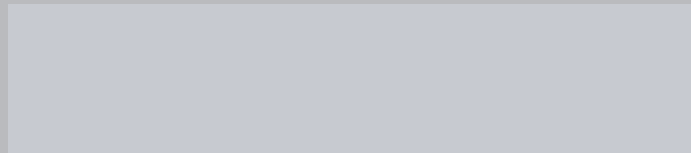


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## Management's Discussion and Analysis

### Forward-Looking Statements

In addition to the historical information presented throughout this report, there are forward-looking statements that reflect management's expectations for the future. Sometimes the words, "estimate," "plan," "expect," "believe," or similar expressions will be used to identify such forward-looking statements. These forward-looking statements are based on current expectations. These statements are not guarantees of future performance and are subject to certain risks and uncertainties.

Many factors could cause actual results to differ materially from these statements. These factors include, but are not limited to, the results of regulatory proceedings, the conditions of the capital markets, interest rates, actuarial assumptions, availability of credit, liquidity and general economic conditions; changes in accounting principles and practices; acts of terrorists; the actions of adjacent control areas and other Regional Transmission Organizations (RTOs) and other operational conditions that could arise on the power system. For a description of these and other factors that may cause actual results to differ, reference is made hereby to PJM Interconnection, L.L.C. (PJM or company) Consolidated Financial Statements, Notes thereto and other documents filed by the company from time to time with the Federal Energy Regulatory Commission (FERC).

These forward-looking statements represent PJM's estimates and assumptions only as of the date of this report and PJM assumes no responsibility to update these forward-looking statements.

### Results of Operations for 2005, 2004 and 2003

#### *Nature of Operations*

The company currently coordinates a pooled generating capacity of more than 164,000 megawatts and operates a wholesale electricity market with more than 390 market buyers, sellers and traders of electricity. PJM enables the delivery of electric power to more than 51 million people in all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia.

In addition to ensuring the reliable supply of electricity, PJM administers Internet-based bid markets in which participants buy and sell spot market energy, capacity credits, fixed transmission rights, spinning reserves and regulation services.

PJM Technologies, Inc. (PJM Tech) is a wholly-owned subsidiary of PJM and is not a FERC-regulated entity. PJM Tech was formed to provide service and technology solutions pioneered by PJM to existing and emerging energy markets, system operators and regional transmission organizations.

On February 10, 2005, PJM Environmental Information Services Inc. (PJM EIS) was incorporated. PJM EIS is a wholly-owned subsidiary of PJM Tech and was formed to provide environmental and emissions attributes reporting and tracking services to its subscribers in support of renewable portfolio standards and other disclosure requirements that may be implemented by governmental agencies.

#### *Market Integrations*

During 2004, PJM completed the integration of Commonwealth Edison (ComEd), a subsidiary of Exelon Corporation, American Electric Power (AEP) and Dayton Power and Light Company (DPL) into PJM's operations and markets.

During 2005, the integration of Duquesne Light Company (Duquesne) and Dominion Virginia Power's (DVP) operations and markets was completed.

ComEd, AEP, DPL and DVP are collectively referred to herein as the market integration participants.

At December 31, 2005, PJM had capitalized \$62.4 million of costs associated with the addition of the market integration participants. These capitalized costs are amortized through PJM's administrative charges to its members over the useful lives of the underlying assets constructed. All non-capitalized integration expenses were billed and collected directly from the market integration participants.

### *Interregional Coordination*

On December 31, 2003, PJM and the Midwest Independent Transmission System Operator, Inc. (Midwest ISO) executed and filed with the FERC a Joint Operating Agreement (JOA). The agreement is the foundation by which the Midwest ISO and PJM will create seamless operations to serve wholesale electricity customers in 22 states, the District of Columbia and parts of Canada. During 2004, PJM and the Midwest ISO completed the implementation of enhanced data sharing protocols and market-to-non-market congestion management systems. During 2005, PJM and the Midwest ISO began coordination of day-ahead and real-time markets.

On April 16, 2003, the Midwest ISO, PJM and the Tennessee Valley Authority (TVA) announced plans to pursue the development of a multi-regional approach to strengthen electric transmission, operations and related transactions.

