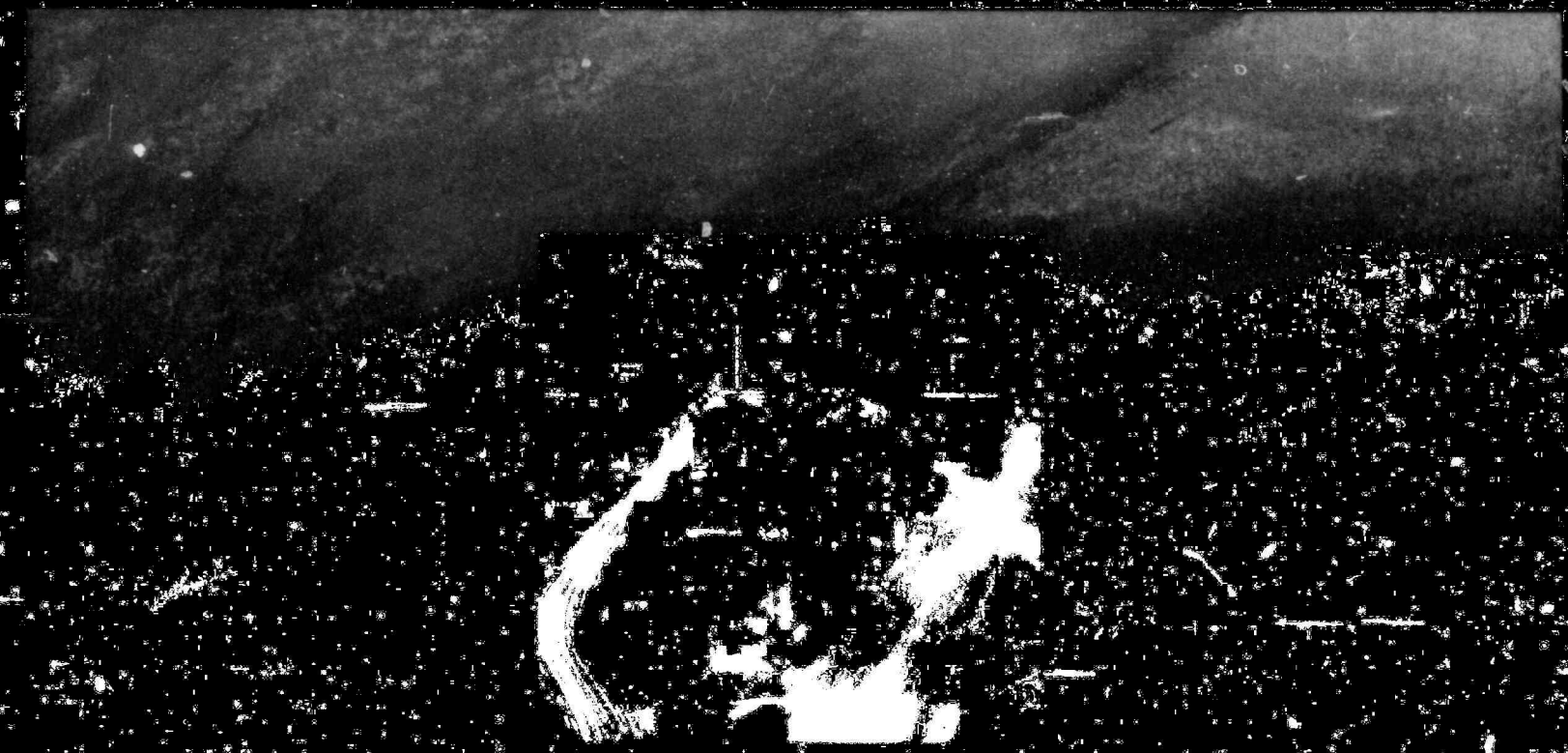


Delmarva Power Annual Report 1985

On the cover: Downtown Wilmington, a vibrant commercial center.

Financial Highlights	1985	1984	Percent Increase (Decrease)
Revenues	$ 722.8 million	$ 702.6 million	2.9
Net Income	$ 96.6 million	$ 92.1 million	4.9
Earnings Per Share	$ 2.76	$ 2.63	4.9
Dividends Declared	$ 1.945	$ 1.83	6.3
Common Stock Outstanding Average Shares	30,481,925	30,248,482	0.8
Common Stock Book Value	$ 18.43	$ 17.70	4.1
Construction Expenditures	$ 94.9 million	$ 79.5 million	19.4
Internally Generated Funds	$ 151.3 million	$ 110.5 million	36.9
Electric Sales	8.53 billion kwh	8.31 billion kwh	2.6
Electric Customer (average)	314,013	303,965	3.3
Average Residential Usage	8,059 kwh	8,283 kwh	(2.7)
Gas Sales	15.71 million mcf	17.24 million mcf	(8.9)
Gas Customers (average)	75,103	74,319	1.1
Average Residential Usage	79.7 mcf	88.8 mcf	(10.2)

To Our Stockholders

The record shows that 1985 was another good, solid, building block year. However, upon reflection, 1985 was more than that. It was a year where sustained performance generated increased confidence among employees.

Highlights are: • Earnings increased for the fifth consecutive year. • There were no electric rate increases in the service territory. • Customer approval ratings increased for the third consecutive year. • Delmarva Power generating plants performed above national averages. • Employee safety records showed continued significant improvements. • Employee participation programs continued to mature and yield innovative ideas. • New outside investments increased earnings.

• Our report this year is designed to reflect another year's good work and confidence gained through sustained performance. This performance and confidence is important to you now as a shareholder or customer because in 1986, we will begin to make some decisions concerning energy supply for the mid 1990s. These decisions will be complex because of changing forces in the economy. Employees will be able to look ahead and focus on these challenges with the confidence that they can perform their current jobs well.

Work crews in Centreville, Maryland, begin each day with "tailgate" sessions designed to promote safety, efficiency, and participation.

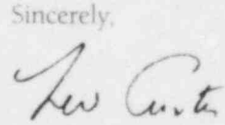
• However, management is concerned about committing to a new power plant now for several reasons. • The construction costs will be large. Around the country, large building programs have become financial and emotional albatrosses for utilities. A new plant in 1996 is projected to cost $3,800 per kilowatt which is more than six times the cost of the Indian River Unit 4 completed in 1980. Total costs are estimated to be three quarters of a billion dollars. • Also, for several years in this letter, concerns have been expressed about the lessons learned in the railroad industry. Large capital investments can be devalued quickly by technology breakthroughs and structural changes within an industry. • Finally, utility barometers are sending contradictory signals. Forces such as increasing summer peaks indicate building while other forces such as wheeling and cogeneration indicate delay.

• So, in 1986, we will be asking ourselves, do we need another plant in 1996 or can it be postponed through a combination of various energy management techniques? What are the benefits if our assumptions turn out to be correct? What are the consequences if they turn out to be wrong?

• While future capacity planning will be emphasized this year, the company has been preparing for the 1990s in other ways including: **Price control** • Competitive pricing is crucial for staying ahead of emerging competition. Delmarva Power has established one of the lowest average electric prices in the region through reducing dependence on oil from 53% in 1979 to 20% in 1985, reducing workforce, consolidating facilities, and developing a participative workstyle which encourages innovative ideas to contain costs without reducing quality. **Technology review** • We will invest $50 million over the next ten years, to keep old plants running longer than planned rather than replace them with more costly new units. **Investment expansion** • Earnings not now needed to finance construction are being used to upgrade facilities in advance of any major building program and to invest in related projects outside the utility business which can achieve returns greater than the principal business. • The next few years will be challenging and exciting. We must plan carefully for the long-run needs of our customers. At the same time, we must find ways to maintain earnings growth in face of modest projected growth in assets and no increase in authorized returns. The 1985 performance shows that employees have the know-how and confidence to perform their current jobs well and take on these challenges. I appreciate their efforts and look forward to working with them as Delmarva Power continues to prepare for the next decade.

Our report this year is designed to reflect another year's good work and confidence gained through sustained performance.

Sincerely,

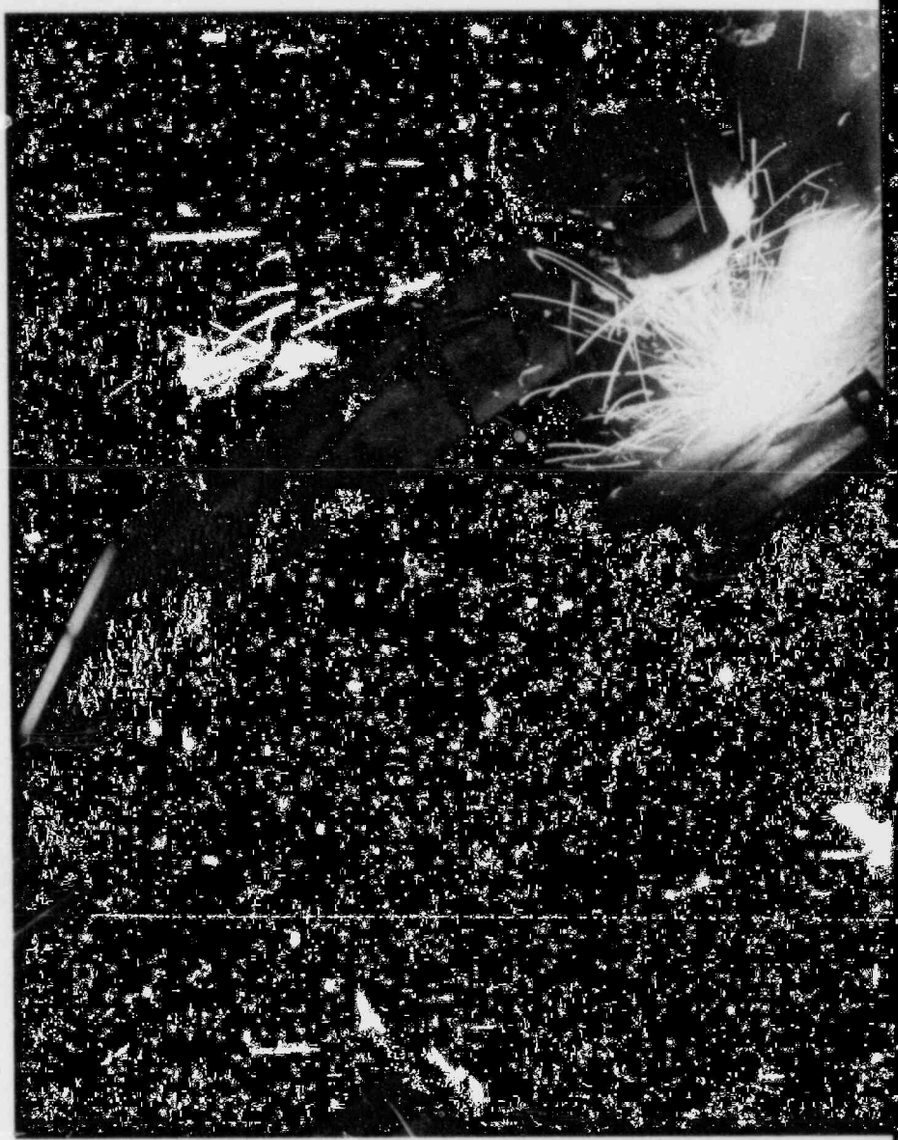


Nev Curtis February 11, 1986

The Stockholders' Perspective

Earnings Improve • In 1985, earnings increased 4.9% to $2.76. Quarterly dividends increased by 5.2% to 50½ cents for an indicated annual rate of $2.02. The price of common stock increased from $22 to $27⅞.

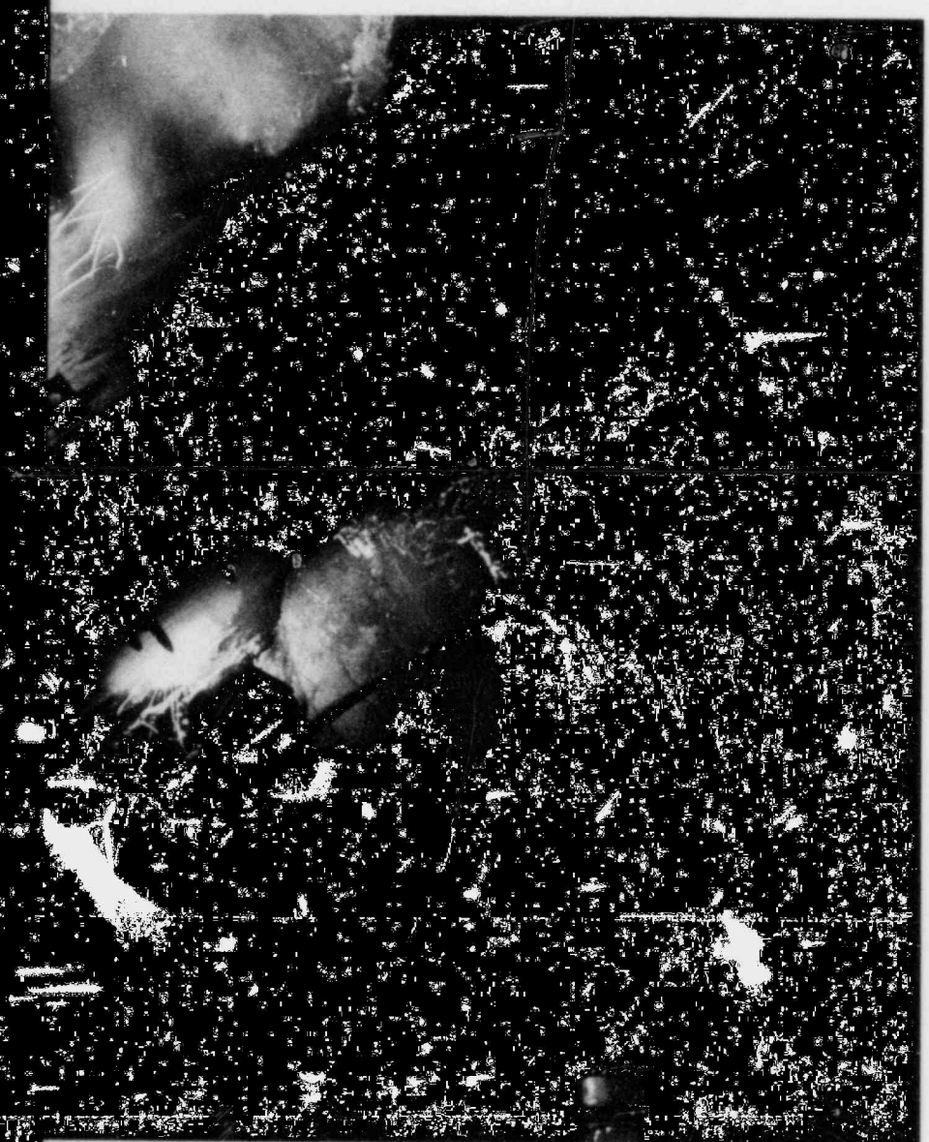
Energy helps people enjoy the Delmarva Peninsula.



• The company paid for all of its construction expenses with its own cash. The AFUDC ratio, a key indicator for financial analysis, remained low at 3.1% of net income. The company's bond rating, in differing technical terms from the differing agencies, is a solid AA.

Facilities Run Well • Delmarva Power's energy system is in good shape. The generating reserves are 27%. The company sells power to the PJM interconnection and to other companies, reducing costs by more than $14 million. Transmission and distribution facilities are in excellent condition. • The company's wholly-owned coal and oil fired plants ran well again this year. The average company availability rate was 88% compared to the most recent industry average of 84%. • On August 15, a new company peak of 1,795 megawatts was set during abnormally hot weather.

Delmarva Power is a financially healthy company with well running facilities and a balanced fuel mix.



The sparks from the welding show progress toward the completion of a new coal pulverizer project at the Edge Moor Power Station. Such investment at existing facilities is a key part of the company's strategy to keep the price of electricity as low as reasonably possible.

When adjusted for weather, the new peak is in line with company forecasts. • The fuel mix is balanced: 65% coal; 20% oil; and 15% nuclear fuel at nuclear plants partially owned by Delmarva Power but run by other companies. • The gas system is capable of growing without major improvements. Gas supplies are plentiful and should remain competitively priced.

• Because of the rapid increase in data processing needs and the presently cramped quarters, the company announced plans to build by 1987 a $20 million computer center on company property at Christiana, Delaware. The computer center along with anticipated environmental control investments in the last half of the decade may mean that the company may have to seek external financing earlier than previously thought but not in 1986.

MODERATE GROWTH EXPECTED • Electric sales grew 2.6% in 1985, mainly because of the continued strong economy in the service area. • Gas sales decreased 8.9% from 1984 because of milder weather and increased competition from declining oil prices.

REFINANCINGS COMPLETED • In order to lower the cost of capital to the company and its customers, the company completed a 30-year bond sale at an attractive interest rate of 10⅛%. The money from this sale was used to replace called and tendered preferred stocks which had higher rates and to refinance maturing debt.

INVESTMENTS GROW • In 1985, the company expanded supplemental investments to include participation in leveraged leases involving financing of three pieces of equipment, an airplane and two communication satellites. Corporate investments contributed 20 cents per share to earnings in 1985 compared to 12 cents in 1984.

The Customers' Perspective

Special efforts were made this year to provide businesses, as those in downtown Wilmington, with useful energy information.

Competitive Prices • Delmarva Power employees have demonstrated that they can hold the line on prices.

• In 1985, there were no rate increases throughout the service territory, and none are expected in 1986. • Delmarva Power's average prices for energy rank low in the region. In cents/kWh: New York, 13.03; Newark, NJ, 9.21; Boston, 8.79; Philadelphia, 8.79; Delmarva Peninsula, 6.99; and Baltimore, 6.57. Rankings of natural gas prices (in cents/ccf) are New York, 79.95; Philadelphia, 67.81; Newark, NJ, 67.33; Boston, 60.81; and Wilmington, 60.16. • These achievements are important to face developing competition such as wheeling, co-generation, and imported power.

Competitive and flexible pricing is the cornerstone of Delmarva Power's plan to meet an uncertain future.

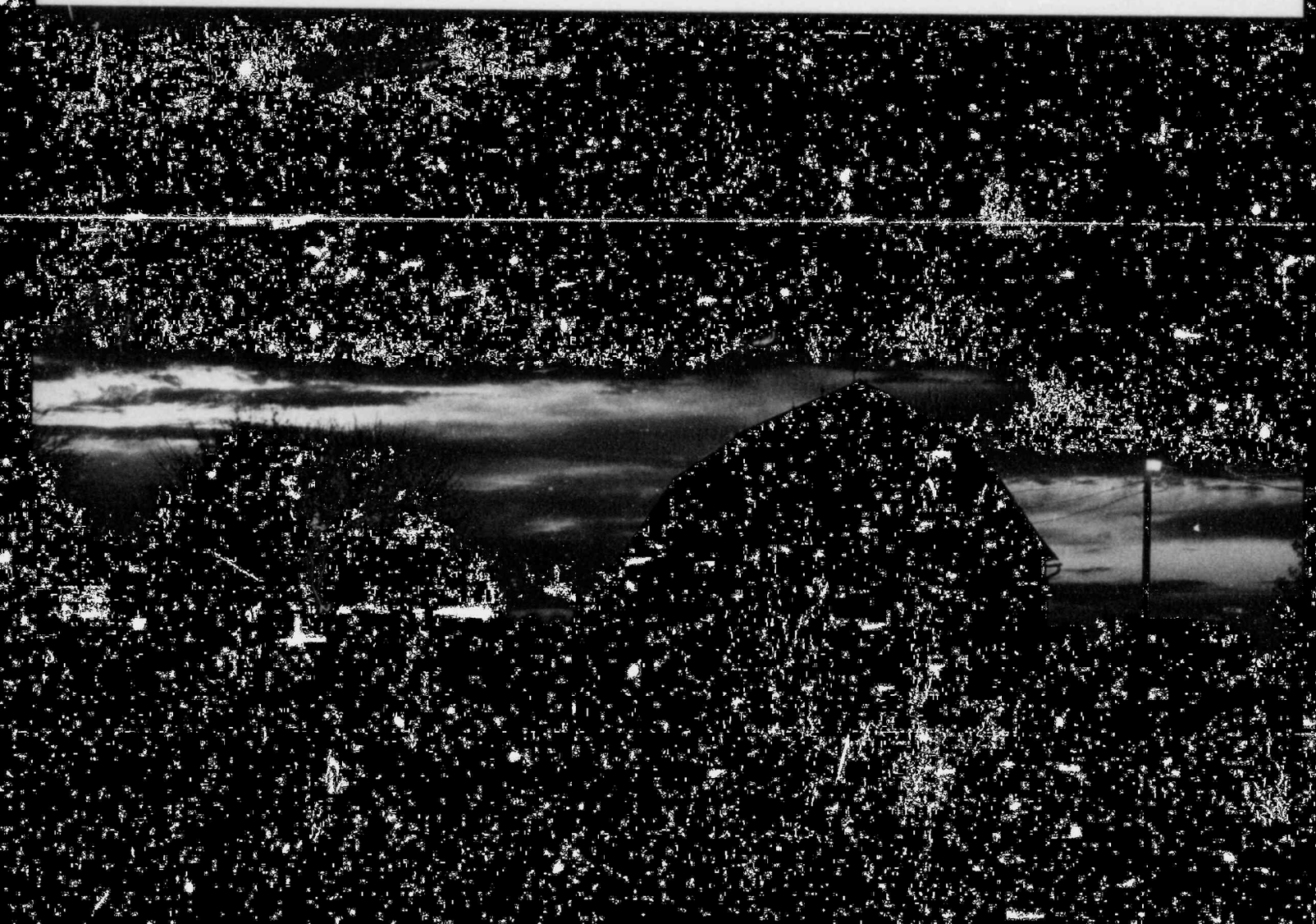
Bill Form Revised • In 1985, the company completed a key project designed to improve customer understanding of its product and cost. The format of the monthly electric and gas bills was revised to include new information and highlight other information that would be of most use to the customer. Customers participated in the development of the new bill format and contributed several major suggestions which were used. In the 1985 customer survey, 81 percent of those polled considered the improvements excellent or good.

Customer Opinion Improves • Customer follow-up surveys completed in 1985 show that while there is always room for improvement, customer service workers at Delmarva Power generally do their job well and find ways to do better. In the gas business for example, 97% of the customers surveyed rated the overall performance of the servicemen who visited their home as excellent or good. Customers in the Wilmington area were more likely to reach a representative the first time they telephoned (90%) than in 1984 (75%). • As a result of these and other efforts in price and customer service, 71 percent of customers gave Delmarva Power a favorable rating in the 1985 customer survey compared to 66 percent in 1984 and 59 percent in 1983.

The diverse blend of customers on the Delmarva Peninsula is a strength. The varied energy needs of farms, cities, homes, and resorts provide balance to the system and less vulnerability during extreme fluctuations in the national economy. This customer's farm is in central Delaware.

Educational programs help future customers recognize the value of energy.

A whirling ride on a hot summer day brings fun at the shore.



The Employees' Perspective

Safety Record Improves • On November 13, 1985, Sam Warrington finished work at the Indian River Power Station and went home to enjoy the company of his family.

• At the end of that day, he and 567 colleagues who work in Delmarva Power's four power plants completed a year, or 1,116,094 work-hours, with-

Working safely means more time with families as illustrated by Phillip Campbell of gas distribution, his daughter Denise and wife Jennifer.

The company's 2,570 employees work to provide energy at the lowest reasonable price.

Donald Myers continues to operate his crane at the Delaware City Power Plant. In October 1985, Texaco and the company agreed to a five-year extension of Texaco's option to purchase the Delaware City generating station. The 94-megawatt plant provides steam and electricity to Texaco's nearby refinery and electricity to other Delmarva Power customers.

out a lost-time accident—a significant achievement in this work environment. • This is an example of the excellent 1985 safety record. Recordable injuries decreased 12% to 50; lost-time injuries decreased 64% to 5; and lost workdays decreased 83% to 71. • In 1982, the company's safety program was strengthened in an effort to reduce accidents and to spare employees and their families the accompanying pain and anxiety. Then, the company ranked near the bottom in safety performance among companies in the Southeastern Electric Exchange. In 1985, Delmarva Power ranked first in its group in the safety performance and fleet safety contests.

To seek innovation, the company has developed a method for involving more employees in decisions affecting their jobs.

PARTICIPATION, INVOLVEMENT, CONCERN • In an effort to seek innovative ideas and solutions in a changing business, the company, during the last three years, has developed and refined a method for involving more employees in the decisions affecting their jobs. • While progress can still be made in this area, by the end of 1985, 1,045 employees had received at least the first level of training and had undertaken more than 2,100 innovative projects with the techniques they had learned. • The long-term goal of this program is to encourage the ideas of the individual and to recognize the benefits of teamwork.

HURRICANE GLORIA RESPONSE • Employees deserve special commendation for their efforts to restore power and serve customers after Hurricane Gloria delivered a glancing but powerful punch to the Delmarva Peninsula. The last of 50,000 customers without electricity were restored within 51 hours after the storm. Customer letters complimented Delmarva Power employees on their high level of preparation for this storm. Customer letters from Long Island, where Delmarva Power employees also worked, were especially appreciative of the time Delmarva Power workers sacrificed from their families to help them.

PERSONNEL • Senior Vice President and Director Frank A. Cook retired after 14 years of distinguished service with the company. His technical expertise and friendly support will be missed.

ENVIRONMENTAL PROTECTION • ON JULY 16, 1985, ED LARMORE, VIENNA POWER PLANT EQUIPMENT OPERATOR, RELEASED THE FIRST OF 26,000 STRIPED BASS FINGERLINGS INTO THE NANTICOKE RIVER NEAR VIENNA, MARYLAND.

• He participated in the first harvest from a fish brooding pond built by the company and maintained by employees on their own time. It was one of many efforts where Delmarva Power employees went beyond their jobs to help improve the quality of life on the Delmarva Peninsula. • In keeping with its commitment to provide energy with as little intrusion into the environment as possible, the company maintained its schedule well ahead of the 1988 federal deadline to remove capacitors containing PCBs from distribution lines. So far, 98% of them have been removed.

COMMUNITY ACTIVITIES • In April, 1985, Delmarva Power employees who dispatch work and who drive company vehicles were hon. .ed at a luncheon in the East Room of the White House by President Ronald Reagan for their efforts to help people in trouble through the Radio Watch program. • While Delmarva Power employees have always used their equipment to summon aid for people, in 1983 the company sought to increase awareness of this service by developing a logo and advertising it. In 1985, the company began informing children about Radio Watch through a campaign in the schools. Dispatchers also broadcast descriptions supplied by police of missing children. • People in the community use this service about twice a day to call for help in situations ranging from a flat tire to serious accidents. • In other activities, the Good Neighbor Energy Fund, raised more than $144,000 in customer and stockholder contributions to help people having trouble paying their energy bills. • Employees again exceeded their goal in contributions to the United Way and volunteered countless hours to community activities.

Energy and employees work together to help improve the quality of life on the Delmarva Peninsula.

The Honorable George Romney and President Ronald Reagan present Marty Duffy, manager, consumer affairs, with a medal honoring Delmarva Power employees for Radio Watch.

The company helps promote area economic development by participating with state and local governments throughout the peninsula in their development efforts and advocating fair rate structures which help businesses maintain a competitive edge. The commercial sector is growing as symbolized by the new building of Chase Manhattan Bank (USA) N.A. which is rising by Wilmington's Trinity Episcopal Church.

Specially reared striped bass are prepared for release into the Nanticoke River.

Informational Activities • The company helps customers understand energy and how to use it wisely through a variety of informational programs including the monthly newsletter "Energy News You Can Use," the senior citizens newsletter "Silver Bulletin," home building information effort "Super E+," a Speakers Bureau, and the face to face help from customer service and marketing representatives.

Joyce Hunt raised $655 at a company sponsored road race to raise money to fight cancer. She is typical of the many employees who volunteer their time for the community.

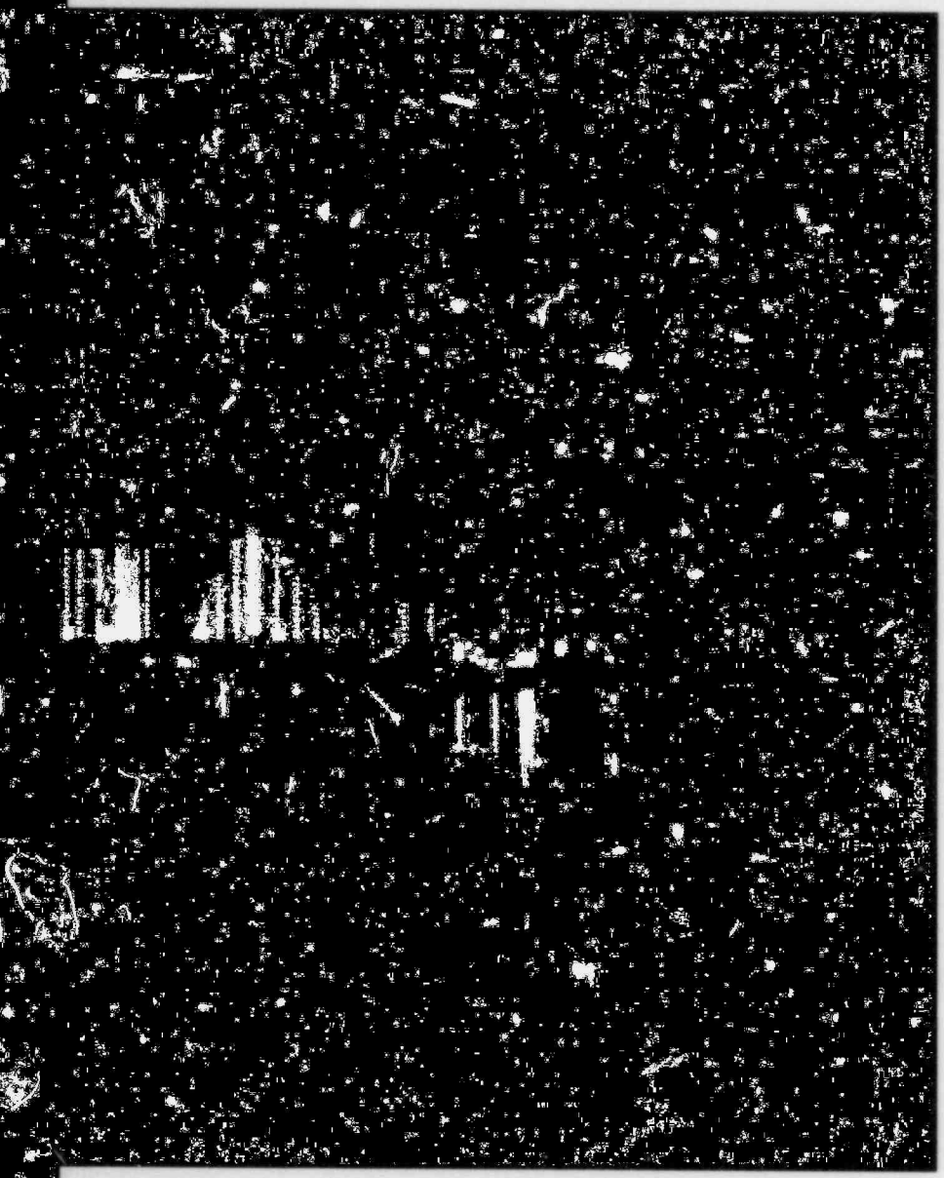
The Future

Facilities • In 1986, the company will develop a plan to displace the growth of 200 megawatts of summer peak demand and 80 megawatts of winter peak demand so the next power plant can be delayed for at least five years.

• The company will examine in detail whether several strategies to control customer demands can together help achieve that goal. To provide flexibility if demand should increase at unexpected rates, the company will also evaluate the possibility of re-activating, in an environmentally acceptable manner, Edge Moor Unit 1 and Unit 2 (70 megawatts each) with either natural gas or coal as the fuel.

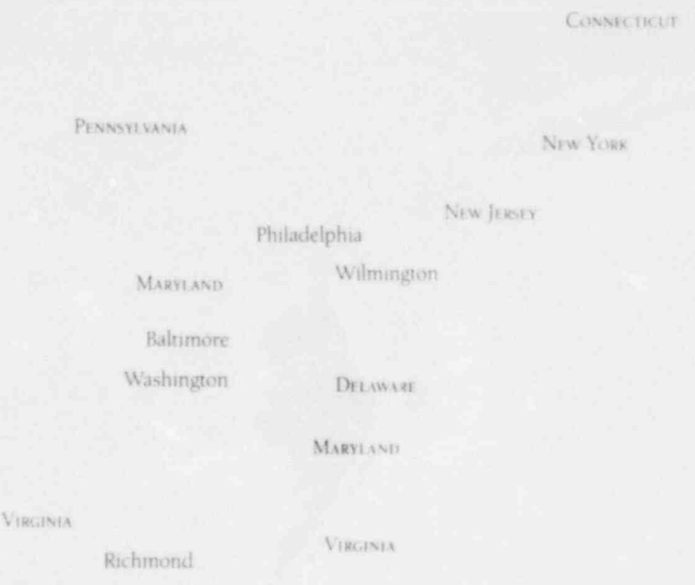
Earnings and Prices • Utility earnings are not expected to increase as much as in the recent past for several reasons. The company does not plan significant new earnings-producing investments in facilities for the short term. Rates are not likely to increase because allowed returns are being achieved generally. Also, since interest rates have declined, regulators are unlikely to increase the authorized rate of return. • While competitive pricing continues to be the cornerstone of Delmarva Power's plan to meet future competition, upward pressure on prices in the late 1980s will come from increasing environmental expenses and the need to upgrade facilities. • Earnings growth and price control will require continued sales improvement, cost control, productivity gains, and supplemental outside investments.

Earnings growth will require continued sales improvement, cost control, productivity gains, and supplemental outside investments.



The lights shine brightly at Ocean City, Maryland. To provide such energy, Delmarva Power owns and operates four major fossil fuel power plants within the service territory and shares ownership of two coal plants and two nuclear plants outside the service territory. Division headquarters are in Christiana, Delaware, and Salisbury, Maryland, and corporate headquarters are in Wilmington, Delaware.

The Service Territory • The Delmarva Peninsula is close enough to East Coast urban centers to benefit from their markets and financial centers yet remote enough to have its own identity and quality of life. • Delmarva Power provides electric service throughout most of the 5,700-square-mile Delmarva Peninsula which includes Delaware, portions of nine Eastern Shore counties in Maryland, and two Eastern Shore counties in Virginia. The company also distributes natural gas in a 275-square-mile area in northern Delaware. To serve this area, Delmarva Power maintains an electric system with 2,277 megawatts of generation capacity, 1,306 miles of transmission lines, and 9,051 miles of distribution lines, and a natural gas system with 1,047 miles of gas main.



Selected Financial Data

(Dollars in Thousands)

	For the Years Ended December 31	1985	1984	1983	1982	1981
Operating	Operating Revenues	$ 722,834	$ 702,593	$ 649,799	$ 636,666	$ 608,504
	Operating Income	135,515	133,209	129,138	116,573	107,325
	Net Income	96,638	92,110	85,063	73,571	58,711
Earnings and Dividends	Earnings Per Share	2.76	2.63	2.45	2.13	1.78
	Dividends Declared on Common Stock	1.945	1.83	1.68	1.595	1.535
	Average Shares Outstanding (000)	30,482	30,248	29,541	28,489	25,747
	Total Assets	1,674,770	1,591,630	1,533,263	1,509,771	1,460,529
	Construction Expenditures[1]	94,923	79,488	76,056	110,646	84,206
	Internal Generation of Funds	151,349	110,485	117,582	77,061	72,346
Capitalization	Long Term Debt[2]	638,090	567,761	567,935	592,615	596,219
	Preferred Stock without mandatory redemption	105,000	105,000	105,000	105,000	105,000
	Preferred Stock with mandatory redemption[3]	5,992	47,836	49,383	50,000	50,000
	Common Equity	561,811	539,630	503,513	468,073	437,080
	Total	$1,310,893	$1,260,247	$1,225,831	$1,215,688	$1,188,299
Capitalization Ratios	Long Term Debt	49%	45%	46%	49%	50%
	Preferred Stock without mandatory redemption	8%	8%	9%	9%	9%
	Preferred Stock with mandatory redemption	0%	4%	4%	4%	4%
	Common Equity	43%	43%	41%	38%	37%
	Total	100%	100%	100%	100%	100%
Electric/Gas Sales	Electric Sales (Kwh 000)	8,530,520	8,308,233	7,878,476	7,249,442	7,395,324
	Gas Sales (Mcf 000)	15,708	17,239	16,449	15,604	16,520

[1] Excludes Allowance for Funds Used During Construction.
[2] Includes long-term debt due within one year.
[3] Includes mandatory redemption due within one year.

RESULTS OF OPERATIONS

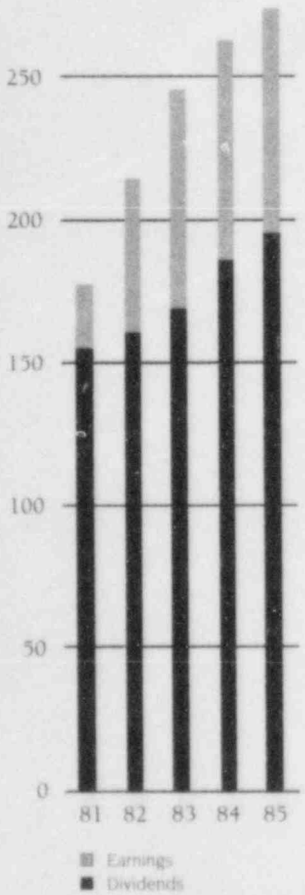
EARNINGS

Delmarva Power & Light Company's financial performance and strength continued to improve in 1985. Earnings per share of common stock were $2.76 for 1985, an increase of 13¢ or 4.9% from 1984. Contributing to the higher 1985 earnings level were higher electric sales, additional amortization of the credit arising from the sale of contracts (Summit), and increased investment income. The 1984 increase of 18¢ in earnings per share to $2.63 was primarily attributable to increased sales which resulted from a strong economy in the service territory and cold-winter weather conditions.

DIVIDENDS

In December 1985, the Board of Directors increased the quarterly dividend 5.2% to 50.5¢ per share, the ninth consecutive annual increase. The current indicated annual dividend rate has increased to $2.02 per share from $1.92 per share. This increase reflects a dividend policy which is to gradually increase dividends on an annual basis, earnings permitting, and thus provide stockholders with a fair and competitive return on their investment.

Earnings and Dividends Declared
(cents)



ELECTRIC REVENUES AND SALES

Electric revenues, net of fuel, increased $12.3 million or 3.0% in 1985 and $19.4 million or 4.9% in 1984. The increases in both years are net of refunds to Delaware retail electric customers. Refunds of $14.7 million in 1985 and $5.8 million in 1984 were designed to bring earned rates of return in line with authorized rates of return, as sales of electricity were greater than projected in both years.

The increase in 1985 and 1984 net revenues was achieved primarily through increased sales, with the company reaching an all-time peak load of 1,795 megawatts in August 1985. The increase in 1985 volume was primarily attributable to higher sales in the commercial and resale classes. A 4.4% increase in commercial sales was partially due to an expansion of the banking and financial services sector in Delaware. Some additional commercial customers were also gained through the ripple effect associated with increased residential construction in the beach areas. The resale class experienced a 7.3% sales growth principally because of a growing residential market that is dominated by electrical heat in the municipalities served by the company.

The increase in 1984 volume-related electric revenues was largely due to higher sales in the residential and commercial classes, which increased mainly as a result of the improved 1984 economy and colder winter weather conditions in the first quarter of 1984.

GAS REVENUES AND SALES

1985 gas revenues, net of fuel costs, increased 2.6% due to increased rates which were partially offset by an 8.9% decrease in sales. Industrial sales declined 8.0% due to switching to alternate fuels and decreased production levels. Residential space-heating sales decreased 9.3%, principally due to milder than normal winter weather conditions in the first quarter of 1985.

1984 net gas revenues increased 7.8% chiefly due to higher sales. Residential space-heating sales increased 11.3% in 1984, reflecting an increase in customers and the cold weather in early 1984. Commercial sales increased 11.0% reflecting an improved economy.

RATE REGULATION

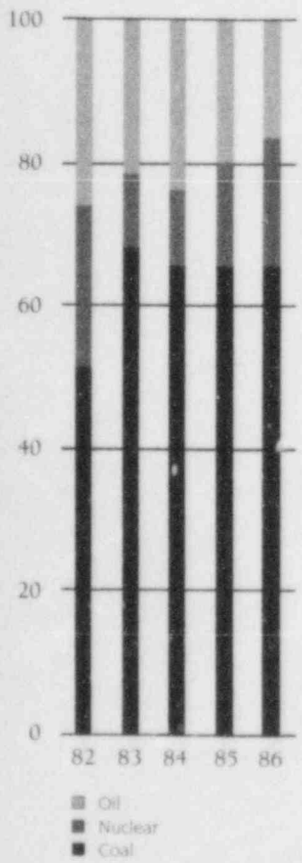
The company is subject to regulation with respect to its retail sales of electricity by the Delaware and Maryland Public Service Commissions and the Virginia State Corporation Commission, which have broad powers over rate matters, accounting and terms of service. The Federal Energy Regulatory Commission (FERC) exercises jurisdiction with respect to the company's accounting systems and policies and the transmission and sale at wholesale (resale) of electric energy in interstate commerce.

On January 29, 1985 the company announced a plan to voluntarily refund a minimum of $7.5 million of 1984 revenues to Delaware electric retail customers. After reviewing the final 1984 results, the Delaware Public Service Commission (DPSC) ruled that an additional $7.2 million should be refunded. Also, the company recommended and the Commission agreed that Delaware electric retail rates should be reduced approximately 1% or $3.6 million annually, effective as of June 28, 1985.

Rate increases were filed in the company's other retail jurisdictions in 1984 and were structured to recover increases in operating costs and to improve the return on utility investment. During the fourth quarter of 1984, rate increases were granted in Virginia for $449,000 or 2.7% and in Maryland for $4.8 million or 3.9%. On March 5, 1985, the DPSC granted a $3.5 million or 3.7% rate increase in gas revenues.

In December 1985, the company reached a tentative settlement with all resale customers to refund $3.5 million. The tentative agreement would have provided for a reduction in resale rates for the period covering July 1985 through December 1986. On February 6, 1986, the company was informed by some of the resale customers that the tentative settlement was not acceptable. The company is currently awaiting further action on the part of the resale customers.

Generation
Fuel Mix
(percent)



FUEL MIX

In 1985 generation from coal, nuclear and oil sources was 65%, 15% and 20% respectively. Nuclear generation increased 29% due to higher availability of nuclear units. The effective customer fuel cost, which includes fuel, interchange and purchased power costs, remained low at 1.94¢/kWh in 1985 and was 1.96¢/kWh in 1984 and 1983.

Operating Expenses

Other operation and maintenance expenses have increased since 1983 primarily as a result of higher payroll and associated benefits, the higher cost of jointly-owned nuclear generating units, and increased steam service expenses, which are billed and reflected in steam revenues. The 1985 increases were partially offset by an additional $2.5 million amortization of the credit arising from the sale of contracts (Summit), which resulted from an out-of-court tax settlement.

During 1984, both Salem Units #1 and #2 were removed from service due to electric generator failures. Salem Unit #1 was returned to service in October 1984 and Unit #2 was returned to service in April 1985. There was an extended outage at Peach Bottom #2 from April 1984 to July 1985 due to piping replacement. Peach Bottom #3 was removed from service in July 1985 for refueling and a piping inspection and is anticipated to begin operating again by the end of the first quarter of 1986.

Impact of Inflation

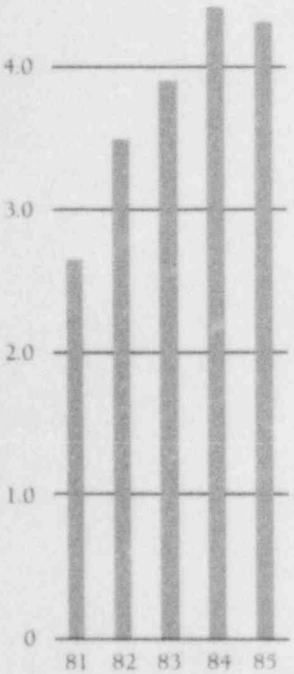
Supplementary unaudited financial information showing the estimated effects of inflation on the company's operations is shown in Note 12 of the Financial Statements. This data should be viewed as estimates of the approximate effects of inflation, rather than as precise measures.

Liquidity and Capital Resources

Financing and Capitalization

The company is committed to maintaining its financial strength and flexibility and believes that it is important to have a strong capital structure. The company's financial strength is evidenced by its continuing high ratio of earnings to fixed charges, which was 4.3 in 1985. The company's financial flexibility was demonstrated through the refinancing of $41.9 million of preferred stock with long-term debt. This refinancing will reduce the company's cost of capital and will enhance the company's ability to issue additional preferred stock in subsequent years, if necessary.

