension costs. The Statement requires a standardized method for measuring pension cost, expanded disclosure of the components of pension plans in the Notes to Financial Statements, and recording of a liability on the balance sheet when the accumulated pension benefit obligation exceeds the fair market value of the pension plan assets. The provisions of Statement No. 87 are effective for calendar year 1987 financial statements, except that the liability recognition provisions, if any, are not effective until 1989.

As shown above, the fair market value of the plan assets exceeded the accumulated pension benefits as of December 31, 1985.

7. Commitments and Contingent Liabilities

Construction and Fuel Supplies

The Company has substantial commitments as part of its construction program. Construction expenditures of $3.0 billion, including about $240 million of AFDC, are expected to be incurred during the years 1986 through 1990. In addition, the Company has commitments to obtain sufficient sources of fuel for electric generation and adequate gas supplies.

The principal project in the Company's current construction program is the Hope Creek Generating Station (Hope Creek), which consists of a 1,067 megawatt nuclear unit owned 95% by the Company and scheduled for operation in 1986. As of December 31, 1985, physical construction was essentially complete. The overall start-up, testing and turnover of plant systems was about 93% complete at that date. As of December 31, 1985, the Company had expended approximately $3.7 billion including $726 million of AFDC, with respect to its share of Hope Creek.

On November 25, 1985, the Company announced that fuel loading at Hope Creek had been delayed until some time in the first quarter of 1986. Earlier estimates had called for fuel to be loaded around the beginning of 1985. Commercial operation is still scheduled for the second half of 1986. As a result of the revised schedule, the estimated overall cost for Hope Creek is presently expected to be between $4.15 billion and $4.3 billion. This exceeds the cost cap referred to below. The actual cost will depend, in large part, on the date of commercial operation, which is difficult to predict as the project nears completion because of numerous pre-operational items and imprecision as to the timing of the testing and power ascension programs which must be adjusted to meet problems as they may arise. Costs at the end of the project, once fuel is loaded and construction is complete, will involve the accrual of AFDC of approximately $18 million per month, plus direct costs of approximately $5 million per month, until the unit is placed in commercial operation. Project delays will only serve to further increase costs. Therefore, the Company's first priority is to get the plant completed and operating as quickly as possible without sacrificing quality. Fuel loading and operation require a license from the Nuclear Regulatory Commission (NRC) which has been applied for. Issuance of a license is within the sole discretion of the NRC.

Hope Creek construction costs are subject to a Cost Containment Incentive Agreement approved by the BPU in July 1983. The Agreement, which the Company entered into in 1982 with the New Jersey Department of Energy and the New Jersey Department of Public Advocate, established a target cost of approximately $3.8 billion and a target in-service date of December 1986. There is an earnings penalty if Hope Creek is completed in excess of the cost cap. Under the agreement, the Company's revenue requirement related to rate base would be based on the exclusion of 20% of costs incurred in excess of $3.8 billion. If the overrun exceeds 10% of the cost cap, the approved revenue requirement related to rate base would be based on the exclusion of 30% of expenditures in excess of the 10% overrun. The current estimate could result in a reduction of earnings in 1987 of between approximately 5¢ and 8¢ per share of Common Stock under the formula provided in the Cost Containment Agreement. The reduction would decline in subsequent years over the depreciable life of the plant. On December 13, 1985, the Company petitioned the BPU for

an increase in its rates. The rate proceeding will examine the prudence and cost of Hope Creek and whether a phase-in of rates should be required so as to spread any authorized increase over a number of years. The Company cannot predict the outcome.

Deferred Items

As shown in the Balance Sheets, the major components of Deferred Items are Property Losses associated with plant abandonments.

The accounting standards relating specifically to regulated enterprises are promulgated by Financial Accounting Standards Board (FASB) Statement No. 71 (SFAS 71). The FASB has issued an exposure draft which would amend SFAS 71 for three types of events that occur in the electric utility industry; phase-in plans, abandonments, and disallowances of costs of newly completed plants. The amendments, if adopted, would become effective for the Company's 1987 calendar year with retroactive application for prior transactions.

The proposed amendments if adopted in their present form could require the Company to:

- reduce the carrying amount of abandonment losses to the present value of probable future revenues associated with each project, and
- reduce the carrying amount of Hope Creek by the present value of the future earnings penalty related to the Cost Containment Agreement with the BPU.

Any reduction in carrying amounts of these assets could result in a corresponding decrease in retained earnings. Subsequent years' results of operation could increase as the discounted amounts are returned to net income.

See Note 4 for additional information on the plant abandonments and other items.

Nuclear Insurance Coverages

The Company's insurance coverages for its nuclear operations are as follows:

(Millions of Dollars) Type and Source of Coverage	Maximum Coverage	Maximum Retrospective Assessment for a single incident
Public Liability		
American Nuclear Insurers	$ 160	$None
Federal Government (A)	490	8.5(B)
	$ 650(C)	$ 8.5
Property Damage		
Nuclear Mutual Limited (D)	$ 5.00	$ 21.9
Nuclear Electric Insurance Limited (D)	525	8.3
American Nuclear Insurers	85	None
	$1,110	$ 30.2
Replacement Power		
Nuclear Electric Insurance Limited (D)	$ 3.0(E)	$ 12.7

A. Retrospective premium program under the Price-Anderson liability provisions of the Atomic Energy Act of 1954, as amended. Subject to retrospective assessment with respect to loss from an incident at any licensed nuclear reactor in the United States.

B. Maximum assessment would be $17.0 million in the event of more than one incident in any year.

C. Limit of liability under the Atomic Energy Act of 1954, as amended, for each nuclear incident.

D. Mutual insurance companies of which the Company is a member. Subject to retrospective assessment with respect to loss at any nuclear generating station covered by such insurance.

E. Maximum weekly indemnity for 52 weeks which commences after the first 26 weeks of an outage. Also provides $1.5 million weekly for an additional 52 weeks.

The Atomic Energy Act provisions in Notes (A), (B) and (C) above expire on Aug. 1, 1987, unless extended by Congress. In December 1983, the Nuclear Regulatory Commission (NRC) submitted a report to Congress with respect to the continuation of the Price-Anderson provisions which recommends that the $650 million limit on liability be eliminated and that the present limits on retrospective assessments against owners of nuclear units be replaced by an annual limit of no more than $10 million per year for each licensed nuclear reactor. Other proposals would retain a limit on liability, but increase such limit substantially. The Company cannot predict whether the Price-Anderson provisions will be extended or what provisions will be enacted if it is extended. In 1984, in a case to which the Company was not a party, the United States Supreme Court held that the Atomic Energy Act, the Price-Anderson limitation of liability provisions thereunder and the extensive regulation of nuclear safety by the NRC do not pre-empt claims under State law for personal, property, or punitive damages related to radiation hazards.

Environmental Controls

The Comprehensive Environmental Response, Compensation and Liability Act of 1980 and certain similar State statutes authorize various governmental authorities to seek court orders compelling responsible parties to take clean-up action at disposal sites determined to present an imminent and substantial danger to the public and to the environment because of an actual or threatened release of hazardous substances. Because of the nature of the Company's business, various by-products and substances are produced or handled which are classified as hazardous under these laws. The Company generally provides for the disposal of such substances through licensed individual contractors but these statutory provisions generally impose potential joint and several responsibility on the generators of the wastes for clean-up costs. The Company has been notified with respect to a number of such sites, and the clean-up of hazardous wastes is receiving increasing attention from the governmental agencies involved. This trend is expected to continue. The Company cannot estimate the costs which may result from these matters, but such costs could be substantial.