On May 24, 2004, the Midwest ISO, PJM and TVA signed a data exchange agreement for the development of a multi-regional approach that will strengthen coordination of their respective systems' electric transmission, operations and related transactions.

On April 22, 2005, the Midwest ISO, PJM and TVA signed a Joint Reliability Coordination Agreement (JRCA). The JRCA provides for active management of the reliability of seams between the wholesale electricity markets of the Midwest ISO and PJM and the service territory of TVA. The agreement was implemented on October 1, 2005.

### **Critical Accounting Policies**

Preparation of the financial statements and related disclosures in compliance with generally accepted accounting principles requires the application of appropriate technical accounting rules and guidance, as well as the use of estimates. PJM's application of those policies involves judgments regarding many factors, which, in and of themselves, could materially impact the financial statements and disclosures. A future change in the assumptions or judgments applied in determining the following matters, among others, could have a material impact on future financial results: accounting for deferred depreciation and amortization, accounting for deferred FERC fees, benefit plan accounting, income tax accounting, study and interconnection activity.

#### *Accounting for Deferred Depreciation and Amortization*

Deferred depreciation and amortization expense results from a difference in the timing of incurring and recovering of depreciation and amortization expense. A rate moderation plan approved by the FERC in July 2000 resulted in a portion of expenses related to the \$104.2 million asset purchase completed in December 2000 being deferred during the period 2000 to 2002. These expenses were recovered from PJM's members from 2003 through 2005. At December 31, 2005, all deferred expenses under this rate moderation plan had been recovered. At December 31, 2004, deferred expenses to be recovered under this rate moderation plan totaled \$12.2 million.

On November 1, 2003, the FERC approved PJM's request to defer, until January 1, 2005, billing of depreciation and amortization expense related to certain capital costs required for market integration totaling \$12.4 million. Those costs will be billed to PJM's members from 2005 through 2007. At December 31, 2005, and 2004, deferred depreciation and amortization expense related to market integration totaled \$8.2 million and \$12.4 million, respectively.

#### *Deferred FERC Fees and Deferred FERC Fee Liability*

The FERC charges an annual assessment to all public utilities based on kilowatt-hours sold. To determine the liability, PJM estimates the aggregate electricity budget of the FERC and the aggregate load under the FERC's jurisdiction. This estimate is based on historical information. PJM then applies that estimated rate to the projected aggregate load of PJM. Any over or under collections from prior periods are included in the final calculation for the current period.

Deferred FERC fees result from PJM's fixed-rate tariff schedule for recovery from PJM's members of annual charges from the FERC. At December 31, 2005, and 2004, PJM had a \$2.4 million and \$7.2 million deferred FERC fee liability, respectively. This liability, which represents the difference between amounts collected from PJM members and amounts ultimately assessed by the FERC, is considered in determining the FERC fee charges billed to PJM members during the subsequent year.

### *Benefit Plan Accounting*

Based on actuarial calculations, PJM accrues costs of providing future employee benefits in accordance with Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions" and Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." Under these accounting standards, assumptions are made regarding the valuation of benefit obligations and performance of plan assets. Delayed recognition of differences between actual results and those assumed is a guiding principle of these standards. This approach allows for a relatively even recognition of changes in benefit obligations and plan performance over the working lives of the employees who benefit under the plans.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 was passed, which expands Medicare to include an outpatient prescription drug benefit beginning 2006. The benefits currently provided by the plan are not expected to qualify for any federal subsidy and therefore no impact on the plan has been reflected.

PJM uses a third-party consultant to assist in evaluating and recording the amounts provided for future employee benefits. PJM's ultimate selection of the discount rate, healthcare cost trend rate and expected rate of return on pension assets is based on its review of available current, historical and projected rates, as applicable.

During 2005, PJM made changes to its assumptions related to the discount rate, expected return on assets and healthcare cost trend rate.

The discount rate assumption at December 31, 2005, for the PJM retirement plans was determined using a yield curve that was produced from a universe containing over 500 U.S.-issued Aa-graded corporate bonds, all of which were noncallable (or callable with make-whole provisions), and excluding the 10% of the bonds with the highest yields and the 10% with the lowest yields. The discount rate was then developed as a level equivalent rate that would produce the same present value as that using spot rates to discount the projected pension benefit payments. Based on this analysis, PJM lowered the discount rate for its pension and postretirement benefit plans from 5.75% to 5.50% at December 31, 2005.