Ratio of Earnings to Fixed Interest Charges
(SEC method)



In December 1985, the company temporarily borrowed $55 million to redeem 100% of the company's 12.56% preferred stock series and approximately 68% of its 9% preferred stock series; the remaining funds were used to retire $10 million of 3½% Series First Mortgage and Collateral Trust Bonds. In January 1986 the company issued $60 million of 10¼% Series First Mortgage and Collateral Trust Bonds, which mature in January 2016. The proceeds from the bond issuance were used to repay the $55 million bank loan, with the balance being applied to general corporate cash requirements.

Due to continued improvements in cash flow, and to control the increasing equity position, the company further modified its Dividend Reinvestment and Common Share Purchase Plan (DRIP). Effective January 1985, all reinvested dividends are being used to purchase shares on the open market.

During 1985 Standard & Poor's increased the company's preferred stock credit rating from A+ to AA−. Credit ratings on the company's first mortgage bonds remained at a high level in 1985, due to the company's continued strong financial performance. The company's bond rating is the equivalent of a strong AA in the language of the different raters.

FINANCING AND CAPITALIZATION (CONTINUED)

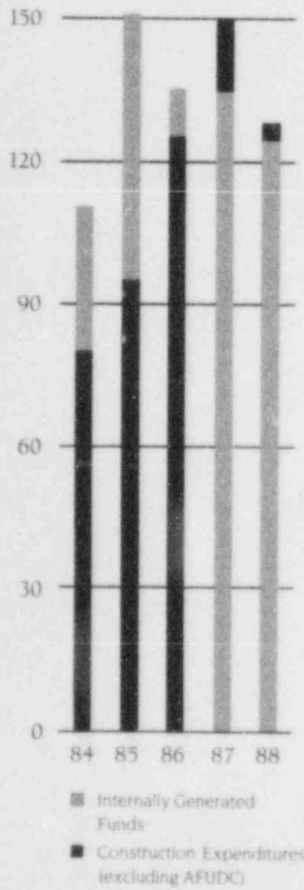
In September 1985, the company issued, through the Delaware Economic Development Authority, $33.5 million of Variable Rate Demand Exempt Facilities Revenue Bonds--Series 1985. The proceeds were primarily used to refinance $33 million of tax-exempt revenue notes, classified as a term loan agreement as of December 31, 1984.

During 1985, Delmarva Capital Investments, Inc., a subsidiary, borrowed $25 million and invested the proceeds in satellite and aircraft leveraged leases. See the related discussion under "Liquidity."

CAPITAL AND CONSTRUCTION REQUIREMENTS

For the period 1983-1985, the company had total capital requirements of $493 million, including $250 million for construction (excluding AFUDC). During the same period, $379 million was generated internally which represents 77% of the capital requirements and 151% of the construction requirements. Capital requirements for the period 1986-1988 are estimated to be $474 million, including $404 million for construction (excluding AFUDC). The company presently anticipates that, for the period 1986-1988, internally generated funds will be $396 million which equals 84% of the total capital requirements and 98% of its construction requirements. The higher level of estimated construction expenditures during 1986-1988 in comparison to 1983-1985 results from the company's plans to build a computer center, increased investment in environmental protection facilities and upgrading of various facilities. Actual construction expenditures may vary from the above estimates due to, among other factors, the rate of inflation, regulation and legislation, rates of load growth, licensing and construction delays, results of rate proceedings, and the cost and availability of capital.

Construction Expenditures and Internally Generated Funds
(millions of dollars)



The company estimates that its annual energy and peak load growth for the next 10 years will be at a rate of 1.84% and 0.6%, respectively. The company's present generating capacity of 2,277 megawatts provides a reserve of 27% against its company peak of 1,795 megawatts experienced in the summer of 1985. In 1984 the company peak was 1,624 megawatts. Although the company continues to plan for new generation, it is actively considering alternatives to a central power station due to the high cost of building a new power plant. The company has a goal to develop a plan to delay, by at least five years, the in-service date of its next generation unit which is currently scheduled for the mid 1990's. The company continues to be committed to maintaining a high degree of flexibility as long as possible in its planning to meet future capacity requirements.

The company has the ability to issue commercial paper supported by adequate lines of credit to meet fluctuations in working capital requirements as well as the interim financing necessary for construction projects. The company has lines of credit with banks in the amount of $44.5 million. These lines are available for bank loans and to secure commercial paper borrowings as the need arises. At December 31, 1985, the company had no commercial paper outstanding.

Report of Management on the Financial Statements

Liquidity

The company's liquidity is affected principally by the construction program and, to a lesser degree, by other capital requirements such as maturing debt and sinking fund requirements. As a result of lower construction expenditures and improved financial condition, financial investments increased from $27.6 million in 1984 to $72 million in 1985 with no short term debt outstanding at the end of either year.

In order to utilize cash generated from ongoing operations beyond construction requirements, the company has invested in both energy related and financial opportunities. During 1985, the company invested $32.1 million of equity capital in a wholly-owned subsidiary, Delmarva Capital Investments, Inc., which has arranged borrowings and generated cash internally to provide an investment portfolio of $71.6 million. On December 31, 1985, these investments included $34.6 million in marketable securities, $9.8 million in a Boeing 747 aircraft lease and $27.2 million in satellite leases with GTE Corporation and RCA Corporation, both of which are currently in operation. These investments are designed to provide yields higher than those earned on the company's utility business.

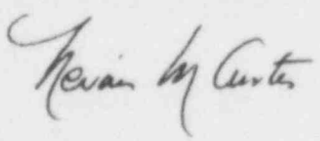
Report of Management

The consolidated financial statements of Delmarva Power & Light Company have been prepared by company personnel in conformity with generally accepted accounting principles, based upon currently available facts and circumstances and management's best estimates and judgements of the expected effects of events and transactions. It is the responsibility of management to assure the integrity and objectivity of such financial statements and to assure that these statements fairly report the financial position of the company and the results of its operations.

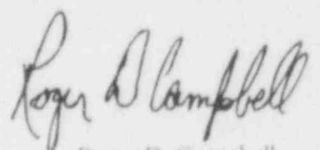
Delmarva Power & Light Company maintains a system of internal controls designed to provide reasonable, but not absolute, assurance of the reliability of the financial records and the protection of assets. The internal control system is supported by written administrative policies, a program of internal audits, and procedures to assure the selection and training of qualified personnel.

These financial statements have been examined by Coopers & Lybrand, independent certified public accountants. Their examination was conducted in accordance with generally accepted auditing standards which include a review of internal accounting controls to determine the nature, timing and extent of auditing procedures, as well as such other procedures they deem necessary to produce reasonable assurance as to the fairness of the company's financial statements and to enable them to express an opinion thereon.

The audit committee of the Board of Directors, composed of outside Directors only, meets with management, internal auditors and the independent accountants to review accounting, auditing and financial reporting matters. The independent accountants are appointed by the Board on recommendation of the audit committee, subject to shareholder approval.



Nevius M. Curtis
Chairman of the Board and
Chief Executive Officer



Roger D. Campbell
Vice President, Treasurer and
Chief Financial Officer

Quarterly Common Stock Dividends and Price Ranges

Common Stock

The company's common stock is listed on the New York and Philadelphia Stock Exchanges and has unlisted trading privileges on the Cincinnati, Midwest and Pacific Stock Exchanges.

The company had 58,824 holders of common stock as of December 31, 1985.

The company's Certificate of Incorporation and the Mortgage and Deed of Trust securing the company's outstanding bonds contain restrictions on the payment of dividends on common stock which would become applicable if its capital and retained earnings fall below certain specified levels or if preferred stock dividends become in arrears.

The retained earnings available for dividends on common stock as of December 31, 1985 were approximately $143,810,000 under the most restrictive of these provisions.

	1985			1984		
	Dividend Declared	Price		Dividend Declared	Price	
		High	Low		High	Low
First Quarter	$.48	23 7/8	21	$.45	19 3/8	17 3/8
Second Quarter	.48	26 1/2	22 7/8	.45	18 3/8	17 1/4
Third Quarter	.48	26 3/8	22 3/4	.45	20 7/8	17 3/4
Fourth Quarter	.505	28 1/4	22 5/8	.48	22 3/8	20 1/8

Report of Independent Certified Public Accountants

To the Board of Directors and Stockholders
Delmarva Power & Light Company
Wilmington, Delaware

We have examined the consolidated balance sheets and statements of capitalization of Delmarva Power & Light Company as of December 31, 1985 and 1984, and the related consolidated statements of income, changes in common stockholders' equity and sources of funds for construction expenditures 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, the financial statements referred to above present fairly the consolidated financial position of Delmarva Power & Light Company at December 31, 1985 and 1984 and the consolidated results of their operations and sources of funds for construction expenditures 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.

Coopers & Lybrand

1900 Three Mellon Bank Center
Philadelphia, Pennsylvania
February 7, 1986

Consolidated Statements of Income

(Dollars in Thousands)

For the Years Ended December 31		1985	1984	1983
Operating Revenues	Electric	$ 605,581	$ 584,163	$ 542,252
	Gas	95,256	101,578	94,358
	Steam	21,997	16,852	13,189
		722,834	702,593	649,799
Operating Expenses	Operation:			
	Fuel for electric generation	240,901	278,474	275,117
	Net interchange and purchased power	(63,962)	(108,011)	(108,654)
	Purchased gas	69,847	74,082	72,475
	Deferred energy costs	(2,549)	(2,345)	(24,507)
	Other operation	121,105	108,001	107,496
	Maintenance	59,406	56,752	53,781
	Depreciation	53,981	53,702	49,596
	Taxes on income	77,836	77,577	67,584
	Taxes other than income	30,754	31,152	27,773
		587,319	569,384	520,661
Operating Income		135,515	133,209	129,138
Other Income	Allowance for other funds used during construction	2,428	2,780	2,447
	Other, net	6,382	3,243	2,440
		8,810	6,023	4,887
Income Before Interest Charges		144,325	139,232	134,025
Interest Charges	Long-term debt	47,236	45,815	45,697
	Short-term debt and other	1,059	2,090	3,999
	Allowance for borrowed funds used during construction	(608)	(783)	(734)
		47,687	47,122	48,962
Earnings	Net Income	96,638	92,110	85,063
	Dividends on preferred stock	12,599	12,662	12,818
	Earnings applicable to common stock	$ 84,039	$ 79,448	$ 72,245
Common Stock	Average shares outstanding (thousands)	30,482	30,248	29,541
	Earnings per average share	$ 2.76	$ 2.63	$ 2.45
	Dividends declared per share	$ 1.945	$ 1.83	$ 1.68

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Sources of Funds for Construction Expenditures

(Dollars in Thousands)

	For the Years Ended December 31	1985	1984	1983
Sources of Funds	Provided from operations:			
	Net Income	$ 96,638	$ 92,110	$ 85,063
	Less—Preferred dividends declared	12,599	12,662	12,818
	—Common dividends declared	59,287	55,361	49,668
	Earnings reinvested during the year	24,752	24,087	22,577
	Items not requiring (providing) funds:			
	Depreciation	61,183	58,464	56,599
	Amortization of credit arising from sale of contracts	(7,202)	(4,762)	(7,003)
	Amortization of nuclear fuel	6,594	2,071	2,394
	Allowance for funds used during construction	(3,036)	(3,563)	(3,181)
	Investment tax credit adjustments, net	21,878	2,253	3,495
	Deferred income taxes, net	47,462	31,935	42,701
	Income from leveraged leases	(2,307)	—	—
	Loss on uranium mine advances	2,025	—	—
	Funds provided from operations	151,349	110,485	117,582
	External financing:			
	Long-term debt:			
	Variable rate demand series	33,500	15,500	—
	Term loan	(33,000)	(5,500)	15,500
	Other long-term debt	80,000	—	—
	Common stock	—	11,921	12,863
	Redemption of long-term debt	(10,100)	(10,100)	(40,100)
	Redemption of preferred stock	(44,387)	(1,418)	(617)
	Externally financed funds	26,013	10,403	(12,354)
	Other sources (uses):			
	Decrease (increase) in working capital*	(65,809)	(29,557)	(17,709)
	Construction funds held by trustee	6,392	(4,933)	(1,041)
	Investment in leveraged leases	(36,959)	—	—
	Refundable taxes and interest	32,322	(2,188)	(2,603)
	Credit arising from sale of contracts	(4,690)	(926)	850
	Other, net	(13,695)	(3,796)	(8,669)
	Other sources (uses)	(82,439)	(41,400)	(29,172)
Construction Expenditures	(excluding allowance for funds used during construction)	$ 94,923	$ 79,488	$ 76,056
Decrease (increase) in working capital*	Marketable securities	$(32,308)	$(19,754)	$(4,314)
	Accounts receivable	33	(3,050)	(7,586)
	Deferred fuel costs, net	(2,537)	(1,831)	(23,126)
	Inventories	13,997	(15,114)	5,428
	Refundable taxes and interest	(35,303)	—	—
	Accounts payable	6,885	(5,865)	7,993
	Taxes accrued	(4,455)	6,842	(4,488)
	Interest accrued	2,532	908	(1,016)
	Other, net	(14,653)	8,307	9,400
	Total	$(65,809)	$(29,557)	$(17,709)

*Other than long-term debt due and preferred stock redeemable within one year and current deferred income taxes.

See accompanying Notes to Consolidated Financial Statements.

Consolidated Balance Sheets

(Dollars in Thousands)

Assets	As of December 31	1985	1984
Utility Plant— at original cost	Electric	$1,624,881	$ 1,555,174
	Gas	90,956	83,104
	Steam	24,389	24,143
	Common	80,541	71,391
		1,820,767	1,733,812
	Less: Accumulated depreciation	535,873	488,987
	Net utility plant in service	1,284,894	1,244,825
	Plant held for future use	15,297	15,022
	Construction work in progress	33,184	36,372
	Nuclear fuel, at amortized cost	19,796	24,955
		1,353,171	1,321,174
Nonutility Property and Other Investments	Net nonutility property, at cost	34,805	5,385
	Construction funds held by trustee	9,186	15,578
		43,991	20,963
Current Assets	Cash	17,408	16,673
	Marketable securities, at cost	59,956	27,648
	Accounts receivable:		
	Customers	49,037	48,839
	Other	24,337	24,568
	Inventories, at average cost:		
	Fuel (coal, oil and gas)	55,694	68,364
	Materials and supplies	20,648	21,975
	Prepayments	4,236	3,776
	Deferred fuel costs, net	1,488	(1,049)
	Refundable taxes and interest	35,303	—
		268,107	210,794
Deferred Charges and Other Assets	Refundable taxes and interest	—	32,322
	Unamortized debt expense	5,368	4,827
	Other	4,133	1,550
		9,501	38,699
	Total	$ 1,674,770	$1,591,630

See accompanying Notes to Consolidated Financial Statements.

Consolidated Balance Sheets

(Dollars in Thousands)

	As of December 31	1985	1984
Capitalization And Liabilities			
Capitalization (see Statements of Capitalization)	Common stock	$ 102,876	$ 102,876
	Additional paid-in capital	235,798	235,473
	Retained earnings	223,137	201,301
	Total common stockholders' equity	561,811	539,650
	Preferred stock:		
	Without mandatory redemption	105,000	105,000
	With mandatory redemption	5,192	47,036
	Long-term debt	637,940	557,661
		1,309,943	1,249,347
Current Liabilities	Long-term debt due and preferred stock redeemable within one year	950	10,900
	Accounts payable	33,129	26,244
	Taxes accrued	16,181	20,636
	Interest accrued	22,729	20,197
	Dividends declared	15,393	14,631
	Nuclear fuel disposal costs	—	10,888
	Deferred income taxes, net	755	(1,661)
	Other	10,440	15,026
		99,577	116,861
Deferred Credits And Other Liabilities	Credit arising from sale of contracts	16,057	27,949
	Deferred income taxes, net	174,746	128,444
	Deferred investment tax credits	70,416	65,386
	Other	4,031	3,643
		265,250	225,422
Other	Commitments and Contingencies (Notes 6 and 10)		
	Total	$1,674,770	$1,591,630

See accompanying Notes to Consolidated Financial Statements

Consolidated Statements of Capitalization

(Dollars in Thousands)

	As of December 31	1985		1984	
Common Stockholders' Equity	Common stock, par value $3.375 per share authorized 35,000,000 shares, outstanding 30,481,925 shares	$ 102,876		$ 102,876	
	Additional paid-in capital	235,798		235,473	
	Retained earnings	223,137		201,301	
	Total Common Stockholders' Equity	561,811	43%	539,650	43%
Cumulative Preferred Stock	Par value $25 per share, 3,000,000 shares authorized, none outstanding				
	Par value $100 per share, 1,800,000 shares authorized				
	Without Mandatory Redemption:				
	Series / Shares Issued				
	3.70%-4.56% / 240,000	24,000		24,000	
	5.00%-7.84% / 330,000	33,000		33,000	
	7.88%-8.96% / 480,000	48,000		48,000	
	Preferred Stock without Mandatory Redemption	105,000	8%	105,000	8%
	With Mandatory Redemption:				
	9.00% Series* / 59,916 and 192,000 shares	5,992		19,200	
	12.56% Series / 0 and 300,000 shares	—		30,000	
		5,992		49,200	
	Less: Reacquired preferred shares held in treasury (at cost)	—		1,364	
		5,992	0%	47,836	4%
	Less: Amount to be redeemed within one year	800		800	
	Preferred Stock with Mandatory Redemption	5,192		47,036	
Long-Term Debt	First Mortgage and Collateral Trust Bonds:				
	Maturity / Interest Rates				
	Dec. 1, 1985 / 3½%	—		10,000	
	Jun. 1, 1988 / 3⅞%	25,000		25,000	
	1994-1997 / 4⅞%-6⅛%	50,000		50,000	
	1998-2002 / 7%-11½%	158,100		158,100	
	2003-2007 / 6.6%-11%	121,250		121,250	
	2008-2011 / 9⅝%-12%	111,900		111,900	
		466,250		476,250	
	Pollution Control Notes:				
	Series, 1973 5.7% effective rate, due 1986-1998	7,700		7,800	
	Series, 1976 7.3% effective rate, due 1992-2006	34,500		34,500	
		42,200		42,300	
	Variable Rate Demand Series, due 2014-2015	49,000		15,500	
	Other Long-Term Debt	80,000		—	
	Term Loan	—		33,000	
	Unamortized premium and discount, net	640		711	
		638,090	49%	567,761	45%
	Long-term debt due within one year	(150)		(10,100)	
	Total Long-Term Debt	637,940		557,661	
	Total Capitalization	$1,309,943	100%	$1,249,347	100%

*Redemption price at December 31, 1985 is $107. See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Changes in Common Stockholders' Equity

(Dollars in Thousands)

For the Three Years Ended December 31, 1985	Common Shares	Par Value	Additional Paid-in Capital	Retained Earnings	Total
Balance as of January 1, 1983	29,048,445	$ 98,039	$215,397	$154,637	$468,073
Net income				85,063	85,063
Cash dividends declared					
Common stock ($1.68)				(49,668)	(49,668)
Preferred stock				(12,818)	(12,818)
Issuance of common stock:					
Dividend Reinvestment and Common Share Purchase Plan	792,737	2,675	10,526		13,201
Common stock expense			(338)		(338)
Balance as of December 31, 1983	29,841,182	100,714	225,585	177,214	503,513
Net income				92,110	92,110
Cash dividends declared					
Common stock ($1.83)				(55,361)	(55,361)
Preferred stock				(12,662)	(12,662)
Issuance of common stock:					
Dividend Reinvestment and Common Share Purchase Plan	640,743	2,162	9,888		12,050
Gain on retirement of preferred stock			125		125
Common stock expense			(125)		(125)
Balance as of December 31, 1984	30,481,925	102,876	235,473	201,301	539,650
Net income				96,638	96,638
Cash dividends declared					
Common stock ($1.945)				(59,287)	(59,287)
Preferred stock				(12,599)	(12,599)
Net loss on retirement of preferred stock			325	(2,916)	(2,591)
Balance as of December 31, 1985	30,481,925	$102,876	$235,798	$223,137	$561,811

See accompanying Notes to Consolidated Financial Statements.

1. Significant Accounting Policies

Financial Statements

The consolidated financial statements include the accounts of the company and its totally-held subsidiaries, Delmarva Energy Company, Delmarva Industries Inc., and Delmarva Capital Investments, Inc. and its subsidiaries. In conformity with generally accepted accounting principles, the accounting policies reflect the economic effects of rate decisions issued by regulatory commissions having jurisdiction over the company.

Certain reclassifications, not affecting income, have been made to amounts reported in prior years to conform to the presentations used in 1985.

Revenues

Revenues are recorded at the time billings are rendered to customers on a monthly cycle basis and include rate increases permitted to be billed subject to refund pending final approval. At the end of each month, there is an amount of unbilled electric and gas service which has been rendered from the last meter reading to the month-end.

Fuel Costs

Fuel costs (electric and gas) are deferred and charged to operations on the basis of fuel costs included in customer billings under the company's tariffs, which are subject to periodic regulatory review and approval.

Depreciation and Maintenance

The annual provision for depreciation is computed on the straight-line basis using composite rates by classes of depreciable property. Provision for the costs of decommissioning of nuclear plant is made to the extent of the net cost of removal allowed for rate purposes (approximately 20% of plant cost). The relationship of the annual provision for depreciation for financial accounting purposes to average depreciable property was 3.6% for 1985 and 3.4% for 1984 and 1983.

The cost of maintenance and repairs, including renewals of minor items of property, is charged to operating expenses. A replacement of a unit of property is accounted for as an addition to and a retirement from utility plant. The original cost of the property retired is charged to accumulated depreciation together with the net cost of removal. For income tax purposes, the cost of removing retired property is deducted as an expense.

Nuclear Fuel

The company's share of nuclear fuel costs relating to jointly-owned nuclear generating stations is charged to fuel expense on a unit of production basis, which includes a factor for spent nuclear fuel disposal costs pursuant to the Nuclear Waste Policy Act of 1982. The company is collecting future storage and disposal costs for spent fuel as authorized by the regulatory commissions in each jurisdiction and is paying such amounts quarterly to the Department of Energy.

Income Taxes

Deferred income taxes result from timing differences in the recognition of certain income and expenses for tax and financial accounting purposes. The principal items accounting for deferred income taxes are: (1) use of the Accelerated Cost Recovery System and other accelerated depreciation methods for income tax purposes, (2) deferred fuel and gas production costs deducted currently for income tax purposes, and (3) other timing differences involving the capitalization of certain taxes and overhead costs.

Investment tax credits utilized to reduce federal income taxes are deferred and generally amortized over the useful lives of the related utility plant. Additional tax credits in 1983, 1984 and 1985 related to an Employee Stock Ownership Plan do not affect net income and are recorded as liabilities until the contribution is made to the Plan.

Allowance for Funds Used During Construction

Allowance for funds used during construction (AFUDC) is a non-cash item and is defined in the regulatory system of accounts as the "net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds so used." AFUDC is segregated into two components: (1) the interest on debt component ("allowance for borrowed funds used during construction"), which is net of taxes and classified as a credit to interest charges, and (2) the common stock equity and preferred dividend component ("allowance for other funds used during construction"), which is classified as an item of other income. AFUDC is considered a cost of utility plant with a concurrent credit to income. It is excluded from taxable income for tax purposes. The rates used in determining AFUDC, which includes semi-annual compounding, were 9.2% in 1985, 9.0% in 1984 and 7.8% in 1983.

2. Taxes on Income

Income tax expense for 1985, 1984 and 1983 is as follows:

(Dollars in Thousands)

	1985	1984	1983
Operations:			
Federal: Current	$32,557	$36,131	$16,557
Deferred	28,638	27,380	36,654
State: Current	6,320	6,560	4,345
Deferred	4,978	4,555	6,047
Investment tax credit adjustments, net	5,343	2,951	3,981
Other income: Current	(29,788)	1,528	816
Deferred	13,846	—	—
Investment tax credit adjustments, net	12,608	—	—
Total	$74,502	$79,105	$68,400

Investment tax credits utilized to reduce federal income taxes payable amounted to $24,992,000 in 1985, $6,890,000 in 1984 and $7,654,000 in 1983. The amounts for 1985, 1984 and 1983 include Employee Stock Ownership Plan credits of $535,000, $707,000 and $360,000, respectively.

2. TAXES ON INCOME (continued)

The following is a reconciliation of the difference between income tax expense and the amount computed by multiplying income before tax by the federal statutory rate:

(Dollars in Thousands)

	1985		1984		1983	
	Amount	Rate	Amount	Rate	Amount	Rate
Statutory income tax expense	$78,725	46%	$78,758	46%	$70,594	46%
Increase (Decrease) in taxes resulting from:						
Exclusion of AFUDC for income tax purposes	(1,397)	(1)	(1,639)	(1)	(1,463)	(1)
Depreciation not normalized	5,026	3	2,490	1	(171)	—
ITC amortized to income	(7,041)	(4)	(3,939)	(2)	(3,673)	(2)
State income taxes, net of federal tax benefit	6,031	4	6,067	3	5,682	4
Amortization of credit arising from sale of contracts	(3,313)	(2)	(2,190)	(1)	(3,221)	(2)
Other, net	(3,529)	(2)	(442)	—	652	—
Income tax expense	$74,502	44%	$79,105	46%	68,400	43%

The components of deferred income taxes relate to the following tax effects of timing differences between book and tax income:

(Dollars in Thousands)

	1985	1984	1983
Depreciation	$33,394	$18,887	$19,251
Deferred energy costs	1,163	954	12,480
Capitalized overhead costs	1,432	1,508	1,648
Nuclear fuel disposal costs	—	—	5,675
Pollution control amortization	3,629	3,687	3,548
ADR repair allowance	4,295	4,863	—
Other, net	3,549	2,036	99
Total	$47,462	$31,935	$42,701

The company has not provided deferred income taxes of approximately $123 million on cumulative timing differences arising before the adoption of full tax normalization for ratemaking purposes by the regulatory authorities. The company is currently collecting the unnormalized taxes in its Delaware and resale electric rate jurisdictions, and in the gas jurisdiction on a levelized basis, over the life of the related plant facilities. For the other jurisdictions, it is anticipated that the amounts will be recovered for rate purposes when paid.

The company's federal income tax returns have been examined for the years 1975 through 1981. During 1985, the company reached a stipulated Tax Court settlement with the government regarding the taxation of the proceeds from the sale of contracts for a nuclear steam supply system (Summit). Pursuant to the decision, the net proceeds are taxable at a rate that approximates a capital gains tax rate, which resulted in a federal and state tax liability and interest of approximately $35.1 million, principally paid in prior years. As of December 31, 1985, approximately $15.4 million of net federal and state taxes and interest are refundable to the company resulting from the reversal of the previous tax treatment applied to the sale of the contracts. As more fully discussed in Note 7, the net proceeds, which were classified as a deferred credit on the balance sheet, are being amortized. The Tax Court decision and resulting adjustment to the deferred credit did not have a material effect on the company's financial position or results of operations.

(Dollars in Thousands)

3. Taxes Other Than Income

	1985	1984	1983
Delaware utility	$12,168	$13,732	$12,341
Property	6,784	6,652	6,483
Other gross receipts	5,799	4,995	4,149
Payroll, franchise and other	6,003	5,773	4,800
Total	$30,754	$31,152	$27,773

4. Pension Plan and Post-Retirement Benefits

The company has a trusteed noncontributory pension plan covering all regular employees. Pension contributions for 1985, 1984 and 1983 were $3,284,000, $2,354,000 and $4,400,00, respectively. The contributions provide for normal cost and amortization of prior service costs over periods of five to twenty-five years.

The actuarial present value of accumulated plan benefits, determined as of January 1, 1985, was $94,410,000 for vested benefits and $15,638,000 for accrued nonvested benefits. The market value of net assets, at that date, available for plan benefits were $201,398,000. The actuarial present value of accumulated plan benefits, determined as of January 1, 1984 was $80,311,000 for vested benefits and $13,816,000 for accrued nonvested benefits. The market value of net assets, at that date, available for plan benefits were $191,062,000. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8.0% for 1985 and 1984.

The company provides certain health care and life insurance benefits for retired employees. Substantially all of the company's employees may become eligible for these benefits if they reach normal retirement age while still working for the company. The company recognizes the cost of providing those benefits by expensing the insurance claims as they are paid. These costs totalled $2,094,000, $1,640,000 and $2,075,000 for 1985, 1984 and 1983, respectively.

5. Capitalization

Retained Earnings

The current first mortgage bond indenture restricts the amount of consolidated retained earnings available for cash dividend payments on common stock to $35,000,000 plus accumulations after June 30, 1978, which available amount at December 31, 1985 was approximately $143,810,000.

Preferred Stock

The annual preferred dividend requirements on all outstanding preferred stock at December 31, 1985 are $7,761,000. If preferred dividends are in arrears the company may not declare common stock dividends or acquire its common stock.

Without Mandatory Redemption

These series may be redeemed at the option of the company at any time, in whole or in part, at the various redemption prices fixed for each series (ranging from $103 to $106 at December 31, 1985).

With Mandatory Redemption

(1) The company redeemed 15,900 shares of the 9% series in December 1985 at $100 per share. Eight thousand of the 15,900 shares were required to be redeemed by the sinking fund and the remaining 7,900 shares were redeemed under an option of the sinking fund. Through a tender offer for the 9% series the company purchased, at $103 per share, 99,834 shares in December 1985 and 3,150 shares in January 1986. (2) The 300,000 shares of the 12.56% series were called and purchased by the company at $108.38 in December 1985. (3) Under certain conditions the 9% series may also be redeemed at the option of the company. (4) Mandatory sinking fund redemptions are $800,000 per year during the next five years. As of December 31, 1985, all shares previously held in the Treasury were retired.

Long-Term Debt

(1) Sinking fund provisions with respect to substantially all issues of the First Mortgage and Collateral Trust Bonds require that there be deposited annually with the Trustee cash equal to one percent (1%) of the greatest aggregate principal amount at any one time outstanding. There shall be credited against such cash requirements (a) an amount not exceeding sixty percent (60%) of the bondable value of property additions which the company then elects to make the basis of this credit, and (b) the aggregate principal amount of bonds which might then be made the basis of the authentication and delivery of bonds and which the company then elects to make the basis of this credit. For the years 1983-1985, the company elected to certify property additions to satisfy its sinking fund requirements equal to 1% of each series as permitted by the indenture. (2) Substantially all utility plant of the company now or hereafter owned is subject to the lien of the related Mortgage and Deed of Trust. (3) Pursuant to a bank loan agreement the company has a $33,000,000 revolving credit commitment through November 1, 1989, convertible into a term loan due November 1, 1992. The loan agreement requires a commitment fee of 1/2% on any unused portion of the revolving credit commitment and term loans may be prepaid at any time without penalty and would bear interest at 100% of the prime rate. (4) On September 26, 1985, the company issued, through the Delaware Economic Development Authority, $33,500,000 of Variable Rate Demand Exempt Facilities Revenue Bonds—Series 1985 (Variable Rate Demand Series 1985), due September 1, 2015. The proceeds were primarily used to refinance $33,000,000 of tax-exempt revenue notes. This series was collateralized with $37,000,000 First Mortgage Bonds due September 1, 2015, which secure repayment of principal and accrued interest. The interest rates on the Variable Rate Demand Series 1985, by election of the company, are subject to change daily, weekly, or under specified conditions, annually, on the basis of prevailing rates. The Variable Rate Demand Series 1985 and the $15,500,000 Variable Rate Demand Gas Facilities Revenue Bonds-Series 1984 have put options for the bondholders whereby the bonds can be presented for payment at specified times. The bonds can be sold by the remarketing agent. The company has sufficient long-term financing arrangements available to redeem any bonds not remarketed. In recognition of the long-term financing capability, both the 1985 and 1984 series of these bonds have been classified as long-term debt. (5) During 1985, a subsidiary of Delmarva Capital Investments, Inc. entered into a loan agreement to borrow up to $25,000,000 at a rate of 10%. The loan matures on February 19, 1989 and may be prepaid at anytime, in some instances subject to a penalty. At December 31, 1985, $25,000,000 was outstanding under this agreement. (6) During December 1985 the company temporarily borrowed $55,000,000 from a bank in order to redeem $44,711,000 of preferred stock (including acquisition costs) and retire $10 million of 3 1/2% Series First Mortgage and Collateral Trust Bonds. On January 15, 1986,

Long-Term Debt (continued)

the company issued $60,000,000 of 10¼% Series First Mortgage and Collateral Trust Bonds, due January 1, 2016. The proceeds from the bond issuance were used to repay the $55,000,000 bank loan in January 1986, with the balance being applied to general corporate cash requirements. As of December 31, 1985, the bank loan was classified as long-term debt in recognition of refinancing the loan through issuance of the bonds. (7) Maturities of long-term debt during the next five years are 1986—$150,000; 1987—$150,000; 1988—$25,150,000; 1989—$25,150,000; 1990—$150,000. (8) The annual interest requirements on all borrowings classified as long-term debt at December 31, 1985 are $55,355,000.

Unamortized Debt Discount, Premium and Expense

These amounts are amortized on a straight-line basis over the lives of the long-term debt issues to which they pertain.

6. Commitments

The company estimates that approximately $125,689,000, excluding AFUDC, will be expended for construction purposes in 1986. The company also has commitments under long-term fuel supply contracts.

Under SFAS No. 71, regulated industries were required to adopt the lease accounting requirements of SFAS No. 13 for all capital leases commencing on or after January 1, 1983. The company's capital leases commencing after January 1, 1983, were not material and, therefore, were not recorded. All capital leases, including leases commencing prior to January 1983, were treated as operating leases. However, if capital leases had been recorded on the balance sheet, related assets and liabilities would have increased by $8,609,000 and $13,324,000 at December 31, 1985 and 1984, respectively.

Minimum commitments as of December 31, 1985 under all non-cancellable lease agreements are as follows:

1986	$ 4,202,000
1987	3,203,000
1988	2,503,000
1989	1,003,000
1990	507,000
Remainder	3,642,000
Total	$15,060,000

The total minimum rental commitments are applicable to the following types of property: railroad coal cars, $1,387,000; distribution facilities, $4,792,000; other, principally transportation and computer equipment, $8,881,000. Rentals charged to operating expenses aggregated $6,634,000 in 1985, $6,213,000 in 1984 and $6,677,000 in 1983.

Nuclear fuel requirements for Peach Bottom Generating Station are being provided by the operating company through a fuel purchase contract. The company is responsible for payment of its share of fuel consumed and interest expense. Nuclear fuel expense totalled $4,520,000 in 1985, $6,072,000 in 1984 and $4,283,000 in 1983.

6. Commitments (continued)

The company has an agreement providing for the availability of fuel storage and pipeline facilities through 1999. Under the agreement, the company must make specified minimum payments monthly, which totaled $1,682,000 in 1985, $1,912,000 in 1984 and $2,101,000 in 1983. The amount of required payments is $2,060,000 in 1986, $1,749,000 in 1987, $1,206,000 in 1988, $1,056,000 in 1989, $812,000 in 1990 and $11,435,000 between 1991 and 1999.

7. Sale of Contracts for Nuclear Plant

The proceeds received by the company for the sale in 1975 of the contracts for a nuclear steam supply system (Summit) and related fuel, net of related plant expenditures which are considered of no future value to the company, are classified as a deferred credit in the balance sheet. The credit has been reduced by applicable income taxes and related interest (See Note 2). The company has obtained regulatory approval for this accounting treatment. As a result of ratemaking orders commencing in 1982, the company is amortizing the net credit in all retail jurisdictions over approximately five years and is recording the credit for financial reporting purposes as a reduction in depreciation expense. Amounts amortized in 1985, 1984 and 1983 were $7,202,000, $4,762,000 and $7,003,000, respectively, which includes, in 1985 and 1983 amortization of $2,500,000 and $3,818,000 for the resale jurisdiction.

8. Short-Term Debt and Lines of Credit

As of December 31, 1985, the company had unused bank lines of credit of $44,500,000 and is generally required to pay commitment fees for these lines. Such lines of credit are periodically reviewed by the company, at which time they may be renewed or cancelled.

9. Jointly-Owned Plant

Information with respect to the company's share of jointly-owned plant, including nuclear fuel for the Salem plant, as of December 31, 1985 is as follows:

(Dollars in Thousands)

	Ownership Share	Plant in Service	Accumulated Depreciation	Construction Work in Progress
Nuclear:				
Peach Bottom	7.51%	$ 90,530	$26,384	$ 2,156
Salem	7.41%	190,486	52,820	11,381
Coal-Fired:				
Keystone	3.70%	10,701	4,158	1,199
Conemaugh	3.72%	13,699	5,430	165
Total		$305,416	$88,792	$14,901

The company provides its own financing for its share of improvements to jointly-owned plant. In addition, the company is a joint guarantor of loans ($760,000 proportionate share) advanced for operation of the coal mines that supply the Keystone plant. The company's share of operating and maintenance expenses of the jointly-owned plant is included in the corresponding expenses in the statements of income.

10. Contingencies

a) FERC Rate Case

In December 1985, the company reached a tentative settlement with all resale customers to refund $3.5 million, which would have reduced resale rates for the period covering July 1985 through December 1986. Accordingly, a revenue reserve of $1.2 million was established as of December 31, 1985. On February 6, 1986, the company was informed by some of the resale customers that the tentative settlement was not acceptable. The company is awaiting further action by the resale customers. In the opinion of management, the ultimate disposition of this matter will not have a material effect on the company's financial position or results of operations.

b) Plant Held for Future Use

In 1982,the company delayed the construction schedule for the coal-fired Nanticoke #1 (formerly Vienna #9) generating unit. The plant is now scheduled to begin commercial operation in the mid 1990's. The decision is based on the company's current load forecast, which indicates a lower rate of growth in the coming decade than had previously been projected. The net investment of $14,424,000 is classified as plant held for future use and is anticipated to be recoverable through the normal ratemaking process.

c) Nuclear Insurance

The company's insurance coverages applicable to its nuclear power units are as follows:

(Millions of Dollars)

Type and Source of Coverage	Maximum Coverage	Maximum Retrospective Assessment for a Single Incident
Public Liability:		
Private	$160	None
Price Anderson Assessment[1]	480	$1.5[2]
	$640[3]	
Property Damage:[4]		
Peach Bottom[5]	$585	—
Salem[6]	$585	$2.8
All units[7]	$525	$1.3
Replacement Power:		
Nuclear Electric Insurance Limited (NEIL)[8]	$3.0	$2.2

[1] 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. [2] Maximum assessment would be $3,000,000 in the event of more than one incident in any year. [3] Limit of liability under the Price-Anderson Act for each nuclear incident. [4] The company is a self insurer, to the extent of its ownership interest, for any property loss in excess of the stated amounts. [5] For property damage to the Peach Bottom nuclear plant facilities, the company and its co-owners have private insurance up to $585 million. [6] Nuclear Mutual Limited, a utility-owned mutual insurance company with which the company and the Salem nuclear facility co-owners are members. Maximum retrospective assessment is ten times annual premium with respect to loss at any nuclear generating station insured by the mutual insurance company. [7] All units are insured by Nuclear Electric Insurance Limited (NEIL II) for losses in excess of $500 million. Maximum retrospective assessment is seven and a half times the annual premiums. [8] Utility owned mutual insurance company with which the company is a member which provides coverage against extra expense incurred in obtaining replacement power during prolonged accidental outages of nuclear power units. Maximum weekly indemnity for 52 weeks which commences after the first 26 weeks of an outage. Also provides $1,300,000 weekly for an additional 52 weeks. Maximum retrospective assessment is five times annual premiums.

d) Other

The company is involved in certain other legal and administrative proceedings before various courts and governmental agencies concerning rates, environmental issues, fuel contracts and other matters. In the opinion of management, the ultimate disposition of these proceedings will not have a material effect on the company's financial position or results of operations.

11. SEGMENT INFORMATION

Segment information with respect to electric, gas and steam operations was as follows:
(Dollars in Thousands)

	1985	1984	1983
Operating Revenues:			
Electric	$ 605,581	$ 584,163	$ 542,252
Gas	95,256	101,578	94,358
Steam	21,997	16,852	13,189
Total	$ 722,834	$ 702,593	$ 649,799
Operating Income:			
Electric	$ 127,148	$ 125,200	$ 122,993
Gas	6,604	6,616	4,928
Steam	1,763	1,393	1,217
Total	$ 135,515	$ 133,209	$ 129,138
Utility Plant:(1)(2)			
Electric	$1,284,062	$1,257,728	$1,242,145
Gas	64,967	59,097	51,033
Steam	4,142	4,349	4,924
	1,353,171	1,321,174	1,298,102
Other Identifiable Assets:			
Electric	99,348	157,437	106,347
Gas	29,985	42,685	12,361
Steam	413	440	471
	129,746	200,562	119,179
Assets Not Allocated	191,853	69,894	115,982
Total Assets	$1,674,770	$1,591,630	$1,533,263
Depreciation Expense:(3)			
Electric	$ 56,577	$ 54,255	$ 52,530
Gas	3,699	3,310	3,173
Steam	907	899	896
Total	$ 61,183	$ 58,464	$ 56,599
Construction Expenditures:(4)			
Electric	$ 86,073	$ 69,233	$ 70,927
Gas	8,382	10,109	5,070
Steam	468	146	59
Total	$ 94,923	$ 79,488	$ 76,056

(1) Includes plant held for future use, construction work in progress and allocation of common utility property.
(2) Stated net of the respective accumulated provisions for depreciation.
(3) Excludes amortization of credit arising from sale of contracts.
(4) Excludes allowance for funds used during construction.

Operating income by segments is reported in accordance with generally accepted accounting and ratemaking principles within the utility industry and, accordingly, includes each segment's proportionate share of taxes on income and general corporate expenses.

12. SUPPLEMENTARY INFORMATION TO DISCLOSE THE EFFECTS OF CHANGING PRICES (UNAUDITED)

The following supplementary financial information, as prescribed by the Financial Accounting Standards Board in Statement No. 33, as amended, is supplied for the purpose of providing information about the effects of changing prices on the company's operations. The information should be viewed as an estimate of the approximate effect of inflation rather than as a precise measure.

Current cost amounts reflect the change in specific prices of plant from the date the plant was acquired to the present. The current cost of utility plant represents the estimated cost of replacing existing plant assets and was determined by indexing existing plant by the Handy-Whitman Index of Public Utility Construction Costs. Constant dollar amounts represent historical costs stated in terms of dollars of equal purchasing power, as measured by the Consumer Price Index for All Urban Consumers, and differ from current cost amounts to the extent that prices in general have increased more or less rapidly than specific prices.

Supplementary Financial Data Adjusted for the Effects of Changing Prices.
(Dollars in Thousands)

For the Year ended December 31,	Historical Cost	Current Cost (Average 1985 Dollars)
Operating Revenues	$722,834	$722,834
Operating Expenses:		
Operation and Maintenance	424,748	424,748
Depreciation	61,183	116,142
Amortization—Summit	(7,202)	(7,202)
Taxes	108,590	108,590
Other Income—Net	(8,810)	(8,810)
Interest Charges	47,687	47,687
Net Income[1]	$ 96,638	$ 41,679
Earnings per common share (after preferred dividend requirements)[2]	$ 2.76	$ 0.95
Increase in current cost of utility plant held during the year[3]		$ 26,308
Adjustment to net recoverable cost		61,394
Effect of increase in general price level		(79,549)
Excess of increase in current costs after adjustment to net recoverable cost over increase in general price level		8,153
Purchasing power gain on net amounts owed		21,441
Net		$ 29,594

(1) Including the adjustment to net recoverable cost, the income on a current cost basis for 1985 would have been $103,073.

(2) Excluding adjustment to net recoverable cost.

(3) At December 31, 1985, the current cost of net utility plant was $2,265,170 while historical cost was $1,353,171.

12. SUPPLEMENTARY INFORMATION (continued)

Supplementary Five-Year Comparison of Selected Financial Data Adjusted for the Effects of Changing Prices

(In Thousands[1] of Average 1985 Dollars)

For the Years ended December 31	1985	1984	1983	1982	1981
Operating revenues					
Historical cost dollars	$722,834	$702,593	$649,799	$636,666	$608,504
Constant dollars	722,834	727,428	701,626	709,560	719,750
Net income					
Current costs	41,679	49,331	34,128	25,065	17,774
Earnings per common share					
Current costs	.95	1.20	.72	.41	.12
Net assets at year end[2]					
Historical cost dollars	666,811	644,650	608,513	573,073	542,080
Current costs	655,619	656,467	646,006	631,478	620,455
Excess of increase in current costs over increase in general price level[3]	8,153	(10,515)	5,848	4,033	(71,210)
Purchasing power gain on net amounts owed	21,441	25,914	24,489	25,276	59,185
Cash dividends declared per common share					
Historical cost dollars	$ 1.945	$ 1.83	$ 1.68	$ 1.595	$ 1.535
Constant dollars	1.945	1.89	1.81	1.78	1.82
Market price per common share at year-end					
Historical cost dollars	27.88	22.00	19.25	16.38	12.63
Constant dollars	27.41	22.40	20.44	18.05	14.46
Average Consumer Price Index (1967 = 100)	322.2	311.2	298.4	289.1	272.4

[1] Except per share amounts.
[2] At net recoverable cost.
[3] After adjustment to net recoverable cost.