8. Other Long-Term Obligations

The amount of other long-term obligations consists of the following:

(Thousands of Dollars)	1985	1984
Nuclear Fuel Disposal Cost Liability	$ 58,337	$ 61,844
Obligations under Capital Leases		61,103
Total	$58,337	$122,947

Nuclear Fuel Disposal Cost Liability

In conformity with the Nuclear Waste Policy Act of 1982 (the Act), the Company entered into contracts with the Department of Energy (DOE) on June 13, 1983 for the disposal of spent nuclear fuel from the Salem and Hope Creek nuclear generating stations. Similarly, Philadelphia Electric Company contracted with the DOE in connection with the Peach Bottom nuclear generating station. Under these contracts, DOE will take title to the spent fuel at the site, then provide for its transport and permanent disposal. Of the three options permitted by the Act, the Company selected the option of a June 1985 lump-sum payment to DOE in accordance with the Act with respect to nuclear fuel disposal cost charges for 1985 and prior periods, aggregating $71.6 million, were reversed in conformity with the payment.

Lease Commitments

Effective December 1984, the Company changed its method of accounting for leases that meet the criteria for capitalization in accordance with Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation", and FERC accounting requirements. The Balance Sheets and Statements of Changes in Financial Position for periods prior to December 1984 have been restated to reflect the retroactive capitalization of leases. Accordingly, the Balance Sheets include assets and related obligations applicable to capital leases. Since the total amortization of the leased assets and interest on the lease obligations equals the net minimum lease payments included in rent expense for capital leases, retroactive adoption had no effect on prior years' Statements of Income or Statements of Retained Earnings.

Capital leases relate primarily to the Company's corporate headquarters and computer equipment. Certain of the leases contain renewal and purchase options and also contain escalation clauses.

Utility plant includes the following amounts for capital leases at December 31:

(Thousands of Dollars)	**1985**	1984
Common Plant	**$65,872**	$71,534
Less Accumulated Amortization	**4,890**	7,653
Net Assets under Capital Leases	**$60,982**	$63,881

Future minimum lease payments for noncancelable capital and operating leases at December 31, 1985 are:

(Thousands of Dollars)	Capital Leases	Operating Leases
1986	$ 16,047	$ 2,696
1987	14,998	1,926
1988	13,863	1,829
1989	13,114	1,744
1990	13,110	1,691
Later Years	316,744	3,441
Minimum lease payments	387,876	$13,327
Less: Amount representing estimated executory costs, together with any profit thereon, included in minimum lease payments	190,264	
Net minimum lease payments	197,612	
Less: Amount representing interest	136,630	
Present value of net minimum lease payments (A)	$ 60,982	

A. Reflected in the balance sheet in Other Long-Term Obligations of $58,337,000 and in Long-Term Debt and Other Obligations due within one year of $2,645,000, respectively.

The following schedule shows the composition of rent expense included in Operating Expenses:

(Thousands of Dollars) For the Years Ended Dec. 31,	**1985**	1984	1983
Interest on Obligations under Capital Leases	**$ 7,344**	$ 7,533	$ 7,004
Amortization of Utility Plant under Capital Leases	**3,448**	2,942	2,096
Net minimum lease payments relating to Capital Leases	**10,792**	10,475	9,100
Other Lease payments	**15,569**	16,514	19,397
Total Rent Expense	**$26,361**	$26,989	$28,497

9. *Supplementary Information Concerning the Effects of Changing Prices (Unaudited)*

The Company's financial statements are prepared in accordance with generally accepted accounting principles and are stated on the basis of historical costs, namely, the prices that were in effect when the underlying transactions occurred. The following supplementary financial information, prepared in accordance with Financial Accounting Standards Board Statement No. 33 (SFAS 33), as amended by SFAS 82, is an estimate of the effects on the Company of changes in specific prices (Current Cost) and General Inflation.

The Company advises readers of the imprecise nature of this data and of the subjective judgments required in the restatement of selected historical costs to amounts adjusted for Current Cost and General Inflation. This data should not be used to make adjustments to the Company's primary financial statements and the related earnings per average share of Common Stock other than those adjustments shown in the following supplementary financial data.

Current Cost data purports to show the estimated cost of currently replacing existing Utility Plant and was generally measured by applying the Handy-Whitman Index of Public Utility Construction Costs to the historical costs of Utility Plant.

General Inflation amounts were determined by adjusting historical costs of certain items into dollars of the same general purchasing power by using the Consumer Price Index for All Urban Consumers (CPI-U).

Depreciation and Amortization expense, Amortization of Nuclear Fuel (included in Electric Fuel, Interchanged Power and Gas), and Amortization of Capital Leases (included in rental expense in Other Operation and Maintenance) were adjusted for Current Cost using the rates and methods for computing book depreciation and amortization applied to the appropriate inflation adjusted Utility Plant balances. In accordance with SFAS 33, income tax expense was not adjusted.

SFAS 33 requires the disclosure of the adjustment needed to reflect Net Utility Plant at its Net Recoverable Cost if that cost differs from the inflation adjusted amounts. Also required under Current Cost is the disclosure of the increase in Current Cost of Net Utility Plant held during the year and the related effect of general inflation. The amounts shown in the following table illustrate that during 1985 the increase in general inflation was less than the increase in the Current Cost of Net Utility Plant after adjustment to Net Recoverable Cost. The Adjustment of Net Utility Plant to Net Recoverable Cost is an adjustment of Utility Plant to Historical Cost in average 1985 dollars. Historical Cost is the amount permitted to be recovered under the rate regulatory process for utilities in New Jersey.

During inflationary periods, holders of monetary assets, such as cash and receivables, suffer losses of general purchasing power while issuers of monetary liabilities experience gains. In 1985 the Company's monetary liabilities, primarily long-term debt, exceeded its monetary assets resulting in a gain. Since this gain is primarily attributable to long-term debt which has been used to finance Utility Plant, it is added to the Amount by which the increase in general inflation was lower than the increase in Current Cost of Net Utility Plant after adjustment to Net Recoverable Cost in the following table.

Supplementary Financial Data Adjusted for the Effects of Changing Prices for the Year Ended December 31, 1985 (Unaudited)

(Millions of Dollars)	Historical Cost (Condensed from the Financial Statements)	Current Cost (Average 1985 Dollars)
Operating Revenues	$4,409	$4,409
Operating Expenses		
Electric Fuel, Interchanged Power and Gas	1,790	1,785
Other Operation and Maintenance	893	894
Depreciation and Amortization of Utility Plant	223	563
Taxes	875	875
Total Operating Expenses	3,781	4,117
Operating Income	628	292
Other (including Interest Expenses)	(83)	(83)
Income from Continuing Operations (excluding Adjustment of Net Utility Plant to Net Recoverable Cost)	$ 545	$ 209
Increase in Current Cost of Net Utility Plant held during the year (A)		$ 299
Adjustment of Net Utility Plant to Net Recoverable Cost		191
Effect of the increase in General Inflation		(457)
Amount by which increase in general inflation was lower than increase in Current Cost of Net Utility Plant after adjustment to Net Recoverable Cost		33
Gain from decline in purchasing power of Net Monetary Liabilities		152
Net		$ 185

A. At December 31, 1985, the Current Cost of Net Utility Plant was $12,525 billion, while historical (net recoverable) cost was $8,475 billion.

Supplementary Five-Year Comparison of Selected Financial Data Adjusted for Effects of Changing Prices (Unaudited)

(Millions of Dollars where applicable. All adjusted figures in average 1985 dollars.) For the Years Ended December 31,	**1985**	1984	1983	1982	1981
Operating Revenues					
Historical	**$4,409**	$4,196	$3,963	$3,874	$3,472
Adjusted for General Inflation	***$4,409***	*$4,346*	*$4,279*	*$4,318*	*$4,106*
Income (Loss) from Continuing Operations (excluding Adjustment of Net Utility Plant to Net Recoverable Cost)					
Historical	**$ 545**	$ 490	$ 390	$ 343	$ 264
Adjusted for Current Cost	***$ 209***	*$ 159*	*$ 72*	*$ 33*	*$ (16)*
Income (Loss) from Continuing Operations per Average Common Share (excluding Adjustment of Net Utility Plant to Net Recoverable Cost) (A)					
Historical	**$ 3.96**	$ 3.95	$ 3.40	$ 3.24	$ 2.63
Adjusted for Current Cost	***$ 1.22***	*$ .89*	*$ .09*	*$ (.30)*	*$ (.94)*
Amount by which increase in general inflation was (higher) lower than increase in Current Cost of Net Utility Plant after adjustment to Net Recoverable Cost	**$ 33**	$ 63	$ 90	$ 107	$ (219)
Gain from decline in purchasing power of Net Monetary Liabilities	***$ 152***	*$ 146*	*$ 130*	*$ 119*	*$ 268*
Net Assets at Year-end (B)					
Historical	**$4,324**	$3,686	$3,338	$3,081	$2,833
Adjusted for Current Cost	***$4,251***	*$3,764*	*$3,543*	*$3,395*	*$3,243*
Cash Dividends Declared per Common Share					
Historical	**$ 2.81**	$ 2.70	$ 2.62	$ 2.53	$ 2.44
Adjusted for General Inflation	***$ 2.81***	*$ 2.80*	*$ 2.83*	*$ 2.82*	*$ 2.89*
Market Price per Common Share at Year-end					
Historical	**$31.63**	$26.75	$22.75	$23.25	$18.00
Adjusted for General Inflation (C)	***$31.63***	*$27.78*	*$24.56*	*$26.06*	*$20.95*
Consumer Price Index (1967 = 100)					
Average	**322.2** (D)	311.1	298.4	289.1	272.4
Year-end	**327.7** (D)	315.5	303.5	292.4	281.5

A. After deducting Cumulative Preferred Stock and $1.40 Dividend Preference Common Stock dividends on a historical basis in 1985 and in Average 1985 Dollars for prior years. **B.** Equals Common Equity and Preferred Stock without mandatory redemption. **C.** Year-end 1985 Dollars. **D.** Estimated.

Prices have been increasing over the last five years. The average CPI-U increased from 272.4 in 1981 to 322.2 in 1985, an average annual increase of 4.3%. The increase from 1983 to 1984 was 4.3% and from 1984 to 1985 was 3.6%, an indication that the rate of inflation is continuing at a slower pace.

Revenues for the five-year period increased from $3.472 billion in 1981 to $4.409 billion in 1985, an average annual increase of 6.2%. Restated in average 1985 dollars, revenues for the same period would have increased from $4.106 billion to $4.409 billion, an average annual increase of only 1.8%.

Cash dividends declared per common share increased from $2.44 in 1981 to $2.81 in 1985 or an average annual increase of 3.6%. However, such dividends would have decreased at an average annual rate of 0.7% or from $2.89 in 1981 to $2.81 in 1985 when restated in average 1985 dollars.

Market price per common share at year-end from 1981 to 1985 had an average annual increase of 15.1% or from $18.00 to $31.63. Restated in year-end 1985 dollars the 1981 market price would have been $20.95, resulting in an average annual increase of 10.8% from 1981 to 1985.

Lack of adequate recognition of inflation in rate-making in addition to delayed rate relief accelerates attrition, thereby contributing to poorer cash flow.

10. *Jointly-Owned Facilities*

The Company has an ownership interest and is responsible for providing its share of the necessary financing for the following jointly-owned facilities. All amounts reflect the Company's share of each jointly-owned project and the corresponding direct expenses are included in the Statements of Income as an operating expense.

(Thousands of Dollars) Plant	Ownership Interest	Amount of Utility Plant In Service	Accumulated Provision for Depreciation	Amount of Plant Under Construction
Coal Generating				
Conemaugh	22.50%	$ 72,297	$ 21,231	
Keystone	22.84%	67,127	20,324	
Nuclear Generating				
Peach Bottom	42.49%	510,134	155,780	
Salem	42.59%	779,678	178,889	
Hope Creek	95.00%			$3,703,036
Nuclear Support Facilities	Various	59,945	3,927	
Pumped Storage Generating				
Yards Creek	50.00%	18,676	4,708	
Transmission Facilities	Various	127,678	14,971	
Merrill Creek Reservoir	16.19%			7,321
Linden Synthetic Natural Gas	90.00%	66,515	48,320	

11. *Financial Information by Business Segments*

(Thousands of Dollars) For the Years Ended December 31,	Electric			Gas			Total		
	1985	1984	1983	**1985**	1984	1983	**1985**	1984	1983
Operating Revenues	**$3,000,564**	$2,815,241	$2,570,457	**$1,408,490**	$1,379,883	$1,392,475	**$ 4,409,054**	$4,196,124	$3,962,932
Depreciation and Amortization	**167,959**	159,388	152,874	**55,004**	51,800	48,913	**222,963**	211,188	201,787
Operating Income Before Income Taxes	**778,957**	753,225	584,508	**117,220**	101,275	101,052	**896,177**	854,500	685,560
Gross Additions to Utility Plant	**1,116,040**	879,458	815,919	**104,049**	87,907	77,890	**1,220,089**	967,365	893,809
December 31,									
Net Utility Plant	**$7,671,465**	$6,797,809	$6,089,825	**$ 803,262**	$ 752,480	$ 713,991	**$ 8,474,727**	$7,550,289	$6,803,816
Gas Exploration Subsidiary and LNG Project (See Note 4)				**233,482**	234,601	304,052	**233,482**	234,601	304,052
Other Corporate Assets	**1,307,784**	1,410,751	1,122,418	**471,060**	465,003	396,060	**1,778,844**	1,875,754	1,518,478
Total Assets	**$8,979,249**	$8,208,560	$7,212,243	**$1,507,804**	$1,452,084	$1,414,103	**$10,487,053**	$9,660,644	$8,626,346

12. *Selected Quarterly Data (Unaudited)*

The information shown below in the opinion of the Company includes all adjustments, consisting only of normal recurring accruals, necessary to a fair presentation of such amounts.