As required by Statement No. 33, the current provisions for depreciation on the current cost amounts of utility plant were determined by applying the company's depreciation rates to the indexed plant amounts, even though depreciation is limited to recovery of historical costs as further discussed below. Other operating expenses were either not required to be adjusted or were not adjusted due to rate-making considerations.

The company, by holding monetary assets such as cash and receivables, loses purchasing power during periods of inflation because these items can purchase less at a future date. Conversely, by holding monetary liabilities, primarily long-term debt, payments in the future will be made with dollars having less purchasing power. For the years 1981-1985, the company's monetary liabilities exceeded monetary assets which resulted in a purchasing power gain on net amounts owed during the year.

The rate regulatory process limits the company to the recovery of the historical cost of plant. Therefore, the excess of the cost of plant stated in terms of current cost over the historical cost of plant is not presently recoverable in rates as depreciation and is reflected as a reduction to net recoverable cost. Based on past practices, however, the company believes it will be allowed to earn on the increased cost of its facilities when replacement actually occurs.

12. SUPPLEMENTARY INFORMATION (continued)

Since the gain from the decline in purchasing power is attributable to long-term debt which has been used to finance utility plant, the reduction of utility plant to net recoverable amount is netted against the purchasing power gain on net amounts owed during the year.

13. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The quarterly data presented below reflect all adjustments necessary in the opinion of the company for a fair presentation of the interim results. Quarterly data normally vary seasonably with temperature variations, differences between summer and winter rates, the timing of rate orders and the scheduled downtime and maintenance of electric generating units.

Quarter Ended	Operating Revenue	Operating Income	Net Income	Earnings Applicable to Common Stock	Average Shares Outstanding	Earnings per Average Share
	(Dollars In Thousands)				(In Thousands)	
1985						
March 31	$198,788	$ 36,946	$27,114	$23,964	30,482	$0.79
June 30	161,093	29,416	20,582	17,433	30,482	0.57
September 30	196,352	43,496	34,235	31,085	30,482	1.02
December 31	166,601	25,657	14,707	11,557	30,482	0.38
	$722,834	$135,515	$96,638	$84,039	30,482	$2.76
1984						
March 31	$190,185	$ 36,823	$25,996	$22,809	30,003	$0.76
June 30	164,181	29,957	19,130	15,954	30,172	0.53
September 30	188,901	42,862	33,092	29,937	30,337	0.99
December 31	159,326	23,567	13,892	10,748	30,482	0.35
	$702,593	$133,209	$92,110	$79,448	30,248	$2.63

In the fourth quarter of 1984, adjustments for a voluntary Delaware revenue refund and other regulatory items were recorded. The effect of these adjustments reduced fourth quarter net income by approximately $4,200,000 (14¢ per share).

In the second quarter of 1985, adjustments were recorded for the additional Delaware electric retail revenue refund for 1984 and additional amortization of the credit arising from the sale of contracts, which resulted from an out-of-court tax settlement. The effect of these adjustments reduced second quarter net income by approximately $1,100,000 (4¢ per share).

In the fourth quarter of 1985, the company wrote-off its share of advances under uranium supply contracts that were terminated and also accrued for a resale revenue refund. The effect of these adjustments reduced fourth quarter net income by approximately $2,063,000 (7¢ per share).

Consolidated Statistics

10 Years of Review		1985	1984	1983	1982
Electric Revenues (thousands):	Residential	$ 212,254	$205,910	$193,021	$183,258
	Commercial	168,957	156,507	140,809	137,434
	Industrial	135,141	128,833	126,703	127,441
	Other utilities, etc.	79,399	79,235	68,991	73,469
	Miscellaneous revenues	9,830	13,678	12,728	13,168
	Total electric revenues	$ 605,581	$584,163	$542,252	$534,770
Electric Sales (1,000 kilowatt-hours):	Residential	2,256,922	2,249,270	2,136,265	2,026,398
	Commercial	2,165,685	2,073,457	1,844,324	1,729,863
	Industrial	2,606,466	2,569,572	2,600,492	2,255,673
	Other utilities, etc.	1,501,447	1,415,934	1,297,395	1,237,508
	Total electric sales	8,530,520	8,308,233	7,878,476	7,249,442
Electric Customers (end of period):	Residential	283,911	275,175	267,357	260,371
	Commercial	33,189	31,548	30,525	29,966
	Industrial	893	929	949	741
	Other utilities, etc.	492	502	434	434
	Total electric customers	318,485	308,154	299,265	291,512
Gas Revenues (thousands):	Residential	$ 39,224	$ 40,933	$ 36,694	$ 36,505
	Commercial	17,901	18,663	16,527	15,792
	Industrial	19,762	22,940	23,232	20,112
	Interruptible	17,419	18,098	17,026	11,733
	Other utilities, etc.	130	160	115	53
	Miscellaneous revenues	820	784	764	552
	Total gas revenues	$ 95,256	$101,578	$ 94,358	$ 84,747
Gas Sales (million cubic feet):	Residential	5,622	6,213	5,640	6,062
	Commercial	2,742	2,971	2,677	2,768
	Industrial	3,579	4,245	4,378	4,108
	Interruptible	3,734	3,769	3,723	2,656
	Other utilities, etc.	31	41	31	10
	Total gas sales	15,708	17,239	16,449	15,604
Gas Customers (end of period):	Residential	70,804	70,183	69,608	69,092
	Commercial	4,417	4,233	4,075	4,057
	Industrial	160	165	160	166
	Interruptible	15	19	19	18
	Other utilities, etc.	1	1	1	1
	Total gas customers	75,397	74,601	73,863	73,334
Refinery Service	Electricity delivered (1,000 kilowatt-hours)	335,260	298,203	309,043	322,804
	Steam delivered (1,000 pounds)	6,238,829	6,683,335	6,965,904	7,778,929

1981	1980	1979	1978	1977	1976	1975	Average Annual Compound % Rate of Growth
$164,919	$144,637	$115,381	$105,237	$ 97,691	$ 80,416	$ 77,069	10.66
123,099	112,166	91,798	82,796	74,641	60,111	58,169	11.25
129,601	116,401	98,023	83,972	76,801	64,458	64,141	7.74
73,602	63,698	53,782	40,840	38,974	34,896	35,606	8.35
12,898	7,025	4,682	5,261	3,461	2,398	4,370	8.44
$504,119	$443,927	$363,666	$318,106	$291,568	$242,279	$239,355	9.73
1,996,647	2,046,546	1,968,452	1,979,624	1,924,723	1,787,663	1,672,180	3.04
1,660,147	1,648,776	1,598,299	1,568,600	1,495,796	1,412,259	1,359,673	4.77
2,454,685	2,429,842	2,624,438	2,418,527	2,277,630	2,260,661	2,142,151	1.98
1,283,845	1,335,216	1,300,611	1,281,498	1,207,941	1,199,155	1,218,785	2.11
7,395,324	7,460,380	7,491,800	7,248,249	6,906,090	6,659,738	6,392,789	2.93
255,646	246,887	242,745	237,925	233,106	230,579	221,780	2.50
29,450	28,162	27,998	28,421	29,648	28,345	27,345	1.96
788	821	874	858	921	1,002	923	(.33)
434	440	478	480	561	550	545	(1.02)
286,318	276,310	272,095	267,684	264,236	260,476	250,593	2.43
$ 34,123	$ 26,525	$ 25,719	$ 28,370	$ 21,829	$ 18,826	$ 15,365	9.83
14,344	10,342	8,954	10,154	7,133	6,062	4,676	14.37
22,259	12,404	9,884	10,191	6,950	5,984	4,343	16.36
11,711	9,293	4,440	716	169	1,301	1,211	30.55
61	46	55	93	49	44	33	14.70
572	430	270	116	103	31	45	33.68
$ 83,070	$ 59,040	$ 49,322	$ 49,640	$ 36,233	$ 32,248	$ 25,673	14.01
6,193	6,321	6,423	6,941	6,751	6,956	6,540	(1.50)
2,704	2,683	2,415	2,593	2,439	2,586	2,429	1.22
4,809	3,937	3,388	3,290	2,811	3,264	2,849	2.31
2,802	2,738	1,720	319	81	953	1,073	13.28
12	14	16	29	17	20	18	5.59
16,520	15,693	13,962	13,172	12,099	13,779	12,909	1.98
68,608	67,784	66,631	66,364	66,231	67,754	68,160	0.38
3,967	3,846	3,712	3,773	3,738	4,154	4,189	0.53
167	155	131	163	163	198	198	(2.11)
16	16	16	21	21	21	21	(3.31)
1	1	1	1	1	1	1	–
72,759	71,802	70,491	70,322	70,154	72,128	72,569	0.38
343,063	328,420	262,159	270,006	289,049	318,389	297,282	1.21
7,673,420	7,570,944	6,378,705	6,016,095	4,888,366	5,301,421	5,517,000	1.24

Officers, Directors and Shareholder Information

NEVIUS M. CURTIS
Chairman of the Board
and Chief Executive Officer

HOWARD E. COSGROVE
Executive Vice President

FRANK A. COOK
Senior Vice President

H. RAY LANDON
Senior Vice President

HARLAND M. WAKEFIELD, JR.
Senior Vice President

ROGER D. CAMPBELL
Vice President, Treasurer
and Chief Financial Officer

WAYNE A. LYONS
Vice President

DONALD E. CAIN
Division Vice President
Northern Division

DONALD T. CONNELLY
Secretary

RICHARD H. EVANS
Vice President, Corporate
Communications

PAUL S. GERRITSEN
Vice President, Regulatory
Practices

CHARLES MARCHYSHYN
Comptroller

FRANK J. PERRY, JR.
Vice President, Gas Division

THOMAS S. SHAW, JR.
Vice President, Production

D. WAYNE YERKES
Division Vice President
Southern Division

EXECUTIVE COMMITTEE
Nevius M. Curtis, Chairman;
Oscar L. Carey; William G.
Simeral; Dr. E. Arthur Trabant;
Harland M. Wakefield, Jr.

AUDIT COMMITTEE
Oscar L. Carey, Chairman;
John R. Cooper; James O. Pippin, Jr.

NOMINATING COMMITTEE
Dr. E. Arthur Trabant, Chairman;
Nevius M. Curtis; Sally V. Hawkins

COMPENSATION COMMITTEE
William G. Simeral, Chairman;
Oscar L. Carey; Nevius M. Curtis;
David D. Wakefield

INVESTMENT COMMITTEE
David D. Wakefield, Chairman;
James O. Pippin, Jr.; Nevius M. Curtis

CHARLOTTE LEE CANNON
Director of H. P. Cannon & Son, Inc.
(warehousing) Bridgeville, Delaware

OSCAR L. CAREY
President and Director of
Larmar Corporation (general
real estate and home builders)
Salisbury, Maryland

FRANK A. COOK
Senior Vice President of
the Company
Frank A. Cook has retired as senior vice president and a director of the company. Mr. Cook joined the company in 1972 as manager of electric production and held several management positions during his years of service. He was elected to the board of directors in 1982.

JOHN R. COOPER
Manager of Environmental Affairs
and Occupational Health,
Petrochemicals Department of
E. I. du Pont de Nemours &
Company (a diversified chemical,
energy and specialty products
company) Wilmington, Delaware

SALLY V. HAWKINS
Director, President and Chief Executive
Officer of Delaware Broadcasting
Company and President and General
Manager of Station WILM (radio
broadcasting) Wilmington, Delaware

JAMES O. PIPPIN, JR.
President and Director of the Centreville
National Bank of Maryland, Centreville,
Maryland

WILLIAM G. SIMERAL
Director and Executive Vice President
and a member of the Executive
Committee of E. I. du Pont de Nemours
& Company (a diversified chemical,
energy and specialty products
company) Wilmington, Delaware

DR. E. ARTHUR TRABANT
President of the University of Delaware,
Newark, Delaware

DAVID D. WAKEFIELD
Director and President of Morgan Bank
(Delaware) Wilmington, Delaware;
Chairman of Morgan Christiana
Corporation, Wilmington, Delaware;
Director of Continental American
Life Insurance Company,
Wilmington, Delaware

HARLAND M. WAKEFIELD, JR.
Senior Vice President of
the Company

TRUSTEES
First Mortgage and Collateral Trust
Bonds—Chemical Bank,
New York, New York

Pollution Control Revenue Bonds—
Mellon Bank (DE) N.A.
Wilmington, Delaware

Bank of Delaware,
Wilmington, Delaware

Wilmington Trust Company,
Wilmington, Delaware

Irving Trust Company
New York, New York

TRANSFER AGENTS AND REGISTRARS
Preferred Stock—
Wilmington Trust Company,
Financial Services Division
Rodney Square North
Wilmington, Delaware 19890

Common Stock—
Wilmington Trust Company,
Financial Services Division
Rodney Square North
Wilmington, Delaware 19890

Manufacturers Hanover Trust Company
Stock Transfer Department
P.O. Box 24935
Church Street Station
New York, New York 10249

STOCK SYMBOL
Common Stock, DEW—listed on
the New York and Philadelphia
Stock Exchanges

REGULATORY COMMISSIONS
Federal Energy Regulatory Commission,
825 North Capitol Street, N.E.,
Washington, D.C. 20426

Delaware Public Service Commission,
1560 S. du Pont Highway,
Dover, Delaware 19901

Maryland Public Service Commission,
American Building,
231 East Baltimore Street,
Baltimore, Maryland 21202.

Virginia State Corporate Commission,
P.O. Box 1197,
Richmond, Virginia 23209

CORPORATE ADDRESS
Delmarva Power,
800 King Street, P.O. Box 231,
Wilmington, Delaware 19899.
Telephone (302) 429-3011

Annual Meeting

The Annual Meeting will be held on April 29 at 11:00 a.m., in the Clayton Hall, University of Delaware, Newark, Delaware.

Additional Reports

To supplement information in this Annual Report, a Financial and Statistical Review (1975-1985) and the Form 10-K are available upon request. Please write to Stockholder Relations, Delmarva Power, 800 King Street, P.O. Box 231, Wilmington, Delaware 19899.

Art Direction & Design: Teresa Zimmerman. Photography: John Carter III. Cover Illustration: Pamela Patrick Higgins.

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Wilmington, DE 19899

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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**	$27.17	3
Year-end Market Price	**31⅝**	26¾	18
Gross Additions to Utility Plant	**$ 1,220,089**	$ 967,365	26
Total Utility Plant at Original Cost	**$10,977,321**	$ 9,870,429	11

Contents

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.

PSE&G Profile

Public Service Electric and Gas Company is the largest utility in New Jersey and one of the largest combination electric and gas utilities in the United States. It serves approximately 5.5 million people, nearly three-quarters of the state's population. The Company's service area, covering some 2,600 square miles; runs diagonally across the state's industrial and commercial corridor from the New York state border on the north to Camden on the south. This diversified and heavily populated area includes the six major cities of New Jersey as well as nearly 300 suburban and rural communities.

To Our Shareholders

In 1985, Public Service Electric and Gas Company stepped boldly toward the threshold of the 21st century. During no other year in its rich history has the Company expressed such excitement for the future and, more important, such confidence in its strength to meet the challenges and opportunities that the years ahead will bring.

The Board of Directors, in July, authorized the formation of a holding company, subject to the approval of the New Jersey Board of Public Utilities and, of course, PSE&G's stockholders. The action, which was strongly supported by management, charted the course PSE&G would travel in order to retain its firm financial footing in a changing utility environment.

The essence of our strategy is, in a word, diversification. A newly formed holding company would diversify, to a limited extent, into non-utility businesses with the potential for enhancing financial strength.

At the same time, electric and gas service by PSE&G as a regulated subsidiary of the holding company would continue as the principal business of the system. In short, PSE&G would be the backbone of the holding company.

The holding company, which would bear the name Public Service Enterprise Group Incorporated, would provide an appropriate structure for diversification and for maintaining the Company's strength in the volatile and competitive utility environment.

In the 1960s, the utility industry was generally stable with manageable capital and energy costs needed to meet customers' demands for electricity and gas. In the 1970s, the industry was faced with energy shortages, a depressed economy, greater regulatory and tax pressures and uncertainty about the future.

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.

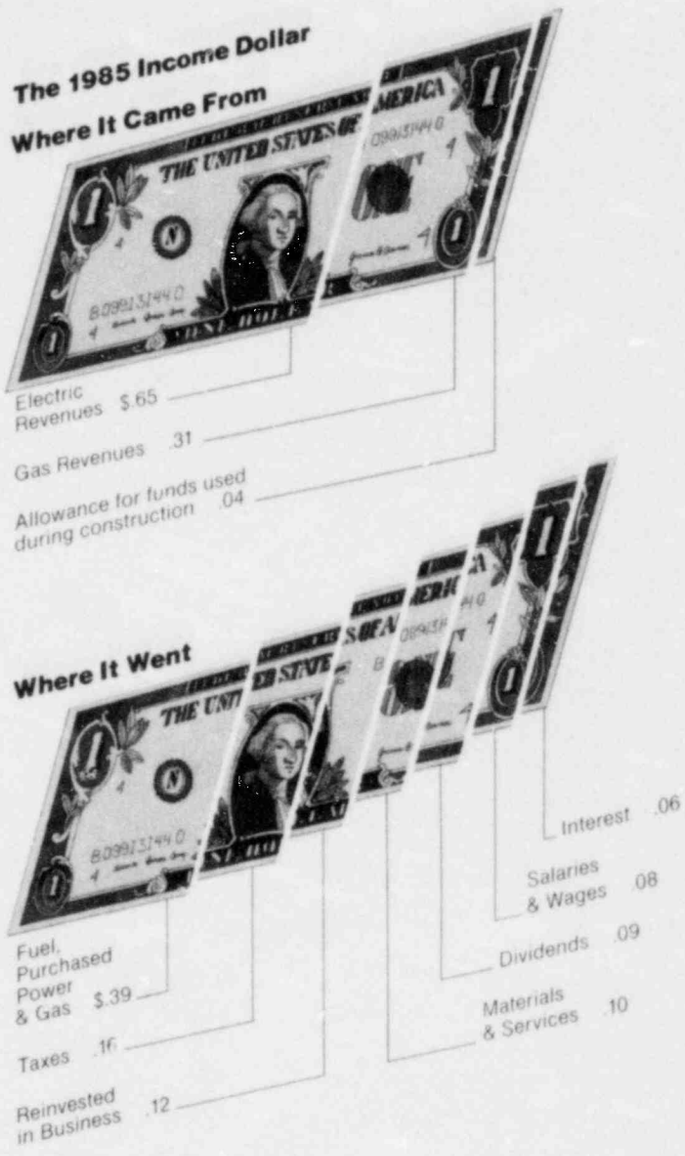
During the 1980s, PSE&G has concentrated on completing the Hope Creek Generating Station, its last major construction project in this century. We will continue focusing on Hope Creek until it is placed in service, which is expected to be later this year.

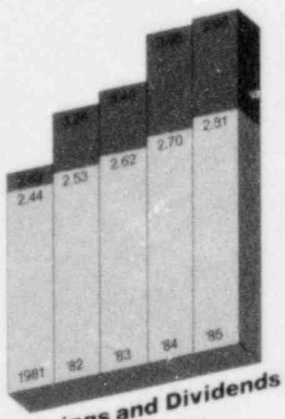
Once this major milestone is reached, PSE&G will be ready for the future, and the holding company will fit this need.

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

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

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.

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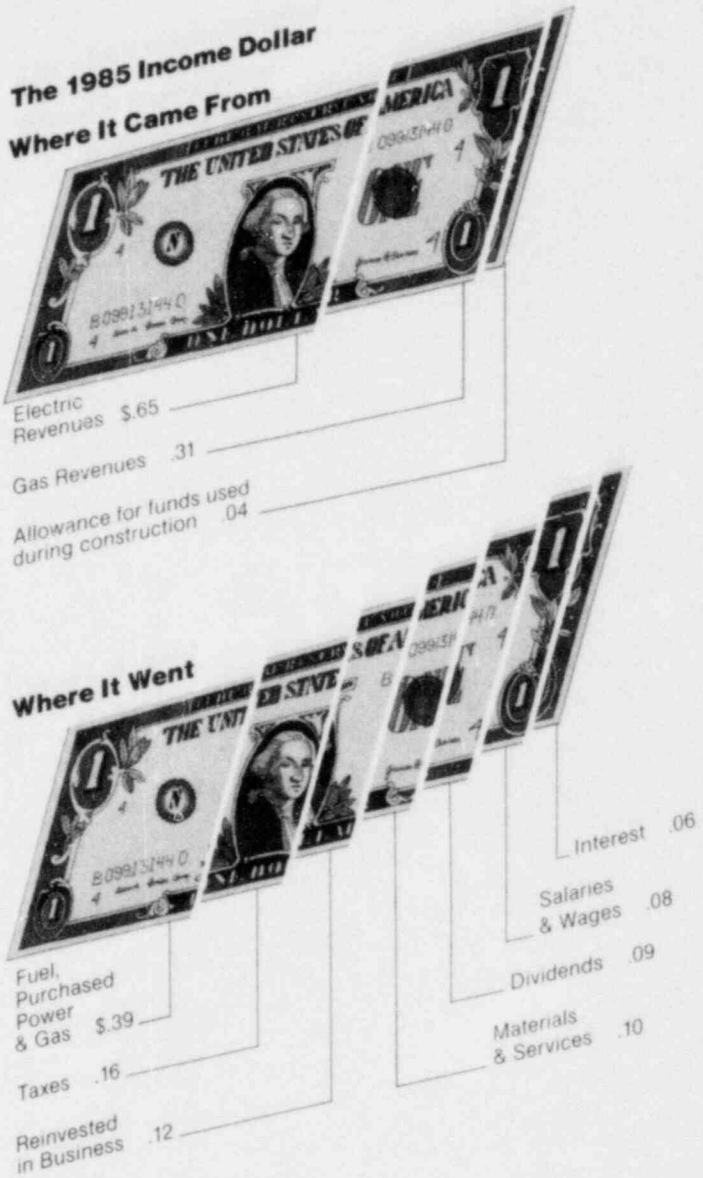

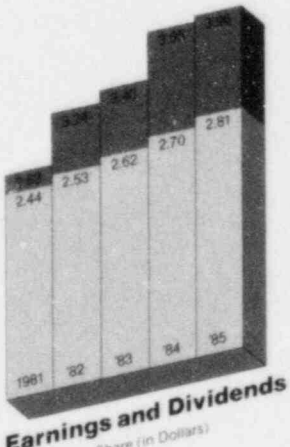

Earnings and Dividends

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

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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.

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

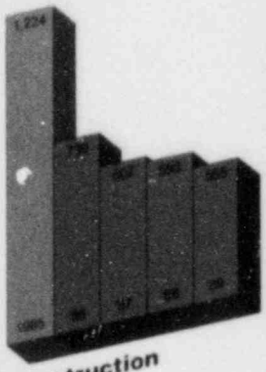
Harold W. Sonn

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 15.6%.

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	10021	29
1988	7820	10021	28
1989	7910	10021	27
1990	8000	10021	25
1991	8100	10021	24
1992	8180	10021	23
1993	8240	10021	22
1994	8280	10021	21
1995	8340	10021	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

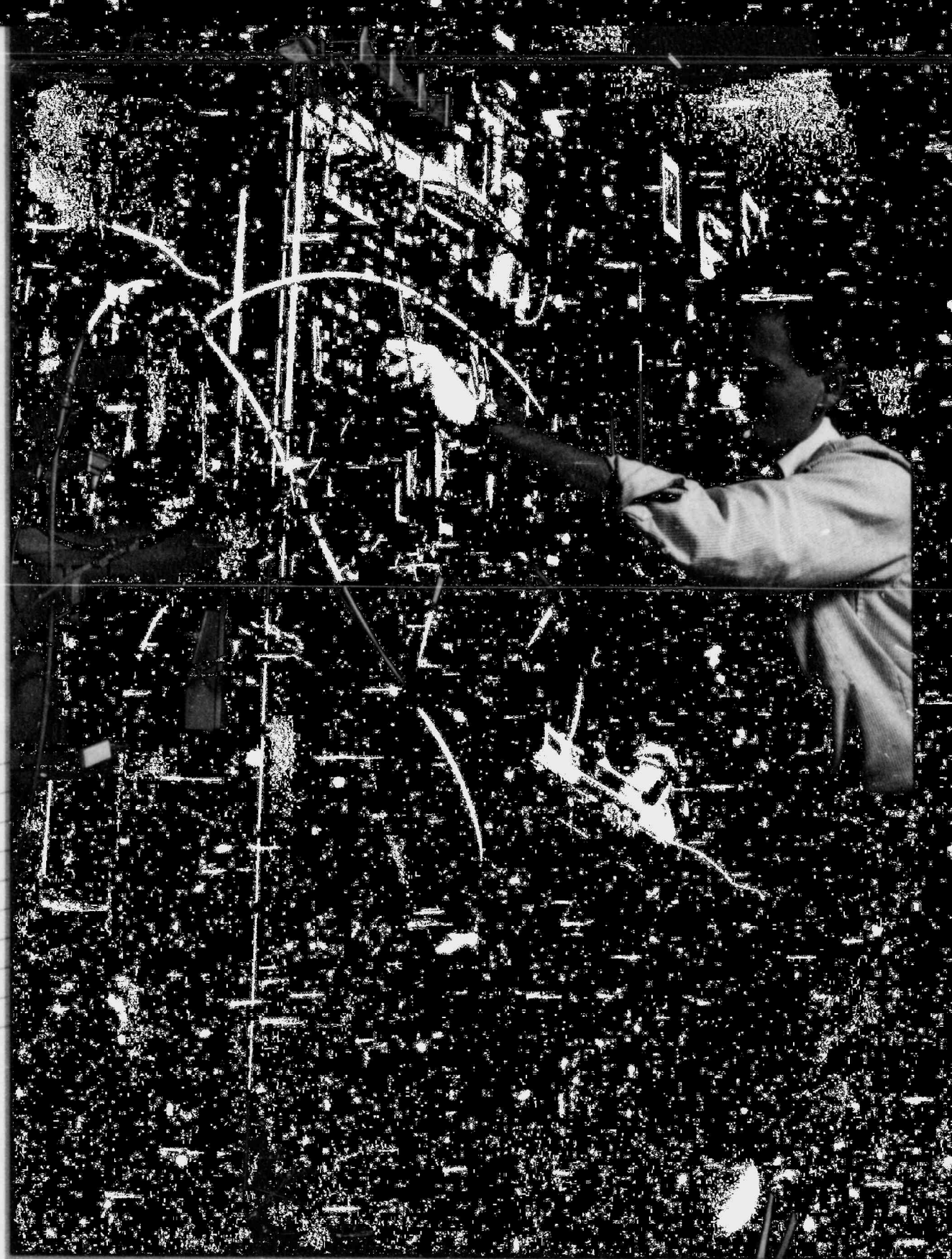
The Company has sufficient uranium supplies under contract with producers in the United States and Canada to meet the fuel needs of both the Salem and Hope Creek Generating Stations through 2000.

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.

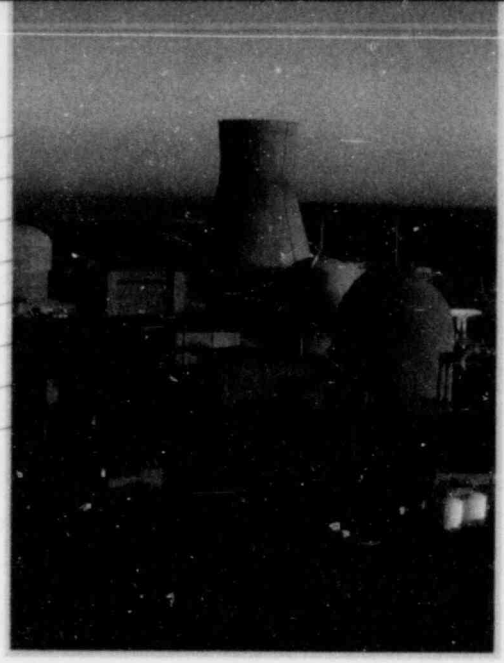
During one period of the year, Salem 1 was on line for 277 consecutive days, breaking its previously longest run of 88 days and establishing a new mark for all PSE&G generating units, regardless of fuel.

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.

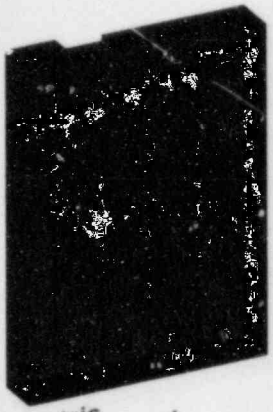
On Labor Day, electric and gas crews cooperated with firefighters battling a blaze that destroyed 40 acres in the heart of Passaic's industrial section. One volunteer, William Koenemund, who worked in the Company's electric transmission and distribution headquarters in Secaucus, died of a heart attack 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.

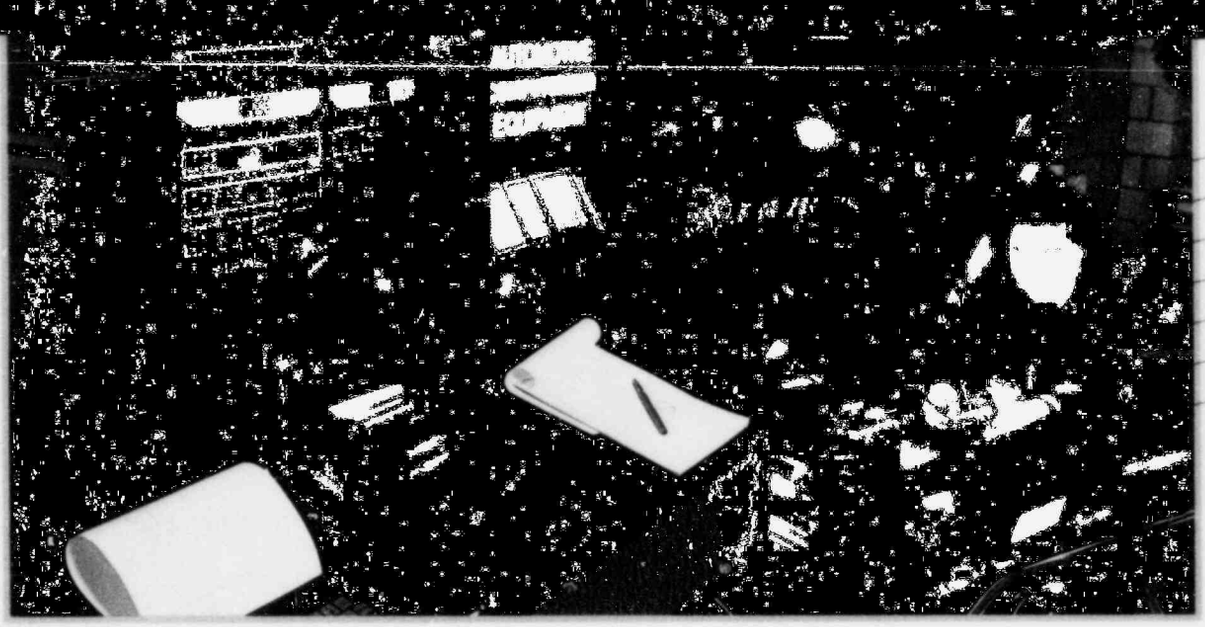
"Seal-Up and Save" served again as the central theme as the Company carried its message to customers in a variety of ways. For example, some 10,000 low-income electric and gas customers attended special workshops at 80 locations. The workshops were held in cooperation with local community action agencies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



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

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

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.

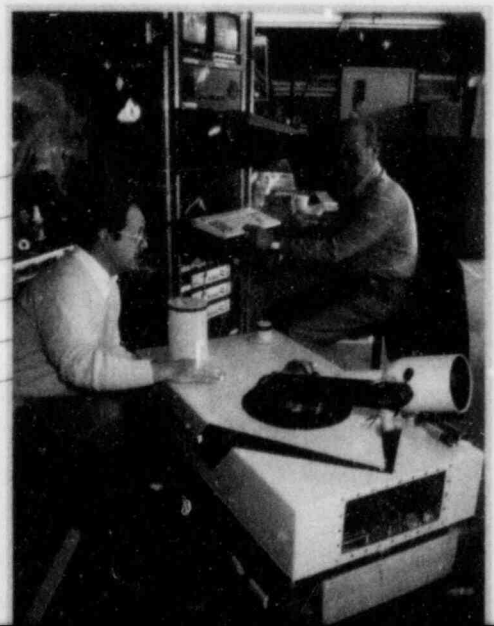
Commercially available robotic devices were tested at the Salem and Hope Creek Generating Stations to gauge their usefulness in carrying out routine inspection, surveillance and maintenance tasks. The aim of the research is to have robots do work in controlled radiation areas of the nuclear plants to 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

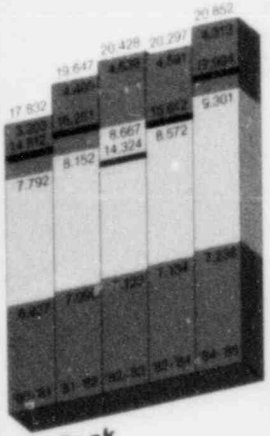
New Jersey remained a strong economic magnet for business in 1985, and PSE&G continued to play a key role in attracting new companies to the state and encouraging existing ones to expand.

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. Randel, 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	**3,16· o41**	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 1983)	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 $181,461,000 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
4¾%	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
4⅝%	September 1, 1994	**60,000**	60,000
4¼%	September 1, 1995	**60,000**	60,000
6¼%	June 1, 1997	**75,000**	75,000
7 %	June 1, 1998	**75,000**	75,000
7⅛%	April 1, 1999	**75,000**	75,000
9⅛%	March 1, 2000	**98,000**	98,000
8⅜%	A May 15, 2001	**69,300**	69,300
7⅝%	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
9¼%	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
15¾%	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
12⅜%	Q August 1, 1993	**100,000**	100,000
9½%	R July 1, 2015	**125,900**	
9¼%	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
10⅛%	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
7¾%	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 subsidiaries 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)	$ 4,531
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	$151,800

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	$68,469

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 1986. 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	85(B)
	$ 650(C)	$ 85
Property Damage		
Nuclear Mutual Limited (D)	$ 500	$ 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)	$ 30(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 August 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	$	$ 61,844
Obligations under Capital Leases	58,337	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 $11.6 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**	$2,816,241	$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,[illegible]	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**	110,061	**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 under recovery 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	(8.0)
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%	51.2%	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		$25.66		$26.38		$24.03	
$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	$2,041,536	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 on 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.

Directors

James R. Cowan, M.D.
President and Chief Executive Officer,
United Hospitals Medical Center, Newark, New Jersey.
Member of Finance Committee and Nominating Committee.

T.J. Dermot Dunphy
President, Chief Executive Officer and director,
Sealed Air Corporation (manufactures protective packaging products and systems), Saddle Brook, New Jersey.
Member of Nominating Committee and Organization and Compensation Committee.

Robert R. Ferguson, Jr.
President, Chief Executive Officer and director,
First Fidelity Bancorporation and Chairman of the Board and director, First Fidelity Bank, National Association, both of Newark, New Jersey.
Member of Finance Committee and Organization and Compensation Committee.

Irwin Lerner
President, Chief Executive Officer and director,
Hoffmann-La Roche Inc. (manufactures prescription pharmaceuticals, vitamins and fine chemicals and provides diagnostic products and services), Nutley, New Jersey.
Member of Audit Committee, Executive Committee and Organization and Compensation Committee.

William E. Marfuggi
Chairman of the Board and director, Victory Optical Manufacturing Company (manufactures ophthalmic frames) and Chairman of the Board and director, Plaza Sunglasses, Inc. (manufactures sunglasses), both of Newark, New Jersey.
Member of Audit Committee and Finance Committee.

Marilyn M. Pfaltz
Partner of P and P, Associates (public relations and publicity specialists), Summit, New Jersey.
Member of Audit Committee and Nominating Committee.

James C. Pitney
Partner in the law firm of Pitney, Hardin, Kipp & Szuch, Newark and Morristown, New Jersey.
Chairman of Audit Committee and member of Organization and Compensation Committee.

Kenneth C. Rogers
President, Stevens Institute of Technology, Hoboken, New Jersey.
Chairman of Nominating Committee and member of Organization and Compensation Committee.

Verdell L. Roundtree
Vice President, National Programs,
United Negro College Fund, New York, New York.
Member of Audit Committee and Nominating Committee.

William E. Scott
Retired Senior Executive Vice President of the Company.
Chairman of Finance Committee and member of Executive Committee.

Robert I. Smith
Retired Chairman of the Board of the Company.
Member of Executive Committee and Finance Committee.

Harold W. Sonn
Chairman of the Board, President and Chief Executive Officer of the Company.
Chairman of Executive Committee and member of Finance Committee.

Robert V. Van Fossan
Chairman of the Board, Chief Executive Officer and director,
The Mutual Benefit Life Insurance Company, Newark, New Jersey.
Chairman of Organization and Compensation Committee and member of Executive Committee and Finance Committee.

Josh S. Weston
President, Chief Executive Officer and director,
Automatic Data Processing, Inc., Roseland, New Jersey.
Member of Audit Committee and Organization and Compensation Committee.

Officers

Harold W. Sonn
Chairman of the Board, President and Chief Executive Officer

Everett L. Morris
Executive Vice President — Finance

Frederick W. Schneider
Executive Vice President — Operations

Fredrick R. DeSanti
Senior Vice President — Customer Operations

Richard M. Eckert
Senior Vice President — Nuclear and Engineering

Robert W. Lockwood
Senior Vice President — Administration

Stephen A. Mallard
Senior Vice President — Planning and Research

Donald A. Anderson
Vice President — Information Systems

Lawrence R. Codey
Vice President and Corporate Rate Counsel

Robert H. Franklin
Vice President — Public Relations

Charles E. Maginn, Jr.
Vice President — Human Resources

Wallace A. Maginn
Vice President and Treasurer

Winthrop E. Mange, Jr.
Vice President — Corporate Services

Thomas J. Martin
Vice President — Engineering and Construction

Corbin A. McNeill, Jr.
Vice President — Nuclear

Parker C. Peterman
Vice President and Comptroller

Louis L. Rizzi
Vice President — Customer and Marketing Services

William Saller
Vice President — Governmental Affairs

R. Edwin Selover
Vice President and General Counsel

Robert S. Smith
Vice President and Secretary

Robert F. Steinke
Vice President — Fuel Supply

Rudolph D. Stys
Vice President — Transmission and Distribution

Richard A. Uderitz
Vice President — Production

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

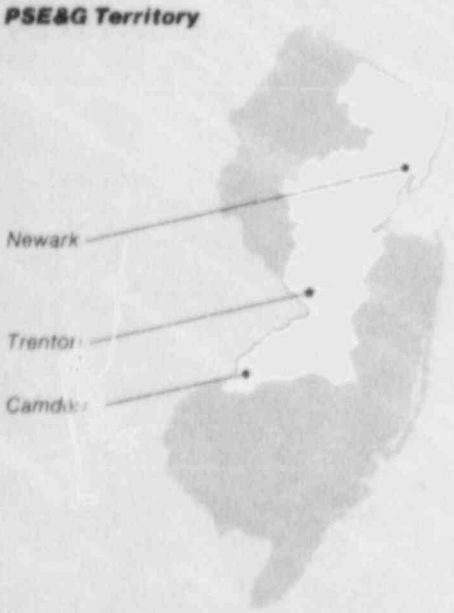
Stockholder Services,
Public Service Electric and Gas Company
80 Park Plaza, P.O. Box 570
Newark, N.J. 07101

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**	24½-20¼
Second Quarter	**32½-27¼**	23 -20⅜
Third Quarter	**32⅛-26⅛**	25⅜-21⅛
Fourth Quarter	**33⅛-26⅜**	27⅛-24½

*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	**14⅜-12¼**	11¾-10⅛
Third Quarter	**15 -13½**	11¼-10⅛
Fourth Quarter	**14½-13¼**	13⅛-10½

Stockholder information — Toll Free

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

Security Analysts and Institutional Investors

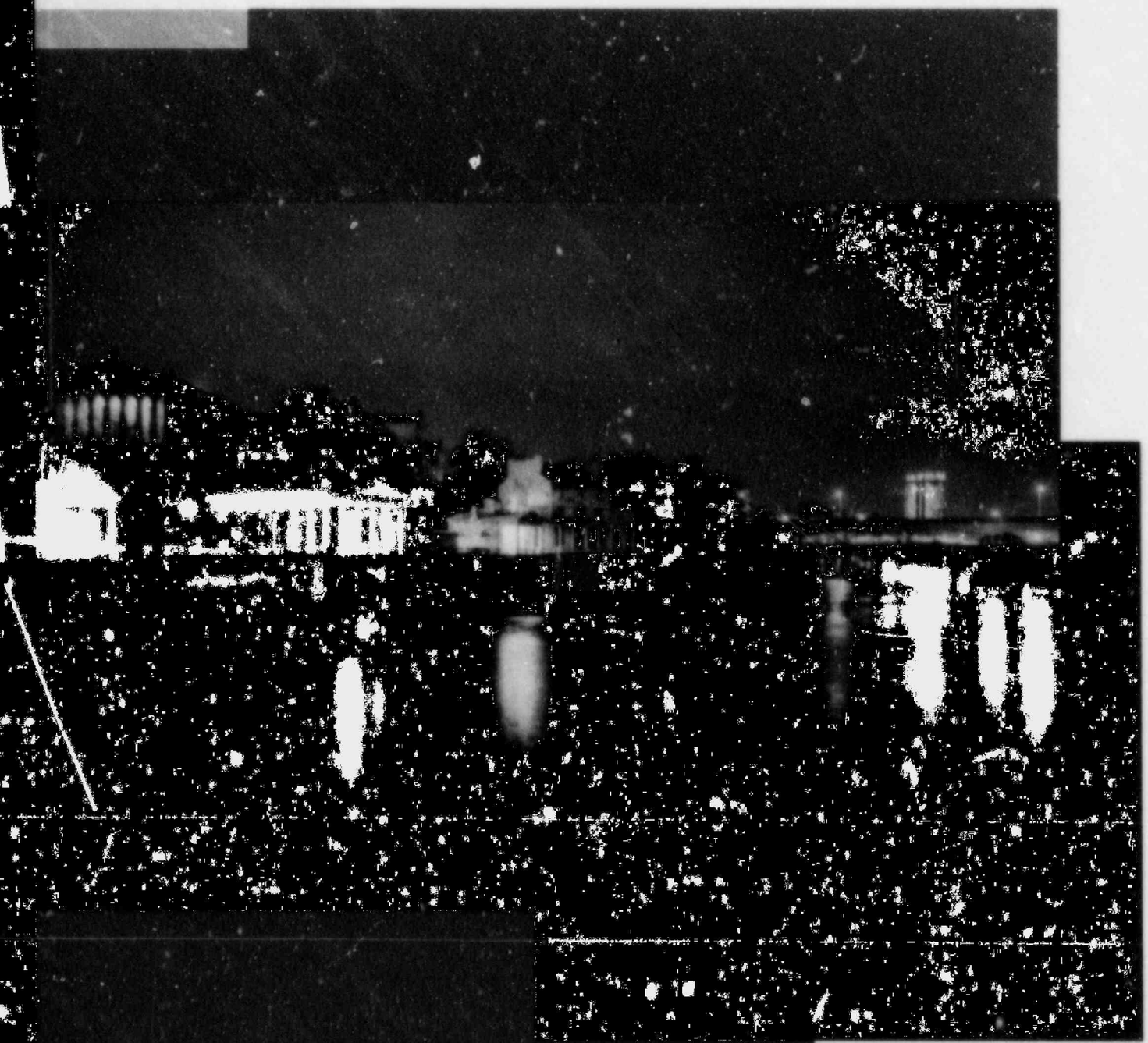
Manager—Investor Relations (201) 430-6564

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

PHILADELPHIA ELECTRIC COMPANY



ANNUAL REPORT 1985

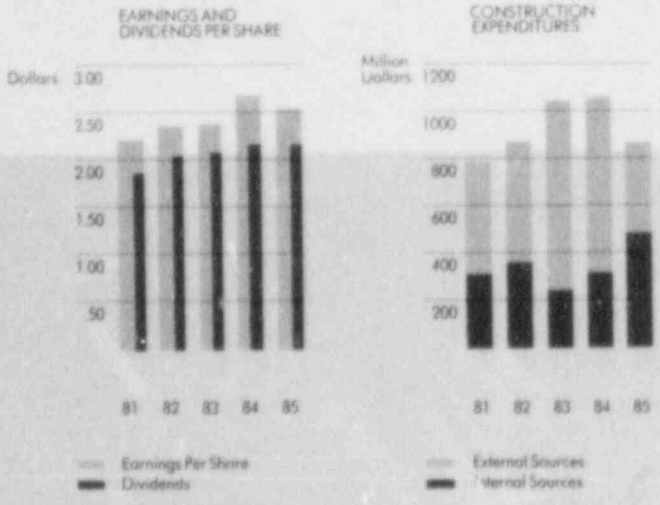
About the Cover—The cultural gateway to center city along the Schuylkill River features the Philadelphia Museum of Art (left) alongside the Fairmount Waterworks (center) with the Company's headquarters building in the distance (right).