Due to the seasonal nature of the business, quarterly amounts vary significantly during the year.

Calendar Quarter Ended	March 31,		June 30,		September 30,		December 31,	
(Thousands where applicable)	**1985**	1984	**1985**	1984	**1985**	1984	**1985**	1984
Operating Revenues	**$1,280,889**	$1,198,151	**$939,204**	$969,474	**$1,057,757**	$1,009,999	**$1,131,204**	$1,018,500
Operating Income	**178,894**	142,878	**136,692**	146,717	**170,330**	181,979	**141,870**	126,564
Net Income	**151,517**	119,924	**127,011**	121,483	**145,618**	151,576	**120,406**	97,046
Earnings Available for Common Stock	**$ 136,503**	$ 104,874	**$112,015**	$106,412	**$ 130,621**	$ 136,527	**$ 105,411**	$ 81,995
Earnings per Share of Common Stock	**$1.16**	$.99	**$.93**	$.98	**$1.07**	$1.24	**$.80**	$.74
Average Shares of Common Stock Outstanding	**117,889**	105,652	**121,038**	108,491	**122,329**	110,051	**128,010**	111,419

Management's Discussion and Analysis of Financial Condition and Results of Operations

The Company's financial condition and results of operations are affected by numerous factors, including the timing and amount of rate relief, weather, the extent of sales growth, the levels of operating costs and carrying costs of both utility plant construction and underrecovered electric energy costs.

On December 13, 1985, the Company filed a petition with the Board of Public Utilities of the State of New Jersey (BPU) for higher rates which are designed to increase revenues by $633.6 million on an annual basis. The request is comprised of $569.2 million for electric service and $64.4 million for gas service for an overall rate increase of 14.2%. The requested increase in electric rates is designed to reflect the full cost of Hope Creek in rates at the time the unit is placed into commercial operation, various general increases in other electric costs and an anticipated $277 million decrease in the electric Levelized Energy Adjustment Clause (LEAC) principally as a result of Hope Creek generation. The petition for an increase in rates is primarily attributable to the full inclusion in rate base of the Company's share of Hope Creek.

The Company's financial condition reflects the near completion of Hope Creek, a 1,067 megawatt nuclear unit owned 95% by the Company. As of December 31, 1985, physical construction was essentially complete. The overall start-up, testing and turnover of plant systems was about 93% complete. At that date, the Company's share of expenditures was $3.70 billion—including $726 million of allowance for funds used during construction (AFDC). Construction is proceeding on a schedule which would permit nuclear fuel to be loaded in the first quarter of 1986. Fuel load requires a license from the Nuclear Regulatory Commission (NRC) which is solely within the control of the NRC.

The costs of construction of Hope Creek are subject to a cost containment agreement approved by the BPU in July 1983. This agreement provides for an earnings penalty for the Company if its share of construction costs exceeds $3.8 billion. The final project cost will exceed the cost cap figure, and the Company's current estimate of the cost of the plant is between $4.15 billion and $4.3 billion. The current estimate could result in a reduction of earnings in 1987 and future years of between approximately 5¢ and 8¢ per share of Common Stock under the formula provided in the Cost Containment Agreement. It is difficult to predict the final cost of the project as it nears completion because of numerous pre-operational items and imprecision as to the timing of the testing and power ascension programs which must be adjusted to meet problems as they may arise. (See Note 7 of Notes to Financial Statements.)

Certain problems experienced by other utilities which are constructing nuclear generating units could have an indirect effect on the Company's operations and financial condition, because of common regulatory requirements, such as those of the NRC, and because industry events in some cases may affect the price of the Company's securities in the capital markets, where the Company must compete for investors' funds.

In July 1985, the Company's Board of Directors approved a draft plan and agreement of merger to provide for a corporate restructuring of the Company's operations and authorized the officers to take the steps necessary to effectuate the plan. The necessary regulatory approval was obtained from the BPU in January 1986. If stockholders approve the proposed restructuring, effective May 1, 1986, the Company will become the subsidiary of a holding company named Public Service Enterprise Group Incorporated. The purpose of the restructuring is to create a corporate structure for diversification into non-utility businesses, and to enhance the corporation's overall financial strength. The electric and gas business will continue as the principal business of the new corporate structure.

Earnings and Dividends

Earnings per share of Common Stock were $3.96 for 1985, an increase of 1¢ or .3% from 1984.

The slight gain was primarily attributable to the $286.4 million annual base rate increase which went into effect on March 23, 1984, higher total kilowatthour sales explained below, and greater AFDC due to the continuing construction of Hope Creek. The increase was tempered by the effect of a greater number of shares outstanding, greater operating expenses (excluding fuel costs), principally higher maintenance, labor costs, taxes and depreciation. Earnings were also reduced approximately 7¢ per share due to the greater write-off of replacement energy costs disallowed by the BPU in 1985 over 1984 and approximately 3¢ per share due to the abandonments of uranium projects. (See Energy Costs below and Note 4 of Notes to Financial Statements.)

Earnings per share were $3.95 for 1984, an increase of 55¢ or 16% from 1983. Increased revenues reflecting the March 1984 rate increase and greater sales explained below, outpaced the rise in operating costs. Earnings were also reduced due to the the write-off of replacement energy costs disallowed by the BPU and the abandonment of a liquefied natural gas project. (See Energy Costs below and Note 4 of Notes to Financial Statements.)

Common Stock dividends have increased for the last three years rising to $2.81 in 1985 from $2.70 in 1984 and $2.62 in 1983. Such amounts resulted in payout ratios of 71%, 68% and 77%, respectively. Total Common Stock dividend payments in 1985 increased 18% and 36% over 1984 and 1983, respectively, due to the greater number of shares outstanding as well as the higher dividend rate.

Revenues and Sales

Electric

Revenues increased 6.5% in 1985 primarily due to the impact of the March 1984 rate increase and greater sales. In 1984, electric revenues increased 9.6% due to higher rates and improved sales. Electric energy costs follow amounts recovered through revenues, as permitted by rate orders, and therefore have no effect on earnings.

The components of the above changes are highlighted in the table below:

(Millions of Dollars)	Increase or (Decrease) 1985 vs. 1984	1984 vs. 1983
Changes in base rates	$ 58	$210
Recoveries of energy costs	56	(25)
Kilowatthour sales	73	62
Other operating revenues	(3)	(1)
	$184	$246

1985—Electric kilowatthour sales increased 2.3%. Residential sales were relatively flat, improving slightly over last year. Both the Residential and Commercial sales categories reflect the impact of the overall cooler, less humid summer weather experienced

this year compared to 1984. Temperature humidity index hours dropped 5.7% from last year. Sales lost in the Commercial category due to the cooler weather conditions were more than offset by the ongoing growth in this service oriented category. The lackluster performance of New Jersey's manufacturing sector throughout 1985 depressed sales in the Industrial category. On August 15, 1985 records were set for a 60-minute net peak load of 7,721 megawatts and the maximum day's output of 149,457 megawatthours.

1984—Electric kilowatthour sales increased 2.7%. Residential sales declined slightly, primarily the result of the cooler weather experienced during the summer of 1984 compared to 1983, while the improved economy during 1984 helped to increase sales in both the Commercial and Industrial categories. Although the overall summer weather was cooler when compared to 1983, on June 11, 1984 records were set for a 60-minute net peak load of 7,422 megawatts and the maximum day's output of 143,558 megawatthours. A monthly record output of 3,452 million megawatthours was attained in August.

Gas

Revenues improved 2.1% in 1985 principally due to the impact of the March 1984 rate increase. This increase was negatively impacted by the one-time refund to customers of $13.2 million and a reduction in the raw materials adjustment charge, both ordered by the BPU during the latter part of 1985. The slight decline in 1984 gas revenues was mainly attributable to the one-time refund to customers of $42.9 million ordered by the BPU during the last quarter of 1984, which was partially offset by higher sales. The refunds mentioned above resulted mainly from an overrecovery of gas costs during the prior levelized period that was attributable primarily to lower than anticipated prices for pipeline gas and substantial purchases at lower prices on the spot market. Gas fuel costs follow amounts recovered through revenues, as permitted by rate orders, and therefore have no effect on earnings.

The components of the above changes are highlighted in the table below:

(Millions of Dollars)	Increase or (Decrease) 1985 vs. 1984	1984 vs. 1983
Changes in base rates	$20	$ 26
Recoveries of gas costs (A)	10	(63)
Therm sales	(2)	21
Other operating revenues	1	3
	$29	$(13)

A. Includes the effect of $13.2 million refund to customers in 1985 and $42.9 million in 1984.

1985—Overall gas heating sales remained relatively flat when compared to 1984. Heating degree days rose only .4% over last year. Since early 1985, switching of certain dual-fuel Commercial and Industrial customers from gas to lower priced oil has depressed sales in these categories. Industrial sales have also been affected by the ongoing slowdown in New Jersey's manufacturing activity.

1984—Gas therm sales increased by 4.5%. Therm sales improved over last year in all major customer categories. The general improvement in the economy during the year and the colder weather early in 1984 favorably impacted all categories.

Energy Costs

Electric energy costs and gas fuel costs are adjusted to match amounts recovered through revenues and have no effect on earnings. However, the carrying of underrecovered energy costs ultimately increases financing costs.

A record total of 34,869 million megawatthours was generated, purchased and interchanged, a 2% increase over 1984, principally due to the growth of high technology and service oriented facilities in our service area. Higher generation, mainly due to the performance of Salem station, which achieved a United States record for power produced by any type of generation—nuclear, coal, oil or gas—accounted for most of the increase.

On July 11, 1985, the BPU determined that approximately $22.5 million of replacement energy costs should not be recovered from customers. The $22.5 million is composed of $19.6 million associated with the Peach Bottom 2 pipe replacement outage and $2.9 million associated with the Salem 2 water hammer outage. (See table below and Note 4 of Notes to Financial Statements).

As a member of the Pennsylvania-New Jersey-Maryland Interconnection and as a party to several agreements which provide for the purchase of available power from neighboring utilities, the Company is able to optimize its mix of internal and external sources using the lowest cost energy available at any given time.

Total electric energy costs increased 11% in 1985 after an increase of less than 1% in 1984, as described below:

(Millions of Dollars)	Increase or (Decrease) 1985 vs. 1984	1984 vs. 1983
Change in prices paid for fuel supplies and power purchases	$(167)	$(16)
Kilowatthour output	21	25
Adjustment of actual costs to match recoveries through revenues (A)	225	(13)
Replacement energy costs for which recovery was disallowed by the BPU	14	8
	$ 93	$ 4

A. Reflects over (under) recovered energy costs, which in the years 1985, 1984 and 1983 amounted to $28 million, $(198) million and $(190) million, respectively, as well as amortization of prior period unrecovered costs of $1 million in 1984 and $11 million in 1983.

Gas costs increased less than 1% in 1985 and were 4% lower in 1984. Contributing factors are shown below:

(Millions of Dollars)	Increase or (Decrease) 1985 vs. 1984	1984 vs. 1983
Change in prices paid for gas supplies	$ (1)	$(47)
Surcharge related to non-production gas costs	9	
Refunds from pipeline suppliers	(10)	12
Therm sendout	(12)	40
Adjustment of actual costs to match recoveries through revenues (A)	16	(40)
	$ 2	$(35)

A. Reflects over (under) recovered gas costs which in the years 1985, 1984 and 1983 amounted to $(8) million, $(24) million and $16 million, respectively. The underrecovery of $8 million in 1985 and $24 million in 1984 reflects gas fuel cost refunds to customers of $11 million and $37 million, respectively.

Liquidity and Capital Resources

The Company's liquidity is affected principally by the construction program, financing costs associated with underrecovered electric energy costs and, to a lesser degree, by other capital requirements such as maturing debt, reacquisition of securities and sinking fund requirements. The capital resources available to meet these requirements are funds from internal generation and external financing. Internally generated funds depend upon economic conditions and the adequacy of timely rate relief, as to which no assurance can be given. Access to the long-term and short-term capital and credit markets is necessary for obtaining

funds externally. The Company expects to generate approximately two-thirds of its capital requirements for 1986 from operations.

Construction Program

The Company maintains a continuous construction program, which includes payments for nuclear fuel. This program is periodically revised as a result of changes in economic conditions, and depends on the ability of the Company to finance construction costs and to obtain timely rate relief. Changes in the Company's plans and forecasts, price changes, cost escalation under construction contracts, and requirements of regulatory authorities may also result in revisions of the construction program.

Construction expenditures of $1.2 billion in 1985 and $964 million in 1984 include AFDC of $196 million and $159 million, respectively. Construction expenditures are estimated at $3.0 billion for the five years ending in 1990 and include AFDC of about $240 million.

These estimates are based on certain expected completion dates and include anticipated escalation due to inflation of approximately 6%. Therefore, construction delays or inordinate inflation levels could cause significant increases in these amounts. If Hope Creek begins commercial operation during the second half of 1986, the Company expects that, with adequate rate relief, as to which no assurance can be given, it will be able to generate internally almost all of its construction expenditure requirements for the next five years.

Long-Term Financing

The Company raised more than $703 million through sales in 1985 of $125 million of First and Refunding Mortgage Bonds and $503 million of Common Stock, and, on January 14, 1986, $75 million of First and Refunding Mortgage Bonds on the European market. As a result, the Company's interest and dividend requirements have continued to increase.

At December 31, 1985 book value per share amounted to $28.04 compared to $27.17 at December 31, 1984. The market value of common shares expressed as a percentage of book value was 112.8% and 98.5% at year-end 1985 and 1984, respectively.

In addition to periodic sinking fund redemptions and the proposed redemption of $69.250 million of preferred stock, five mortgage bond issues aggregating $270 million will mature by the end of 1990.

Under the terms of the Company's Mortgage and Restated Certificate of Incorporation, at December 31, 1985 the Company could issue an additional $2.115 billion principal amount of Mortgage Bonds at a rate of 10.625% or $2.167 billion of Preferred Stock at a rate of 9.375%. Present plans for the remainder of 1986 call for the issuance of debt and equity securities.

In February 1985, the Company renewed its Credit Agreement with 12 domestic banks to May 1, 1986 for the issuance of revolving loans up to an aggregate of $200 million to be outstanding at any time. The agreement permits the Company to convert the outstanding balance at the end of the period to three-year term loans. Also, the Company has the right, with the consent of the banks, to extend the agreement on a year-to-year basis.