About the Company—Philadelphia Electric Company is an operating utility which provides electric, gas and steam service to the public in southeastern Pennsylvania and to certain portions of northeastern Maryland through a subsidiary. The total area served by the Company and subsidiaries covers 2,475 square miles. Electric service is supplied in an area of 2,340 square miles with a population of about 3,700,000, including 1,700,000 in the City of Philadelphia. Approximately 95 percent of the electric service area and 63 percent of retail kilowatthour sales are in the Philadelphia suburbs and in northeastern Maryland, and 5 percent of the service area and 37 percent of such sales are in the City of Philadelphia. Natural gas service is supplied in a 1,475-square mile area of southeastern Pennsylvania adjacent to Philadelphia with a population of 1,900,000. Steam service is supplied in the central and west Philadelphia areas.

Contents

Philadelphia
Electric
Company
Annual Report
1985

Financial Highlights	**1985**	1984	% Change
Operating Revenue	**$3,013,704,000**	$2,981,017,000	1%
Operating Expenses	**$2,598,751,000**	$2,526,758,000	3%
Taxes Charged to Operations	**$443,347,000**	$453,612,000	(2%)
Operating Income	**$414,953,000**	$454,259,000	(9%)
Earnings Applicable to Common Stock	**$434,724,000**	$409,707,000	6%
Earnings per Average Common Share	**$2.56**	$2.70	(5%)
Cash Dividends Paid per Common Share	**$2.20**	$2.20	—
Average Shares of Common Stock Outstanding	**169,784,471**	151,803,698	12%
Construction Expenditures	**$864,700,000**	$1,063,630,000	(19%)
Total Assets	**$10,165,314,000**	$9,555,729,000	6%



To Our Shareholders

1985 was a year of solid accomplishments for the Company.

- *Limerick Unit No. 1* received its full-power operating license on August 8. After the unit was exhaustively tested while gradually being raised to full capacity, it was placed in commercial operation on February 1, 1986.
- *Limerick Unit No. 2* received Pennsylvania Public Utility Commission (PUC) permission in December to be completed under a cost containment and operational incentive program which includes a construction cost cap, operating and maintenance cost controls and performance incentives and penalties. Full construction resumed in February 1986, with a targeted completion date of late 1990.
- *Earnings per share* were $2.56, a decline of 14 cents from last year. A PUC disallowance in October of approximately $73 million of prior years' deferred costs reduced earnings per share by 20 cents. The Company has appealed this disallowance to the Commonwealth Court of Pennsylvania.
- *Electric sales* to retail customers remained essentially flat compared to last year as milder weather offset growth in customers. Gas sold and transported declined slightly due to warmer weather during the heating season. Steam sales were also down.
- A 28.2% *electric rate increase request*, the largest in the Company's history, was filed in September to bring Limerick Unit No. 1 into rate base. To moderate the impact of the increase on customers, the Company proposed to phase in the increase over a three-year period in three equal steps of 9.4% each.
- *Gas tariffs* were reduced by approximately $28 million per year in several reductions that took effect during 1985. These reductions match comparable reductions in suppliers' prices to the Company and did not affect Company earnings.
- *The Point Pleasant Water Project*, which is designed to provide permanent supplemental cooling water for the operation of Limerick, was ordered completed by the Court of Common Pleas of Bucks County in February, which was affirmed by the Commonwealth Court in October. Bucks County and the Neshaminy Water Resources Authority have petitioned the Supreme Court of Pennsylvania for allowance of an appeal.

1986 will be another year of challenges as the Company attempts to put its investment in Limerick Unit No. 1 into base rates. Construction work has begun again on Unit No. 2 and will be

pursued vigorously during 1986 and until completion. These items comprise our top priorities for 1986.

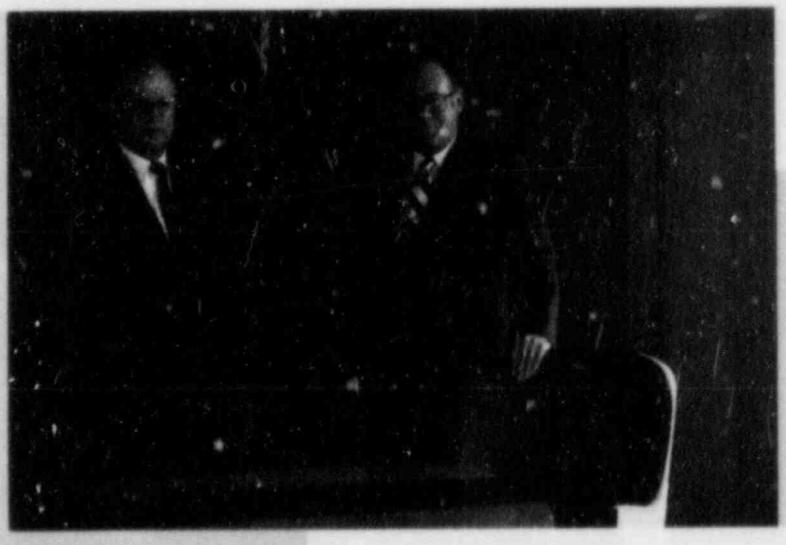
The Company's accomplishments in 1985 are the result of the continuing effort of a dedicated and talented group of employees. Their commitment to efficient operation, high-quality customer service and innovative technology serves our Company well. They are also actively involved in our local communities, leading and participating in a wide variety of activities that contribute to the quality of life within the Company's service area. Examples of our employees' activities are highlighted in this report.

The counties that we serve in southeastern Pennsylvania and northeastern Maryland are rich in history, culture, scenic beauty, recreational activities and economic opportunity. We have attempted to capture some of these elements in the photography of this year's report.

As we face the future, we recognize the support of our investors that has made this year's significant achievements possible. Thank you for your continuing support.

James L. Everett
Chairman of the Board
and Chief Executive Officer

John H. Austin, Jr.
President
and Chief Operating Officer

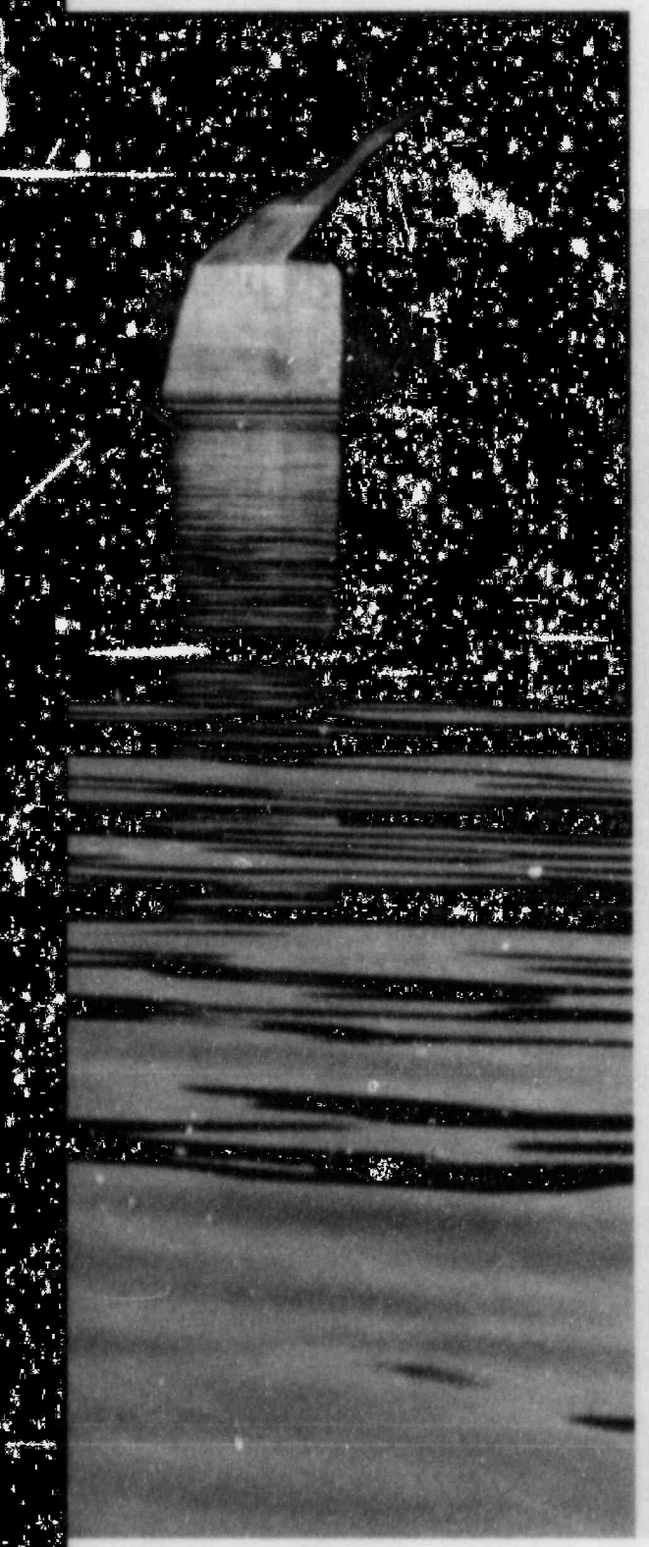


John H. Austin, Jr.

James L. Everett

PHILADELPHIA COUNTY

The Schuylkill River traverses our service territory from above Pottstown along the Chester County and Montgomery County borders and through Philadelphia and provides many recreational activities for area residents. The Temple University varsity crew completes a workout.



Earnings

Common stock earnings per share in 1985 were $2.56, a 5% decrease from the $2.70 earned in 1984. Total common stock earnings amounted to $435 million, up $25 million or 6% from last year, while the average number of shares outstanding increased 12% to 170 million shares.

The decline in per share earnings is attributable to a disallowance by the Pennsylvania Public Utility Commission (PUC) of approximately $73 million of fuel and other costs incurred in 1983 and 1984 which reduced earnings per share by 20 cents. The Company has appealed this decision to the Commonwealth Court of Pennsylvania.

Financial Statements and Notes begin on page 23.

Sales and Customers

Total electric sales amounted to 28.1 billion kilowatthours, a decrease of 4% from the 29.4 billion kilowatthours sold in 1984 which included the sale of the Company's share of the output of Salem Unit No. 2 to Jersey Central Power & Light Company. The Salem Unit No. 2 contract with Jersey Central expired at year-end 1984. Retail sales of electricity were essentially flat as compared to 1984 sales excluding the sale of Salem Unit No. 2 output.

Natural gas sold and transported decreased 1% to 73 billion cubic feet due to warmer weather during the heating season although increases in gas transported for seven large industrial customers partially offset the unfavorable weather. Steam sales were also adversely affected by warmer weather and decreased 11% to 4.2 billion pounds.

The Greenfield Elementary School at 22nd and Chestnut Streets is more than PE's center city neighbor. PE adopted Greenfield under the Philadelphia School District's Adopt-A-School Program through which the Company provides facilities and services to help the school.

The number of electric customers grew 1% in 1985, totalling nearly 1.4 million at year-end. The number of gas customers also grew, increasing 2% to 311,700.

Additional information on sales, revenue and customers can be found on pages 42 and 43.

Financing

The Company raised over $1.0 billion in new capital during 1985 to provide funds for construction, debt refunding and other needs. As a result of lower interest rates, the Company sold $250 million of 11-3/4% mortgage bonds due 2014 and $150 million of 10-7/8% mortgage bonds due 1995 in November for the purpose of repurchasing, through a tender offer, certain of the Company's outstanding bonds consisting of the 18-3/4% Series due 2009, the 18% Series due 2012 and the 17-5/8% Series due 2011. As a result of the offer, $217 million of bonds were tendered enabling the Company to reduce its annual interest payments by approximately $9.6 million per year. Funds not needed for the tender offer will be used for construction and other corporate purposes.

1985 Major Financings

Month		Millions of Dollars
Apr.	Common Stock—4,000,000 shares @ $15.48	$ 61.9
May	Pollution Control Bonds—10½% due 2015	245.0
Oct.	Pollution Control Bonds—10½% due 2014	41.0
Nov.	Mortgage Bonds— 10⅞% due 1995	150.0
	11¾% due 2014	250.0
Jan.-Dec.	Common Stock Purchase Plans: Dividend Reinvestment, Employee, PAYSOP— 7,990,000 shares Average Price of $15.77	126.0
	Common Stock continuous offerings: 3,387,100 shares Average Price of $15.65	53.0
	Sub-Total	$ 926.9
	Limerick Credit Agreement— Net additional borrowing (Outstanding 12/31/85—$550 million)	150.0
	Total	$1,076.9

Construction Expenditures

Investment in new plant and equipment amounted to $865 million in 1985 with approximately 70% spent on Limerick and related transmission facilities. Outlays for 1986 are expected to amount to approximately $771 million including $304 million for Limerick Unit No. 2.

Construction cranes dominate the downtown Philadelphia skyline. Work on IPM's Commerce Square continues as James C. O'Brien of Area Development and P. John Polizzi of Industrial and Commercial Services look on. The $300 million twin-tower office complex project is located at 21st and Market Streets.

E. Martin Shane of Area Development and Francis I. Corey of Industrial and Commercial Services confer near a model of One Liberty Place, which is the first phase of a $600 million Rouse & Associates development. The project will include two office towers, a 250-room luxury hotel, two levels of retail space and a parking garage. Scheduled to be completed in the fall of 1987, One Liberty Place will rise 60 stories above ground level, higher than the tower and statue of William Penn atop City Hall (40 stories).

Rates and Regulation

Effective January 25, 1985, the PUC adopted an Order granting the Company a net increase in annual electric revenues of $49 million, comprised of a base rate increase of $150 million, reflecting the inclusion of Salem Unit No. 2, less $101 million in fuel cost savings. The Company agreed to guarantee that Salem Unit No. 2 would produce $116 million of fuel savings for the period from February 1, 1985 to March 31, 1986.

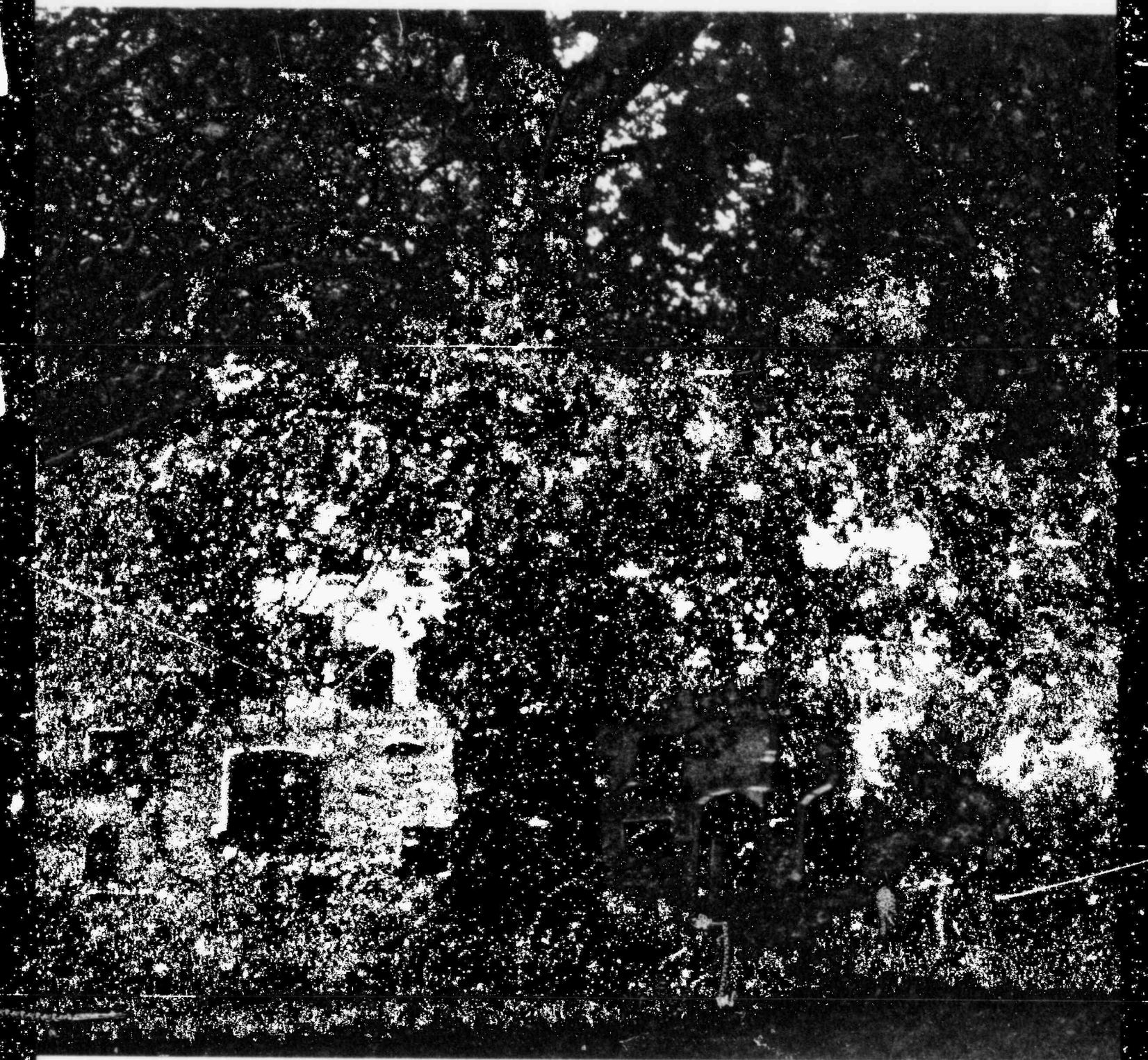
In September, the Company filed a $671 million electric rate increase to begin earning a cash return on the $3.8 billion investment in Limerick Unit No. 1 and 100% of common plant and to recover the costs of operating the unit. The request reflects an estimated $207 million in annual fuel cost savings resulting from the operation of Unit No. 1. The Company proposes to phase in the 28.2% increase over three years in three equal steps of 9.4% each and thereby lessen the impact of the increase on customers. In addition, the Company proposes that revenues deferred by the phase-in plan be recovered after the third or final step is effective, but without interest. The PUC suspended the rate increase until June 27, 1986, and ordered full public hearings.

In December, the PUC issued an Order in the Limerick Unit No. 2 Show Cause proceeding that approved the completion of construction of Unit No. 2 provided the Company agreed to a cost containment and operational incentive program. This program includes a $3.2 billion cap on the total cost of the unit for rate-making purposes and two plant performance requirements with incentives and penalties. After careful consideration, the Company's Board of Directors unanimously accepted the terms of the PUC Order and full construction resumed on Unit No. 2 in February 1986. Unit No. 2 is needed by the early 1990s to provide additional capacity for new load growth and to replace old oil-fired generation. The Company has scheduled the unit to be completed in late 1990 at a total cost of $3.2 billion, including the $901 million spent through December 1985. The Company believes that it can complete the unit on schedule with the highest degree of quality and within the PUC's cost containment cap.

In October, the PUC issued an Order denying the Company recovery of approximately $73 million of the $101 million of deferred replacement fuel costs associated primarily with Salem Unit No. 1 outages in 1983 and 1984 and costs incurred during operation of the Company's magnesium oxide (MgO) regeneration equipment in 1983. (The MgO regeneration equipment is part of the Company's scrubber system for removing sulfur

Paul Rudolph, Jr. of Gas Operations coaches boys and girls in soccer, basketball, and baseball for the Swarthmore Recreation Association.

DELAWARE COUNTY



The Brandywine Battlefield Park in Delaware County is one of many historic sites located in the county. Both Washington's and Lafayette's headquarters are located in this scenic park which dates back to the mid-17th century. This cemetery, which is still in use, has gravestones dating back to the Revolutionary War era.

dioxide from the stacks of its coal-fired plants located in its service area.) The disallowed costs were written off against third quarter income and reduced common stock earnings by $34.7 million, or 20 cents per share. The Company has filed a petition for review of this decision with the Commonwealth Court. In a later action on November 14, the PUC approved a revision to the current Energy Cost Rate (ECR) to collect the $28 million of withheld deferred fuel costs that were allowed by the Order. Finally, the Company was ordered to file a new ECR which permits the recovery of 80% of prospective fuel costs with the remaining 20% of fuel costs to be recovered through base rates. This new ECR is proposed to become effective at the end of the Limerick Unit No. 1 rate case.

Gas tariffs were reduced by approximately $28 million in several steps during the year due to supplier price decreases to the Company. These reductions did not affect earnings.

1985 Retail Base Rate Increases

	Application Date	Effective Date	Millions of Dollars Annual Revenue
Electric—Pa	4/27/84	1/25/85	$ 48.6
Electric—Pa	9/27/85	—	670.7*

*Net of $207.5 million of fuel savings

CHESTER COUNTY

World famous Longwood Gardens in scenic Chester County consists of 350 acres of outdoor gardens and woodlands, glassed conservatories encompassing 20 indoor gardens, and illuminated fountains.

Limerick Generating Station Update

On August 8, the Nuclear Regulatory Commission (NRC) voted to authorize a full-power operating license for Limerick Unit No. 1. This license replaced the low-power license, issued October 26, 1984, which limited operation of the reactor to 5% of full power.

Upon receipt of the full-power license, the Company increased the unit's power as called for in its start-up test program. However, on August 16, the NRC suspended operation above 5% of rated power as a result of an emergency stay order issued by the Third Circuit Court of Appeals in response to petitions filed by two intervenors in the NRC proceedings who had unsuccessfully opposed issuance of the Limerick license. After the filing of briefs and oral arguments, the Court removed the stay, and on August 21, the NRC lifted its suspension of the full-power license and the Company resumed testing at power levels above 5%.

Nuclear power plant start-up tests are conducted in a sequence that assures that all systems that are relied on for plant safety are fully tested. During the start-up phase, power is increased in steps that allow for the final setting of system controls to assure the reliable operation of the facility. In addition, start-up test data are recorded to provide operating guidelines throughout the life of the plant.

In Chester County, a community of energy efficient homes is being built by Amos Stoltzfus, a noted Chester and Lancaster County builder. Here, Mr. Stoltzfus (right) discusses his new community called "Wytheburn" with Robert B. Horne (left) of Western Division and Samuel E. Markley, Jr. (center) of Business Services.

The Limerick Unit No. 1 test program went extremely well and surpassed expectations. The program was completed in January 1986, and the unit was placed in commercial operation on February 1, 1986.

Water Requirements

A critical component of the permanent supplemental cooling water system for Limerick is the Point Pleasant Water Project, which was designed to be constructed and operated by the Neshaminy Water Resources Authority (NWRA), a municipal authority created by Bucks County, under a contract among NWRA, the Company and Bucks County. The Point Pleasant project has been the subject of substantial opposition from various groups, including a majority of the current Commissioners of Bucks County and a majority of the new members of the board of NWRA, which has resulted in interruption of construction and in litigation. In March 1985, appeals were filed by Bucks County and NWRA with the Commonwealth Court of Pennsylvania from the decision of the Court of Common Pleas of Bucks County which found the Point Pleasant contract to be valid and enforceable and ordered completion of the Project. In October 1985, the Commonwealth Court affirmed the decision of the Court of Common Pleas of Bucks County, and NWRA and Bucks County petitioned the Supreme Court of Pennsylvania for allowance of an appeal. Work on the project has been halted since early 1984.

During 1985, in order to provide an interim supply of supplemental cooling water necessary for the Limerick Unit No. 1 testing program, the Company applied to the Delaware River Basin Commission (DRBC) and obtained approvals for the modification of restrictions on the use of the Schuylkill River and the reallocation of cooling water to Limerick from two other fossil-fired power plants on the Schuylkill River. The DRBC approvals for the above-mentioned modifications of restrictions and reallocations were effective through December 31, 1985, and the Company has again filed requests with the DRBC for its 1986 supplemental cooling water needs pending resolution of the Point Pleasant project.

In September, Governor Thomas Kean of New Jersey and other dignitaries participated in ground breaking ceremonies for the Merrill Creek Project. This $217 million reservoir facility, which will be owned jointly by PE and six other electric utilities, is scheduled to be in service by May 1988 and will provide water for power plants along the Delaware River as well as Limerick. PE's share of the project cost will be $96 million.

Community involvement by the Company and its employees are an important contribution to our service area. Robert W. Kane of Energy Information and Education volunteers his services to the students and staff of the Chester County Child and Career Development Center, a school for children with learning disabilities.

Dolores E. McGuigan of Commercial Operations served as chairman of Bucks County's 1986 United Way Campaign. She is shown visiting the Bucks County Association for Retarded Citizens Preschool Center in Croydon, a United Way agency.

Located near Phillipsburg, New Jersey, about 50 miles north of Philadelphia, Merrill Creek is a small tributary of the Delaware River which is being dammed to create a 15 billion gallon reservoir. Water will be stored there when it is plentiful; then, during times of extreme low flow on the Delaware, this stored water will be returned to the Delaware River to replace the water the project owners use in operating their power plants. This will ensure that the region's electric generation needs will not be curtailed due to lack of water. Construction of a water storage facility was ordered by the DRBC in connection with its authorization to take water from the Delaware River for certain generating units, including Limerick.

Curtis S. Ruddle, Jr. of Eastern Division makes an aerial inspection of the Highlands, a new residential community of approximately 1,300 homes. Located in Chalfont, Bucks County, the homes are part of PE's Excellence in Energy Efficiency (EEE) Program and will have heat pumps.

Marketing

The Company continued to aggressively market programs designed to encourage the use of high-efficiency equipment and appliances and to promote greater off-peak use of our energy services.

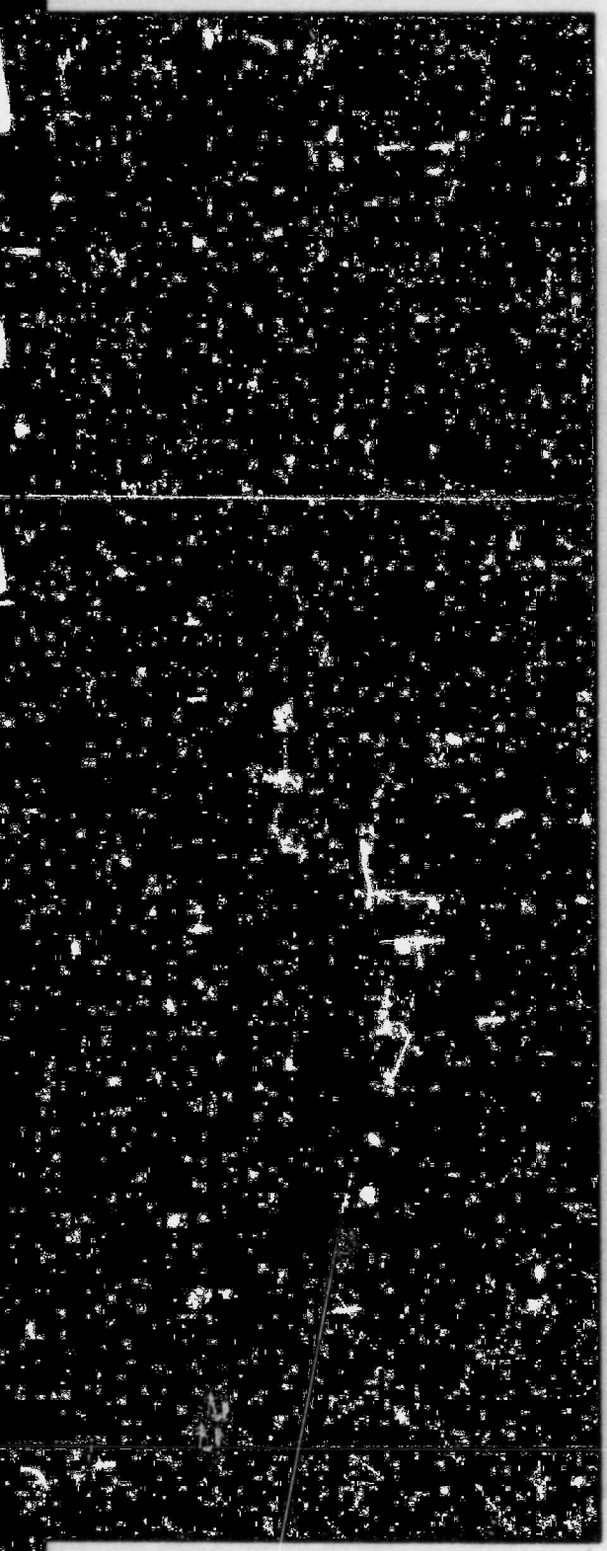
Much of our marketing effort is directed to electric space heating. Our territory experienced a record level of commercial construction in 1985—16 million square feet of new space underway. Over 65% will be heated electrically, while 18% will be heated by Company gas, resulting in a total Company penetration of 83% in this important market.

The residential market was also unusually active with 12,200 new units connected. Electric space heating was installed in 65% of these units. Heat pumps, which are actively promoted by the Company because of their efficiency and economy, will heat and cool 58% of these new dwelling units. Another 23% will have gas heat, so that over 88% of new homes in the service territory will be heated with PE's efficient, clean energy products.

Area Development

Southeastern Pennsylvania is on the move and Philadelphia Electric Company continues to play a leading role in promoting economic development in the area. Capitalizing on the successful theme, "We Know the Territory", Area Development's radio and print advertising continues to promote the many benefits the Greater Philadelphia metropolitan area has to offer.

BUCKS COUNTY



Bucks County offers abundant visual wealth and has attracted a community of artists and craftmen. Noted furniture designer George Nakashima inspects wooden slabs at his studio in New Hope.

The resurgence in the area's economy has been led by the non-manufacturing sector. Service industries, particularly medical and health care, have shown the greatest strength. Southeastern Pennsylvania has also become a strong center for finance, insurance and real estate. The area's unemployment rate of 5.7% is well below the national average.

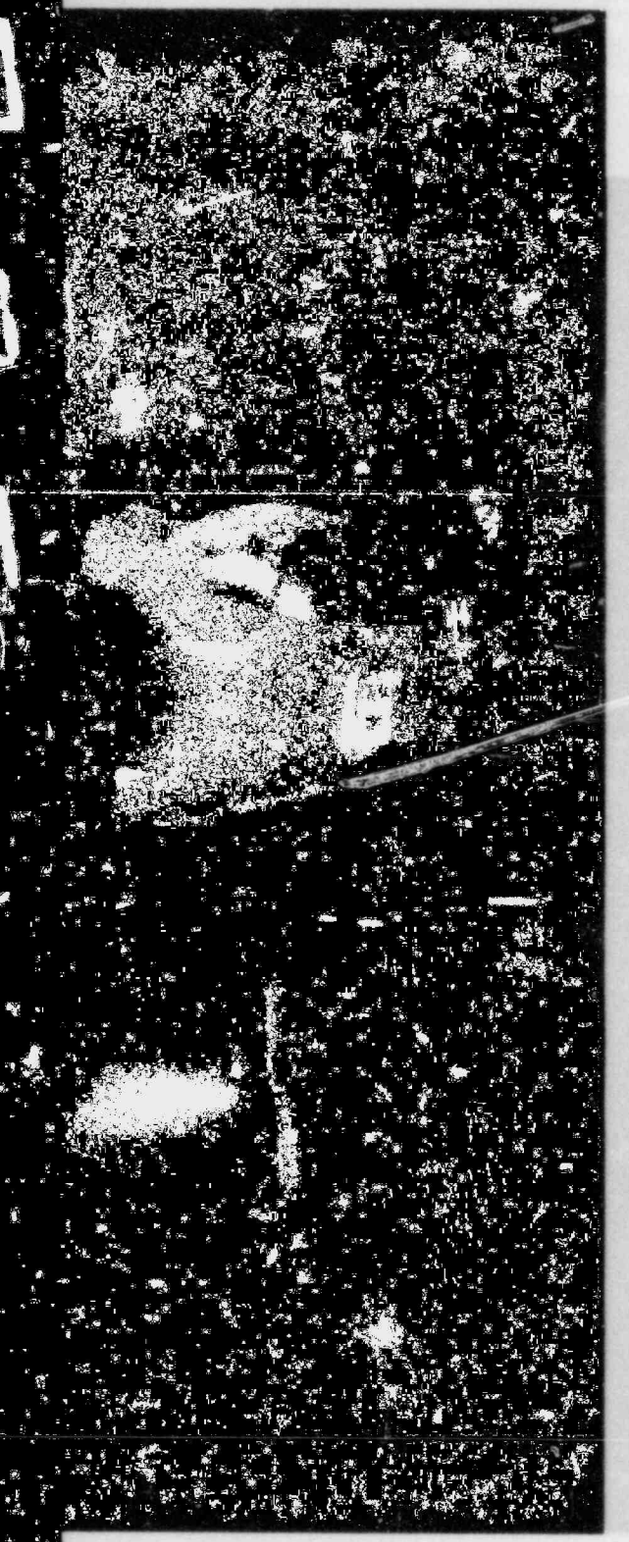
Southeastern Pennsylvania continues to be one of the leading high-tech areas in the country. The rapidly expanding Route 202 corridor was host this year to President Reagan when he barnstormed across the country to seek support for his tax plan. The area is one of the prime markets in the country for real estate investment. In downtown Philadelphia alone over 10 million square feet of new and rehabilitated office space is planned or under construction.

Aided by the strength of the local economy and the success of our promotional programs, the Area Development Department located 49 new firms which will result in 3,200 new jobs. In addition, it assisted in the retention of 62 existing business involving 5,800 jobs.

Cogeneration

The Company assists customers interested in installing their own systems to produce electricity by providing technical and cost-benefit analyses. Several customers are installing large systems, including Scott Paper and SmithKline Beckman. Meanwhile, six customers have installed small engine-generator sets of less than 300 kilowatts each to generate a portion of their power requirements. While some utilities along the Gulf Coast and the far west have large potential for cogeneration, the

MONTGOMERY COUNTY



Willow Grove Naval Air Station in Montgomery County is one of several major military installations in the Company's service territory. Major Peter Meyer of Marine Aircraft Group 49 completes a test flight.

Company's service area is not expected to be significantly impacted due to the small number of manufacturing or commercial customers which could find cogeneration to be cost-effective.

Conservation

The Company is continuing to pursue an extensive energy conservation program including its Residential Conservation Service (RCS) which has audited 16,500 homes for existing customers, its Tighten-Up/Low-Cost Conservation (TLC) program which has helped to weatherize 3,000 dwelling units for lower income families, and its Excellence in Energy Efficiency (EEE) program for new homes.

Excellence in Energy Efficiency (EEE) is a new and innovative program designed to encourage area builders to construct better houses for new home buyers, our future customers. Its goal is to achieve reduced energy bills, an increased level of comfort, and improved satisfaction with electric and gas service. To qualify for the EEE program, a builder must meet stringent construction standards that are above those required by statutes in these four basic areas: efficiencies of the heating and cooling equipment, design of the distribution system, air infiltration, and domestic water heating. The response has been outstanding with 99 builders having requested evaluation for EEE compliance.

Electric Operations

Although Limerick received the major share of the Company's publicity during the year, significant efforts were also taking place at other plants, notably the Peach Bottom Atomic Power Station. Peach Bottom Unit No. 2 returned to service in July 1985, after an outage for its

sixth refueling as well as major pipe replacement. Stainless steel piping connected to the reactor vessel was replaced with an improved alloy pipe to prevent weld cracking. This project incorporated a modified pipe system design to reduce the number of welds. This replacement involved the efforts of approximately 650 craftsmen and engineers at peak times and was the largest plant modification ever undertaken on the Company's system. The total cost of the replacement was $85 million of which the Company's share was $36 million. An extensive restart testing program, similar to that required for a new plant, was carried out to assure that no conditions or system characteristics were created during the outage which would in any way jeopardize the safe operation of the plant.

Likewise, Peach Bottom Unit No. 3 was shut down for a scheduled refueling and pipe inspection in July 1985. Weld cracks were found in the stainless steel piping connected to the reactor vessel and were repaired using a weld overlay technique. The unit is expected to be returned to service in February 1986. A pipe replacement program similar to that performed on Unit No. 2 is being studied for the next scheduled refueling outage in early 1987.

In 1985, Salem Unit No. 1 established a new United States record for electrical production in a calendar year by a single unit, operating at full capacity 95.3% of the time. Salem Unit No. 2 returned to full operation in May and operated at 76.1% of full capacity for the remainder of the year. However, as a result of lower oil prices, the unit did not fully achieve its contemplated fuel savings that the Company agreed to guarantee, necessitating an $8 million charge against 1985 pre-tax income. The Company owns 42.59% of the Salem Generating Station which is operated by Public Service Electric and Gas Company.

William G. Gotshall of Safety Division, currently serving as fire chief of the Enterprise Fire Company in Hatboro, has served as a volunteer firefighter for 22 years.

Eddystone Station celebrated its 25th anniversary in October. When first completed in 1960, the two supercritical, high-pressure, coal-fired units were the most efficient in the world. The station has more than doubled its generating capacity since the initial operation of these pioneering base load units with total capacity now equaling 1.5 million kilowatts, enough to serve a city of 650,000 people. The station achieved another engineering milestone in 1983 by installing a particulate and sulfur dioxide removal system, or scrubbers, which utilize a unique magnesium oxide regeneration system to remove in excess of 90% of the sulfur dioxide from the flue gas.

The Company's new magnesium oxide regeneration facilities, located at Allied Chemical Company in Claymont, Delaware, and Essex Chemical Company in Clifton, New Jersey, continued to perform well during 1985. The regeneration equipment at these sites separates the sulfur dioxide from the magnesium sulfite by-product of the flue gas scrubbing systems at the Eddystone and Cromby coal-burning stations and recovers the mag-

Buildings under construction in this Blue Bell office complex typify the strong office growth in the neighboring counties. An additional 16 million square feet of office space were underway in 1985, particularly in the Chester and Montgomery County areas of Great Valley, King of Prussia, Blue Bell, Plymouth Meeting, and Willow Grove.

Robert E. Bryson of Conowingo Power Company (a PE subsidiary) visits with Dolph Stiles of W. L. Gore and Associates, Inc. at the Fair Hill Plant in Maryland. The company manufacturers industrial filtration and pollution control products in seven plants in Maryland and approximately 40 plants throughout the world.

nesium oxide for reuse in the scrubbers. During 1985, the the process reclaimed 18,300 tons of magnesium oxide for reuse and supplied 19,600 tons of sulfur dioxide to the chemical companies for the production of sulfuric acid. Regeneration of the scrubber by-product not only provides economic recovery of the magnesium oxide, it also eliminates the need for the disposal of thousands of tons of scrubber waste in landfill sites.

The Company owns 21% of the Keystone and Conemaugh mine-mouth, coal-fired stations in western Pennsylvania which have a combined capacity of 3.4 million kilowatts. Both stations continued to perform well during 1985 and PE's share of their output was 4.4 billion kilowatthours. The high level of performance of these stations is directly attributable to capital investments which were made during recent years to increase the efficiency and reliability of these economic units. Both Keystone and Conemaugh receive coal directly from mines located near plant sites.

Thoroughbred horse racing and breeding are the major activities of Windfields Farm in Chesapeake City, Maryland. This customer of PE subsidiary Conowingo Power Company became the all-time leading breeder of stakes winners in the 1970s and 1980s.

PE continued to make optimum use of its transmission connections with systems outside the Pennsylvania-New Jersey-Maryland Interconnection (PJM), enabling the Company to buy economical coal-fired power rather than using its oil-burning units. These arrangements, combined with normal PJM purchases, minimized the operation of the higher-priced, oil-fired generating units on the Company's system. In 1985, 10.3 billion kilowatthours of economical power, representing 34% of the Company's total output, were purchased by PE. The resultant savings of approximately $135 million were passed on to PE customers.

The Company's Electric Transmission and Distribution (T&D) forces had another busy year in 1985. The interruption of electric service to about 190,000 customers caused by the high winds of Hurricane Gloria made it the fourth most severe storm in the Company's history. Due to the efforts of more than 1,400 employees, service was restored to all customers in about two days. At the completion of the work on the Company's system, more than 200 employees were sent to Long Island and New England to aid in the restoration of service in those areas under an industry-wide mutual assistance program. In addition to dealing with an extraordinary occurrence like Hurricane Gloria as well as the more typical emergency situations, the T&D department experienced its busiest year since 1979 in constructing facilities to serve new customers.

The Company has acquired two new electronic systems to aid in predicting the size and severity of storms such as Gloria which approach the Company's system. The first, a new color weather radar, shows levels of

Boat House Row along the Schuylkill River is a famous center-city landmark.

precipitation throughout the service territory and well beyond. The second, a computerized lightning detection system, locates cloud-to-ground lightning strikes anywhere along the east coast. The information from both systems is used by the Company to anticipate storm activity and to better allocate manpower in order to reduce the service restoration time to Company customers affected by the storms.

Gas Operations

Philadelphia Electric Company has consistently been a leader in the gas utility industry in developing and using new technology. The pipeline insertion machine (PIM) for cast iron gas main replacement continues this tradition. PIM is a unique, cost-effective system that permits the in-place replacement of cast iron gas mains with polyethelene gas pipe of the same or larger diameter.

Travelling at speeds up to seven feet per minute, the PIM, guided by a winch-pulled cable, is pneumatically pushed through the existing cast iron main, shattering the old pipe as it moves and simultaneously pulling the new rigid plastic sleeve to fill the void left by the existing cast iron pipe. This later serves as a conduit through which a new polyethylene plastic gas main is inserted. The method yields many benefits for the Company, the most significant and obvious being less excavation and restoration of paving.

An oversupply of natural gas in the interstate market continued to depress prices throughout 1985. The Company took full advantage of the soft natural gas market through reduced commodity rates from both of its interstate pipeline suppliers, and by purchasing 25% of its annual supply through spot transactions at a savings of $14.9 million. Reductions in the Company's gas rates totaling $28 million per year made in September and November passed these savings through to our customers.

In addition, the Company transported and delivered 10.3 billion cubic feet of gas purchased directly by large end-users for consumption at their local facilities.

Other Developments

In 1985, the Company installed a 40 kilowatt prototype fuel cell on the site of the Variety Club children's camp in Worcester, Pennsylvania, as a joint research effort funded by the Gas Research Institute, the U. S. Department of Energy and PE. The fuel cell uses natural gas as fuel. By a process similar to that of an electric battery, it converts the chemical energy contained in the gas to direct current. This current is converted to alternating current and fed into the distribution system. The waste energy from the process is used to heat a large indoor swimming pool used for rehabilitation therapy. Although not economic in its present configuration, the fuel cell concept holds promise for the future. It could ultimately utilize gasified coal to produce electric power in large central stations. The Company is following advanced fuel cell concepts with great interest.

General. The revenue growth of recent years has been accompanied by substantial increases in operating costs and carrying charges on increased investment in plant and equipment. Any future increases in such costs and charges may be expected to adversely affect future net income and earnings per average common share unless periodic rate relief is obtained to offset them. The capital carrying charges associated with the construction of Limerick, which are capitalized by crediting income with an allowance for funds used during construction (AFUDC) and recovered through future depreciation, continued to represent a major portion of net income during 1985. These charges will decrease as the commercial operation of Limerick Unit No. 1 is reflected in revenue. On September 27, 1985, the Company filed with the Pennsylvania Public Utility Commission (PUC) for an additional $671 million per year in electric revenue, net of fuel savings, to recover the costs associated with placing Unit No. 1 and one hundred percent of common plant in rate base. The PUC is expected to issue a final order in late June 1986. The Company has PUC approval to utilize an accounting treatment which synchronizes the expense accounting for Limerick Unit No. 1 with rate recognition of the unit.
On January 25, 1985, a $150 million per year base rate increase for electric service was put into effect to recover the costs associated with placing Salem Unit No. 2 in rate base. Output from the unit had previously been sold to Jersey Central Power & Light Company under a contract which expired on December 31, 1984. Despite the increase in electric rates granted in January 1985, the return on investment is still below that allowed by the PUC as a fair return in the Company's last rate order.

Electric Operating Revenue. Increased electric revenue in 1985 over 1984 is primarily attributable to higher base rates. Revenue associated with Salem Unit No. 2 output, formerly sold to Jersey Central Power & Light Company, is now reflected in the base rates for retail customers. The increase in 1984 compared with 1983 reflected higher base rates and higher fuel-related revenue. Kilowatthour sales of electricity to retail customers were essentially the same in 1985 and 1984.

Electric Revenue

Increase/(Decrease) Millions of Dollars	'85 vs. '84	'84 vs. '83
Rate Increases	$141.4	$140.0
Fuel-Related Revenue	(2.8)	104.0
Salem Unit No. 2	(67.0)	36.5
Other	8.9	47.3
Total	$ 80.5	$327.8

Gas Operating Revenue. Decreased gas revenue in 1985 compared with 1984 is attributable to a decrease in sales and lower fuel-related revenue resulting from reductions in the price of gas purchased from suppliers. Gas operating revenue net of fuel costs increased 6.7 percent in 1985 over 1984.