In addition to the domestic capital markets described above, the Company lists its Common Stock on the London Stock Exchange, London, England and the $75,000,000 First and Refunding Mortgage Bonds have been listed on the Luxembourg Stock Exchange.

Short-Term Financing

For interim financing, the Company is authorized by the BPU to have up to a total of $300 million of short-term obligations outstanding at any given time. This availability of short-term financing provides the Company flexibility in the issuance of long-term securities. The Company's average daily short-term debt during 1985 was $72 million —$17 million above last year's average. At year end the Company had $107 million of short-term debt outstanding, excluding $75 million, which was reclassified as Long-Term Debt.

As mentioned above, the Company has a Credit Agreement with a group of domestic banks for the issuance of revolving loans. The Company also has a $75 million revolving credit agreement with a group of foreign banks, under which the Banks have agreed to make revolving loans for one month, three months or six months at a rate based upon the London Interbank Offered Rate for deposits in United States Dollars. These agreements provide the Company with an intermediate-term source of funds.

Cash Position

The Company's cash position decreased $87.4 million since year-end 1984. The components of the decrease are:

(Millions of Dollars)	Increase or (Decrease)
Cash	$ 9.0
Working Funds	(2.8)
Pollution Control Escrow Funds	(96.6)
Commercial Paper	78.0
Commercial Paper – reclassified to Long-Term Debt	(75.0)
Total	$(87.4)

Customer Accounts Receivable

At December 31, 1985, customer accounts receivable approximated $354 million (excluding unbilled revenues of $210 million), as the Company is continuing to finance large receivables from its customers. Net write-off of uncollectible accounts in 1985 was down 31% to approximately $28 million, a decrease of $13 million from last year. Net write-off per $100 of revenues was down 32 cents to 64 cents compared to 1984, the result of improved collection procedures and continued improvement in the economy. The level of the Company's rates and a BPU requirement prohibiting the termination of electric and gas service during winter months to financially needy customers also have an impact upon the level of receivables, uncollectible accounts and net write-off thereof.

Effects of Inflation

The effect of inflation on the Company was severe during the period 1979 through 1981 when the Average Consumer Price Index (CPI-U) reflected increases of over 10%. Since 1981, the inflation rate has moderated. The increases in the CPI-U in 1982, 1983, 1984 and 1985 were 6.1%, 3.2%, 4.3% and 3.6%, respectively. Even though the rate of inflation has dropped below double digit rates, the cost of capital has remained relatively high during a time when substantial amounts must be raised in the capital markets to finance construction.

For additional information on the effects of changing prices see Note 9 of Notes to Financial Statements.

Operating Statistics

(Thousands of Dollars where applicable)	1985	1984	% Annual Inc. (Dec.) — 1985 compared with 1984	1975
Electric				
Revenues from Sales of Electricity				
Residential	**$ 918,911**	$ 883,652	3.99	8.33
Commercial	**1,236,027**	1,111,175	11.24	11.15
Industrial	**774,963**	749,725	3.37	8.53
Public Street Lighting	**43,786**	42,164	3.85	6.48
Total Revenues from Sales to Customers	**2,973,687**	2,786,716	6.71	9.43
Interdepartmental	**1,877**	1,810	3.70	1.78
Total Revenues from Sales of Electricity	**2,975,564**	2,788,526	6.71	9.42
Other Electric Revenues	**25,000**	27,715	(9.80)	19.09
Total Operating Revenues	**$ 3,000,564**	$ 2,816,241	6.55	9.48
Sales of Electricity — megawatthours				
Residential	**8,390,658**	8,373,471	.21	1.00
Commercial	**13,313,639**	12,452,020	6.92	4.00
Industrial	**10,290,711**	10,444,412	(1.47)	.14
Public Street Lighting	**300,612**	301,702	(.36)	1.59
Total Sales to Customers	**32,295,620**	31,571,605	2.29	1.81
Interdepartmental	**24,888**	25,796	(3.52)	(4.61)
Total Sales of Electricity	**32,320,508**	31,597,401	2.29	1.80
Megawatthours Produced, Purchased and Interchanged — net	**34,869,192**	34,178,862	2.02	1.77
Load Factor	**51.6%**	52.4%		
Capacity Factor	**31.3%**	32.6%		
Heat Rate — Btu of fuel per net kwh generated	**10,692**	10,616	.72	.10
Net Installed Generating Capacity at December 31 — megawatts	**9,007**	8,999	.09	.28
Net Peak Load — megawatts (60-minute integrated)	**7,721**	7,422	4.03	2.10
Temperature Humidity Index Hours	**15,720**	16,677	(5.74)	1.45
Average Annual Use per Residential Customer — kilowatthours	**5,494**	5,543	(.88)	.27
Meters in Service at December 31 — Thousands	**1,788**	1,769	1.07	.57
Gas				
Revenues from Sales of Gas				
Residential	**$ 751,339**	$ 717,286	4.75	11.23
Commercial	**407,073**	393,197	3.53	14.77
Industrial	**242,767**	263,080	(7.72)	16.14
Street Lighting	**372**	369	.81	12.36
Total Revenues from Sales to Customers	**1,401,551**	1,373,932	2.01	12.91
Interdepartmental	**1,321**	1,682	(21.46)	7.40
Total Revenues from Sales of Gas	**1,402,872**	1,375,614	1.98	12.90
Other Gas Revenues	**5,618**	4,269	31.60	43.29
Total Operating Revenues	**$ 1,408,490**	$ 1,379,883	2.07	12.94
Sales of Gas — kilotherms				
Residential	**1,019,850**	1,019,025	.08	.52
Commercial	**634,059**	628,855	.83	3.54
Industrial	**468,489**	495,719	(5.49)	3.11
Street Lighting	**736**	339		6.18
Total Sales to Customers	**2,123,134**	2,143,938	(.97)	1.88
Interdepartmental	**2,540**	3,377	(24.79)	(2.30)
Total Sales of Gas	**2,125,674**	2,147,315	(1.01)	1.88
Gas Produced and Purchased — kilotherms	**2,218,818**	2,249,352	(1.36)	1.98
Effective Daily Capacity at December 31 — kilotherms	**19,990**	19,856	.67	.21
Maximum 24-hour Gas Sendout — kilotherms	**17,994**	14,927	20.55	4.97
Heating Degree Days	**4,764**	4,743	.44	.24
Average Annual Use per Residential Customer — therms	**853**	863	(1.16)	(.10)
Meters in Service at December 31 — Thousands	**1,422**	1,404	1.28	.48