Fuel and Energy Interchange Expense. For accounting purposes, fuel and energy interchange costs are deferred until billed as fuel adjustment revenue. In 1985, gross fuel and energy interchange costs were $212 million lower than in 1984 due primarily to the excellent nuclear performance of Salem Station. Fuel and energy interchange costs deferred in previous years and charged to expense in 1985 amounted to $135 million, resulting in net fuel and energy interchange expense remaining essentially the same in 1985 as in 1984. Included in net fuel and energy interchange expense in 1985 was approximately $73 million of replacement energy costs associated primarily with Salem Unit No. 1 outages in 1983 and 1984 and costs incurred during the operation of the Company's flue gas scrubbing systems at coal-burning stations in 1983. Recovery of these costs was disallowed by the PUC in an order which the Company has appealed. Also included was an $8 million charge in recognition that Salem Unit No. 2 fuel savings were not expected to reach the minimum guaranteed to the PUC when the unit was included in the rate base. The $73 million write-off and the $8 million Salem charge reduced 1985 earnings by approximately 23 cents per share.
In 1984, gross fuel and energy interchange costs were essentially the same as in 1983. However, electric fuel costs deferred were lower by $104.2 million, resulting in a net increase in fuel and energy interchange expense compared with 1983.

Other Operating and Maintenance Expenses. Other operating and maintenance expenses have increased in the last two years due to inflation, growth in utility plant, and increased costs associated with the Company's nuclear generating units and with operating the new flue gas scrubbing systems at the Company's two coal-burning stations.

Depreciation. Increases in depreciation in the last two years reflect additions to plant in service.

Income Taxes. Income taxes charged to operations decreased in 1985 compared with 1984 as a result of lower operating income. Income tax credits, net, included in other income, have increased in the last two years as a result of the higher allowance for borrowed funds used during construction.

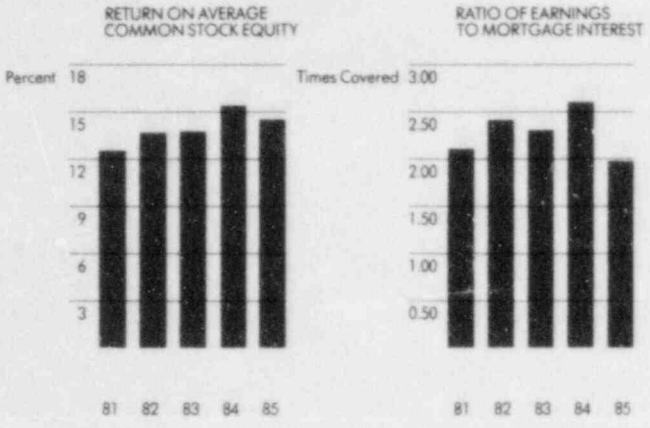
Other Taxes. Other taxes have increased primarily due to higher capital stock and realty taxes.

Allowance for Funds Used During Construction. The increases in AFUDC for the last two years have resulted primarily from increases in construction work in progress.

Interest Charges. Interest charges on debt increased in the last two years due to additional debt outstanding. The ratio of earnings to mortgage interest, which is one measure of the Company's ability to issue additional mortgage bonds, was 1.98 times at December 31, 1985.

Capital Expenditures and Changes in Financial Position. The Company is carrying on a construction program which is estimated to require expenditures of $771 million in 1986 and $2.9 billion from 1987 to 1989. A majority of these expenditures relates to the construction of the Company's second 1055 mW nuclear generating unit at Limerick. Successful completion of this program is dependent on the Company's ability to obtain external financing, primarily through debt arrangements and sales of equity securities which are subject to market conditions and to meeting certain earnings tests. The program also is subject to the licensing requirements of the Nuclear Regulatory Commission, to financing approvals by the PUC, and to change due to litigation. The Company cannot predict the outcome of such regulatory reviews, but believes the safety requirements have been or will be met, the economic desirability of the program has been demonstrated, and that the program will be successfully completed and approved.

Interim financing of the construction program is provided by commercial paper borrowings and short- and intermediate-term bank loans, which also are dependent on the Company's financial position.



Accountants' Report

To the Shareholders and Board of Directors
Philadelphia Electric Company

We have examined the consolidated balance sheets of Philadelphia Electric Company and Subsidiary Companies as of December 31, 1985 and 1984, and the related consolidated statements of income, retained earnings, changes in common stock, preferred stock, and other paid-in capital, 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, the financial statements referred to above present fairly the consolidated financial position of Philadelphia Electric Company and Subsidiary Companies as of December 31, 1985 and 1984, and the consolidated results of their operations and changes in their 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.

1900 Three Mellon Bank Center
Philadelphia, Pennsylvania
February 3, 1986

Coopers + Lybrand

Philadelphia Electric Company and Subsidiary Companies

Consolidated Statements of Income

For the Year Ended December 31	1985	1984	1983
		(Thousands of Dollars)	
Operating Revenues			
Electric	**$2,516,191**	$2,435,731	$2,107,897
Gas	**428,984**	462,966	417,042
Steam	**68,529**	82,320	71,111
Total Operating Revenues	**3,013,704**	2,981,017	2,596,050
Operating Expenses			
Fuel and Energy Interchange	**1,139,553**	1,122,177	986,634
Other Operating Expenses	**565,713**	527,060	449,101
Maintenance	**265,173**	245,583	222,640
Depreciation	**184,965**	178,326	165,327
Income Taxes	**201,823**	246,749	200,026
Other Taxes	**241,524**	206,863	178,615
Total Operating Expenses	**2,598,751**	2,526,758	2,202,343
Operating Income	**414,953**	454,259	393,707
Other Income and Deductions			
Allowance for Other Funds Used During Construction	**176,310**	134,485	108,126
Income Tax Credits, Net	**133,415**	116,423	87,912
Other, Net	**(3,464)**	239	(3,125)
Total Other Income and Deductions	**306,261**	251,147	192,913
Income Before Interest Charges	**721,214**	705,406	586,620
Interest Charges			
Long-Term Debt	**435,373**	402,475	330,200
Short-Term Debt	**17,721**	30,912	35,199
Allowance for Borrowed Funds Used During Construction	**(257,181)**	(220,370)	(167,868)
Net Interest Charges	**195,913**	213,017	197,531
Net Income	**525,301**	492,389	389,089
Preferred Stock Dividends	**90,577**	82,682	67,384
Earnings Applicable to Common Stock	**$ 434,724**	$ 409,707	$ 321,705
Average Shares of Common Stock Outstanding *(Thousands)*	**169,784**	151,804	133,852
Earnings Per Average Common Share *(Dollars)*	**$2.56**	$2.70	$2.40
Dividends Per Common Share *(Dollars)*	**$2.20**	$2.20	$2.12

See notes to financial statements.

Philadelphia Electric Company and Subsidiary Companies

Consolidated Balance Sheets

ASSETS

December 31	1985	1984
	(Thousands of Dollars)	
Utility Plant, at original cost		
Electric	**$ 4,982,099**	$4,806,496
Gas	**474,599**	443,946
Steam	**54,138**	53,846
Common, used in all services	**132,323**	129,649
	5,643,159	5,433,937
Less: Accumulated Depreciation	**1,824,420**	1,726,321
Net Utility Plant in Service	**3,818,739**	3,707,616
Construction Work in Progress	**4,929,093**	4,400,166
Leased Property, net	**338,141**	352,133
Net Utility Plant	**9,085,973**	8,459,915
Investments	**87,670**	80,871
Current Assets		
Cash and Temporary Cash Investments	**188,785**	30,357
Escrow Deposits	**13,301**	88,076
Accounts Receivable		
Customers	**348,233**	346,018
Other	**22,687**	38,284
Inventories, at average cost		
Fossil Fuel	**63,594**	93,004
Materials and Supplies	**60,152**	57,532
Deferred Energy Costs	**101,655**	229,895
Compensated Absences	**46,370**	41,478
Other	**12,101**	7,392
Total Current Assets	**856,878**	932,036
Deferred Debits	**134,793**	82,907
Total	**$10,165,314**	$9,555,729

See notes to financial statements.

CAPITALIZATION AND LIABILITIES

December 31	1985	1984
	(Thousands of Dollars)	
Capitalization		
Common Shareholders' Equity		
Common Stock	**$ 2,601,989**	$2,360,948
Other Paid-In Capital	**7,331**	6,727
Retained Earnings	**583,728**	523,300
	3,193,048	2,890,975
Preferred Stock		
Without Mandatory Redemption	**572,472**	572,472
With Mandatory Redemption	**318,309**	326,235
Long-Term Debt	**4,309,131**	3,777,961
Total Capitalization	**8,392,960**	7,567,643
Current Liabilities		
Short-Term Debt		
Bank Loans	**1,000**	20,000
Pollution Control Notes	**—**	240,000
Long-Term Debt Due Within One Year	**80,800**	50,361
Capital Lease Obligations Due Within One Year	**76,326**	68,332
Accounts Payable	**144,407**	156,245
Taxes		
Accrued	**58,509**	40,314
Deferred Income Taxes-Energy	**51,814**	117,729
Interest Accrued	**93,008**	91,110
Dividends Declared	**40,698**	43,796
Compensated Absences	**46,370**	41,478
Other	**25,583**	85,749
Total Current Liabilities	**618,515**	955,114
Deferred Credits and Other Liabilities		
Deferred Income Taxes	**502,621**	373,343
Unamortized Investment Tax Credits	**302,409**	299,419
Capital Lease Obligations	**261,815**	283,802
Other	**86,994**	76,408
Total Deferred Credits and Other Liabilities	**1,153,839**	1,032,972
Total	**$10,165,314**	$9,555,729

Philadelphia Electric Company and Subsidiary Companies

Consolidated Statements of Changes in Financial Position

For the Year Ended December 31	1985	1984	1983
		(Thousands of Dollars)	
Sources of Funds			
Funds From Operations			
Net Income	**$ 525,301**	$ 492,389	$ 389,089
Principal Non-Cash Charges (Credits) to Income			
Depreciation	**184,965**	178,326	165,327
Nuclear Fuel Disposal Costs	**5,601**	13,201	12,166
Deferred Income Taxes	**66,281**	76,197	175,307
Investment Tax Credits, Net of Amortization	**3,567**	49,927	(46,064)
Allowance for Other Funds Used During Construction	**(176,310)**	(134,485)	(108,126)
Total from Operations	**609,405**	675,555	587,699
Funds from Financings			
Sales of Securities			
Common Stock	**241,041**	250,445	284,305
Preferred Stock	**—**	100,000	150,000
Long-Term Debt	**686,000**	258,700	175,000
Short-Term Pollution Control Notes	**—**	240,000	—
Net Borrowings Under Revolving Credit Agreements	**150,000**	200,000	200,000
Sale of Magnesium Oxide Regeneration Facilities	**—**	55,928	37,679
Increase in Capital Lease Obligations	**46,364**	12,690	72,514
Increase in Short-Term Debt	**—**	—	202,800
Total from Financings	**1,123,405**	1,117,763	1,122,298
Total Sources	**$1,732,810**	$1,793,318	$1,709,997
Uses of Funds			
Additions to Utility Plant	**$ 826,609**	$1,053,133	$1,030,321
Additions to Leased Assets	**46,364**	12,690	72,514
Allowance for Other Funds Used During Construction	**(176,310)**	(134,485)	(108,126)
Dividends on Preferred and Common Stock	**464,003**	416,098	352,553
Retirement of Long-Term Debt	**273,394**	11,194	41,573
Premium on Retirement of Long-Term Debt	**48,589**	—	—
Redemption of Preferred Stock	**7,926**	8,628	7,427
Redemption of Short-Term Pollution Control Notes	**240,000**	—	—
Decrease in Short-Term Debt	**19,000**	247,500	—
Net Change in Deferred Energy Costs	**(128,240)**	80,649	234,625
Net Change in Nuclear Fuel Escrow Account	**(51,816)**	32,160	7,113
Net Change in Other Items of Working Capital	**153,528**	50,340	71,451
Other, Net	**9,763**	13,411	546
Total Uses	**$1,732,810**	$1,793,318	$1,709,997

See notes to financial statements.

Philadelphia Electric Company and Subsidiary Companies

Consolidated Statements of Retained Earnings

For the Year Ended December 31	1985	1984	1983
		(Thousands of Dollars)	
Balance, January 1	**$ 523,300**	$452,964	$423,596
Net Income	**525,301**	492,389	389,089
	1,048,601	945,353	812,685
Cash Dividends Declared			
Preferred Stock (at specified annual rates)	**90,524**	83,820	68,970
Common Stock (per share, $2.20 in 1985 and 1984, $2.12 in 1983)	**373,479**	334,278	283,583
Expenses of Issuing Preferred and Common Stock	**870**	3,955	7,168
	464,873	422,053	359,721
Balance, December 31	**$ 583,728**	$523,300	$452,964

Consolidated Statements of Changes in Common Stock, Preferred Stock and Other Paid-in Capital

	Common Stock		Preferred Stock		Other Paid-In
	Shares	Amount	Shares	Amount	Capital
		(All Amounts in Thousands)			
Balance, January 1, 1983	125,767	$1,826,198	6,648	$664,762	$4,641
Issuance of Stock					
Public Sales	11,000	186,055	1,500	150,000	—
Employee Stock Ownership Plans	1,256	21,054	—	—	—
Dividend Reinvestment and Stock Purchase Plan	4,788	77,196	—	—	—
Redemptions	—	—	(75)	(7,427)	1,215
Balance, December 31, 1983	142,811	2,110,503	8,073	807,335	5,856
Issuance of Stock					
Public Sales	11,613	144,548	1,000	100,000	—
Employee Stock Ownership Plans	914	10,563	—	—	—
Dividend Reinvestment and Stock Purchase Plan	6,965	95,334	—	—	—
Redemptions	—	—	(86)	(8,628)	871
Balance, December 31, 1984	162,303	2,360,948	8,987	898,707	6,727
Issuance of Stock					
Public Sales	**7,387**	**115,008**	—	—	—
Employee Stock Ownership Plans	**873**	**15,294**	—	—	—
Dividend Reinvestment and Stock Purchase Plan	**7,117**	**110,739**	—	—	—
Redemptions	—	—	**(79)**	**(7,926)**	**604**
Balance, December 31, 1985	**177,680**	**$2,601,989**	**8,908**	**$890,781**	**$7,331**

See notes to financial statements.

1. SIGNIFICANT ACCOUNTING POLICIES

General. All utility subsidiary companies of Philadelphia Electric Company are wholly owned and are included in the consolidated financial statements. Nonutility subsidiaries are included in investments and accounted for by the equity method. Accounting policies are in accordance with those prescribed by the regulatory authorities having jurisdiction, principally the Federal Energy Regulatory Commission (FERC) and the Pennsylvania Public Utility Commission (PUC).

Revenues. Revenues are recorded in the accounts upon billing to the customer. Rate increases are billed from dates authorized or permitted to become effective by the regulatory authorities.

Fuel Expenses. Fuel expenses, which are recoverable under energy adjustment clauses, are recognized when the related revenue is billed to customers. Nuclear fuel used in the Peach Bottom and Salem Generating Stations is leased, and the costs of such leased fuel are charged to fuel expense on the unit of production method. Nuclear fuel disposal costs are being charged to fuel expense as the related fuel is burned.

Depreciation. For financial reporting purposes, depreciation is provided over the estimated service lives of the plant on the straight-line method and, for tax purposes, generally, over shorter lives on accelerated methods. The estimated decommissioning costs of nuclear plants, totaling approximately $181,862,000 at December 31, 1985, are being charged to operations as permitted for rate-making purposes. The amounts charged are deposited in an escrow account and invested for funding of future costs. The Company believes that any increase in the estimated costs would be recoverable through adjustments of rates charged to its customers. Annual depreciation provisions, expressed as a percent of average depreciable utility plant in service, were approximately 3.35% for 1985, 3.29% for 1984 and 3.20% for 1983.

Income Taxes. Deferred income taxes are provided for differences between book and taxable income to the extent permitted for rate-making purposes. Investment tax credits, other than credits resulting from contributions to employee stock ownership plans, which do not affect income, are deferred and amortized to income over the estimated useful life of the related utility plant.

Allowance for Funds Used During Construction (AFUDC). AFUDC is a non-cash item which is defined in the uniform systems of accounts as "the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used." AFUDC is recorded as a charge to Construction Work In Progress, and the equivalent credits are to "Interest Charges" for the pretax cost of borrowed funds and to "Other Income" for the remainder as the allowance for equity funds. The rate used for capitalizing AFUDC, which averaged 9.5% in 1985, 9.4% in 1984, and 9.3% in 1983, is computed under a method prescribed by the regulatory authorities. The rate is a "net after-tax rate" and the current income tax reductions applicable to the interest charges capitalized are recorded in "Other Income." AFUDC is not included in taxable income and the depreciation of capitalized AFUDC is not tax deductible.

Gas Exploration and Development Joint Ventures. The Company has invested in several joint ventures for exploring and drilling for natural gas. Costs are capitalized under the full cost method and charged to operations commensurate with production.

2. JOINTLY OWNED ELECTRIC UTILITY PLANT

The Company's ownership interests in jointly owned utility plant at December 31, 1985, were as follows:

	Production Plants					Transmission Plant
	Peach Bottom	Salem	Keystone	Conemaugh	Merrill Creek	
Operator	Philadelphia Electric Company	Public Service Electric and Gas Company	Pennsylvania Electric Company	Pennsylvania Electric Company	Jersey Central Power & Light Company	Various Companies
Participating Interest	42.49%	42.59%	20.99%	20.72%	44.24%	21% to 43%
			(Thousands of Dollars)			
Company's share of:						
Utility Plant	$510,652	$903,473	$60,683	$62,186	—	$68,658
Accumulated Depreciation	120,522	145,577	23,464	23,520	—	13,991
Construction Work In Progress	12,717	19,936	7,791	2,469	$18,458	—

The Company's participating interests are financed with Company funds and, when placed in service, all operations are accounted for as if such participating interests were wholly owned facilities.

3. COMMON STOCK

At December 31, 1985 and 1984, Common Stock, without par value, consisted of 240,000,000 shares authorized and 177,679,977 and 162,303,390 shares, respectively, outstanding. At December 31, 1985, there were 8,394,449 shares reserved for issuance under stock purchase plans.

4. PREFERRED STOCK

At December 31, 1985 and 1984, Preferred Stock $100 par, cumulative

	Current Redemption Price (a)	Refunding Restricted Prior to (b)	Shares			Amount	
			Authorized	Outstanding 1985	Outstanding 1984	1985	1984
						(Thousands of Dollars)	
Series (without mandatory redemption)							
14.15%(c)	$114.15	2-1-90	500,000	**500,000**	500,000	**$ 50,000**	$ 50,000
13.35% (c)	113.35	2-1-89	750,000	**750,000**	750,000	**75,000**	75,000
12.8% (c)	112.80	5-1-88	750,000	**750,000**	750,000	**75,000**	75,000
9.50%	103.50		750,000	**750,000**	750,000	**75,000**	75,000
8.75%	104.00		650,000	**650,000**	650,000	**65,000**	65,000
7.85%	103.00		500,000	**500,000**	500,000	**50,000**	50,000
7.80%	103.00		750,000	**750,000**	750,000	**75,000**	75,000
7.75%	103.00		200,000	**200,000**	200,000	**20,000**	20,000
4.68%	104.00		150,000	**150,000**	150,000	**15,000**	15,000
4.4%	112.50		274,720	**274,720**	274,720	**27,472**	27,472
4.3%	102.00		150,000	**150,000**	150,000	**15,000**	15,000
3.8%	106.00		300,000	**300,000**	300,000	**30,000**	30,000
			5,724,720	**5,724,720**	5,724,720	**572,472**	572,472
Series (with mandatory redemption)(d)							
17.125%	$117.13	5-1-87	300,000	**300,000**	300,000	**30,000**	30,000
15.25%	110.00	5-1-90	500,000	**500,000**	500,000	**50,000**	50,000
14.625%	108.70 (e)	5-1-90	500,000	**500,000**	500,000	**50,000**	50,000
10%	104.44	5-1-90	220,000	**220,000**	220,000	**22,000**	22,000
9.52%	106.25	5-1-86	500,000	**393,690**	401,650	**39,369**	40,165
8.75%	105.15	5-1-88	500,000	**433,400**	466,700	**43,340**	46,670
7.325%	103.81		750,000	**540,000**	570,000	**54,000**	57,000
7%	101.00		400,000	**296,000**	304,000	**29,600**	30,400
			3,670,000	**3,183,090**	3,262,350	**318,309**	326,235
Unclassified			605,280	—	—	—	—
Total Preferred Stock			10,000,000	**8,907,810**	8,987,070	**$890,781**	$898,707

(a) Redeemable, at the option of the Company, at the indicated dollar amounts per share, plus accrued dividends.

(b) Prior to the date specified, none of the shares of each series indicated may be redeemed through refunding at an interest cost or dividend rate which is less than the dividend rate of such series.

(c) Ownership of these series of Preferred Stock is evidenced by Depositary Preference Shares, each representing 1/10 of a share of Preferred Stock.

(d) Sinking Fund requirements (par value) in the period 1986 -1990 are as follows: 1986-$14,599,000; 1987-$15,230,000; 1988-$17,530,000; 1989-$17,530,000; 1990-$27,530,000.

(e) Not redeemable prior to May 1, 1990.

5. LONG-TERM DEBT
At December 31, 1985 and 1984

	Series	Due	1985	1984
			(Thousands of Dollars)	
First and Refunding Mortgage Bonds (a)				
	3-1/8%	1985	—	$ 50,000
	4-3/8%	1986	$ 50,000	50,000
	4-5/8%	1987	40,000	40,000
	3-3/4%-14%	1988	52,500	52,500
	5%-14%	1989	62,500	62,500
	14%	1990	11,000	11,000
	4-1/2%-14%	1991-1995	508,225	359,700
	6-1/8%-15-1/4%	1996-2000	608,684	610,817
	7-3/8%-12-1/2%	2001-2005	480,000	480,000
	6%-18-3/4%	2006-2010	447,369	523,500
	10-1/2%-18%	2011-2015	745,283	350,000
Total First and Refunding Mortgage Bonds			3,005,561	2,590,017
Notes Payable—Banks	(b)	1987-1989	225,000	225,000
Notes Payable—Other	17%	1986-1987	20,000	20,000
Revolving Credit and Term Loan Agreements	(c)	1988-1991	550,000	400,000
Pollution Control Notes	5-1/2%-13%	1997-2013	272,685	274,190
Debentures	4.85%	1986	20,800	21,161
Debentures	14-1/8%	1990	50,000	50,000
Debentures	14-3/4%	2005	100,000	100,000
Debentures	14.5%	2009	150,000	150,000
Sinking Fund Debentures—				
Philadelphia Electric Power Company, a Subsidiary	4-1/2%	1995	15,325	16,397
Unamortized Debt Discount and Premium, Net			(19,440)	(18,443)
Total Long-Term Debt			4,389,931	3,828,322
Due Within One Year (d)			80,800	50,361
Long-Term Debt included in Capitalization(e)			$4,309,131	$3,777,961

(a) Utility plant is subject to the lien of the Company's mortgage. Proceeds from the November, 1985 sale of $250,000,000 principal amount of 11-3/4% Series due 2014 and $150,000,000 principal amount of 10-7/8% Series due 1995 were used in part to repurchase $76,131,000 principal amount of 18-3/4% Series due 2009, $62,621,000 principal amount of 18% Series due 2012, and $78,096,000 principal amount of 17-5/8% Series due 2011. Premium on the repurchase of $48,588,515 was charged to Deferred Debits. The Company, in its currently pending electric rate case, will request the PUC to allow recovery in rates of this amount over the weighted average life of the new debt, approximately 21 years. Amortization of the premium will be charged to interest expense over the period of recovery.

(b) At interest rates ranging from prime rate to prime rate plus 1/2%.

(c) The Company has a $550 million revolving credit and term loan agreement with a group of banks which provided the financing required to complete Limerick Unit No. 1. The revolving credit arrangement converts into a term loan in August 1987. The borrowings are due in eight semi-annual installments with the first payment due 6 months after the conversion into the term loan. Interest on outstanding borrowings is based on specific formulas selected by the Company involving yields on several types of debt instruments. There is an annual commitment fee of 1/2% on the unused amount. At December 31, 1985, $550 million was outstanding under this agreement.
The Company also has a $400 million revolving credit and term loan agreement with a group of banks which expires in 1987, but which may be extended through 1990 upon approval of the banks. There is an annual commitment fee of 3/8% on the unused amount. There were no borrowings under this agreement during the year.

(d) Long-term debt maturities in the period 1987-1990 are as follows:
1987-$187,844,000; 1988-$281,775,000; 1989-$241,850,000; 1990-$215,350,000.

(e) The annualized interest on long-term debt at December 31, 1985, was $455.7 million of which $309.3 million was associated with mortgage bonds and $146.4 million was associated with other long-term debt.

6. SHORT-TERM DEBT

	1985	1984	1983
		(Thousands of Dollars)	
Average Short-Term Borrowings	**$127,392**	$166,713	$164,429
Average Interest Rates, Computed on Daily Basis	**6.38%**	9.88%	9.06%
Maximum Short-Term Borrowings Outstanding	**$360,000**	$302,500	$340,000
Average Interest Rates on Short-Term Borrowings at December 31:			
Bank Loans	**9.50%**	9.95%	10.53%
Commercial Paper—Tax Exempt	**—**	—	5.61%
Commercial Paper—Taxable	**—**	—	10.64%
Pollution Control Notes	**—**	6.44%	—

At December 31, 1985, the Company had borrowed $1.0 million under formal and informal lines of credit with banks aggregating approximately $371 million. The Company generally does not have formal compensating balance arrangements with these banks.

7. RETIREMENT BENEFITS

The Company and its subsidiaries have noncontributory trusteed retirement plans applicable to all regular employees. Pension costs include normal cost for the year and amortization of unfunded prior service costs over ten to twenty years. Approximately 80% of such costs were charged to operating expenses and the remainder, associated with construction labor, to the cost of new utility plant. Retirement plan costs, which are funded as accrued, were $46,700,000, $42,000,000 and $41,000,000 in 1985, 1984 and 1983, respectively.

Pension Plan data as of the dates of the most recent actuarial valuations is as follows:

	January 1	
	1985	1984
		(Thousands of Dollars)
Actuarial present value of accumulated plan benefits		
(7.0% assumed rate of return)		
Vested	**$512,639**	$447,994
Nonvested	**60,990**	54,174
	$573,629	$502,168
Net assets available for benefits	**$645,726**	$573,372

Changes in plan provisions, effective January 1, 1985, increased the actuarial present value of accumulated plan benefits by approximately $16.3 million and increased pension expense by approximately $2.8 million. The actuarial methods and assumptions, as well as the accounting policy, are the same as those in the prior year.

The preceding tabular disclosures are required under applicable accounting principles. However, the Company is of the opinion that comparing the actuarial present value of accumulated plan benefits with the net assets available for benefits may be misleading. The plan is of a long-term nature and is funded on a basis consistent with this concept. The actuarial value of accumulated plan benefits is, essentially, a hypothetical plan termination calculation which does not take into account future salaries or future service. Net assets, which are measured at fair value at January 1, are subject to fluctuations in the securities markets and therefore, may not be indicative of the plan's long-term funded status.

In December, 1985, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 87 (FASB 87), *Employer's Accounting for Pensions*. FASB 87 supersedes existing accounting principles for defined benefit pension plans and becomes applicable to the Company in 1987. The Company has not fully evaluated FASB 87, but it believes it would not have a material negative impact on the financial statements.

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for retired employees. Substantially all of the Company's employees may become eligible for these benefits if they reach retirement age while still working for the Company. These benefits and similar benefits for active employees are provided by an insurance company whose premiums are based on the benefits paid during the year. The Company recognizes the cost of providing these benefits by charging the annual insurance premiums to expense. The cost of providing benefits for approximately 2,400 retirees during the years 1983 to 1985 is not separable from the cost of providing benefits for approximately 10,000 active employees for the same period. Total premiums amounted to $29.3 million, $26.6 million, and $24.3 million, in 1985, 1984 and 1983, respectively.

8. INCOME TAXES

	1985	1984	1983
		(Thousands of Dollars)	
Included in operations:			
Federal			
Current	**$106,994**	$ 96,915	$ 54,495
Deferred	**59,837**	49,770	151,259
Investment tax credits, net	**3,567**	49,927	(46,064)
State			
Current	**24,981**	23,710	16,288
Deferred	**6,444**	26,427	24,048
Included in other income and deductions (principally current):			
Federal	**(109,580)**	(93,818)	(70,902)
State	**(23,835)**	(22,605)	(17,010)
Total	**$ 68,408**	$130,326	$112,114

Investment tax credits and income tax credits resulting from contributions to employee stock ownership plans reduced Federal income taxes currently payable by $12 million in 1985 and $58 million in 1984. Approximately $244 million of such additional tax credits generated from 1982 through 1985 have not been utilized due to limitations based on taxable income. These credits may be used to reduce Federal income taxes in future years and expire at various times from 1997 to 2000.

Effective with the PUC's electric rate order dated January 24, 1985, the Company began flowing through the state income tax benefits associated with accelerated depreciation attributable to its electric operations. This change reduced operating revenues and operating expenses by approximately $1.8 million but had no effect on operating income and net income.

For a number of years the Company has used accelerated depreciation for income tax purposes and straight line depreciation for financial reporting purposes. Deferred taxes were recorded only on those timing differences recognized for rate-making. The cumulative net amount of such timing differences for which deferred taxes were not recorded was approximately $790 million at December 31, 1985. Since the Company expects to charge customers for taxes paid when the timing differences reverse, the tax effect of such timing differences is not recorded currently.

Provisions for deferred income taxes on operating income consist of the tax effects of the following timing differences:

	1985	1984	1983
		(Thousands of Dollars)	
Depreciation and amortization	**$ 34,417**	$ 33,965	$ 38,792
Nuclear waste disposal costs	**(5,932)**	(7,355)	24,281
Deferred energy costs	**(65,915)**	41,212	119,867
Precommercial operation of Limerick Unit No. 1	**97,867**	—	—
Premium on retirement of long-term debt	**24,731**	—	—
Other	**(18,887)**	8,375	(7,633)
Total	**$ 66,281**	$ 76,197	$175,307

The total income tax provisions differ from amounts computed by applying the Federal statutory tax rate to income and adjusted income before income taxes for the following reasons:

Net income	**$525,301**	$492,389	$389,089
Total income tax provisions	**68,408**	130,326	112,114
Income before income taxes	**593,709**	622,715	501,203
Deduct—allowance for funds used during construction (nontaxable)	**433,491**	354,855	275,994
Adjusted income before income taxes	**$160,218**	$267,860	$225,209
Income taxes on above at Federal statutory rate of 46%	**73,700**	123,215	103,596
Increase (decrease) due to:			
Depreciation timing differences not normalized	**7,297**	7,247	7,941
State income taxes, net of Federal income tax benefits	**4,099**	14,867	12,597
Amortization of investment tax credits previously deferred	**(8,265)**	(7,752)	(6,210)
Other, net	**(8,423)**	(7,251)	(5,810)
Total income tax provisions	**$ 68,408**	$130,326	$112,114
Provision for income taxes as a percent of:			
Income before income taxes	**11.5%**	20.9%	22.4%
Adjusted income before income taxes	**42.7%**	48.7%	49.8%

9. TAXES, OTHER THAN INCOME

	1985	1984	1983
		(Thousands of Dollars)	
Gross receipts	**$128,346**	$122,881	$108,211
Capital stock	**28,246**	13,240	19,198
Realty	**62,296**	48,030	30,975
Other	**22,636**	22,712	20,231
Total	**$241,524**	$206,863	$178,615

10. ESCROW DEPOSITS

Escrow deposits are stated at cost plus accrued interest, which approximates market, and consist of cash equivalent securities held in trusteed accounts which are restricted as to withdrawal pending the Company's incurring qualified costs. Below is a summary of such escrow deposits at December 31, 1985 and 1984.

	1985	1984
		(Thousands of Dollars)
Pollution Control Facilities Under Construction	**$ 5,415**	$31,305
Other Facilities Under Construction	**7,886**	4,955
Nuclear Fuel Disposal	**—**	51,816
Total	**$13,301**	$88,076

11. INVESTMENTS

At December 31	1985	1984
		(Thousands of Dollars)
Gas Exploration and Development Joint Ventures	**$44,743**	$46,406
Real Estate Developments and Other Ventures	**15,433**	12,120
Nonutility Property	**13,931**	13,441
Escrow Deposits for Decommissioning Nuclear Plants	**12,563**	7,792
Other Deposits	**1,000**	1,112
Total	**$87,670**	$80,871

12. LEASES

Leased property included in Utility Plant at December 31, 1985 and 1984:	1985	1984
		(Thousands of Dollars)
Nuclear Fuel	**$445,699**	$424,721
Electric Plant	**48,342**	48,342
Common Plant	**3,116**	3,702
Gross Leased Property	**497,157**	476,765
Accumulated Amortization	**(159,016)**	(124,632)
Net Leased Property	**$338,141**	$352,133

The nuclear fuel obligation is amortized as the fuel is burned. Amortization of leased property totaled $60.9 million, $39.1 million and $28.8 million in 1985, 1984 and 1983, respectively. Other operating expenses include interest on capital lease obligations of $18.2 million, $22.0 million, and $19.0 million in 1985, 1984 and 1983, respectively. Minimum future lease payments as of December 31, 1985, are:

Year Ending December 31	Capital Leases	Operating Leases	Total
		(Thousands of Dollars)	
1986	$103,780	$ 30,700	$134,480
1987	89,861	29,502	119,363
1988	91,072	26,917	117,989
1989	56,851	27,327	84,178
1990	45,790	26,483	72,273
Remaining Years	32,047	108,324	140,371
Total Minimum Future Lease Payments	419,401	$249,253	$668,654
Imputed Interest (rates ranging from 6.5% to 17%)	(81,260)		
Present Value of Net Minimum Future Lease Payments	$338,141		

Rental expense under operating leases totaled $43.9 million, $29.2 million, and $19.3 million, in 1985, 1984, and 1983, respectively.

13. SEGMENT INFORMATION

1985	Electric	Gas	Steam	Total
		(Thousands of Dollars)		
Operating revenues	$2,516,191	$428,984	$68,529	$ 3,013,704
Operating expenses, excluding depreciation	1,974,222	375,399	64,165	2,413,786
Depreciation	168,208	14,841	1,916	184,965
Total operating expenses	2,142,430	390,240	66,081	2,598,751
Operating income	$ 373,761	$ 38,744	$ 2,448	$ 414,953
Utility plant additions	$ 793,195	$ 32,896	$ 518	$ 826,609
December 31:				
Allocable assets				
Net utility plant (*)	8,675,701	389,396	20,876	9,085,973
Inventories	100,793	22,745	208	123,746
Deferred energy costs	109,244	(4,766)	(2,823)	101,655
	$8,885,738	$407,375	$18,261	$ 9,311,374
Nonallocable assets				853,940
Total assets				$10,165,314
1984				
Operating revenues	$2,435,731	$462,966	$82,320	$ 2,981,017
Operating expenses, excluding depreciation	1,858,505	413,938	75,989	2,348,432
Depreciation	162,959	13,474	1,893	178,326
Total operating expenses	2,021,464	427,412	77,882	2,526,758
Operating income	$ 414,267	$ 35,554	$ 4,438	$ 454,259
Utility plant additions	$1,022,496	$ 30,613	$ 135	$ 1,053,244
December 31:				
Allocable assets				
Net utility plant (*)	8,068,233	369,239	22,443	8,459,915
Inventories	116,775	32,572	1,189	150,536
Deferred energy costs	227,524	4,147	(1,776)	229,895
	$8,412,532	$405,958	$21,856	$ 8,840,346
Nonallocable assets				715,383
Total assets				$ 9,555,729
1983				
Operating revenues	$2,107,897	$417,042	$71,111	$ 2,596,050
Operating expenses, excluding depreciation	1,592,027	377,624	67,365	2,037,016
Depreciation	150,898	12,694	1,735	165,327
Total operating expenses	1,742,925	390,318	69,100	2,202,343
Operating income	$ 364,972	$ 26,724	$ 2,011	$ 393,707
Utility plant additions	$1,004,219	$ 26,020	$ 82	$ 1,030,321
December 31:				
Allocable assets				
Net utility plant (*)	7,257,594	353,979	24,599	7,636,172
Inventories	98,391	32,350	343	131,084
Deferred energy costs	116,661	29,359	3,226	149,246
	$7,472,646	$415,688	$28,168	$ 7,916,502
Nonallocable assets				627,962
Total assets				$ 8,544,464

(*) Includes construction work in progress, leased property and allocated common utility property.

The Company is considering a proposal for the sale of its steam operation. Ultimate sale of the steam operation is subject to many factors, including acceptance of the proposal by the Company's management and Board of Directors and approval of the sale by the PUC. The Company estimates that a sale of the steam operation would result in no significant gain or loss.

14. LIMERICK GENERATING STATION

The Company's Limerick Unit No. 1 commenced commercial operation on February 1, 1986. Construction of the second of the two nuclear units at Limerick resumed in February 1986, following a suspension of approximately 2 years. Unit No. 2 is scheduled to be completed in late 1990. As of December 31, 1985, the Company had invested approximately $4.61 billion in the Limerick Generating Station, consisting of $2.48 billion in Unit No. 1, $901 million in Unit No. 2 and $1.23 billion in common facilities.

On September 27, 1985, the Company filed with the PUC for an electric rate increase designed to yield $671 million annually, net of fuel savings. The increase, designed to recover the costs associated with Limerick Unit No. 1 and 100 percent of common plant was requested to become effective November 27, 1985. On November 1, 1985, the PUC issued an order which suspended the effective date of the increase until June 27, 1986, pending hearings and investigation into the reasonableness of the requested increase. In order to lessen the impact of the increase on customers, the Company has proposed to phase in the increase in three equal steps over three years and to collect from customers the amounts unrecovered by the phase-in plan, without interest, after the last step is effective. In addition, the Company has announced that it does not intend to file for another electric base rate increase prior to September 27, 1987, unless, in the Company's judgment, a failure to file such a request would jeopardize its financial viability. In the past, the PUC's practice has been to include in any rate increase with respect to one unit of a two-unit generating station only one-half of the costs of the common facilities. On January 21, 1986, the PUC entered an order stating that the prudence of the Company's 1976 and 1978 construction deferral announcements would not be examined in the rate proceeding, because a finding of imprudence had allegedly been issued in an earlier PUC proceeding. The Company intends to appeal this decision to the Commonwealth Court of Pennsylvania. As a result of these construction deferral announcements, the PUC staff and the Office of Consumer Advocate contend that certain amounts of construction costs should be excluded from rate base. The Company maintains, however, that the 1976 and 1978 construction deferrals were prudent and that rate base should not be reduced.

The unavailability of sufficient supplemental cooling water would limit or prohibit operation of Limerick during certain months of the year. Until the planned supplemental cooling water system is completed and in operation, the Company must obtain interim supplemental cooling water for the operation of Limerick during such months. The Delaware River Basin Commission (DRBC) approved, for a portion of 1985, two Company requests for modification of restrictions on the use of the Schuylkill River for Limerick cooling water and for a reallocation of cooling water to Limerick from two other power plants on the Schuylkill River. The DRBC's approvals were effective through December 31, 1985. The Company filed one similar modification request and the same reallocation request with the DRBC for its 1986 supplemental cooling water needs. If only the request for reallocation were granted, supplemental cooling water is expected to be available to permit Unit No. 1 to operate at approximately 25 percent of its capacity. Based on historic river conditions, even if both the modification request and the reallocation request were granted, it is unlikely that there would be sufficient water to operate Unit No. 1 at 100 percent capacity throughout the year. Therefore, the Company is investigating other possible sources of supplemental cooling water for 1986, all of which would require regulatory approval.

One component of the supplemental cooling water system for Limerick is the Point Pleasant project to be constructed and operated by Bucks County and by the Neshaminy Water Resources Authority (NWRA), a municipal authority created by Bucks County, under a contract among NWRA, the Company and Bucks County. The Point Pleasant project has been the subject of substantial opposition from various groups, including a majority of the Commissioners of Bucks County and a majority of the members of the Board of Directors of NWRA. This opposition has resulted in disruption of construction and in litigation. During 1985, the Court of Common Pleas of Bucks County ordered completion of the Point Pleasant project, this decision was affirmed by the Commonwealth Court, and NWRA and Bucks County petitioned the Supreme Court of Pennsylvania for an allowance of an appeal from the decision of the Commonwealth Court. The Supreme Court of Pennsylvania has not yet acted on the petition.

Following a lengthy investigation, on December 5, 1985 the PUC determined that the Company could complete construction of Unit No. 2 subject to a cost containment and operational incentive program ("Program"). The Company agreed to the Program on December 23, 1985. Principal elements of the Program are a construction cost cap of $3.2 billion, which would represent the maximum allowed rate base for Unit No. 2 throughout its lifetime; an operating performance incentive/penalty related to the unit's capacity factor; and operating and maintenance expense standards. The construction cost cap of $3.2 billion includes AFUDC, but does not include any costs related to common plant. The cost cap includes capital additions after commercial operation, net of accumulated depreciation. Any expenditures in excess of $3.2 billion cannot be recovered from ratepayers or included in rate base. Adjustment of the cap for inflation, regulatory scope changes, or any other factors is not permitted. The estimated total cost of Unit No. 2 does not exceed the cost cap.

In 1984 the Commonwealth of Pennsylvania enacted a law which requires the PUC to compare the actual cost of construction of an electric generating facility with the estimate submitted at the commencement of construction. The law provides that if the actual cost exceeds the estimated cost, the PUC must exclude the excess cost from the utility's rate base unless the utility can show that some or all of the excess cost was necessary and proper. In 1974 the original estimated cost of construction of the Limerick Generating Station was in the range of $1.7 to $2 billion. Estimates at earlier stages were significantly lower but the Company does not believe that such earlier estimates are applicable to determine the excess cost applicable under the law.

On December 19, 1985, the Financial Accounting Standards Board issued an exposure draft of a proposed amendment to the accounting principles applicable to rate regulated enterprises, such as the Company. The proposed amendment, if adopted in its present form, would become applicable to the Company in 1987 and would affect, principally, accounting for phase-in plans and disallowances of plant costs. In general, this amendment would accelerate the timing of recognition of expenses in the Company's financial statements. Under the exposure draft, allowable costs could be deferred in connection with a phase-in plan only if the regulatory authority agreed to the plan and all amounts deferred were recovered within ten years; otherwise, no deferrals would be allowed. If the PUC disallowed a portion of Limerick's construction costs through either a reduction in rate base or rate of return, or if the Company estimated that the total construction costs of Unit No. 2 would exceed the cost cap, an immediate write-off of portions of Limerick's construction costs would be required. Such a write-off could be material to results of operations or retained earnings of the Company in the year of write-off and could affect the Company's ability to pay dividends and to finance its construction program. Under existing accounting principles, it is unlikely that the aforementioned circumstances would cause the Company to write off immediately any amounts of Limerick's construction costs.

15. COMMITMENTS AND CONTINGENCIES

The Company has incurred substantial commitments in connection with its construction program. Construction expenditures are estimated to be $771 million for 1986 and $2.9 billion for 1987 through 1989. These estimates are reviewed and revised periodically to reflect changes in economic conditions, revised load forecasts and other appropriate factors. Plant facilities under construction, particularly the Limerick Generating Station, require numerous permits and licenses, which the Company cannot be assured will be issued at completion of the facilities.

The Price-Anderson Act places a "Limit of Liability" presently of $650 million, for claims that could arise from an incident involving any licensed nuclear facility in the nation. All nuclear utilities, including the Company, have covered this exposure through a combination of private insurance and mandatory participation in a secondary financial protection pool. In the event of such a nuclear incident at any licensed nuclear facility in the nation, the Company could be assessed up to $13.5 million per incident, with a maximum amount of $27 million in any one year.

The Company maintains property insurance, including radiation contamination coverage, for loss or damage to its nuclear facilities. Although it is impossible to determine the total amount of the loss that may result from an occurrence at these facilities, the Company maintains the maximum amount of insurance presently available, $1.1 billion for each station. Under the terms of the various insurance agreements, the Company could be assessed up to $35 million for losses incurred at any plants insured by the insurance companies. The Company is a member of an industry mutual insurance company which provides replacement power cost insurance in the event of a major outage at a nuclear station. The premium for this coverage is subject to an assessment for adverse loss experience. The Company's maximum share of any assessment is $13 million.

The PUC has conducted several investigations involving the Company's management of major plant outages during 1983 and 1984 and the resulting impact on energy costs recoverable from customers under the electric energy cost rate. On October 24, 1985, the PUC issued its final order in an investigation which addressed the prudency of outages of certain base load nuclear and coal units during 1983 and 1984. As a result of this order, the Company was denied recovery of approximately $73 million of energy costs. The disallowed energy costs were charged to expense as of September 30, 1985, and reduced operating income and earnings applicable to common stock by $34.7 million and earnings per average common share by approximately 20¢. On November 26, 1985 the Company filed a Petition for Review with Commonwealth Court appealing the PUC order.

The PUC is holding hearings in connection with $47 million of replacement energy costs related to other outages of nuclear units during 1984 and 1985. The Company believes its management of those outages was prudent and that it should not be precluded from recovering the replacement energy costs. Ultimate resolution of this matter will not have a material adverse effect on the results of operations or financial position of the Company. A final decision by the PUC is not expected until mid 1986.

On October 9, 1985, a law was enacted in Pennsylvania granting the PUC statutory authority to modify or halt construction of any generating unit if the PUC determines that such construction is not in the public interest. The law provides that a utility may recover a return of, but not a return on, prudently incurred costs of any partially completed facility, the cancellation of which is found to be in the public interest.

The Company is a nominal defendent in a class action and derivative suit against certain of its directors and officers, brought by four shareholders owning in the aggregate 202 shares of common stock. The suit arises out of the construction of the Limerick Generating Station and seeks to cause Unit No. 2 to be abandoned, its cost to be written off as a loss, dividends on common stock to be terminated until certain earnings levels have been met, and the shares authorized under the 1983 Amendment to the Articles of Incorporation to be declared invalid. Additional damages also are sought. While the outcome of litigation cannot be predicted with certainty, management believes resolution of the suit will not have a material affect on the Company's financial position. The defendants have filed a motion to dismiss the complaint.

16. QUARTERLY DATA (Unaudited)

The data shown below include all adjustments which the Company considers necessary for a fair presentation of such amounts.

Quarter Ended	Operating Revenues		Operating Income		Net Income	
	1985	1984	**1985**	1984	**1985**	1984
			(Thousands of Dollars)			
March 31	**$852,299**	$818,031	**$126,892**	$128,942	**$151,166**	$134,838
June 30	**683,519**	703,219	**98,153**	100,680	**118,859**	108,151
September 30	**750,904**	755,619	**93,240**	121,524	**124,163**	132,339
December 31	**726,982**	704,148	**96,668**	103,113	**131,113**	117,061

Quarter Ended	Earnings Applicable to Common Stock		Average Shares Outstanding		Earnings Per Average Share	
	1985	1984	**1985**	1984	**1985**	1984
	(Thousands of Dollars)		(Thousands)		(Dollars)	
March 31	**$128,422**	$115,451	**162,859**	143,044	**$.79**	$.81
June 30	**96,212**	87,098	**168,723**	150,266	**.57**	.58
September 30	**101,569**	111,340	**171,993**	153,519	**.59**	.73
December 31	**108,521**	95,818	**175,401**	160,274	**.62**	.60

1985 third quarter results include a charge of approximately $34.7 million (net of related income taxes) resulting from the PUC's denial of recovery of approximately $73.0 million of energy costs (see Note #15).

17. SUPPLEMENTARY INFORMATION TO DISCLOSE THE ESTIMATED EFFECTS OF INFLATION FOR THE YEAR ENDED DECEMBER 31, 1985 (Unaudited)

The following supplementary information is supplied to show the estimated effects of inflation under the "current cost" method. The techniques required to develop this information are approximate and complex, and may not necessarily reflect the true effects of inflation on the Company. Under existing regulatory law, the Company is permitted to recover actual operating and capital costs incurred to serve customers and a reasonable return on investment, and the Company believes it will be allowed to recover cost increases caused by inflation as such increases are actually incurred.

Effect of Inflation on Reported Income. In adjusting the Consolidated Statements of Income, as shown below, only depreciation expense was adjusted for the effect of inflation. Depreciation expense was determined by applying the Company's depreciation rates to restated 1985 average depreciable plant in service. Other Operating Expenses were not required to be adjusted.

If the Company had to replace its entire utility plant at this time, the costs to do so would greatly exceed the original costs incurred when the facilities were built because of the cumulative effect of inflation. These plant replacement costs, net of accumulated depreciation, are estimated at $14.2 billion. The effect ($496 million) of general inflation in 1985 on net utility plant was greater than the increase ($456 million) in specific prices by $40 million.

Consolidated Statements of Income Adjusted for Inflation for the Year Ended December 31, 1985.

	As Reported	As Adjusted (Average 1985 Dollars)
	(Thousands of Dollars, except per share amounts)	
Operating Revenues	$3,013,704	$3,013,704
Depreciation	184,965	477,987
Other Operating Expenses	2,413,786	2,413,786
Operating Income	414,953	121,931
Other Income	306,261	306,261
Income Before Interest Charges and Preferred Stock Dividends	721,214	428,192
Interest Charges and Preferred Stock Dividends	286,490	286,490
Earnings Applicable to Common Stock	$ 434,724	$ 141,702
Earnings Per Average Share	$ 2.56	$ 0.83

Adjustment of Selected Five Year Financial Information.
In order to reflect the impact of general inflation on selected financial information for each of the years 1981 through 1985, the following table shows actual data compared with data adjusted to 1985 dollars.

Five Year Summary of Selected Financial Information and Current Cost Data
(Thousands of Dollars, except per share amounts)

	1985	1984	1983	1982	1981
Development of Adjustment Factors					
Consumer Price Index					
Average During Year	**322.2**	311.1	298.4	289.1	272.4
Year End	**327.4**	315.5	303.5	292.4	281.5
Consumer Price Index Multiplier					
A = Average (322.2 ÷ Index)	**1.00**	1.04	1.08	1.11	1.18
B = Year End (327.4 ÷ Index)	**1.00**	1.04	1.08	1.12	1.16
Actual and Adjusted Historical Financial Information					
Dividends Per Common Share					
Actual Paid	**$2.20**	$2.20	$2.12	$2.06	$1.90
Adjusted (Actual x A)	**$2.20**	$2.29	$2.29	$2.29	$2.24
Market Price Per Common Share					
Actual Year End	**$17.38**	$14.87	$14.38	$17.00	$13.63
Adjusted (Actual x B)	**$17.38**	$15.46	$15.53	$19.04	$15.81
Operating Revenues					
Actual	**$3,013,704**	$2,981,017	$2,596,050	$2,644,753	$2,433,425
Adjusted (Actual x A)	**$3,013,704**	$3,100,258	$2,803,734	$2,935,676	$2,871,442
Earnings Applicable to Common Stock					
Actual	**$434,724**	$409,707	$321,705	$278,623	$223,761
Adjusted (Actual × A)	**$434,724**	$426,095	$347,441	$309,272	$264,038
Earnings per Average Common Share					
Actual	**$2.56**	$2.70	$2.40	$2.39	$2.25
Adjusted (Actual × A)	**$2.56**	$2.81	$2.59	$2.65	$2.66
Common Shareholders' Equity					
Actual Year End	**$3,193,048**	$2,890,975	$2,569,323	$2,254,435	$1,963,527
Adjusted (Actual x B)	**$3,193,048**	$3,006,614	$2,774,869	$2,524,967	$2,277,691
Current Cost Data					
Excess of Increase in General Inflation over Increase in Specific Prices on Utility Plant Cost					
Actual Current Cost	**$39,973**	$296,690	$147,379	$(9,011)	$186,585
Adjusted (Actual x A)	**$39,973**	$308,558	$159,169	$(10,002)	$220,170
Purchasing Power Gain on Net Amounts Owed					
Actual Current Cost	**$199,010**	$190,521	$165,235	$148,672	$307,972
Adjusted (Actual x A)	**$199,010**	$198,142	$178,454	$165,026	$363,407
Earnings Applicable to Common Stock					
Actual Current Cost	**$141,702**	$113,662	$51,049	$48,471	$23,044
Adjusted (Actual x A)	**$141,702**	$118,208	$55,133	$53,803	$27,192
Earnings per Average Common Share					
Actual Current Cost	**$0.83**	$0.75	$0.38	$0.42	$0.23
Adjusted (Actual x A)	**$0.83**	$0.78	$0.41	$0.47	$0.27

Financial Statistics

SUMMARY OF EARNINGS (Millions of Dollars)

For the Year Ended	1985	1984	1983	1982	1981	1980	1975
Operating Revenues (for details see pages 42 and 43)	**$3,013.7**	$2,981.0	$2,596.0	$2,644.8	$2,433.4	$2,123.4	$1,134.8
Operating Expenses							
Fuel and Energy Interchange	**1,139.6**	1,122.2	986.6	1,128.5	1,187.6	1,090.5	457.8
Labor	**370.8**	345.3	317.2	291.1	256.8	232.1	152.2
Other Materials, Supplies and Services	**460.0**	427.3	354.6	320.5	260.9	184.5	72.6
Total Operation and Maintenance	**1,970.4**	1,894.8	1,658.4	1,740.1	1,705.3	1,507.1	682.6
Depreciation	**185.0**	178.3	165.3	143.8	130.3	122.9	91.2
Taxes	**443.3**	453.6	378.6	372.2	274.8	227.4	163.9
Total Operating Expenses	**2,598.7**	2,526.7	2,202.3	2,256.1	2,110.4	1,857.4	937.7
Operating Income	**415.0**	454.3	393.7	388.7	323.0	266.0	197.1
Other Income							
Allowance for Other Funds Used During Construction	**176.3**	134.5	108.1	65.7	65.0	50.5	23.3
Income Tax Credits, Net	**133.4**	116.4	87.9	75.8	63.2	49.0	22.3
Other, Net	**(3.5)**	.2	(3.1)	(0.7)	2.5	3.4	2.0
Total Other Income	**306.2**	251.1	192.9	140.8	130.7	102.9	47.6
Income Before Interest Charges	**721.2**	705.4	586.6	529.5	453.7	368.9	244.7
Interest Charges							
Long-Term Debt	**435.4**	402.5	330.2	308.9	266.7	225.0	136.5
Short-Term Debt	**17.7**	30.9	35.2	32.0	33.2	13.9	7.9
Allowance for Borrowed Funds Used During Construction	**(257.2)**	(220.4)	(167.9)	(147.6)	(123.8)	(97.1)	(43.6)
Net Interest Charges	**195.9**	213.0	197.5	193.3	176.1	141.8	100.8
Net Income	**525.3**	492.4	389.1	336.2	277.6	227.1	143.9
Preferred Stock Dividends	**90.6**	82.7	67.4	57.6	53.8	52.2	36.0
Earnings Applicable to Common Stock	**434.7**	409.7	321.7	278.6	223.8	174.9	107.9
Dividends on Common Stock	**373.5**	334.3	283.6	240.5	189.5	157.4	95.4
Earnings Retained	**$61.2**	$75.4	$38.1	$38.1	$34.3	$17.5	$12.5
Earnings Per Average Common Share (Dollars)	**$2.56**	$2.70	$2.40	$2.39	$2.25	$2.00	$1.86
Dividends per Common Share (Dollars)	**$2.20**	$2.20	$2.12	$2.06	$1.90	$1.80	$1.64
Common Stock Equity (Per Share)	**$17.97**	$17.81	$17.99	$17.93	$18.10	$18.72	$19.05
Average Shares of Common Stock Outstanding (Millions)	**169.8**	151.8	133.9	116.5	99.6	87.3	58.1

Ratings on Philadelphia Electric Company's Securities

	Mortgage Bonds		Debentures		Preferred Stock	
Agency	Rating	Date Established	Rating	Date Established	Rating	Date Established
Duff and Phelps, Inc.	9	3/80	10	3/80	11	2/83
Fitch Investors Service	BBB	9/82	BBB –	9/82	BB +	9/32
Moody's Investors Service	Baa3	1/83	Ba1	1/83	ba1	1/83
Standard & Poor's Corporation	BBB –	9/82	BB +	9/82	BB	9/82

SUMMARY OF FINANCIAL CONDITION (Millions of Dollars)

December 31	**1985**	1984	1983	1982	1981	1980	1975
Assets							
Utility Plant, at original cost	**$10,572.2**	$9,834.1	$8,864.2	$7,905.7	$7,044.7	$6,415.7	$4,445.6
Less: Accumulated Depreciation	**1,824.4**	1,726.3	1,592.0	1,450.1	1,330.6	1,235.7	775.8
Leased Property, net	**338.1**	352.1	364.0	299.1	270.0	139.3	91.0
Net Utility Plant	**9,085.9**	8,459.9	7,636.2	6,754.7	5,984.1	5,319.3	3,760.8
Investments	**87.7**	80.9	99.4	91.4	77.8	58.7	12.3
Current Assets							
Cash and Temporary Cash Investments	**188.8**	30.4	57.2	50.0	30.7	6.7	17.4
Escrow Deposits	**13.3**	88.1	8.0	—	—	—	—
Accounts Receivable	**370.9**	384.2	338.6	342.2	342.4	300.3	139.8
Inventories	**123.7**	150.5	131.1	143.0	132.2	121.1	88.0
Deferred Energy Costs	**101.7**	229.9	149.3	(85.4)	(31.3)	11.0	17.9
Other	**58.5**	48.9	44.3	40.2	35.1	31.8	19.2
Deferred Debits	**134.8**	82.9	80.4	24.9	31.5	18.5	13.8
Total	**$10,165.3**	$9,555.7	$8,544.5	$7,361.0	$6,602.5	$5,867.4	$4,069.2
Capitalization and Liabilities							
Common Stock	**$ 2,602.0**	$2,361.0	$2,110.5	$1,826.2	$1,572.4	$1,377.4	$ 916.6
Other Paid-In Capital	**7.3**	6.7	5.9	4.6	3.9	2.6	1.5
Retained Earnings	**583.7**	523.3	452.9	423.6	387.2	353.6	304.7
Common Shareholders' Equity	**3,193.0**	2,891.0	2,569.3	2,254.4	1,963.5	1,733.6	1,222.8
Preferred Stock							
Without Mandatory Redemption	**572.5**	572.5	522.5	372.5	372.5	372.5	372.5
With Mandatory Redemption	**318.3**	326.2	284.9	292.3	266.9	274.3	113.4
Long-Term Debt	**4,309.2**	3,778.0	3,381.8	3,028.5	2,745.7	2,371.9	1,776.9
Total Capitalization	**8,393.0**	7,567.7	6,758.5	5,947.7	5,348.6	4,752.3	3,485.6
Current Liabilities							
Short-Term Debt	**1.0**	260.0	267.5	64.7	54.2	52.6	108.0
Current Maturities of Long-Term Debt	**80.8**	50.4	—	21.3	36.1	130.8	60.9
Capital Lease Obligations due within one year	**76.3**	68.3	61.5	32.5	53.9	18.5	12.4
Accounts Payable and Dividends Declared	**185.1**	200.1	179.9	188.5	188.9	187.6	80.1
Taxes Accrued and Deferred	**110.3**	158.0	102.3	22.6	51.4	77.8	44.2
Interest Accrued	**93.0**	91.1	91.8	99.8	82.3	64.9	37.8
Other	**72.0**	127.2	54.1	24.7	18.1	17.4	20.2
Deferred Credits and Other Liabilities							
Capital Lease Obligations	**261.8**	283.8	302.5	266.6	216.1	120.8	78.6
Other	**892.0**	749.1	726.4	692.6	552.9	444.7	141.4
Total	**$10,165.3**	$9,555.7	$8,544.5	$7,361.0	$6,602.5	$5,867.4	$4,069.2

Operating Statistics

ELECTRIC OPERATIONS

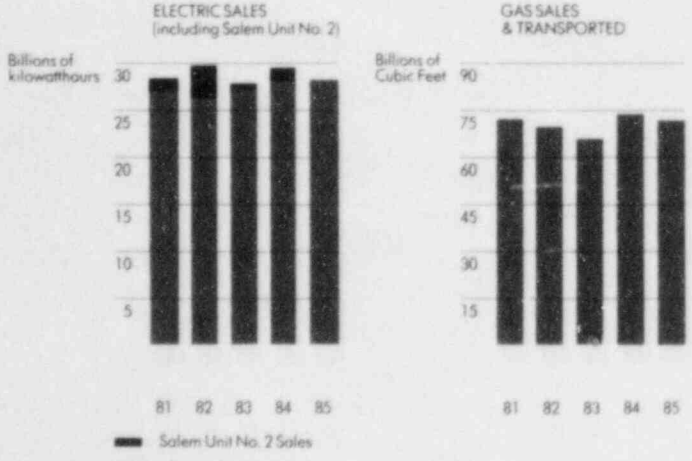
	1985	1984	1983	1982	1981	1980	1975
Output (Millions of Kilowatthours)							
Steam	**9,455**	11,085	10,457	8,598	9,931	11,234	12,814
Nuclear	**8,359**	6,462	5,520	10,743	7,464	7,333	4,387
Hydraulic	**1,484**	2,085	1,739	1,581	1,397	1,240	2,275
Pumped Storage Output	**1,235**	1,100	979	1,126	1,101	1,050	1,275
Pumped Storage Input	**(1,754)**	(1,579)	(1,427)	(1,665)	(1,624)	(1,526)	(1,785)
Purchase and Net Interchange	**10,252**	11,975	12,181	11,120	11,173	9,973	7,363
Internal Combustion	**178**	425	491	178	283	442	914
Other	**1,254**	—	—	—	528	—	—
Total Electric Output	**30,463**	31,553	29,940	31,681	30,253	29,746	27,243
Sales (Millions of Kilowatthours)							
Residential	**8,440**	8,515	8,467	7,877	8,014	8,341	7,424
Small Commercial and Industrial	**3,731**	3,543	3,284	3,142	3,115	3,065	2,624
Large Commercial and Industrial	**14,920**	14,881	14,478	14,178	14,916	15,056	14,060
All Other	**1,044**	1,061	1,003	1,012	1,005	1,159	1,227
Service Territory	**28,135**	28,000	27,232	26,209	27,050	27,621	25,335
Jersey Central Power & Light (Salem #2)	—	1,395	346	3,352	1,218	—	—
Total Electric Sales	**28,135**	29,395	27,578	29,561	28,268	27,621	25,335
Number of Customers, December 31							
Residential	**1,245,481**	1,230,883	1,217,635	1,206,944	1,200,238	1,190,312	1,120,981
Small Commercial and Industrial	**124,719**	121,676	119,292	118,407	117,016	116,808	114,896
Large Commercial and Industrial	**4,881**	5,100	5,437	5,616	5,790	5,820	5,719
All Other	**773**	751	751	762	746	736	2,305
Total Electric Customers	**1,375,854**	1,358,410	1,343,115	1,331,729	1,323,790	1,313,676	1,243,901
Operating Revenues (Millions of Dollars)							
Residential	**$923.9**	$354.9	$744.0	$694.4	$643.7	$607.8	$364.7
Small Commercial and Industrial	**388.7**	360.2	316.6	310.6	285.9	249.8	138.9
Large Commercial and Industrial	**1,061.8**	1,008.5	877.4	922.3	917.1	813.9	418.3
All Other	**141.8**	145.1	139.4	118.3	109.5	95.4	56.5
Service Territory	**2,516.2**	2,368.7	2,077.4	2,045.6	1,956.2	1,766.9	978.4
Jersey Central Power & Light (Salem #2)	—	67.0	30.5	135.4	45.9	—	—
Total Electric Revenues	**$2,516.2**	$2,435.7	$2,107.9	$2,181.0	$2,002.1	$1,766.9	$978.4
Operating Expenses (Millions of Dollars)							
Operating expenses excluding depreciation	**$1,974.2**	$1,858.5	$1,592.0	$1,688.4	$1,586.5	$1,414.0	$717.6
Depreciation	**168.2**	163.0	150.9	130.2	117.3	111.1	81.6
Total Operating Expenses	**$2,142.4**	$2,021.5	$1,742.9	$1,818.6	$1,703.8	$1,525.1	$799.2
Electric Operating Income (Millions of Dollars)	**$373.8**	$414.2	$365.0	$362.4	$298.3	$241.8	$179.2
Average Use per Residential Customer (kilowatthours)							
Without Electric Heating	**6,034**	6,160	6,319	5,875	6,022	6,411	6,354
With Electric Heating	**15,923**	17,293	16,523	16,813	18,054	19,482	18,916
Total	**6,820**	6,960	6,990	6,544	6,699	7,058	6,645
Electric Peak Load, Demand (thousands of kws)	**6,034**	5,925	5,879	5,691	5,731	6,095	5,530
Net Electric Generating Capacity—Year End Summer rating (thousands of kws)	**7,599**	7,765	7,974	8,006	8,006	7,698	7,186
Cost of Fuel per Million Btu	**$1.72**	$2.22	$2.25	$1.57	$2.10	$1.90	$1.23
Btu per Net Kilowatthour Generated	**10,843**	10,920	10,906	10,918	10,930	10,787	10,523

GAS OPERATIONS

	1985	1984	1983	1982	1981	1980	1975
Sales (Millions of Cubic Feet)							
Residential	**1,810**	1,941	2,168	2,442	2,446	2,461	2,334
House Heating	**23,227**	25,429	22,981	24,237	24,675	23,671	20,817
Commercial and Industrial	**36,254**	41,145	39,043	41,660	45,670	42,890	30,012
All Other	**1,209**	1,282	672	422	127	92	74
Total Gas Sales	**62,500**	69,797	64,864	68,761	72,918	69,114	53,237
Gas Transported for Customers	**10,262**	3,794	789	—	—	—	—
Total Gas Sales & Transported	**72,762**	73,591	65,653	68,761	72,918	69,114	53,237
Number of Customers, December 31							
Residential	**69,632**	70,794	72,501	76,638	78,426	81,346	90,117
House Heating	**217,840**	211,984	206,443	198,910	193,038	182,246	162,914
Commercial and Industrial	**24,234**	23,442	22,810	22,324	21,578	20,197	19,874
Total Gas Customers	**311,706**	306,220	301,754	297,872	293,042	283,789	272,905
Operating Revenues (Millions of Dollars)							
Residential	**$18.7**	$19.0	$19.1	$18.1	$15.4	$14.0	$8.1
House Heating	**185.4**	191.7	165.8	147.1	128.5	108.5	54.8
Commercial and Industrial	**214.1**	243.7	227.3	221.1	209.7	166.7	54.5
All Other	**5.2**	5.6	3.0	1.8	0.5	0.3	0.1
Subtotal	**$423.4**	$460.0	$415.2	$388.1	$354.1	$289.5	$117.5
Other Revenues (including Transported for Customers)	**5.5**	3.0	1.8	2.3	2.3	1.2	0.5
Total Gas Revenues	**$428.9**	$463.0	$417.0	$390.4	$356.4	$290.7	$118.0
Operating Expenses (Millions of Dollars)							
Operating expenses excluding depreciation	**$375.4**	$413.9	$377.6	$354.1	$322.0	$258.0	$93.7
Depreciation	**14.8**	13.5	12.7	11.9	11.3	10.2	8.3
Total Operating Expenses	**$390.2**	$427.4	$390.3	$366.0	$333.3	$268.2	$102.0
Gas Operating Income (Millions of Dollars)	**$38.7**	$35.6	$26.7	$24.4	$23.1	$22.5	$16.0

STEAM OPERATIONS

Sales (Millions of Pounds)	**4,229**	4,735	4,552	5,086	5,484	6,044	7,117
Number of Customers, December 31	**487**	540	545	571	593	618	689
Operating Revenues (Millions of Dollars)	**$68.5**	$82.3	$71.1	$73.4	$74.9	$65.8	$38.5
Operating Expenses (Millions of Dollars)							
Operating expenses excluding depreciation	**$64.2**	$76.0	$67.4	$69.8	$71.6	$62.4	$35.3
Depreciation	**1.9**	1.9	1.7	1.7	1.7	1.7	1.4
Total Operating Expenses	**$66.1**	$77.9	$69.1	$71.5	$73.3	$64.1	$36.7
Steam Operating Income (Millions of Dollars)	**$2.4**	$4.4	$2.0	$1.9	$1.6	$1.7	$1.8



Shareholder Information

Stock Exchange Listings

Most PE securities are listed on the New York Stock Exchange and the Philadelphia Stock Exchange. Philadelphia Electric Power Company debentures are listed on the Philadelphia Stock Exchange.

Dividends

The Company has paid dividends on its common stock continually since 1902. The Board of Directors normally considers common stock dividends for payment in March, June, September and December.

The Company estimates that 4% of the $2.20 per share dividend paid to common shareholders in 1985 represents a return of capital which is not taxable as dividend income for Federal income tax purposes. All dividends on preferred stock are taxable.

Dividend Reinvestment and Stock Purchase Plan

Shareholders may use their dividends to purchase additional shares of common stock through the Company's Dividend Reinvestment and Stock Purchase Plan. Philadelphia Electric pays all brokerage and service fees.

Customers of the Company who are not shareholders may enroll in the plan by making a one-time purchase of common stock directly from the Company.

All shareholders have the opportunity to invest additional funds in common stock of the Company, whether or not they have their dividends reinvested - also with all fees borne by the Company.

Over 35% of the Company's common shareholders were participants. In 1985, they invested more that $110 million through the Plan, including cash payments. Information concerning this Plan may be obtained from M.W. Rimerman, Treasurer, Philadelphia Electric Company, 2301 Market Street, P.O. Box 8699, Philadelphia, PA 19101.

Comments Welcomed

The Company always is pleased to answer questions and provide information. Please address your comments to Mrs. L. S. Binder, Secretary, Philadelphia Electric Company, 2301 Market Street, P.O. Box 8699, Philadelphia, PA 19101.

Inquiries relating to shareholder accounting records, stock transfer and change of address should be directed to Philadelphia Electric Company,
2301 Market Street, P.O. Box 8699, Philadelphia, PA 19101,
Attn: Stock Transfer Section, S6-4.

Toll-Free Telephone Line

Toll-free telephone lines are available to the Company's shareholders for inquiries concerning their stock ownership. When calling from outside Pennsylvania, dial 1-800-223-7326. From within Pennsylvania dial 1-800-242-7326. Local Philadelphia calls should be made to 841-5795.

Annual Meeting

The Annual Meeting of the Shareholders of the Company will be held on April 9, 1986, at 10:30 A.M. at the Adams Mark Hotel, Monument Road & City Line Avenue, Philadelphia, PA. Common stock shareholders of record at the close of business on February 28, 1986, are entitled to vote at this meeting.

Notice of the meeting, proxy statement, and proxy will be mailed under separate cover. Prompt return of the proxies will be appreciated.

Form 10-K

Form 10-K, the annual report filed with the Securities and Exchange Commission, is available, without charge, to shareholders upon written request to Philadelphia Electric Company, 2301 Market Street, P.O. Box 8699, Philadelphia, PA 19101,
Attn: Financial Division, S21-1.

Shareholders

The Company has 302,097 shareholders of record of common stock, a 13% increase in 5 years.

Transfer Agents and Registrars

PHILADELPHIA ELECTRIC COMPANY—
Preferred and Common Stocks

Registrars: Mellon Bank (East) N.A., Four Mellon Bank Center, Philadelphia, PA 19102
Morgan Guaranty Trust Co. of NY, 30 W. Broadway, NY, NY 10015

Transfer Agents: Philadelphia Electric Company, 2301 Market St., Phila., PA 19101
Morgan Guaranty Trust Co. of NY, 30 W. Broadway, NY, NY 10015

PHILADELPHIA ELECTRIC COMPANY—
First and Refunding Mortgage Bonds

Trustee: Fidelity Bank, National Association, Broad & Walnut Sts., Phila., PA 19109

New York Agent: Morgan Guaranty Trust Co. of NY, 30 W. Broadway, NY, NY 10015

PHILADELPHIA ELECTRIC COMPANY—Debentures
PHILADELPHIA ELECTRIC POWER COMPANY
(A Subsidiary)—Debentures

Trustee: The Philadelphia National Bank, Broad & Chestnut Sts., Phila., PA 19101

New York Agent: Irving Trust Co., One Wall Street, NY, NY 10015

General Office

2301 Market Street, P.O. Box 8699, Phila., PA 19101.
(215)841-4000.

NYSE—Composite Common Stock Prices, Earnings and Dividends by Quarters (Per Share)

	1985				1984			
	Fourth Quarter	**Third Quarter**	**Second Quarter**	**First Quarter**	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
High Price	**$17⅞**	**$16⅝**	**$16⅛**	**$16⅜**	$15⅞	$13¾	$14⅛	$16
Low Price	**$14**	**$14**	**$13⅞**	**$14½**	$12⅞	$ 9	$11⅞	$14
Earnings	**62¢**	**59¢**	**57¢**	**79¢**	60¢	73¢	58¢	81¢
Dividends	**55¢**	**55¢**	**55¢**	**55¢**	55¢	55¢	55¢	55¢

Directors

* John H. Austin, Jr.
President and Chief Operating Officer of the Company

William T. Coleman, Jr., Esq.
Senior Partner of the law firm of O'Melveny & Myers

M. Walter D'Alessio
President and Chief Executive Officer Latimer & Buck, Inc. (Mortgage Banking and Real Estate Development)

* James L. Everett
Chairman of the Board and Chief Executive Officer of the Company

William S. Fishman
Chairman of the Executive Committee ARA Services, Inc. (Service Management)

William S. Gaither
President Drexel University

* Robert F. Gilkeson
Chairman of the Executive Committee of the Company

Richard G. Gilmore
Consultant

* Robert D. Harrison
Vice Chairman John Wanamaker, Philadelphia (Merchandising)

Paul R. Kaiser
Chairman Emeritus Tasty Baking Company (Diversified Manufacturing)

* Joseph C. Ladd
Chairman and Chief Executive Officer Fidelity Mutual Life Insurance Company

Edithe J. Levit, M.D.
President and Chief Executive Officer National Board of Medical Examiners

* Joseph J. McLaughlin
President and Chief Executive Officer Beneficial Mutual Savings Bank

* *Member of the Executive Committee*

Officers

James L. Everett
Chairman of the Board and Chief Executive Officer

John H. Austin, Jr.
President and Chief Operating Officer

Vincent S. Boyer
Senior Vice President Nuclear Power

Edward G. Bauer, Jr.
Vice President and General Counsel

Clifford Brenner
Vice President Corporate Communications

Thomas W. Coppock
Vice President Electric Transmission and Distribution

Shields L. Daltroff
Vice President Electric Production

Charles L. Fritz
Vice President Personnel and Industrial Relations

Raymond F. Holman
Vice President General Administration

John S. Kemper
Vice President Engineering and Research

William B. Morlok
Vice President Commercial Operations

Philip G. Mulligan
Vice President Gas Operations

Joseph F. Paquette, Jr.
Vice President Finance and Accounting

A. Lewis Parry, Jr.
Vice President Purchasing and General Services

Lucy S. Binder
Secretary

Morton W. Rimerman
Treasurer

James D. Lynch
Assistant Secretary

J. Robert Causton
Assistant Treasurer

Jon A. Katherine
Assistant Treasurer

William M. Lennox, Jr.
Assistant Treasurer

Director Changes:
William S. Gaither was elected to the Board July 22, 1985.

Richard G. Gilmore was re-elected to the Board December 23, 1985.

William W. Hagerty, a member of the Board of Directors since 1966, died on January 14, 1986. Dr. Hagerty, 69, served as President of Drexel University from 1963 to 1984. We are grateful for his many years of service and are deeply saddened at his passing.

Philadelphia Electric Company
2301 Market Street
PO Box 8699
Philadelphia PA 19101

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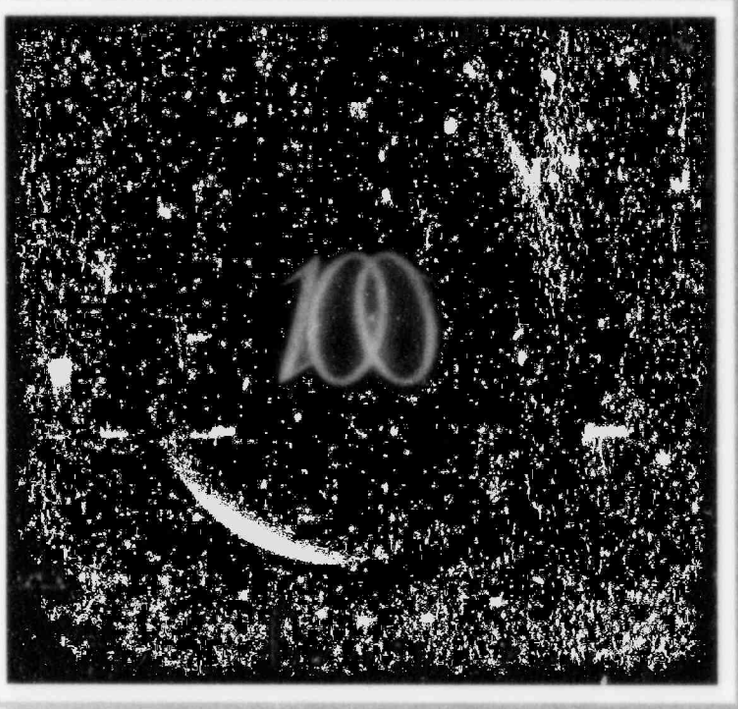
Philadelphia PA
Permit No. 378

ATLANTIC ELECTRIC



1985 ANNUAL REPORT

ABOUT THE COMPANY

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

Corporate Address

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

NOTICE OF ANNUAL MEETING

The 1986 Annual Meeting of Shareholders will be held on Wednesday, April 23, 1986 at the Quail Hill Inn, Smithville, New Jersey. A Notice of Annual Meeting will be mailed in March to those shareholders entitled to vote.

CONTENTS

ABOUT THE COVER

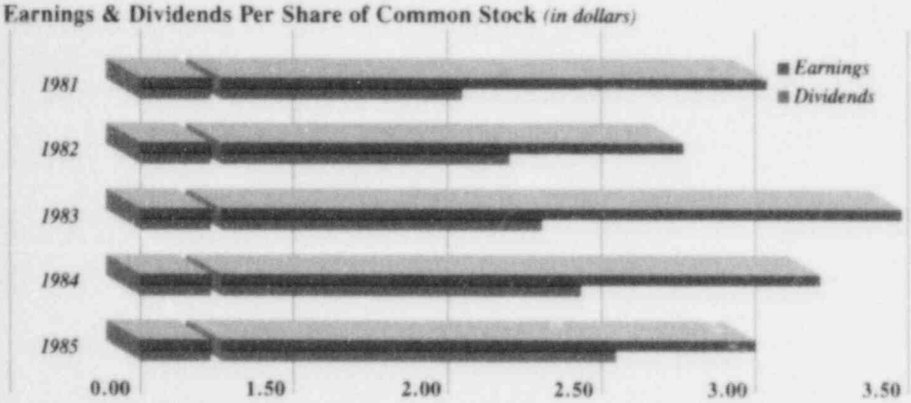
This year's cover design represents a significant milestone for the Company. The Electric Light Company of Atlantic City and the Bridgeton Electric Light Company were each incorporated in 1886. Over the one hundred years which followed, these and other companies grew, merged and matured into Atlantic Electric, which today provides service for more than one million people in Southern New Jersey.

FINANCIAL HIGHLIGHTS

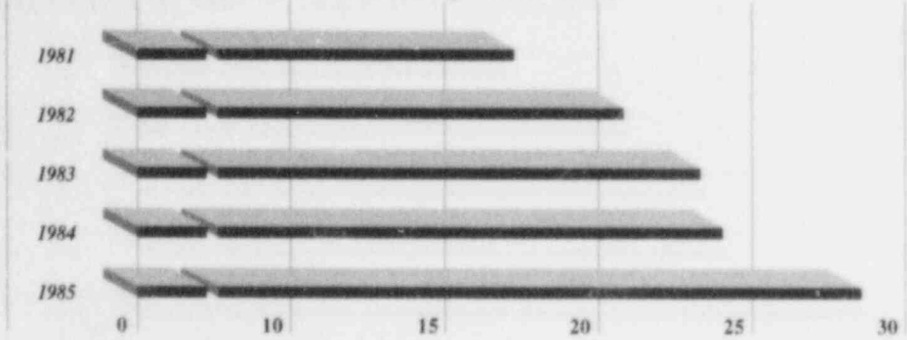
Results of Operations 1985-1983

	1985	% Change 1985-1984	1984	% Change 1984-1983	1983
Electric Operating Revenues (000's)	**$ 579,733**	5.5	$ 549,531	6.3	$ 517,142
Operating Expenses (000's)	**$ 490,327**	7.0	$ 458,140	8.0	$ 424,040
Net Income (000's)	**$ 60,519**	(4.4)	$ 63,277	(4.3)	$ 66,152
Earnings Per Common Share	**$ 3.00**	(6.3)	$ 3.20	(8.0)	$ 3.48
Dividends Paid Per Common Share	**$ 2.53**	4.5	$ 2.42	5.2	$ 2.30
Total Assets (000's)	**$1,299,633**	6.5	$1,220,503	7.1	$1,139,978
Cash Construction Expenditures (000's)	**$ 94,017**	11.1	$ 84,630	13.7	$ 74,457
Sales of Electricity (KWH) (000's)	**6,199,672**	2.4	6,053,791	3.5	5,851,434
Price Paid Per KWH— (All Customers)	**9.481¢**	5.4	8.999¢	7.6	8.360¢
Total Customer Service Installations (Year-end)	**417,625**	2.5	407,277	2.2	398,526
Number of Shareholders— Common Stock (Year-end)	**48,635**	2.5	47,446	(1.8)	48,299
Number of Employees (Year-end)	**2,099**	4.3	2,012	.9	1,995
Book Value	**$ 24.76**	2.0	$ 24.27	2.9	$ 23.58

Earnings & Dividends Per Share of Common Stock *(in dollars)*



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



TO OUR SHAREHOLDERS:

Reporting to you upon the completion of 1985, we can cite major accomplishments for the year, and opportunities for the future from a vantage point unique in the Company's history.

Earnings per share for 1985 totaled $3.00, compared with $3.20 per share achieved in 1984. This decrease in earnings resulted from the fact that, despite our efforts, base rate relief has not kept pace with general increases in the costs of providing service.

After consideration of earnings prospects and the importance of steady dividend performance, the Board of Directors raised the quarterly dividend rate last June by 2½ cents, to 64½ cents. With this increase, the dividends paid per share in 1985 amounted to $2.53.

This represents the thirty-third consecutive year of growth in dividends paid.

Our annual dividend rate is now $2.58 per share.

Energy sales to our customers increased 2.4% in 1985, to a total 6.2 billion kilowatt-hours. We have witnessed renewed strength in our residential and commercial customer segments: The average number of residential customers for the year grew by more than 8,700 and we recorded an increase of more than 600 commercial customers. A new system peak demand of 1,432 megawatts was recorded in August. This new peak represents an increase of 10.2% over the peak recorded in 1984, and it is 6.3% higher than the Company's record peak set in 1983.

We have been quite successful in the management of fuel and purchased power costs. In 1985, such costs per kilowatt-hour declined by 8.3% from the year earlier. And for 1986, our energy adjustment rates, reflecting the costs of fuel and purchased power borne by our customers, have been reduced by approximately $44 million.

For the second year in a row, coal and nuclear sources of power provided more than 80% of total system requirements.

Several records for generating unit and station performance were set in 1985, and Salem Unit 1, one of our jointly-owned nuclear units, established an all-time national record for power output produced by a unit in a calendar year.

E. D. Huggard, J. D. Feehan

The only generating capacity which we have under construction is a 5% interest in the Hope Creek Nuclear Generating Station. Construction of the unit is virtually finished. Fuel loading and testing are yet to be completed, and Public Service Electric and Gas Company, which owns the other 95% of the unit and is responsible for its construction, has advised the Company that Hope Creek should be operational in late 1986. A cost containment agreement for the Hope Creek unit was approved by the New Jersey Board of Public Utilities in 1983. It established a targeted in-service date of December 1986 and a targeted cost for the plant at the time it would begin commercial operation. The agreement provided for incentives and penalties based upon the final cost of the unit. Our portion of the originally targeted amount was approximately $198 million, and at December 31, 1985 we had recorded approximately $204 million of costs. Our cost of the unit at completion is currently expected to be approximately $226 million. Based upon developments to date, we do not currently expect that the cost containment provisions will have a significant negative impact on earnings.

Improvement and support of corporate earnings depend upon receiving adequate base rate relief. We are continuing our efforts to obtain the needed increases in base rates. Our appeal from the BPU's denial of rate relief in August 1984, and the affirmance of the BPU's action by the New Jersey Superior Court, have now been taken to New Jersey Supreme Court. Last April, we filed requests with the BPU for rate increases in two phases: a first phase, in the amount of $63.3 million, to reflect more current cost levels; and the second phase, for a net amount of $28.5 million, to recover costs associated with the forthcoming operation of Hope Creek. We anticipate a decision by the BPU on the first-phase request in the first quarter of 1986, and are seeking to have the second-phase increase timed to coincide with the commercial start-up of the Hope Creek unit.

The legislature in New Jersey has mandated periodic management audits of electric and gas utilities in the State, and the Company was among the first to have a comprehensive management audit completed in 1985. On balance, the findings of the independent auditors confirmed the effectiveness and efficiency of the Company's operations.

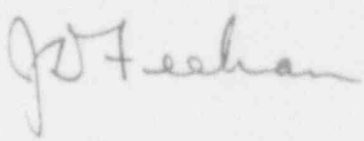
The audit report noted that decisions and actions by corporate management have saved customers hundreds of millions of dollars.

Audit recommendations suggested the potential for a modest reduction in overall expenses. Many corporate projects designed to cut costs and improve efficiency had already been underway at the time of the audit, and other efforts based upon the audit findings and recommendations have been started.

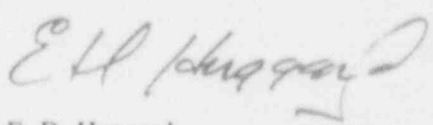
In large measure, we would characterize 1985 as a year of reflection and assessment of future opportunities. While others evaluated us in a management audit, we took a closer look at ourselves and set out to enhance our operating and planning practices. We have worked to better understand our customers' needs, making changes within the organization to more effectively meet those needs. And, we have taken a closer look at our business environment, observing that deregulation, competition and changing technology are having ever greater effects upon our industry.

Almost a century ago, the Electric Light Company of Atlantic City and the Bridgeton Electric Light Company were formed. Customers sought out these corporate predecessors of ours for the service and convenience that electric lighting could provide, and not the electricity that was produced. As we celebrate a centennial of service, we do well to remind ourselves of that fact, and to find in it the essence of success which lies ahead. We believe that the years to come are filled with challenges and opportunities for the Company. Our future progress will be built upon a competitive spirit, with renewed emphasis on service, performance and the effective management of costs. The Company's commitment to be alert to the opportunities of the future, and its ability to respond to them and manage them, will guide it toward the success of a new century.

For the Board of Directors,



J. D. Feehan
Chairman of the Board



E. D. Huggard
President and Chief Executive Officer

January 31, 1986

CUSTOMERS AND SERVICE

The continuing success of Atlantic Electric depends on its ability to measure and interpret customers' needs, and then to dedicate resources to meet those needs.

In early 1985, the Company's efforts to assess customers' needs was supported by means of a residential customer attitude survey. It provided important information on public perceptions of energy use, conservation and the Company. Customers said they preferred coal-fired generation and conservation as the means of avoiding future energy shortages. Although customers indicated an increased awareness of the importance of conservation, there was no increase in the reported level of action taken by them to save energy. The survey results suggested that more immediate economic incentives may be needed to encourage conservation efforts. Generally, customers appeared to hold a more favorable opinion of the Company than in the past. However, survey results indicated that we may be able to improve customers' perceptions regarding corporate profits and the value of electricity.

The responses to a separate 1985 appliance saturation survey of residential customers, and comparison with prior years' responses, helped us identify trends with respect to household characteristics and energy use. Although single family homes remain the dominant type of housing, there has been a shift in new housing units to multiple-family dwellings, such as condominiums and apartments. There has also been a shift from the use of oil to electricity for central heating, while changes in the use of natural gas have varied slightly over a five-year period. Electricity currently appears to be the predominant heating source in duplexes, condominiums and townhouses. Survey information with respect to changes in appliance usage helps us to address customer needs, forecast future energy requirements and identify additional opportunities for marketing conservation programs.

For 1985, the Company sought to greatly expand customer participation in its various conservation programs. Some improvements over the 1984 levels of participation were noted, although 1985 results did not meet all of our goals. During the year, the Company made changes to make it easier for customers to select our conservation services, and to provide greater incentives for them to do so. We introduced shop-at-home convenience for customers desiring our Seal-Up program services. In addition, we offered to install electric water heater insulation wraps at no charge, giving us the opportunity to offer other quick and inexpensive conservation measures. In 1985, over 2,000 residential customers took advantage of various Seal-Up services. More than 7,000 home energy audits were performed, and more than 200 other customers took advantage of energy audits available through a new Commercial and Apartment Conservation Program.

For the first time in several years, the Company conducted a survey of commercial customers to examine the relationship of energy use at various types of businesses to factors such as floor space, lighting, heating and cooling needs. A better understanding of these relationships will assist the Company in forecasting the future

The Atlantic City skyline has become a familiar scene of America's most visited city.

needs of this rapidly growing segment of our customer base, as well as aiding in the development of better energy management services.

Concern with improving customer service was exemplified with the opening of two pilot customer courtesy centers in 1985. The results of a special telephone poll had overwhelmingly indicated that personalized customer service at remote locations could complement the Company's centralized customer service operation. Visitors to these centers have access to a full range of services, from help with energy conservation to bill payment assistance. The experience with these two trial locations will be used to guide decisions on the potential opening of additional customer courtesy centers.