1983	1982	1981	1980	1975
$ 829,967	$ 791,279	$ 728,642	$ 684,343	$ 413,005
984,499	981,795	871,377	765,356	429,428
686,880	716,662	684,976	598,716	341,749
38,672	37,809	33,249	32,693	23,375
2,540,018	2,527,545	2,318,244	2,081,108	1,207,557
1,863	1,709	1,612	1,720	1,573
2,541,881	2,529,254	2,319,856	2,082,828	1,209,130
28,576	13,937	2,186	1,072	4,358
$ 2,570,457	$ 2,543,191	$ 2,322,042	$ 2,083,900	$ 1,213,488
8,402,397	7,686,548	7,795,988	8,129,198	7,598,964
11,753,667	11,114,655	10,940,609	10,726,086	8,994,855
10,283,784	10,017,613	10,923,042	11,049,642	10,144,917
302,053	301,603	275,489	265,126	256,755
30,741,901	29,120,419	29,935,128	30,170,052	26,995,491
27,800	25,154	25,567	27,684	39,910
30,769,701	29,145,573	29,960,695	30,197,736	27,035,401
33,391,011	31,563,231	32,204,191	32,703,504	29,255,628
52.6%	51.7%	52.3%	52.0%	53.3%
31.6%	34.7%	33.2%	35.6%	30.1%
10,717	10,677	10,725	10,713	10,582
8,999	8,995	9,101	9,242	8,756
7,244	7,042	7,034	7,159	6,270
17,262	12,155	15,494	16,526	13,612
5,602	5,156	5,261	5,443	5,348
1,757	1,746	1,739	1,732	1,689
$ 746,200	$ 716,308	$ 604,521	$ 515,013	$ 259,095
396,159	371,027	302,281	228,577	102,656
246,408	241,437	240,711	164,762	54,369
358	350	290	282	116
1,389,125	1,329,122	1,147,803	908,634	416,236
1,011	1,068	1,075	925	647
1,390,136	1,330,190	1,148,878	909,559	416,883
2,339	595	732	595	154
$ 1,392,475	$ 1,330,785	$ 1,149,610	$ 910,154	$ 417,037
995,686	994,647	993,527	1,023,027	968,487
596,868	581,739	555,806	506,550	447,600
460,601	465,835	514,136	447,474	344,987
327	331	334	335	404
2,053,482	2,042,552	2,063,803	1,977,386	1,761,478
1,857	2,090	2,430	2,322	3,204
2,055,339	2,044,642	2,066,233	1,979,708	1,764,682
2,151,417	2,148,839	2,145,325	2,077,653	1,823,191
19,129	19,139	19,010	18,439	19,575
15,612	16,201	14,812	14,444	11,077
4,677	4,820	5,082	5,256	4,653
850	853	857	875	862
1,392	1,384	1,378	1,370	1,355

Financial Statistics

(Thousands of Dollars where applicable)	1985		1984	
Condensed Statements of Income (A)	**Amount**	**%**	Amount	%
Operating Revenues				
Electric	**$ 3,000,564**	**68**	$2,816,241	67
Gas	**1,408,490**	**32**	1,379,883	33
Total Operating Revenues	**4,409,054**	**100**	4,196,124	100
Operating Expenses				
Operation				
Fuel for Electric Generation and Interchanged Power—net	**965,966**	**22**	872,805	21
Gas Purchased and Materials for Gas Produced	**824,648**	**19**	822,583	20
Other	**546,267**	**12**	527,371	13
Maintenance	**291,437**	**7**	269,974	6
Depreciation and Amortization of Utility Plant	**222,963**	**5**	211,188	5
Amortization of Property Losses	**55,263**	**1**	58,975	1
Taxes				
Federal Income Taxes	**266,379**	**6**	255,304	6
New Jersey Gross Receipts Taxes	**557,270**	**13**	529,654	13
Other	**51,075**	**1**	50,132	1
Total Operating Expenses	**3,781,268**	**86**	3,597,986	86
Operating Income				
Electric	**547,343**	**12**	527,625	12
Gas	**80,443**	**2**	70,513	2
Total Operating Income	**627,786**	**14**	598,138	14
Allowance for Funds Used During Construction (Debt and Equity)	**195,845**	**4**	158,792	4
Other Income—net	**10,214**		12,866	
Interest Charges	**(289,293)**	**(6)**	(279,767)	(6)
Income before Extraordinary Items	**544,552**	**12**	490,029	12
Extraordinary Items, net of income tax:				
Unrecoverable costs of Atlantic Project				
Gain on sale of Transport of New Jersey				
Net Extraordinary Items				
Net Income	**544,552**	**12**	490,029	12
Preferred and Preference Stock Dividends	**60,002**	**1**	60,221	2
Earnings Available for Common Stock	**$ 484,550**	**11**	$ 429,808	10
Shares of Common Stock Outstanding (Thousands)				
End of Year	**131,699**		112,563	
Average for Year	**122,344**		108,913	
Earnings per average share of Common Stock	**$ 3.96**		$ 3.95	
Dividends Paid per Share	**$ 2.81**		$ 2.70	
Payout Ratio	**71%**		68%	
Rate of Return on Average Common Equity (C)	**14.03%**		14.43%	
Ratio of Earnings to Fixed Charges Before Income Taxes (D)	**3.76**		3.61	
Book Value per Common Share (E)	**$28.04**		$27.17	
Utility Plant (F)	**$10,977,321**		$9,870,429	
Accumulated Depreciation and Amortization (F)	**$ 2,502,594**		$2,320,140	
Total Assets (F)	**$10,487,053**		$9,660,644	
Capitalization				
Mortgage Bonds	**$ 2,945,723**	**39**	$2,877,518	41
Debenture Bonds	**218,918**	**3**	225,825	3
Other Long-Term Debt				
Total Long-Term Debt	**3,164,641**	**42**	3,103,343	44
Other Long-Term Obligations (F)	**58,337**	**1**	122,947	2
Preferred Stock with Mandatory Redemption	**65,000**	**1**	137,750	2
Preferred Stock without Mandatory Redemption	**554,994**	**7**	554,994	8
$1.40 Dividend Preference Common Stock and Common Stock	**2,508,945**	**33**	2,005,923	28
Premium on Capital Stock	**557**		557	
Paid-In Capital	**26,185**		26,185	
Retained Earnings	**1,232,849**	**16**	1,098,219	16
Total Common Equity	**3,768,536**	**49**	3,130,884	44
Total Capitalization	**$ 7,611,508**	**100**	$7,049,918	100

A. See Summary of Significant Accounting Policies, Notes to Financial Statements, and Management's Discussion and Analysis of Financial Condition and Results of Operations.
B. Excludes the net extraordinary gain of $6,316,000 or $.09 per share.
C. Balance available for $1.40 Dividend Preference Common Stock and Common Stock divided by the thirteen-month average of Common Equity.

1983		1982		1981		1980		1975	
Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
$2,570,457	65	$2,543,191	66	$2,322,042	67	$2,083,900	70	$1,213,488	74
1,392,475	35	1,330,785	34	1,149,610	33	910,154	30	417,037	26
3,962,932	100	3,873,976	100	3,471,652	100	2,994,054	100	1,630,525	100
868,977	22	959,382	25	1,059,539	31	866,802	29	478,312	30
858,018	22	821,479	21	692,319	20	513,988	17	198,653	12
503,568	13	452,115	12	385,149	11	322,220	11	201,286	12
238,766	6	220,456	6	192,768	6	169,813	6	83,494	5
201,787	5	192,860	5	178,532	5	169,987	6	122,775	8
49,040	1	43,345	1	15,362	1	11,024		438	
191,033	5	176,639	4	118,737	3	131,178	4	54,368	3
513,760	13	514,266	13	462,095	13	400,040	13	217,105	13
44,033	1	38,975	1	12,884		31,850	1	23,862	2
3,468,982	88	3,419,517	88	3,117,385	90	2,616,902	87	1,380,293	85
421,364	10	383,213	10	288,087	8	307,372	10	217,429	13
72,586	2	71,246	2	66,180	2	69,780	3	32,803	2
493,950	12	454,459	12	354,267	10	377,152	13	250,232	15
128,592	3	91,427	2	95,679	3	77,552	2	43,325	3
12,605	1	17,578	1	15,780		10,259		1,758	
(245,368)	(6)	(220,637)	(6)	(201,589)	(6)	(189,562)	(6)	(136,709)	(8)
389,779	10	342,827	9	264,137	7	275,401	9	158,606	10
						(13,219)			
						19,535			
						6,316			
389,779	10	342,827	9	264,137	7	281,717	9	158,606	10
58,234	2	53,865	2	51,538	1	46,341	1	36,008	2
$ 331,545	8	$ 288,962	7	$ 212,599	6	$ 235,376	8	$ 122,598	8
102,858		94,845		86,089		76,615		56,523	
97,467		89,233		80,962		73,069		54,513	
$3.40		$3.24		$2.63		$3.13[B]		$2.25	
$2.62		$2.53		$2.44		$2.29		$1.72	
77%		78%		93%		73%[B]		76%	
12.66%		12.22%		9.79%		11.63%		9.01%	
3.33		3.32		2.87		3.14		2.56	
$26.36		$25.90		$23.66		$26.38		$24.02	
$9,017,951		$8,165,130		$7,385,315		$6,945,426		$4,920,765	
$2,214,135		$2,046,372		$1,877,815		$1,705,912		$1,078,121	
$8,626,346		$7,968,861		$7,338,496		$6,787,125		$4,473,473	
$2,452,954	39	$2,341,142	40	$2,140,835	40	$2,041,556	41	$1,418,854	36
231,945	4	238,640	4	269,268	5	276,590	5	380,619	10
				720		1,200		153,600	4
2,684,899	43	2,579,782	44	2,410,823	45	2,319,346	46	1,953,073	50
119,815	2	118,419	2	60,086	1	61,073	1		
139,500	2	111,250	2	77,913	2	29,750	1	35,000	1
554,994	9	554,994	9	554,994	10	554,994	11	474,994	12
1,792,340	29	1,610,879	27	1,423,739	26	1,252,103	25	855,874	22
557		557		557		557		550	
26,185		26,185	1	26,143	1	26,093		26,065	1
963,617	15	888,262	15	827,497	15	813,181	16	540,041	14
2,782,699	44	2,525,883	43	2,277,936	42	2,091,934	41	1,422,530	37
$6,281,907	100	$5,890,328	100	$5,381,752	100	$5,057,097	100	$3,885,597	100

D. Net Income plus Income Taxes, Deferred Income Taxes, Investment Tax Credits and Fixed Charges divided by Fixed Charges. Fixed Charges include Interest on Long-Term and Short-Term Debt, Other Long-Term Obligations, Other Interest Expense and, starting in 1980, an interest factor in rentals.

E. Total Common Equity divided by year-end Common Stock shares plus double the $1.40 Dividend Preference Common Stock shares.

F. Years 1980-1983 restated to conform to current classification.

Corporate Information

Annual Meeting

Please note that the Annual Meeting of Stockholders of the Company will be held in Newark Symphony Hall, 1020 Broad Street, Newark, N.J. Tuesday, April 15, 1986 at 2:00 p.m. A summary of the meeting will be sent to all stockholders of record at a later date.

Additional Reports Available — Form 10-K

Stockholders or other interested persons wishing to obtain a copy of the Company's 1985 Annual Report to the Securities and Exchange Commission, filed on Form 10-K, may obtain one without charge by writing to the Manager—Investor Relations, Public Service Electric and Gas Company, P.O. Box 570, T6B, Newark, N.J. 07101. The copy so provided will be without exhibits. Exhibits may be purchased for a specified fee.

Financial and Statistical Review

A comprehensive statistical supplement to this report, containing financial and operating data for the years 1975-1985 will be available this Spring. If you wish to receive a copy, please write to the Manager—Investor Relations, Public Service Electric and Gas Company, P.O. Box 570, T6B, Newark, N.J. 07101.

Transfer Agents

All Stocks,
Morgan Guaranty Trust Company of New York,
30 West Broadway, New York, N.Y. 10015

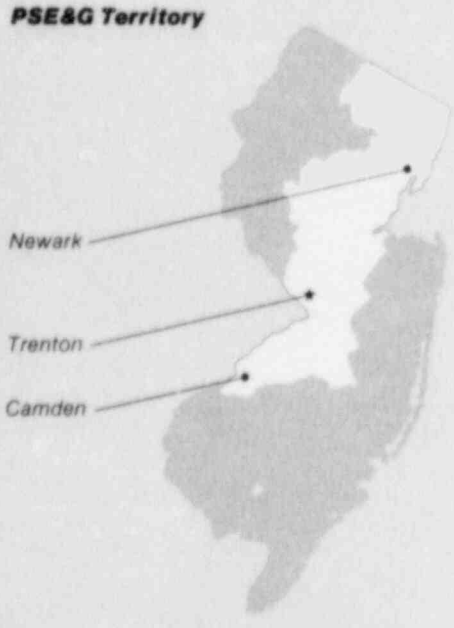
Stockholder Services,
Public Service Electric and Gas Company
80 Park Plaza, P.O. Box 570
Newark, N.J. 07101

Registrars

All Stocks,
First Fidelity Bank, N.A., New Jersey
765 Broad Street, Newark, N.J. 07101

Morgan Guaranty Trust Company of New York,
30 West Broadway, New York, N.Y. 10015

PSE&G Territory



Stock Exchange Listings

Common and Preference:

New York Stock Exchange
Philadelphia Stock Exchange
London Stock Exchange (Common only)

Preferred:

New York Stock Exchange

Stock Symbol: PEG

The table below shows the quarterly dividends paid for the periods indicated and the high and low Composite prices of such stocks.

Common Stock

	1985	1984
Dividend	**71¢***	68¢**
Price		
First Quarter	**27½-25⅛**	24½-20⅛
Second Quarter	**32½-27¼**	23 -20⅜
Third Quarter	**32⅛-26⅝**	25⅛-21⅛
Fourth Quarter	**33⅛-26⅝**	27¼-24½

*68¢ First Quarter only. **66¢ First Quarter only.

$1.40 Dividend Preference Common Stock

	1985	1984
Dividend	**35¢**	35¢
Price		
First Quarter	**13 -12**	12 -11¼
Second Quarter	**14⅛-12¼**	11¾-10⅛
Third Quarter	**15 -13½**	11¼-10⅛
Fourth Quarter	**14½-13¼**	13¼-10½

Stockholder Information — Toll Free

New Jersey residents (800) 242-0813
Outside New Jersey (800) 526-8050

Security Analysts and Institutional Investors

Manager—Investor Relations (201) 430-6564

PSE&G

Public Service Electric and Gas Company
80 Park Plaza Newark New Jersey 07101

Mailing Address
P.O. Box 570 Newark New Jersey 07101