Offering various rate schedules enables the Company to meet specific customer needs. Recently the Company re-established a street lighting tariff which gives communities the choice of renting or owning energy-efficient street lighting. In 1985, a small group of residential customers agreed to participate in a one-year pilot program to test the effectiveness of time-of-use rates. These rates are intended to provide an incentive for customers to shift energy usage from times of peak demand, thereby reducing the need for costly additional generating capacity.

The Company's concerns with regulation are not only related to securing necessary rate relief, but are also related to the interests of its customers. One of the proceedings continuing through 1985 has involved the allocation of charges for electric service, and the Company has asked the Board of Public Utilities to reconsider a decision which the Company believes would adversely affect a majority of its customer classes and the economic vitality of the service area. In another State regulatory forum, a proposal was made which would ban the use of electric resistance heating in favor of natural gas. The proposal was ultimately withdrawn, following efforts by the Company to demonstrate the cost-effectiveness of electric heating, and the need to afford customers a choice of home heating methods.

Roadside stands have become a trademark of the southern portion of the "Garden State."

In September 1985, Hurricane Gloria struck our service area. Company personnel were able to restore 95% of the customers affected by the storm in less than 24 hours. Once the situation in Southern New Jersey was controlled, volunteers from

Employees of the Safety Department volunteer their time to explain high voltage hazards.

the Company work force went to help restore service to Long Island Lighting Company customers, who were more seriously hit by the hurricane.

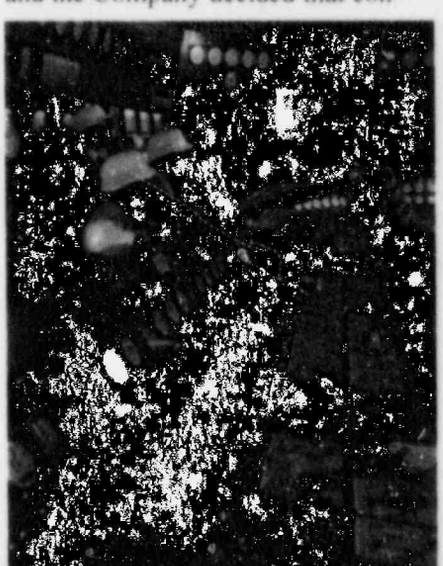
For the Company, community involvement has long been an extension of customer service. In 1985, the Speakers Bureau made over 240 presentations to community organizations and schools on such topics as energy conservation, electrical safety and environmental concerns. Also in 1985, the Company began supporting Childwatch, by distributing information on missing children in monthly customer mailings. The Good Neighbor Fund, now in its third year, helps deserving South Jersey residents meet winter heating costs. In the summer months, the Company has opened its doors at the B. L. England Generating Station to let visitors "see electricity being made." Employees in radio-equipped Company vehicles have helped summon life-saving services and assistance in emergencies such as car accidents and fires through its Radio Watch Program. For customers with limited financial resources, the Company has participated in town meetings to discuss the availability of free or low-cost weatherization services.

The new customer courtesy centers provide an extra opportunity for personal contact out in the service area.

OPERATIONS

For 1985, the Company's cost of fuel and purchased power per kilowatt-hour, by far the largest single element of the cost of service, declined by 8.3%. Output from our nuclear sources of energy improved substantially during the year and, together with our coal-fired sources, helped contain the cost of energy. In 1985, Salem Unit 1, one of our jointly-owned nuclear units, set a new record for 277 consecutive days' operation, and it also set an all-time national record for energy generated by a unit in a calendar year. Nuclear power purchased under contract from Pennsylvania Power & Light Company in 1985 was double the 1984 amount, due to the start-up of Susquehanna Unit 2 in February. That unit set a record in 1985 for the most power produced by reactors of its type. In addition, both of the jointly-owned, coal-fired Keystone and Conemaugh Stations set new records for plant output. Compared with the use of oil-fired power generation, the use of relatively low-cost coal and nuclear fuel saved the Company and its customers more than $136 million in 1985.

Units 1 and 2 at the B. L. England Station are the largest of the Company's coal-fired units. There are certain unusual weather conditions which can create a downwash of plant emissions in the nearby area. In order to assure compliance with regulatory requirements, many alternative operating configurations were evaluated, and the Company decided that con-



The Company's open house tours at B. L. England Station provide an opportunity for visitors to see how electricity is made.

Opportunities to provide friendly, personalized service may be found at every customer location.

struction of a 475-foot chimney would be the most effective means of responding to the situation. The new stack will be designed to replace the three smaller ones now at the station.

Several studies were conducted in 1985 to identify additional ways to reduce the costs of providing electricity. We examined the feasibility of modifying some of the Company's oil-fired generating units so that they could be cycled to more economically follow changes in system energy requirements. Based upon results of another study completed in 1985, plans have been made to modify a second unit at Deepwater Station to enable it to burn natural gas when it is available and economical to do so.

In 1985, a new computerized maintenance management system was selected for use starting in 1986 by the Company's production department. This system will aid in planning maintenance work by identifying tool and material requirements,

Cogeneration may prove to be an effective means of providing energy to hospitals.

Growth in the Company's service territory includes the construction of modern and efficient public buildings, such as the Atlantic County Office Building and Atlantic City Free Public Library.

setting work standards, and formalizing maintenance procedures. Savings are expected through reductions in maintenance overtime, contractor costs and improvements in generating unit availability.

By replacing major unit components, the useful life of existing generating facilities can be extended, and costly additions of new generating capacity can be delayed or reduced. In 1985, major studies were begun to identify situations at the B. L. England and Deepwater Stations where the replacement or refurbishment of major generating unit components would result in improved efficiency and availability, as well as longer operating life.

The Company's transmission system was strengthened in 1985 with the rebuilding and upgrading of the Corson-Sherman 69,000 volt transmission line to 138,000 volts. This project will serve to reduce power line energy losses and improve system reliability. Import reliability was also increased in 1985 with the inception of a program to install back-up power transformers at the Company's Sickler, Silver Lake and Mickleton Substations.

ENERGY SYSTEM PLANNING

In effect, our customers are buying necessities and conveniences such as lighting, heating and air conditioning. Some of these "end-uses" can be provided by other means. The potential for substitution, together with deregulation and technological developments, present many challenges and opportunities for the Company. Our planning process has been developed to enable us to recognize the options created by this changing business environment.

K-Tron Corporation, a major manufacturer of digital weighing systems, has found the Company's service area ideal for expansion.

One of our customers, Airwork Corporation, is an industry leader in contract maintenance and repair of gas turbine engines for aircraft and industrial applications.

Different techniques for controlling demand and energy usage from the customer's side of the meter can have a wide range of effects upon the costs and forms of customer service, as well as the financial well-being of the Company. A special study to investigate demand-side management was completed in late 1985, and the results will aid us in developing effective strategies for managing growth and delivering services desired by customers at the lowest reasonable cost.

One of the methods which should be helpful in controlling costly growth in peak demand is the direct control of appliance load. In 1985, the Company enlisted more than 500 residential customers in its "Peak Saver Club," to test the effectiveness of radio-controlled switches for air conditioners and electric water heaters. When demand approacnes a peak level, the Company will be able to turn these appliances off and on for short periods without perceptible discomfort or inconvenience. Test operation of the radio-controlled system will begin in 1986, and results from the trial program will be used to determine the value of offering the service to more customers.

Cogeneration involves the production of electricity and other forms of energy, such as hot water and steam. Successful applications of cogeneration may help reduce the need for other more costly forms of generating capacity. For more than 50 years, the Company has provided cogeneration services to DuPont. Additional cogeneration opportunities in the service territory are dependent upon customers' use of steam and hot water. In 1985, the Company supported cogeneration feasibility studies at more than 20 mid-sized commercial and industrial facilities. The Company also helped fund a major study of the cogeneration potential of a district hot water heating system in Atlantic City. Such a system appeared to be feasible, and the Company is involved in more detailed negotiations with the project sponsor. Major cogeneration opportunities with certain large industrial customers are also being evaluated.

One of the more promising future alternate energy technologies is photovoltaic generation. This means of converting solar energy directly into electricity may prove to be cost-effective by the early 1990's. For years, the Company has been collecting local solar data and reviewing

developments in solar technology. In 1985, the Company combined the results of its data gathering with findings of an alternate energy technology study to develop a better assessment of the potential of this technology. The Company has plans for further research in solar energy, and would hope to confirm the commercial feasibility of photovoltaic generation in our service area by means of test programs and joint ventures.

The Company has also studied the feasibility of using refuse-derived fuel at its generating facilities. These studies responded to the interest and concerns of municipalities seeking to manage waste disposal and have helped develop criteria for the safe and efficient use of this potential source of energy.

Personalized shareholder service has been enhanced this year by bringing all transfer agent and registrar functions in-house.

CORPORATE FINANCE AND ADMINISTRATION

Transfer agent and registrar services were brought completely in-house in late 1985 to provide more timely and efficient turnaround of shareholder transactions. Last year, a cross-section of shareholders participated in a survey which has helped us know them better, understand their investment objectives and get feedback on shareholder publications.

The Company's 1985 financing program included the issuance of both long-term debt and Common Stock. In October, we sold $70 million of 30-year First Mortgage Bonds with an annual interest rate of 11½%. We were unable to secure an allocation of the State's limited tax-exempt financing capacity for financing Hope Creek pollution control facilities in 1985, but we are continuing to seek the necessary allocation in 1986. During 1985, we issued a total of 423,305 shares of Common Stock for approximately $11.2 million, through the Dividend Reinvestment and Stock Purchase Plan and the Employee Stock Ownership Plan. Over the last 10 years, the Dividend Reinvestment and Stock Purchase Plan has been effective in raising more than $62.6 million of equity capital, while providing a convenient means for shareholders to buy additional shares of Common Stock. With the Company's reduced needs for capital and the expiration of Federal tax benefits afforded dividends reinvested in new shares of stock, the Company amended the Plan in late 1985. Beginning in 1986, reinvested dividends are being applied to the purchase of shares in the open market.

The first phase of an Integrated Customer Service System was implemented in 1985. Scheduled for completion in 1987, it is designed to allow quicker response to customers' billing inquiries, improve record-keeping accuracy, and provide for more timely responses to service order requests.

This past year, the Company completed its evaluation and selection of a new automated general ledger accounting system. When implemented as an integral part of the Cost Center Management System currently being developed, it will provide more detailed budget information, and help establish clear-cut lines of cost control responsibility.

Company-wide performance indicators were established in 1985 to keep track of progress in achieving long-term goals. Approximately 20 indicators were selected to measure performance in such areas as service reliability, safety and dividend growth. The use of performance indicators is now being expanded to include measurements at the departmental level.

Atlantic Electric's promotion of safe work habits involves not only formal training, but also informal recognition, encouragement and group incentives. One of the most far-reaching safety training programs in the Company's history, the Confidence with Chemicals Program, briefed more than 1,400 employees in the safe handling of potentially hazardous chemicals. Dinners have been used by the Company to honor employees working together to set new safety records. In 1985, several operating groups celebrated more than ten years without a lost-time accident, with one of them setting a record of more than sixteen years.

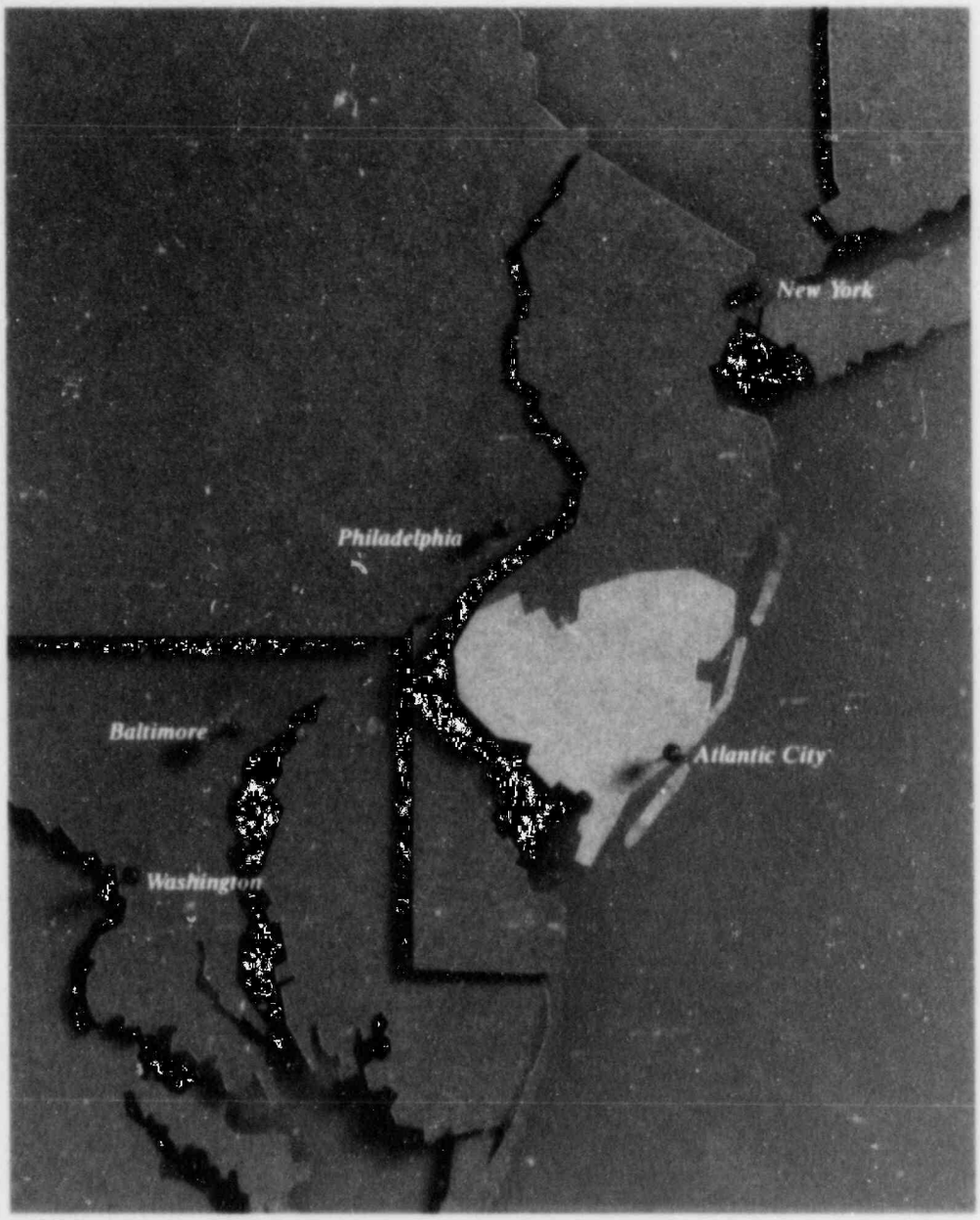
Throughout 1985, the Company has sponsored and encouraged various employee programs designed to promote self-confidence, healthful lifestyles and general well-being. Voluntary skill refresher courses proved to be a source of accomplishment and incentive for many of our employees to pursue more advanced education. The Company made available its facilities for a program promoting good eating habits and sensible weight control, and an after-hours aerobic exercise program was started by employees at Company headquarters.

Laser scanning techniques permit rapid, accurate gathering of information for meter records.

A comprehensive employee attitude survey was conducted by the Company in 1985. Almost 1,800 physical workers and office personnel responded to the survey, which covered such matters as work relations, communication, pay and opportunity for growth and advancement. The results have suggested some areas for improvement, and will also be used as a benchmark for comparison with future surveys.

The President's Award was established to recognize outstanding achievement by employees. The award for 1985 was presented to one of the Company's customer service employees for the interested, caring approach she has demonstrated to customers. Her spirit of thoughtfulness and dedication to customer service were cited as the strengths, shared by all of her fellow employees, upon which the future prosperity of Atlantic Electric's customers and shareholders will be built.

The production of reports to shareholders and members of the financial community involves a coordinated team effort of financial, accounting and production skills.



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

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

RESIDENTIAL

The average number of Atlantic Electric residential customers increased 2.6% in 1985, while average use per customer declined 2.8%. Over 9,100 new dwelling units were connected in 1985, of which 36% were electrically heated. The majority of 1985 new home construction occurred in the eastern part of the service area.

	1985	2000	Est. 1985-2000 Annual Growth Rate
Energy (billion kwh)	2.638	3.473	1.85%
Peak (Mw)	680	874	1.69%

COMMERCIAL

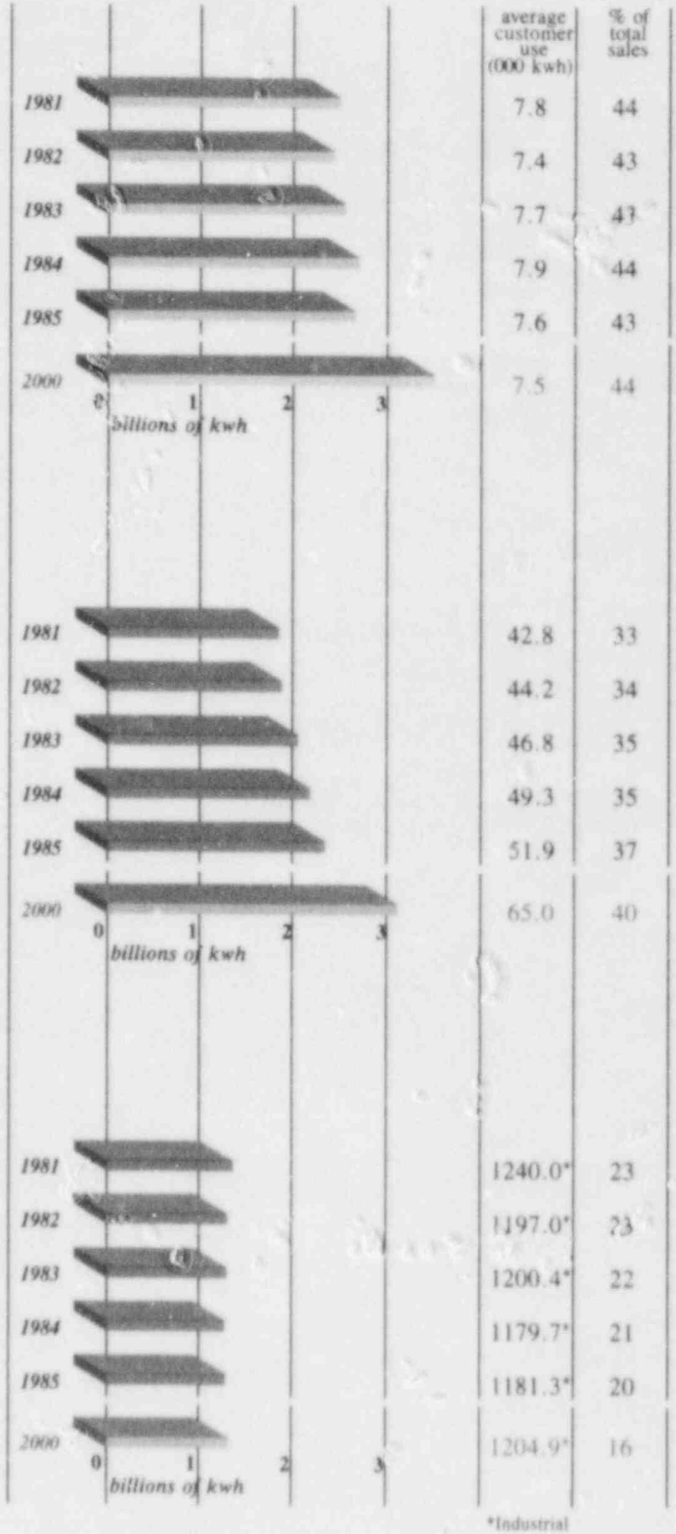
Sales to commercial customers increased 6.9% in 1985. Eleven casino-hotels were in operation at year-end. Sales to that segment increased almost 19% from 1984 and represented almost 6% of total energy sales. Approximately 1,700 of the 44,256 commercial customers engaged in farming and related activities during 1985.

	1985	2000	Est. 1985-2000 Annual Growth Rate
Energy (billion kwh)	2.299	3.094	2.00%
Peak (Mw)	562	765	2.08%

INDUSTRIAL & OTHER

The Company's 1,020 industrial customers are located primarily in the inland and western portions of the service area. Industries include the manufacture of chemical, glass, plastic and rubber products. Sales to this segment increased slightly in 1985.

	1985	2000	Est. 1985-2000 Annual Growth Rate
Energy (billion kwh)	1.263	1.282	0.10%
Peak (Mw)	190	198	0.28%



INDEX TO FINANCIAL INFORMATION

GENERAL

The nature of the Company's operations is capital intensive. We invest a significant amount of our funds in property and plant to generate, transmit and distribute electric energy service to our customers. At December 31, 1985 our gross investment in property and plant was over $1.4 billion. As a utility, our business is generally subject to regulation by the New Jersey Board of Public Utilities (BPU), including regulation of the rates which are charged for providing electric service. The Company's ability to finance its construction program, maintain service reliability, meet its working capital requirements and provide a fair rate of return on investment to its shareholders is dependent upon adequate rate relief.

LIQUIDITY AND CAPITAL RESOURCES

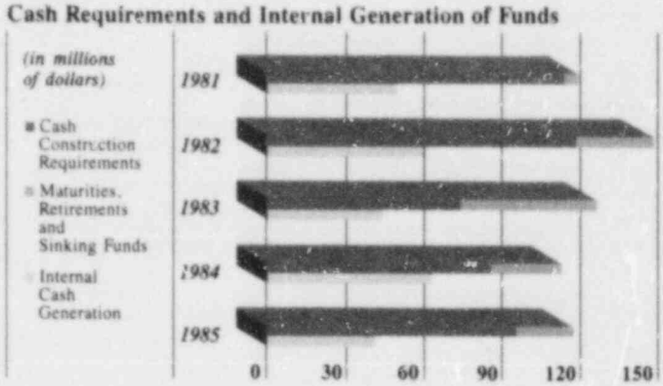
Construction Program

During 1985, cash construction expenditures aggregated $94 million, which is an 11% increase from the $85 million expenditure level experienced in 1984 and a 27% increase from the $74 million level in 1983. Included in the above amounts are cash construction expenditures associated with the Company's 5% interest in the Hope Creek Generating Station, the only additional generating capacity of the Company under construction. Such cash construction expenditures amounted to $31 million in 1985, and $23 million in each of the years 1984 and 1983. The five-year (1986-1990) cash construction expenditures are currently projected to be $388 million. The construction program has been developed in response to the need to improve or replace existing production plant, upgrade our transmission and distribution system and provide for projected growth. The current forecast of peak load growth for the period 1986-1990 is 2.1% per year.

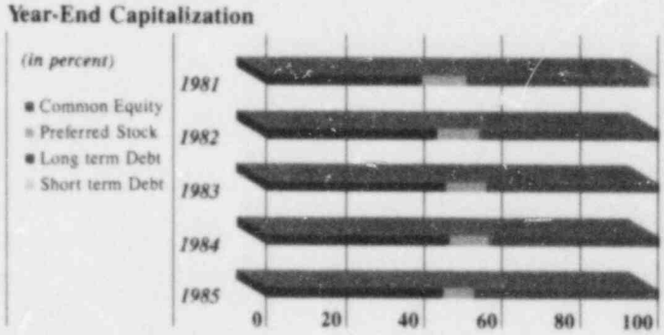
Financing Program

In 1985, the Company's external financings totaled $81.2 million, represented by $70.0 million of First Mortgage Bonds, $10.8 million of Common Stock issued through the Dividend Reinvestment and Stock Purchase Plan (DRP) and $.4 million of Common Stock issued through the Employee Stock Ownership Plan (ESOP). In 1984, $54.4 million was raised in the capital markets, with three pollution control series of First Mortgage Bonds totalling $42.2 million; $11.4 million of Common Stock sold through the DRP and $.8 million of Common Stock sold through the ESOP. In 1983, $64.3 million was raised in the capital markets from the sale of $50 million of First Mortgage Bonds, $11.7 million of Common Stock sold through the DRP and $2.6 million of Common Stock sold through the ESOP. Interim financing of our construction program and working capital needs was provided by the issuance of short term debt.

Cash Requirements and Internal Generation of Funds



Year-End Capitalization



Approximately 41% of the cash requirements for construction, debt maturities and sinking fund requirements during the period 1983-1985 was generated from operations after deductions for dividends and working capital needs, but exclusive of changes in temporary cash investments. The Company estimates that with adequate rate relief, more than 70% of its total cash construction requirements, debt maturities and sinking fund requirements will be generated internally during the five-year period from 1986-1990. Additional cash requirements will be satisfied through external financing. Capitalization ratios at December 31, 1985 are 47% long term debt, 45% common equity and 8% preferred stock. The Company will continue to use short term debt financing on an interim basis and currently maintains aggregate lines of credit of $115 million.

Provisions of the Company's charter, mortgage and debenture agreements can limit, in certain cases, the amount and types of additional financing which may be employed. Estimated additional funding capacities at December 31, 1985, giving effect to such provisions,

would amount to more than $400 million for First Mortgage Bonds, or $150 million for Preferred Stock or $140 million for unsecured debt, and may not necessarily be additive.

RESULTS OF OPERATIONS

The tabulation on page 36 includes key historical indicators which are helpful in evaluating the performance of the Company over the past five years.

Earnings

Earnings per share of Common Stock, based on the weighted average number of shares outstanding, were $3.00 in 1985, compared to $3.20 in 1984 and $3.48 in 1983. The decrease in earnings per share in 1985 and 1984 is attributable to increases in operating expenses without corresponding rate relief. In addition to rate relief, our earnings are sensitive to other changes in revenues and expenses as discussed below.

Revenues

Operating revenues increased by 5.5% in 1985 to $579.7 million compared to $549.5 million in 1984. The 1984 level of revenues represented a 6.3% increase compared to 1983. These overall increases reflect the net results of base revenue increases, changes in Levelized Energy Clause revenues and changes in kilowatt-hour sales. The effects of the above factors on 1985 and 1984 revenues are shown below:

(Thousands of Dollars)	1985		1984	
Base Revenues	$24,142	4.4%	$12,971	2.4%
Levelized Energy Clause	(7,039)	(1.3)	1,972	.4
Kilowatt-hour Sales	13,099	2.4	17,446	3.5
Increase	$30,202	5.5%	$32,389	6.3%

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

Sales

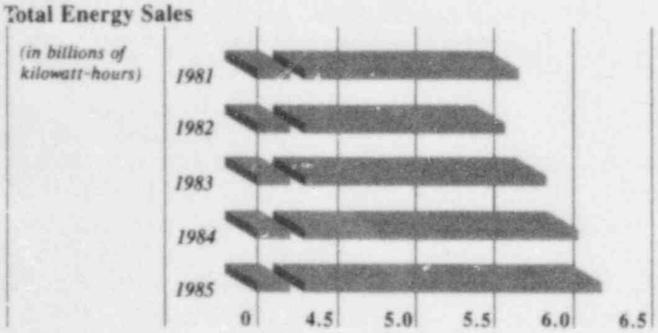
Changes in kilowatt-hour sales are generally due to changes in the average number of customers and average customer use, which is also affected by weather conditions.

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

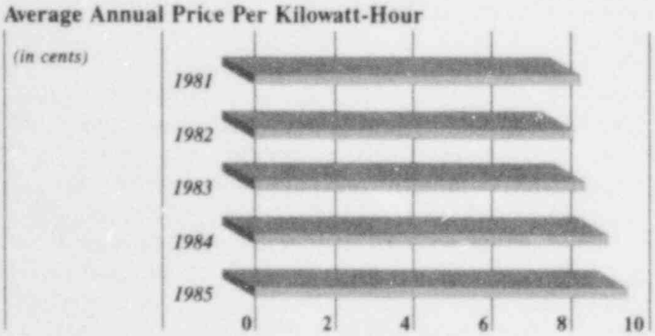
	Increase (Decrease) from Prior Year					
	1985			1984		
Customer Class	Sales	Average Use	# of Cust.	Sales	Average Use	# of Cust.
Residential	(.3)%	(2.8)%	2.6%	4.0%	2.0%	2.0%
Commercial	6.9	5.4	1.5	6.5	5.4	1.1
Industrial	.6	.1	.5	(2.3)	(1.8)	(.5)
Other	(2.4)	(4.2)	1.8	(3.0)	(2.2)	(1.1)
Total	2.4	—	2.5	3.5	1.6	1.9

The 2.4% and 3.5% increase in total kilowatt-hour sales in 1985 and 1984, respectively, is largely attributable to the number of new customers added to the Company's system in those years, and increased commercial activity in the service territory. Sales to residential customers in 1985 remained virtually unchanged from 1984 which, in turn, had increased 4.0% from 1983. In 1985, mild weather conditions and a lower average use per customer acted to offset the effects of an average of 8,700 new residential customers. In 1984, the effects of 6,500 new customers, together with an increased use per customer, resulted in increased kilowatt-hour sales. Sales to commercial customers increased 6.9% and 6.5% in 1985 and 1984, respectively. Business activities related to the expansion of the hotel/casino industry contributed to this commercial sales growth in both years. Sales to industrial customers increased by .6% in 1985 and declined 2.3% in 1984 as the result of changes in the number of customers and changes

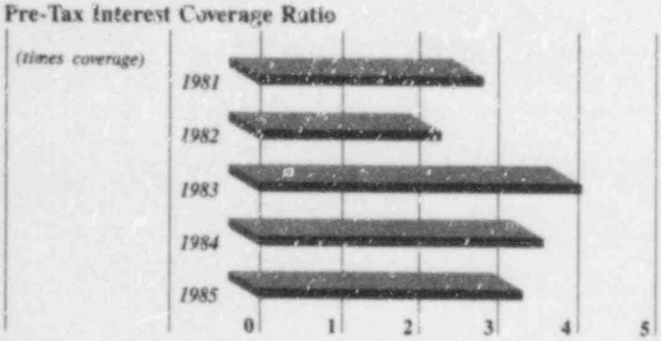
Total Energy Sales



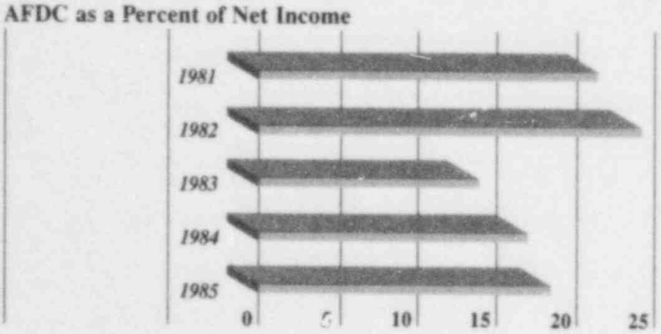
Average Annual Price Per Kilowatt-Hour



Pre-Tax Interest Coverage Ratio



AFDC as a Percent of Net Income



in the use of energy. Overall, however, the combined effects of the changes in our sales and rates have resulted in an increase in revenues per kilowatt-hour of 2.3% in 1985 compared to 1984 and 4.2% in 1984 compared to 1983.

Costs and Expenses

Total operating expenses increased 7.0% in 1985 compared to 1984. The 1984 operating expenses represented an increase of 8.0% compared to 1983. Excluding depreciation and taxes, operating expenses rose to $332.8 million in 1985, an increase of 6.9% over 1984, which had increased 13% from 1983.

Net Energy Costs reflect the amount of energy produced, as well as the various fuel and purchased power sources used to produce it. Information on the sources and costs per kilowatt-hour of energy are set forth in the accompanying graph. In 1984, Net Energy Costs were reduced by $6,969,000 reflecting the deferral of fuel costs incurred in excess of revenues collected under the fuel clause effective for that year. For 1985, Net Energy Costs include $5,865,000 of previously Deferred Energy Costs representing fuel costs recovered under our energy clause. At December 31, 1985 $4,466,000 is shown on the balance sheet as Deferred Energy Revenues associated with the current energy clause.

The Company's annual fuel, interchange and purchased power costs reflect changes in availability of low-cost generation from Company-owned and purchased sources, as well as changes in the needs of other utilities participating in energy interchange. Certain costs associated with purchased power are deferred on the balance sheet since rates are levelized to collect these costs over the 17-year life of the PP&L Agreements (see Note 3 to the Financial Statements).

Power production operation and maintenance costs include the cost of maintenance of both wholly- and jointly-owned generating units. In addition, the Company has embarked on an aggressive program to upgrade our production and other facilities to insure efficiency and extend service life. Other operation and maintenance costs consist of the price of materials, supplies and services, as well as wages and employee benefits.

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

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

Interest charges before the allowance for borrowed funds used during construction rose to $41.6 million in 1985 compared to $40.3 million in 1984, and $37.0 million in 1983. The increase of $3.3 million in interest expense in 1984 from the 1983 level reflects a full year's effect of interest on the Company's 11⅞% First Mortgage Bonds which were issued in November 1983, the issuance in 1984 of an aggregate $42.2 million principal amount of several pollution control series of First Mortgage Bonds, and higher average short term borrowing rates, offset by the retirement and maturities of First Mortgage Bonds and by lower average short term debt outstanding. The increase of $1.3 million in interest expense in 1985 from the 1984 level reflects a full year's effect of interest expense associated with the pollution control series of First Mortgage Bonds issued in 1984, the issuance of $70 million principal amount of 11½% First Mortgage Bonds issued in October 1985 and higher average short term debt outstanding, offset by the maturities of First Mortgage Bonds and lower average short term borrowing rates. Interest rates on our debt offerings are sensitive to the timing at which such financings are undertaken. Pollution control series of bonds and variable rate debt have been used to moderate the general upward pressures on interest rates. The embedded cost of our long term debt at December 31, 1985, was 9.6%, compared to 9.2% in 1984 and 1983.

The Allowance for Funds Used During Construction (AFDC) including both the Borrowed Funds portion, which is used to reduce interest charges, and the Equity Funds portion, shown under Other Income, was $11.2 million in 1985 compared to $10.8 million in 1984 and $9.2 million in 1983. The increases are due to increases in the average balances of construction work in progress. AFDC as a percent of net income for 1985, 1984 and 1983 was 18.5%, 17.0% and 13.9%, respectively.

Inflation

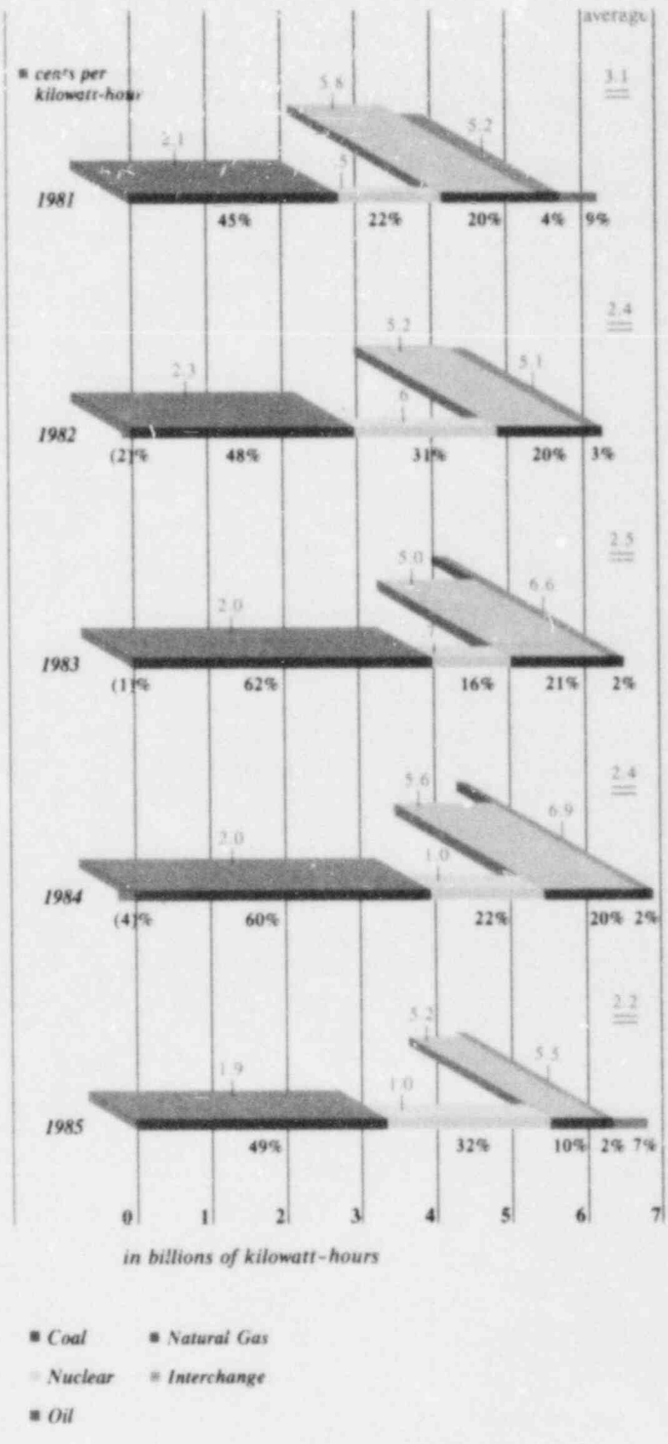
Supplementary unaudited financial information showing the estimated effects of inflation on the Company's operations is shown on pages 34 through 36. These data, which should be viewed as estimates of the approximate effects of inflation, rather than as precise measures, demonstrate the need to control costs and the responsibility for regulatory agencies to provide timely and adequate rate relief.

Accounting Standards

The Financial Accounting Standards Board has issued an Exposure Draft of a Proposed Accounting Standard entitled "Regulated Enterprises—Accounting for Phase-in Plans, Abandonments, and Disallowances of Plant Costs" which is a proposed amendment to existing accounting standards for regulated enterprises, including electric utilities such as the Company. This proposal, if adopted in its present form, would modify current accounting standards for the types of events enumerated. While the Company is still evaluating this proposal, it believes its operating results and financial position will be impacted if applied to certain past events such as the abandonment of Hope Creek Unit No. 2.

The Company intends to submit written comments to the Financial Accounting Standards Board concerning this proposal.

Total Sources and Costs of Energy



REPORT OF MANAGEMENT

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

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

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

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

AUDITORS' OPINION

Deloitte
Haskins + Sells
Certified Public Accountants

One World Trade Center
New York, New York 10048

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

We have examined the balance sheets of Atlantic City Electric Company as of December 31, 1985 and 1984 and the related statements of income and retained earnings and of 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, the accompanying financial statements present fairly the financial position of the 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

January 31, 1986

STATEMENT OF INCOME AND RETAINED EARNINGS

(Thousands of Dollars Except Per Share Amounts)	For the Years Ended December 31 1985	1984	1983
Operating Revenues—Electric	$579,733	$549,531	$517,142
Operating Expenses:			
Energy:			
Fuel	133,437	178,681	167,988
Interchange	17,272	(15,558)	(1,697)
Deferred Costs	5,865	(6,969)	(15,055)
Net Energy	156,574	156,154	151,236
Purchased Power-Exclusive of Fuel	42,636	28,905	12,435
Power Production-Operation and Maintenance	55,329	56,124	48,794
Other Operation and Maintenance	78,236	69,989	62,800
Depreciation and Amortization	41,985	38,318	38,383
New Jersey Gross Receipts and Franchise Taxes	71,100	60,769	55,324
Federal Income Tax Expense	36,308	41,227	48,728
Other Taxes	8,159	6,654	6,340
Total Operating Expenses	490,327	458,140	424,040
Operating Income	89,406	91,391	93,102
Other Income:			
Allowance for Equity Funds Used During Construction	5,216	4,821	4,320
Miscellaneous Income—Net	1,502	1,424	833
Total Other Income	6,718	6,245	5,153
Income Before Interest Charges	96,124	97,636	98,255
Interest Charges:			
Interest on Long Term Debt	39,604	38,231	33,795
Interest on Short Term Debt	1,565	1,861	2,669
Other Interest Expense	416	204	535
Total Interest Charges	41,585	40,296	36,999
Allowance for Borrowed Funds Used During Construction	(5,980)	(5,937)	(4,896)
Net Interest Charges	35,605	34,359	32,103
Net Income	60,519	63,277	66,152
Retained Earnings at Beginning of Year	161,629	148,454	128,825
	222,148	211,731	194,977
Dividends Declared:			
Cumulative Preferred Stock	6,282	6,949	7,171
Common Stock	46,220	43,153	39,352
Total Dividends Declared	52,502	50,102	46,523
Retained Earnings at End of Year	$169,646	$161,629	$148,454
Earnings for Common Stock:			
Net Income	$ 60,519	$ 63,277	$ 66,152
Less Preferred Dividend Requirements	6,369	6,968	7,201
Balance Available for Common Stock	$ 54,150	$ 56,309	$ 58,951
Average Number of Shares of Common Stock Outstanding (in thousands)	18,069	17,581	16,923
Per Common Share:			
Earnings	$ 3.00	$ 3.20	$ 3.48
Dividends Declared	$ 2.555	$ 2.45	$ 2.32
Dividends Paid	$ 2.53	$ 2.42	$ 2.30

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

STATEMENT OF CHANGES IN FINANCIAL POSITION

ATLANTIC CITY ELECTRIC COMPANY

(Thousands of Dollars)	For the Years Ended December 31 1985	1984	1983
Source of Funds:			
Funds from Operations:			
Net Income	$ 60,519	$ 63,277	$ 66,152
Principal Non-Cash Charges (Credits) to Income:			
Depreciation and Amortization	41,985	38,318	38,383
Allowance for Funds Used During Construction	(11,196)	(10,758)	(9,216)
Deferred Federal Income Taxes—Net	16,865	20,304	18,359
Investment Tax Credit Adjustments—Net	7,261	2,765	6,114
Other—Net	738	264	1,353
Total Funds from Operations	116,172	114,170	121,145
Funds from Outside Sources:			
Long Term Debt	70,000	42,200	50,000
Pollution Control Funds (Held) Released by Trustees	7,718	(5,539)	7,885
Subtotal	77,718	36,661	57,885
Sale of Common Stock	11,515	12,487	15,060
Total Funds from Outside Sources	89,233	49,148	72,945
Other—Net	1,802	(2,517)	(1,978)
Total Source of Funds	$207,207	$160,801	$192,112
Application of Funds:			
Gross Additions to Utility Plant	$105,213	$ 95,388	$ 83,673
Allowance for Funds Used During Construction	(11,196)	(10,758)	(9,216)
Net	94,017	84,630	74,457
Dividends on Preferred Stock	6,282	6,949	7,171
Dividends on Common Stock	46,220	43,153	39,352
Retirement and Maturity of Long Term Debt	10,000	26,000	50,300
Unrecovered Purchased Power Costs	14,680	6,530	11,450
Unrecovered Nuclear Fuel Advances	5,215	—	—
Conversion of Preferred Stock	353	267	711
Redemption of Preferred Stock	11,850	2,100	2,100
Increase (Decrease) in Working Capital*	18,590	(8,828)	6,571
Total Application of Funds	$207,207	$160,801	$192,112
Increase (Decrease) in Working Capital*			
Cash and Cash Items	$ 14,245	$ (751)	$(11,616)
Accounts Receivable	6,247	6,576	6,858
Unbilled Revenue	3,076	(1,340)	5,671
Fuel	(2,614)	10,657	(5,146)
Materials and Supplies	(569)	597	974
Nuclear Fuel Disposal Costs	8,481	(8,481)	—
Deferred Energy Costs and Revenue	(22,190)	6,967	26,626
Accounts Payable	630	(5,261)	(1,647)
Taxes Accrued	6,850	(3,923)	(3,831)
Deferred Taxes	1,136	(2,589)	(7,557)
Other	3,298	(11,280)	(3,761)
Increase (Decrease) in Working Capital	$ 18,590	$ (8,828)	$ 6,571

*Excludes Short Term Debt, Notes and Current Maturities of Long Term Debt and Cumulative Preferred Stock Subject to Mandatory Redemption.

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

BALANCE SHEET

(Thousands of Dollars)	December 31 1985	1984
Assets		
Electric Utility Plant:		
In Service:		
Production	$ 553,253	$ 515,637
Transmission	200,517	190,969
Distribution	345,177	326,466
General	63,590	52,987
Total	1,162,537	1,086,059
Less Accumulated Depreciation	330,895	300,037
Net	831,642	786,022
Construction Work in Progress	237,310	216,026
Land Held for Future Use	6,849	6,957
Nuclear Fuel	—	628
Electric Utility Plant—Net	1,075,801	1,009,633
Non Utility Property and Investments	4,298	5,901
Pollution Control Construction Funds	2,871	11,076
Current Assets:		
Cash and Working Funds	5,379	5,234
Temporary Cash Investments	18,500	4,400
Accounts Receivable:		
Utility Service	42,899	36,276
Miscellaneous	8,386	8,662
Allowance for Doubtful Accounts	(1,600)	(1,500)
Unbilled Revenues	26,401	23,325
Fuel (at average cost)	29,828	32,442
Materials and Supplies (at average cost)	17,223	17,792
Prepayments	8,382	5,066
Unrecovered Nuclear Fuel Disposal Costs	—	2,407
Deferred Energy Costs—Net	—	17,724
Total Current Assets	155,398	151,828
Deferred Debits:		
Property Abandonment Costs	19,878	17,029
Unrecovered Purchased Power Costs	32,660	17,980
Unamortized Debt Expense	5,220	4,343
Other	3,507	2,713
Total Deferred Debits	61,265	42,065
Total Assets	$1,299,633	$1,220,503

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

(Thousands of Dollars)	December 31 1985	1984
Liabilities and Capitalization		
Capitalization:		
Common Shareholders' Equity:		
Common Stock	$ 54,771	$ 53,464
Premium on Capital Stock	229,287	219,078
Capital Stock Expense	(1,607)	(1,660)
Retained Earnings	169,646	161,629
Total Common Shareholders' Equity	452,097	432,511
Cumulative Preferred Stock Not Subject to Mandatory Redemption	41,353	41,706
Cumulative Preferred Stock Subject to Mandatory Redemption	34,100	49,550
Long Term Debt	437,462	412,462
Total Capitalization	965,012	936,229
Current Liabilities:		
Current Portion:		
Cumulative Preferred Stock Subject to Mandatory Redemption	5,050	1,450
Long Term Debt	45,000	10,000
Accounts Payable	28,755	29,385
Taxes Accrued	5,372	12,222
Interest Accrued	12,865	11,721
Dividends Declared	13,224	12,757
Customer Deposits	2,945	2,737
Deferred Taxes	17,747	18,883
Nuclear Fuel Disposal Costs	—	10,888
Deferred Energy Revenues—Net	4,466	—
Other	5,681	7,482
Total Current Liabilities	141,105	117,525
Deferred Credits:		
Deferred Investment Tax Credits	65,412	58,151
Deferred Income Taxes	120,464	103,599
Other	7,640	4,999
Total Deferred Credits	193,516	166,749
Commitments and Contingent Liabilities (Note 11)		
Total Liabilities and Capitalization	$1,299,633	$1,220,503

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

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

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

Electric Utility Plant
Property is stated at original cost. Generally the plant is subject to a first mortgage lien. The cost of property additions, including replacement of units of property and betterments, is capitalized. Included in certain additions is an Allowance for Funds Used During Construction (AFDC) which is defined in the applicable regulatory system of accounts as the cost during the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used. AFDC has been calculated using a rate of 8.5% and was semi-annually compounded on Hope Creek Unit No. 1 expenditures beginning in 1984. Such rates are less than the maximum allowed by FERC.

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

Depreciation
The Company provides for straight-line depreciation based on the estimated remaining life of transmission and distribution property and, based on the estimated average service life, for all other depreciable property. Depreciation applicable to nuclear plant includes amounts provided for decommissioning. The overall composite rate of depreciation was approximately 3.7% for 1985, 3.6% for 1984 and 3.7% for 1983. Accumulated depreciation is charged with the cost of depreciable property retired together with removal costs less salvage and other recoveries.

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

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

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

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

The Hope Creek Unit No. 2 investment is being amortized over a 15-year period that began in 1983. The investment in the offshore nuclear units is being amortized over a 20-year period that began in 1979. Unrecovered nuclear fuel advances are being amortized, subject to BPU approval of their recovery, over 5 years, beginning in 1985. The unamortized amounts are $12,765,000, $2,745,000, and $4,172,000, respectively, at December 31, 1985.

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

Other
Debt premium, discount and expenses are amortized over the life of the related debt. Gains and losses relating to reacquired debt are recognized currently.

Certain 1984 and 1983 amounts have been reclassified to conform with 1985 presentations.

NOTE 2. FEDERAL INCOME TAX

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

	Years Ended December 31		
(Thousands of Dollars)	1985	1984	1983
Net Income	$60,519	$ 63,277	$ 66,152
Federal Income Tax Expense (as below)	36,317	41,876	49,061
Book Income Subject to Tax	$96,836	$105,153	$115,213
Income Tax Computed at the Statutory Rate	$44,544	$ 48,370	$ 52,998
Items for which deferred taxes are not provided:			
Difference between Tax and Book Depreciation	2,801	(250)	1,896
Allowance for Funds Used During Construction	(5,029)	(4,832)	(4,211)
Capitalized Overheads	(1,209)	(1,221)	(1,245)
Investment Tax Credits	(2,178)	(1,842)	(1,775)
Other	(2,612)	1,651	1,398
Total Federal Income Tax Expense	$36,317	$ 41,876	$ 49,061
Components of Federal Income Tax Expense:			
Federal Income Taxes Currently Payable	$12,956	$ 15,512	$ 15,072
Deferred Federal Income Taxes:			
Liberalized Depreciation	11,899	18,335	10,438
Unbilled Revenues	1,415	(616)	2,609
Unrecovered Purchased Power Costs	6,753	3,004	5,267
Deferred Energy Costs	(2,551)	3,205	4,948
Other	(1,787)	(1,034)	2,654
Deferred Investment Tax Credits	7,261	2,765	6,114
Employee Stock Ownership Plan Credits	371	705	1,959
Total Deferred Federal Income Tax Expense	23,361	26,364	33,989
Total Federal Income Tax Expense	36,317	41,876	49,061
Less Federal Income Taxes Included in Other Income	9	649	333
Federal Income Taxes Included in Operating Expenses	$36,308	$ 41,227	$ 48,728

In 1984, the Company filed amended federal income tax returns for 1981 and 1982 reflecting the election of the Asset Guideline Repair Allowance. The effect of this election is included in Deferred Federal Income Taxes—Liberalized Depreciation and Deferred Investment Tax Credits.

The Company purchased tax benefits on equipment having an aggregate tax basis of approximately $10,400,000 and $2,900,000 in 1983 and 1982, respectively. These tax benefits include depreciation and investment tax credits.

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

At December 31, 1985 the cumulative amount of deferred income taxes which have not been provided on timing differences, principally depreciation, amounted to approximately $85,000,000 computed at the current statutory rate of 46%.

NOTE 3. RATE MATTERS

Base Rate Case Decisions

During the three year period ended December 31, 1985 base rate case decisions of the New Jersey Board of Public Utilities (BPU) are shown below:

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

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

In August 1984 the BPU denied the Company's October 1983 request for the $25,300,000 increase in base rates. The BPU, in denying rate relief, made several adjustments to the Company's requested rate base, test year operating income and rate of return, providing for an overall rate of return of 11.35% and a return on common equity of 14.30%. Prior to the BPU decision, the Company had been authorized to earn an overall rate of return of 11.7% and a return on common equity of 15.0%. In November 1985, the decision by the BPU was affirmed by the New Jersey Superior Court. The Company has filed a request with the New Jersey Supreme Court for review of the appellate ruling. The Company cannot predict the final outcome of the proceedings or the ultimate effect upon the Company.

The February 1985 increase relates to the second half of the Company's agreements with PP&L and commenced with the start of commercial operation of PP&L's Susquehanna Unit 2.

In April 1985 the Company filed a petition requesting a net increase of $91,850,000 to be implemented in two phases. The first phase request, for $63,316,000, is related to increased operations and maintenance costs and capital investment, and is based upon a test year of September 30, 1985. The Company anticipates a decision on this request in the first quarter of 1986. The second phase request, for a net increase of $28,534,000, relates to the Company's 5% ownership in the Hope Creek Generating Station, and would become effective upon commercial operation of the unit.

Energy Clauses

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

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

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

As part of the January 1986 energy clause approval, the Company agreed to expense $3,975,000 of replacement power costs associated with maintenance and repair outages at Peach Bottom Unit 2 and Salem Unit 2. Also, the Company agreed to increase the deferral of $7,500,000 of Deferred Energy Costs to $12,179,000.

These costs represent the Company's pro rata impact of BPU findings in proceedings related to other co-owners with respect to replacement power costs associated with certain outages at the Salem Nuclear Generating Station (see Note 11).

NOTE 4. RETIREMENT BENEFITS

The cost to the Company in providing a retirement plan for its employees was $6,465,000, $7,555,000 and $6,563,000 in 1985, 1984 and 1983, respectively. Approximately 80% of these costs were charged to operating expense and the remaining 20%, which was associated with construction labor, was charged to the cost of new utility plant.

The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8% for 1985 and 7% for 1984. The Company's Plan is in compliance with the Employee Retirement Income Security Act of 1974 as amended.

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

	January 1	
(Thousands of Dollars)	**1985**	1984
Actuarial present value of accumulated plan benefits:		
Vested	$ 84,563	$ 86,758
Nonvested	4,459	3,846
Total	$ 89,022	$ 90,604
Net Assets available for benefits	$121,778	$115,596

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for retired employees. Substantially all of the Company's employees may become eligible for those benefits if they reach normal retirement age while working for the Company. Those and similar benefits for active employees are provided through insurance companies and other plan providers whose premiums and related plan costs are based on the benefits paid during the year. The Company recognizes the cost of providing those benefits by expensing the annual insurance premiums and related plan costs. The cost of providing those benefits for retirees totalled $992,000 for 1985 and $845,000 for 1984.

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

NOTE 5. JOINTLY-OWNED GENERATING STATIONS

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

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

Station	Energy Source	Company's Share	Electric Plant in Service		Construction Work in Progress		Generation	
			1985	1984	**1985**	1984	**1985**	1984
			(Thousands of Dollars)				*(MWH)*	
Keystone	Coal	2.47%	$ 7,306	$ 6,893	$ 976	$ 798	258,436	237,233
Conemaugh	Coal	3.83	12,355	11,684	210	332	400,790	423,653
Peach Bottom	Nuclear	7.51	91,010	77,292	2,490	8,873	420,469	738,447
Salem	Nuclear	7.41	160,977	154,806	2,605	4,751	1,039,420	395,037
Hope Creek	Nuclear	5.00	—	—	203,656	162,676	—	—

The operators of the Salem and Peach Bottom Nuclear Generating Stations entered into contracts with the United States Department of Energy for spent nuclear fuel disposal. These contracts require the payment of a one-time fee related to the Company's ownership interest in the Salem and Peach Bottom Stations, which was made in June 1985, as well as ongoing quarterly charges. Current recovery of these spent nuclear fuel disposal costs is provided as part of the Company's energy clause.

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

NOTE 6. INVESTMENT IN OPERATING SUBSIDIARY

The Company's investment in Deepwater Operating Company (Deepwater), a wholly-owned subsidiary which operates generating and process steam units owned by the Company, was $3,291,000 at December 31, 1985 and 1984. The principal asset of Deepwater is working capital in which the equity of the Company is fairly represented by its investment. The net production costs of Deepwater are included in the Company's accounts classified as to operation, maintenance and taxes.

NOTE 7. COMMON STOCK

As of December 31, 1985 and 1984, the Company's Common Stock included 25,000,000 authorized shares of Common Stock ($3 par value).

Shares Issued and Outstanding:	1985	1984	1983
Beginning of Year	17,821,346	17,250,882	16,574,021
Dividend Reinvestment and Stock Purchase Plan	408,999	525,118	535,614
Employee Stock Ownership Plan	14,306	36,009	116,347
Conversion of Preferred Stock	12,358	9,337	24,900
End of year	18,257,009	17,821,346	17,250,882
At $3 Par Value	$54,771,027	$53,464,038	$51,752,646

Premium on Capital Stock was credited in 1985 and 1984 with $10,209,000 and $10,799,000, respectively, representing the excess of proceeds over the par value of shares of Common Stock issued, sold and converted. At December 31, 1985 there were 57,179 shares of Common Stock authorized for issuance pursuant to the Employee Stock Ownership Plan and 47,375 shares of Common Stock reserved for the conversion of 5⅞% Convertible Series of Preferred Stock.

NOTE 8. CUMULATIVE PREFERRED STOCK

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

NOTE 8(A).

Cumulative Preferred Stock Not Subject To Mandatory Redemption:

$100 Par Value-Cumulative and Non-participating shares issued and outstanding:	December 31 1985	1984	Current Redemption Price Per Share
	(Thousands of Dollars)		
Series:			
4% 77,000 Shares	$ 7,700	$ 7,700	$105.50
4.10% 72,000 Shares	7,200	7,200	101.00
4.35% 15,000 Shares	1,500	1,500	101.00
4.35% 36,000 Shares	3,600	3,600	101.00
4.75% 50,000 Shares	5,000	5,000	101.00
5% 50,000 Shares	5,000	5,000	100.00
5⅛% Convertible Series:			
13,530 Shares (1985)	1,353	—	101.50
17,061 Shares (1984)	—	1,706	
7.52% 100,000 Shares	10,000	10,000	104.89
Total	$41,353	$41,706	

Cumulative Preferred Stock Not Subject to Mandatory Redemption is redeemable solely at the option of the Company upon payment of the redemption price plus accumulated and unpaid dividends to the date fixed for redemption. Premium on such Preferred Stock was $93,000 at December 31, 1985 and 1984.

The 5⅛% Convertible Series, of which 3,531 and 2,668 shares were converted in 1985 and 1984, respectively, is convertible, subject to adjustment in certain events, into Common Stock at the rate of 3.5 shares of Common Stock for each share of Preferred.

NOTE 8(B).

Cumulative Preferred Stock Subject To Mandatory Redemption:

Shares Issued and Outstanding:	Par Value	December 31 1985	1984	Current Redemption Price Per Share	Refunding Restricted Prior to
		(Thousands of Dollars)			
Series:					
8.40% 100,000 Shares (1984)	$100	—	$10,000		
9.96% 104,000 Shares (1985)	100	$10,400	—	$106.06	
120,000 Shares (1984)		—	12,000		
$8.25 87,500 Shares (1985)	None	8,750	—	106.56	November 1, 1987
90,000 Shares (1984)		—	9,000		
$9.45 200,000 Shares	None	20,000	20,000	104.20	November 1, 1989
		39,150	51,000		
Less Portion due within one year		5,050	1,450		
Total		$34,100	$49,550		

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

On August 1 of each year 8,000 shares of the 9.96% Series must be redeemed through the operation of a sinking fund at a redemption price of $100 per share. At the option of the Company, an additional 8,000 shares may be redeemed on any sinking fund date, without premium, up to 40,000 shares in the aggregate. The Company redeemed 16,000 shares at par in 1985 and 1984 through the operation of the sinking fund and optional redemption provisions. As of December 31, 1985 the Company had redeemed the maximum 40,000 shares pursuant to the optional redemption without premium provisions.

On November 1 of each year, 2,500 shares of the $8.25 No Par Preferred Stock Series must be redeemed through the operation of a sinking fund at a redemption price of $100 per share. At the option of the Company, not more than an additional 2,500 shares may be redeemed on any sinking fund date without premium. The Company redeemed 2,500 and 5,000 shares at par in 1985 and 1984, respectively.

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

The annual minimum sinking fund provisions of the above series aggregate $5,050,000 each year from 1986 through 1990.

NOTE 9. LONG TERM DEBT

	December 31,	
(Thousands of Dollars)	1985	1984
First Mortgage Bonds:		
3¼% Series due (March 1) 1985	—	$ 10,000
4½% Series due (January 1) 1987	$ 10,000	10,000
3⅞% Series due (April 1) 1988	10,000	10,000
4½% Series due (April 1) 1989	2,775	2,775
4½% Series due (March 1) 1991	10,000	10,000
4½% Series due (July 1) 1992	10,350	10,350
4⅜% Series due (March 1) 1993	9,540	9,540
11⅞% Series due (November 1) 1993	50,000	50,000
5⅛% Series due (February 1) 1996	9,980	9,980
8⅞% Series due (September 1) 2000	19,000	19,000
8% Series due (May 1) 2001	27,000	27,000
7½% Series due (April 1) 2002	20,000	20,000
7¼% Series due (June 1) 2003	29,976	29,976
7⅝% Pollution Control Series due (January 1) 2005	6,500	6,500
6⅜% Pollution Control Series due (December 1) 2006	2,500	2,500
12⅝% Series due (January 1) 2010	63,750	63,750
11⅝% Pollution Control Series due (May 1) 2011	39,000	39,000
10½% Pollution Control Series B due (July 15) 2012	850	850
Adjustable Rate Pollution Control Series A due (April 15) 2014 (7¼% Until 4-15-87)	18,200	18,200
10½% Pollution Control Series C due (July 15) 2014	23,150	23,150
11½% Series due (October 1) 2015	70,000	—
Total	432,571	372,571
Debentures:		
5¼% Sinking Fund Debentures due (February 1) 1996	2,267	2,267
7¼% Sinking Fund Debentures due (May 1) 1998	2,619	2,619
Total	4,886	4,886
Notes—Variable Rate Notes due (April 30) 1986	45,000	45,000
Unamortized Premium and Discount—Net	5	5
Total	482,462	422,462
Less Long Term Debt due within one year	45,000	10,000
Total	$437,462	$412,462

Deposits in sinking funds for retirement of debentures are required on February 1 of each year through 1995 for the 5¼% debentures, and on May 1 of each year through 1997 for the 7¼% debentures in amounts in each case sufficient to redeem $100,000 principal amount plus, at the election of the Company, up to an additional $100,000 principal amount in each year. At December 31, 1985 the Company had reacquired and cancelled $1,233,000 and $1,081,000 principal amount of the 5¼% and 7¼% debentures, respectively, toward its requirements for 1986 and subsequent periods.

A sinking fund requirement of $3,000,000 each year relative to the 12⅝% First Mortgage Bonds begins in 1986 and continues through 2009. The Company also has the option to redeem an additional $3,000,000 principal amount on any sinking fund date without premium. At December 31, 1985 the Company had reacquired and cancelled $11,250,000 principal amount of the 12⅝% Series which may be applied toward its requirements for 1986 and subsequent periods. On January 1, 1986 the Company redeemed an additional $6,000,000 of these bonds through the operation of the sinking fund and optional redemption provisions. Current sinking fund requirements of $750,000 in connection with certain First Mortgage Bonds outstanding may be satisfied by certification of property additions as provided for in the related mortgage indentures.

The aggregate amount of debt maturities, in addition to sinking fund requirements, of all long term debt outstanding at December 31, 1985 are $45,000,000 in 1986, $10,000,000 in 1987 and 1988, and $2,775,000 in 1989. No maturities of long term debt occur in 1990.

NOTE 10. SHORT TERM DEBT AND COMPENSATING BALANCES

As of December 31, 1985, the Company had bank lines of credit available for use of $115,000,000. The Company is required, with respect to $15,000,000 of these credit lines, to maintain average compensating balances of $487,500. These compensating balances are maintained in demand deposits which are not legally restricted. The Company is in compliance with such compensating balance arrangements. With respect to the remaining available credit lines, the Company pays commitment fees (generally ¼%) for which charges amounted to $235,000 for 1985, $242,000 for 1984 and $269,000 for 1983. The Company had no outstanding short term debt at December 31, 1985, 1984 or 1983. Additional information regarding short term debt follows:

(Thousands of Dollars)	1985	1984	1983
For the year ended—			
Maximum amount of total short term debt at any month-end:			
Commercial Paper	$55,700	$35,000	$50,000
Notes Payable to Banks	$10,000	—	$ 7,000
Average amount of short term debt (based on daily outstanding balances):			
Commercial Paper	$19,905	$17,519	$23,954
Notes Payable to Banks	$ 4,239	$ 301	$ 2,567
Weighted daily average interest rates on short term debt:			
Commercial Paper	7.9%	10.6%	9.0%
Notes Payable to Banks	8.1%	9.2%	9.3%

NOTE 11. COMMITMENTS AND CONTINGENCIES

Construction Program
Total cash construction expenditures for 1986 are estimated at approximately $86,082,000, which includes $18,796,000 for jointly-owned facilities. Current commitments for the construction of major production and transmission facilities amount to approximately $12,380,000 of which it is estimated approximately $8,905,000 will be expended in 1986. These amounts exclude allowance for funds used during construction and customer contributions.

Nuclear Insurance Programs
The Company is a member of certain insurance programs which provide coverage for property damage to members' nuclear generating plants. Facilities at the Peach Bottom and Salem Stations are insured against property damage losses up to $1.1 billion per site under these programs.

The Company is also a member of an insurance program which provides insurance coverage for the cost of replacement power during prolonged outages of nuclear units caused by certain specific conditions. Under the property and replacement power insurance programs, the Company could be assessed retrospective premiums in the event the insurers' losses exceed their reserves. As of December 31, 1985, the maximum amount of retrospective premiums the Company could be assessed for losses during the current policy year was $8.2 million under these programs.

In the event of a nuclear incident at any of the facilities covered by the federal government's third-party liability indemnification program, the Company could be assessed up to $2.1 million per incident, but not more than $4.2 million in a calendar year, in the event more than one incident is experienced.

Purchase Power Agreements
The Company has an arrangement for a limited term purchase of energy and capacity from Allegheny Power System which was effective for 1985 and subject to annual extensions. The Company also has agreements to purchase certain capacity and energy output from units of Pennsylvania Power & Light Company.

Hope Creek Cost Containment
The Company owns 5% of the the Hope Creek Nuclear Generating Station, currently under construction by Public Service Electric & Gas Company (PSE&G), which owns the other 95% of the unit. In July 1983 the BPU approved an Agreement between the Company, PSE&G, the New Jersey Department of Energy and the New Jersey Department of the Public Advocate which establishes a program to contain the continuing construction costs of Hope Creek, which is currently 99% complete as to physical construction and approximately 93% complete as to start-up, and scheduled for completion in the second half of 1986. The cost containment agreement established a targeted in-service date of December 1986 and a targeted cost of $3.7952 billion, and provides for penalties for overruns based on the final cost of the unit. The Company's portion of the originally targeted cost is approximately $198.1 million, including the Allowance for Funds Used During Construction (AFDC). However, the targeted amount may be subject to adjustment on account of changes in the regulatory treatment of Construction Work In Progress and AFDC, as well as changes due to certain extraordinary events not contemplated by the parties in 1983. At December 31, 1985 the Company's costs associated with Hope Creek amount to approximately $204 million and the Company has recently been advised by PSE&G that the estimated overall cost for Hope Creek is expected to be between $4.15 and $4.30 billion. The Company cannot predict the final cost of the Hope Creek unit, the date of commencement of commercial operation, or the ultimate effects thereof on its operations. However, Management believes the final outcome of this matter will not have a material adverse effect on the Company's financial position.

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

Nuclear Fuel
The Company's contractual liability to purchase nuclear fuel from Pearl Fuel Corporation for Salem and Hope Creek Generating Stations as of December 31, 1985 was approximately $31,000,000. Under certain conditions of termination, the Company will be required to purchase all nuclear fuel then existing at a price which will allow Pearl Fuel Corporation to recover its net investment costs. Nuclear fuel requirements for Peach Bottom Generating Station are being provided by the operating company through a fuel purchase contract. The Company is responsible for payment of its share of fuel consumed and related operating costs and interest expense. These costs are included in fuel expense.

NOTE 12. LEASES

The Company has certain obligations which, in accordance with criteria established by the Financial Accounting Standards Board (FASB), are capital leases, but are accounted for as operating leases in accordance with the ratemaking treatment. An accounting standard issued by the FASB requires that the Company record such leases on its balance sheet by 1987. Recording capital leases would not have a material effect on assets or liabilities, and would not affect income, since the total amortization of the leased assets and the interest on the lease obligation would equal the rental expense currently allowed for ratemaking purposes. Rentals charged to operating expenses for the years ended December 31 were as follows:

(Thousands of Dollars)	1985	1984	1983
Nuclear Fuel	$11,800	$ 8,457	$ 6,364
Other	4,511	4,759	5,268
Total	$16,311	$13,216	$11,632

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

NOTE 13. SUPPLEMENTARY INCOME STATEMENT INFORMATION

Operating expenses include maintenance costs of $43,378,000, $39,247,000 and $35,066,000 for 1985, 1984 and 1983 respectively. Charges to income for royalties and advertising are less than 1% of gross revenue.

NOTE 14. QUARTERLY FINANCIAL RESULTS (UNAUDITED)

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

Quarter	Operating Revenues	Operating Income	Net Income	Earnings For Common Stock	Earnings Per Share
(Thousands of Dollars Except Per Share Amounts)					
1985					
1st	$140,491	$19,104	$12,658	$10,962	$ .61
2nd	134,214	15,683	8,866	7,176	.40
3rd	180,411	35,630	27,815	26,283	1.45
4th	124,617	18,989	11,180	9,729	.53
	$579,733	$89,406	$60,519	$54,150	$3.00(1)
1984					
1st	$133,649	$21,527	$15,360	$13,588	$ .78
2nd	125,073	18,448	11,431	9,660	.55
3rd	163,929	36,275	28,330	26,586	1.51
4th	126,880	15,141	8,156	6,475	.36
	$549,531	$91,391	$63,277	$56,309	$3.20

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

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

SUPPLEMENTARY INFORMATION CONCERNING THE EFFECTS OF CHANGING PRICES (UNAUDITED)

The following supplementary information about the effects of changing prices is presented in accordance with standards issued by the Financial Accounting Standards Board (FASB). The Company cautions readers on using this information to draw any conclusions concerning the Company or its operations, since the Company's rates are subject to regulation. Additionally, this information is still considered experimental in nature and under continuing review by the FASB. The Company has expressed its views to the FASB concerning these disclosures and has made certain recommendations it believes would simplify both the presentation and understanding of the effects of inflation on a business enterprise. The effects of changing prices are calculated by adjusting the financial data for changes in specific prices of the components of the Company's utility plant by applying the Handy-Whitman Index of Public Utility Construction Costs to historical cost by vintage years, reflecting the current cost of replacing resources actually used in the Company's operations.

STATEMENT OF INCOME FROM CONTINUING OPERATIONS ADJUSTED FOR CHANGING PRICES

(In Average 1985 Dollars)

Results of Operations:

(Thousands of Dollars)	Year Ended December 31, 1985	
	Historical	At Current Cost
Operating Revenues	$579,733	$579,733
Operating Expenses:		
Operation and Maintenance Expenses	412,034	412,034
Depreciation and Amortization Expense	41,985	89,273
Federal Income Tax Expense	36,308	36,308
Other	28,887	28,887
Income from Continuing Operations	$ 60,519	$ 13,231

Depreciation and amortization expense expressed in current cost amounts were determined using the rates and methods used for computing book depreciation and amortization applied to utility plant balances re-expressed in terms of current costs.

Operating revenues and expenses, other than depreciation and amortization, were incurred ratably during the year and are, in effect, stated in average 1985 dollars. Income taxes were not adjusted because the present tax laws do not allow a deduction for depreciation and amortization adjusted for the impact of inflation. Therefore, the Company's effective tax rate rises from 37.5% under the historical cost basis to 73.3% under current cost basis.

This supplementary information should not be used to assess the probability of future cash flows when existing utility plant is replaced. The estimates do not reflect the effects of the regulatory process nor the specific plans of the Company for the replacement or modernization of utility plant. A meaningful estimate of the estimated level of future capital expenditures is set forth on page 15 of the annual report.

Current Year Effect of Increased Price Levels

(Thousands of Dollars)	
Increase in General Price Levels on Utility Plant Held	$63,611
Increases in Specific Prices on Utility Plant Held	29,406
Excess of Increase in General Price Levels Over Increases in Specific Prices	$34,205

At December 31, 1985 the cost of utility plant, net of accumulated depreciation was $1,835,324,000 on a current cost basis, while historical cost was $1,075,801,000. The accumulated provision for depreciation and amortization under the current cost method was estimated for each major class of utility plant (production, transmission, distribution and general plant) by multiplying the respective cost data by a percentage representing the expired life of existing facilities of each class at December 31, 1985.

Fuel inventories, the cost of fossil fuels used in generation, have not been restated from their historical cost. New Jersey regulation controls fuel costs, through the operation of a levelized energy clause, such that recovery is ultimately limited to actual cost. For this reason fuel inventories are effectively monetary assets.

Net Utility Plant Costs Recoverable

Under rate making prescribed by the regulatory commissions to which the Company is subject, only the historical cost of utility plant is recoverable in revenues as depreciation. Therefore, the excess of the cost of utility plant stated in terms of current cost over the historical cost of plant is not presently recoverable. Due to this feature, the value of utility plant and its effect on income from continuing operations adjusted for changing prices must be considered in terms of its net recoverable cost which is historical cost. While the rate making process gives no recognition to the current cost of replacing utility plant, based on past practices the Company believes it will be allowed to earn a return on the increased cost of its net investment when replacement of facilities actually occurs.

Current Year Decline in Purchasing Power of Net Amounts Owed

The current year decline in purchasing power of net amounts owed was $28,980,000. During a period of inflation, holders of monetary assets such as cash and receivables suffer a loss of general purchasing power while holders of monetary liabilities, generally long term debt, experience a gain because debt will be repaid in dollars having less purchasing power. The Company's gain from the decline in purchasing power of its net amounts owed is primarily attributable to the substantial amount of debt and cumulative preferred stock subject to mandatory redemption which has been used to finance utility plant. This gain, however, should not be considered as providing funds to the Company, since the Company is limited under rate making procedure to the recovery only of its embedded cost of debt.

FIVE-YEAR COMPARISON OF SELECTED FINANCIAL DATA INCLUDING UNAUDITED SUPPLEMENTARY DATA ADJUSTED FOR CHANGING PRICES

Thousands of Dollars Except Per Share Amounts—
Current Cost Amounts Expressed in 1981 Dollars

	Years Ended December 31				
	1985	1984	1983	1982	1981
Operating Revenue					
—historical	$ 579,733	$ 549,531	$ 517,142	$ 444,178	$ 469,683
—trended in 1981 dollars	490,128	481,016	471,925	418,231	469,683
Income from Continuing Operations					
—historical	$ 60,519	$ 63,277	$ 66,152	$ 49,055	$ 46,988
—at current cost (a)	11,186	15,740	19,846	3,805	7,648
Income from Continuing Operations per Share of Common Stock (b)					
—historical	$ 3.00	$ 3.20	$ 3.48	$ 2.76	$ 3.03
—at current cost	.32	.55	.79	(.21)	.01
Effective Income Tax Rate					
—historical	37.5%	39.8%	42.6%	35.5%	36.8%
—current cost basis	76.5	82.3	94.7	112.7	102.3
Excess of Increases in General Price Levels Over Increases in Specific Prices (a)	$ 28,918	$ 49,792	$ 290	$ (6,724)	$ (25,204)
Decline in Purchasing Power of Amounts Owed (a)	$ 24,501	$ 26,795	$ 16,948	$ 20,401	$ 39,572
Net Assets at Year End					
—historical	$ 493,450	$ 474,217	$ 448,894	$ 414,834	$ 338,846
—trended in average 1981 dollars	410,179	408,270	402,895	386,460	327,892
Net Income as a Percent of Operating Revenue (b)					
—historical	10.44%	11.51%	12.79%	11.04%	10.00%
—trended in 1981 dollars	8.83	10.07	11.67	10.40	10.00
Earned Rate of Return on Shareholders' Equity					
—historical	11.98%	13.02%	14.49%	11.20%	12.21%
—trended in 1981 dollars	10.13	11.40	13.22	10.55	12.21
Total Assets at Year End					
—historical	$1,299,633	$1,220,503	$1,139,978	$1,077,969	$1,013,789
Long Term Debt and Cumulative Preferred Stock Subject to Mandatory Redemption					
—historical	$ 521,612	$ 473,462	$ 459,366	$ 462,470	$ 447,389
Dividends Declared per Share of Common Stock					
—historical	$ 2.555	$ 2.45	$ 2.32	$ 2.24	$ 2.08
—trended in 1981 dollars	2.16	2.14	2.12	2.11	2.08
Market Price per Common Share at Year End					
—historical	$ 28.50	$ 24.13	$ 23.25	$ 20.75	$ 17.25
—trended in 1981 dollars	24.48	21.47	21.56	19.98	17.25
Average Consumer Price Index	322.2	311.2	298.5	289.3	272.4

Certain comparative per share data trended in 1985 dollars (without adjustment of earnings for the pro forma effects of inflation on depreciation amounts) are as follows:

	1985	1984	1983	1982	1981
Earnings (b)	$ 3.00	$ 3.31	$ 3.76	$ 3.07	$ 3.58
Dividends Declared	2.555	2.54	2.50	2.49	2.46
Market Price (Year End)	28.50	24.99	25.10	23.26	20.08

(a) These amounts will differ from those shown in Statement of Income From Continuing Operations Adjusted for Changing Prices because a different base year has been used in the data presented above (1981) and in the changing price information (1985) in order to illustrate the impact of changing prices in alternative forms.

(b) Income from Continuing Operations, Net Income and Earnings Per Share data for 1982 include the cumulative effect of a change in accounting method.

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

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

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

Mr. M. R. Meyer, Secretary, is the Corporate Officer responsible for all investor services—Mr. R. E. Moeller is Manager of Investor Services and Mrs. M. T. Lindsay is Supervisor of Shareholder Recordkeeping.

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

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

Where is the Company stock listed?

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

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

	1985		1984	
	High	Low	High	Low
First Quarter	25¼	23¾	23½	20¼
Second Quarter	29¾	24¾	21⅜	19⅞
Third Quarter	29¼	25⅝	23	20⅜
Fourth Quarter	29¾	26	25	22½

Is additional information about the Company available?

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

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

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

When are dividends paid?

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

Record Dates	Payable Dates
March 20, 1986	April 15, 1986
June 19, 1986	July 15, 1986
September 18, 1986	October 15, 1986
December 18, 1986	January 15, 1987

The following table indicates dividends paid in 1985 and 1984 on Common Stock:

	1985	1984
First Quarter	$ .62	$ .59
Second Quarter	$ .62	$ .59
Third Quarter	$ .645	$ .62
Fourth Quarter	$ .645	$ .62
Annual Total	$2.53	$2.42

Dividends paid on Common Stock in 1985 and 1984 were fully taxable.

	1985	1984	1983	1982
Facilities for Service				
Total Utility Plant (Thousands)	$1,406,696	$1,309,670	$1,226,165	$1,153,321
Gross Additions to Utility Plant (Thousands)	$ 105,213	$ 95,388	$ 83,673	$ 126,893
Pole Miles of Transmission and Distribution Lines	6,977	6,958	6,925	6,918
Generating Capacity (Kilowatts) (a) (b)	1,605,700	1,594,200	1,594,200	1,531,200
Maximum Utility System Demand—kw	1,432,000	1,298,800	1,346,700	1,264,200
Capacity Reserve at Time of Peak (% of Instal. Gen.)	10.8%	18.5%	15.5%	17.4%
Energy Supply (Thousands of kwh):				
Net Generation	5,817,254	6,237,724	5,913,196	5,676,118
Purchased and Interchanged—Net	1,049,393	393,175	579,488	466,667
Total System Load	6,866,647	6,630,899	6,492,684	6,142,785
Electric Sales (Thousands of kwh)				
Residential	2,638,121	2,646,813	2,545,351	2,415,292
Commercial	2,298,895	2,150,464	2,019,468	1,894,535
Industrial	1,204,971	1,197,392	1,225,637	1,218,520
All Others	57,685	59,122	60,978	63,770
Total	6,199,672	6,053,791	5,851,434	5,592,117
Residential Electric Service (Average per Customer)				
Amount of Electricity used during the year (kwh)	7,643	7,866	7,715	7,444
Revenue for a year's service	$ 778.77	$ 783.47	$ 735.66	$ 644.77
Revenue per Kilowatt-hour	10.19¢	9.96¢	9.54¢	8.66¢
Customer Data (Average)				
Residential With Electric Heating	68,871	65,261	62,272	59,319
Residential Without Electric Heating	276,305	271,207	267,642	265,124
Total Residential	345,176	336,468	329,914	324,443
Commercial	44,256	43,615	43,152	42,885
Industrial	1,020	1,015	1,021	1,018
Other	554	544	549	627
Total Customers	391,006	381,642	374,636	368,973
Total Service Locations	417,625	407,277	398,526	391,989
Population Served	1,142,000	1,112,000	1,092,000	1,069,000
Financial Data (Thousands of Dollars)				
Energy Revenues:				
Residential	$ 268,814	$ 263,612	$ 242,705	$ 209,191
Commercial	209,880	190,435	175,520	154,792
Industrial	80,392	79,123	76,109	71,255
All Others	10,315	10,405	10,133	9,255
Total Energy Revenues	569,401	543,575	504,467	444,493
Unbilled Revenues—Net	3,076	(1,340)	5,671	(6,795)
Other Electric Revenue	7,256	7,296	7,004	6,480
Total	$ 579,733	$ 549,531	$ 517,142	$ 444,178
Investor Information				
Earnings per Average Common Share	$ 3.00	$ 3.20	$ 3.48	$ 2.76(c)
Average Number of Shares Outstanding (In Thousands)	18,069	17,581	16,923	15,116
Dividends Paid on Common Stock	$ 2.53	$ 2.42	$ 2.30	$ 2.20
Dividend Payout Ratio	84%	76%	66%	80%
Book Value Per Share (Year End)	$ 24.76	$ 24.27	$ 23.58	$ 22.45
Price Earnings Ratio (Year End)	10	8	7	8
Times Fixed Charges Earned (before income taxes)	3.33	3.61	4.11	2.27(c)
Shareholders and Employees (Year End)				
Common Shareholders	48,635	47,446	48,299	48,790
Employees	2,099	2,012	1,995	2,022

(a) Excludes capacity allocated to a large industrial customer

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

(c) Earnings calculation includes the cumulative effect of an accounting change. Financial ratio is computed excluding the cumulative effect.

1981	1980	1979	1978	1977	1976	1975
$1,064,928	$ 962,052	$ 870,075	$ 802,473	$ 753,269	$ 710,343	$ 675,617
$ 123,318	$ 97,330	$ 72,773	$ 58,073	$ 48,733	$ 41,702	$ 46,745
6,910	6,879	6,831	6,786	6,735	6,696	6,645
1,524,600	1,431,600	1,384,700	1,414,700	1,414,700	1,334,700	1,334,700
1,263,800	1,261,700	1,192,600	1,177,400	1,176,000	1,030,300	1,069,400
17.1%	11.9%	13.9%	16.7%	16.9%	22.8%	19.9%
5,302,023	5,533,178	5,397,338	5,625,988	5,293,019	4,918,906	4,715,357
946,241	643,106	464,143	130,037	224,169	324,196	190,852
6,248,264	6,176,284	5,861,481	5,756,025	5,517,188	5,243,102	4,906,209
2,480,225	2,514,738	2,411,732	2,377,202	2,221,250	2,070,766	1,938,724
1,849,863	1,769,208	1,580,384	1,586,097	1,478,559	1,392,029	1,346,216
1,279,724	1,286,205	1,255,304	1,250,636	1,220,260	1,143,170	1,036,755
65,555	63,753	60,799	60,705	58,866	57,667	56,465
5,675,367	5,633,904	5,308,219	5,274,640	4,978,935	4,663,632	4,378,160
7,751	8,003	7,849	7,951	7,653	7,320	7,018
$ 670.66	$ 536.99	$ 439.92	$ 406.18	$ 378.36	$ 349.64	$ 329.25
8.65¢	6.71¢	5.61¢	5.11¢	4.94¢	4.78¢	4.69¢
56,10[illegible]	52,225	48,339	44,387	40,318	37,581	35,235
263,904	261,988	258,941	254,592	249,927	245,296	241,019
320,004	314,213	307,280	298,979	290,245	282,877	276,254
43,219	43,267	43,219	42,672	42,033	41,170	40,608
1,032	1,041	1,048	1,034	1,047	1,071	1,100
634	654	667	673	676	681	684
364,889	359,175	352,214	343,358	334,001	325,799	318,646
386,046	379,242	371,362	362,131	352,205	343,147	336,105
1,056,000	1,037,000	1,015,000	990,000	961,000	937,000	915,000
$ 214,614	$ 168,733	$ 135,178	$ 121,440	$ 109,818	$ 98,904	$ 90,956
156,624	115,973	88,819	80,539	73,354	66,354	63,544
82,908	60,512	47,590	42,185	40,885	36,438	34,974
9,700	7,836	6,624	5,973	5,630	5,406	4,881
463,846	353,054	278,211	250,137	229,687	207,102	194,355
5,837	5,337	4,895	4,921	5,308	4,925	4,724
$ 469,683	$ 358,391	$ 283,106	$ 255,058	$ 234,995	$ 212,027	$ 199,079
$ 3.03	$ 2.62	$ 2.36	$ 2.21	$ 2.06	$ 2.60	$ 2.41
13,034	12,372	11,980	10,791	10,630	9,747	9,490
$ 2.04	$ 1.90	$ 1.765	$ 1.67	$ 1.62	$ 1.56	$ 1.51
67%	73%	75%	76%	79%	60%	63%
$ 22.40	$ 22.22	$ 21.63	$ 21.27	$ 20.71	$ 20.25	$ 19.34
6	6	7	8	11	9	7
2.84	3.03	3.62	3.62	3.17	3.14	2.88
48,424	47,762	48,194	44,490	43,826	42,516	39,232
2,035	1,968	1,903	1,797	1,739	1,714	1,741

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

BOARD OF DIRECTORS

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

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

JOHN D. FEEHAN
Chairman of the Board of the Company

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

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

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

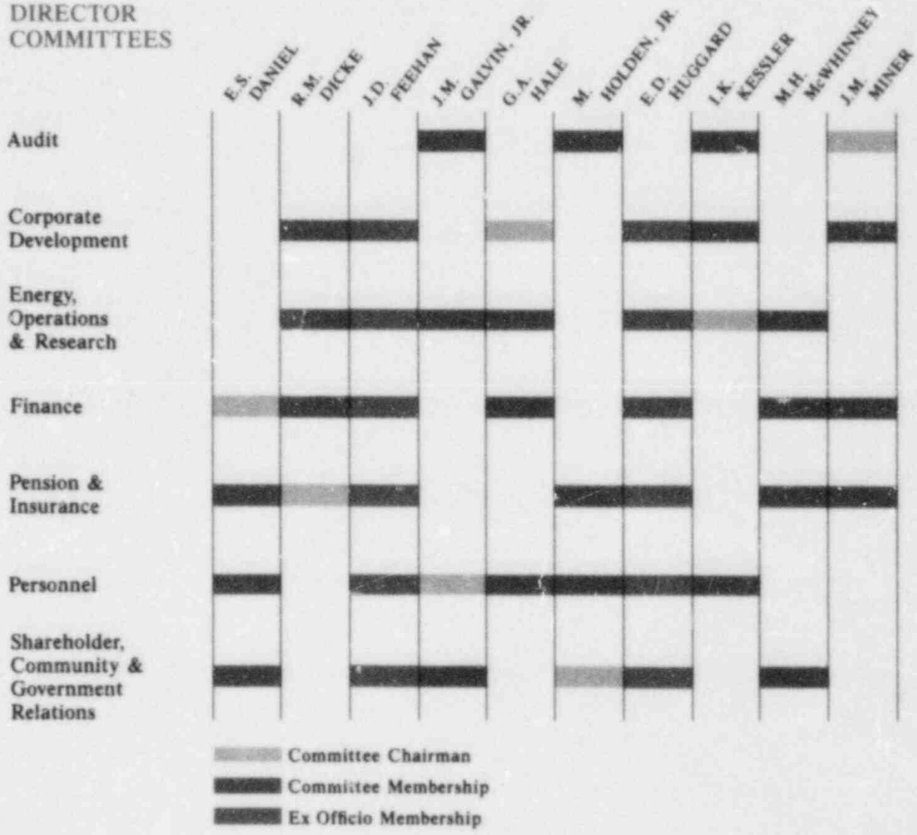
E. DOUGLAS HUGGARD
President and Chief Executive Officer of the Company

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

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

JOHN M. MINER
Financial Consultant

DIRECTOR COMMITTEES



OFFICERS

	Years of Service		Years of Service		Years of Service
E. DOUGLAS HUGGARD *President and Chief Executive Officer*	30	DAVID V. BONEY *Vice President—Customer and Community Services*	31	JOSEPH T. KELLY, JR. *Assistant Vice President—Operations*	35
JERROLD L. JACOBS *Senior Vice President—Operations and Engineering*	24	JOHN F. BORN *Vice President—Electric Operations*	33	HENRY K. LEVARI, JR. *Vice President—Corporate Planning*	14
MICHAEL A. JARRETT *Senior Vice President—Corporate Services*	10	LANCE E. COOPER *Vice President—Control and Assistant Treasurer*	3	J. DAVID McCANN *Vice President, Treasurer and Assistant Secretary*	13
BRIAN A. PARENT *Senior Vice President—Planning and Rates*	18	THOMAS E. FREEMAN *Vice President—Human Resources*	5	MARTIN R. MEYER *Secretary and Assistant Treasurer*	37
J. G. SALOMONE *Senior Vice President—Finance and Accounting*	9	MEREDITH I. HARLACHER, JR. *Vice President—Engineering*	20	HENRY C. SCHWEMM, JR. *Vice President—Production*	16

Front: J. D. Feehan, M. H. McWhinney, J. M. Galvin, Jr., I. K. Kessler
Back: J. M. Miner, R. M. Dicke, E. S. Daniel, M. Holden, Jr., E. D. Huggard;
G. A. Hale *not shown*

Left to right: J. D. McCann, M. R. Meyer,
L. E. Cooper, J. G. Salomone

Left to right: B. A. Parent, H. K. Levari, Jr.

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