In selecting an expected return on plan assets, PJM considered past performance and economic forecasts for the types of investments held by the plans. For the year ended December 31, 2005, PJM lowered the expected return on plan assets from 8.00% to 7.75%.

In selecting healthcare cost trend rates, PJM considers past performance and forecasts of healthcare costs. The previous rates were 11.00% for 2004, gradually declining to 5.00% over seven years. The new rates are 10.00% for 2005, declining to 5.00% over six years. Changes in the assumptions listed above could have a significant impact on the accrued pension and other postretirement benefit liabilities and reported annual net periodic pension and other postretirement benefit costs.

During 2005, PJM recognized net periodic pension and other postretirement benefit costs of \$13.5 million. This amount represents a \$2.2 million increase in expense compared with the amount recognized during 2004. This increase was primarily due to increased costs associated with staffing levels, changes in actuarial assumptions and a reduction in the actual return on plan assets. See Note 10 to the financial statements for the year ended December 31, 2005, for further information on PJM's benefit plans.

### *Income Tax Accounting*

PJM recognizes income taxes in accordance with the liability method. See Note 9 to the Consolidated Financial Statements for the year ended December 31, 2005. PJM believes that sufficient uncertainty exists regarding its ability to realize its deferred income tax assets and accordingly has recorded a valuation reserve against these assets. To the extent that management determines that any portion of these deferred income tax assets are realizable, PJM would recognize that change in valuation reserve through income.

### *Study and Interconnection Activity*

Under the PJM Open Access Transmission Tariff (the Tariff), PJM's transmission provider role is to direct the operation and coordinate the maintenance of the transmission system and indicate, based on studies conducted by PJM, necessary enhancements or modifications to the transmission system. The modifications that are performed on the transmission system, such as network upgrades and generation additions, are conducted principally by third-party vendors at the request of transmission customers. In its system planning capacity as transmission service provider, PJM provides billing and collection services in the interconnection service agreement process. The amounts reported on a net basis represent billings and collections for work performed by PJM as a conduit for the counterparties to the specific interconnection agreements.

### **Revenues**

PJM's total revenues increased \$52.3 million, or 24%, to \$267.6 million from 2004 to 2005, compared with an increase of \$35.6 million, or 20% from 2003 to 2004. The primary factors contributing to the increase in revenues in 2005 were increases in reimbursements of \$29 million for the cost of operating PJM's larger region and \$20 million for administering greater market transaction volumes.

PJM's total revenues increased \$35.6 million, or 20%, to \$215.4 million from 2003 to 2004, compared with an increase of \$32.0 million, or 22% from 2002 to 2003. The primary factors contributing to the increase in revenues in 2004 were increased reimbursements of \$11 million for the cost of operating PJM's larger region, \$9 million for administering greater market transaction volumes and \$12 million for the increase in FERC fees.

Transmission volumes for 2005 were 728 terawatt hours (TWhs) as compared with 474 TWhs for 2004. Increased transmission volumes in 2005 are due to the market integrations that occurred during 2004 and the first half of 2005.

## Expenses

The following table summarizes the percentage of total expenses, excluding study and interconnection services, for the years ended December 31, 2005, 2004 and 2003:

Year Ended December 31,	2005	2004	2003
Compensation expense	28	28	31
Depreciation and amortization expense, net	24	24	27
FERC fees	10	11	6
Outside services	15	14	13
Software licenses and fees	3	3	3
Lease expenses	2	4	5
Computer maintenance and office supplies	3	3	3
Pension and postretirement benefit expenses	5	6	5
Other expense	4	3	3
Interest expense	3	3	4
Income taxes	3	1	–
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Total expenses, excluding study and interconnection services, increased \$52.6 million, or 25%, to \$267.1 million in 2005 as compared with an increase of \$35.9 million, or 20% in 2004. The increase in 2005 resulted primarily from the following factors: (1) a \$12.4 million increase in net depreciation and amortization expense due to additional depreciation associated with the \$104 million asset purchase in 2000 that was deferred until the years 2003 through 2005 as well as recovery of deferred depreciation and amortization expenses related to market integration that was deferred until the years 2005 through 2007, (2) a \$13.4 million increase in compensation expense and a \$2.2 million increase in retirement plan expenses both resulting principally from staff additions during 2005 and 2004 to serve PJM's increased membership and market activity, (3) a \$6.0 million increase in state and federal income tax liability due to the interaction of various items, including a state limitation on the use of net operating loss carryforwards and an increase in the valuation allowance on the deferred tax asset, and (4) an \$8.9 million increase in outside services principally from telecommunications and contract workers to serve PJM's expanded control area. For the years ended December 31, 2005, and 2004, outside services included amounts paid to PJM's independent auditor, PricewaterhouseCoopers LLP, totaling \$0.9 million and \$1.2 million, respectively, which were predominantly for audits of the PJM Consolidated Financial Statements and audits of certain internal control systems in accordance with Statement of Auditing Standards No. 70.

During 2005, PJM EIS's operations resulted in a loss of \$0.6 million. PJM EIS began billing customers in September 2005 for Generation Attributes Tracking System (GATS) data. The start-up costs of the GATS were funded by a non-recourse loan with the New Jersey Board of Public Utilities.

Key information systems, system enhancements and improvements completed by PJM in 2005 included:

- > *Energy Management System (EMS) Enhancements*, providing increased reliability and functionality to the operating system; increased modeling capability to meet the expanded control area; and increased real-time computing capability and improved processing performance;
- > *Midwest ISO/PJM Market Data Exchange*, providing more efficient operations and reduction of seams between PJM and Midwest ISO via direct market data exchange;
- > *PJMnet Expansion*, providing additional telecommunication links to PJM's EMS for new members and additional facilities in the PJM control area as well as replacing outdated links;
- > *Inter Control Connector Protocol Enhancements*, providing enhanced EMS communication capability and reliability with member energy management systems; and,
- > *Market Monitoring System Enhancement*, providing enhanced market data quality and availability to the Market Monitoring Unit as well as greater market analysis capability.

Total expenses, excluding study and interconnection services, increased \$35.9 million, or 20%, to \$214.5 million in 2004 as compared with an increase of \$31.7 million, or 22% in 2003. The increase in 2004 resulted primarily from the following factors: (1) a \$3.3 million increase in net amortization and depreciation expense due to additional depreciation associated with the \$104 million asset purchase in 2000 that was deferred until the years 2003 through 2005, (2) a \$5.1 million increase in compensation expense and a \$3.1 million increase in retirement plan expenses both resulting principally from staff additions during 2004 and 2003 to serve PJM's increased membership, (3) a \$2.6 million increase in state income tax liability due to the combination of depreciation adjustments relating to recovery of deferred costs and a state limitation on the use of net operating loss carryforwards, (4) a \$12.5 million increase in FERC fees relating to 2004, and (5) a \$6.8 million increase in outside services principally from telecommunications and contract workers to serve PJM's expanded control area. For the years ended December 31, 2004, and 2003, outside services included amounts paid to PJM's independent auditor, PricewaterhouseCoopers LLP, totaling \$1.2 million and \$1.1 million, respectively, which were predominantly for audits of the PJM Consolidated Financial Statements and an audit of certain internal control systems in accordance with Statement of Auditing Standards No. 70.

### Billings for Services

Membership increased to over 390 members at December 31, 2005, as compared with approximately 340 members at December 31, 2004.

For 2005, 2004 and 2003, settlements processed by PJM under the Tariff, Operating Agreement and Reliability Assurance Agreement were as follows:

(\$ in millions)	2005 Amount Billed	2004 Amount Billed	2003 Amount Billed
Energy Markets	\$ 16,407.6	\$5,682.4	\$4,908.5
Transmission Congestion	2,137.5	761.2	307.9
PJM Scheduling, System Control and Dispatch (Operating Expense Reimbursement)	260.0	211.8	176.4
RTO Scheduling, System Control and Dispatch (Transmission Owners' Control Center Expenses)	56.3	47.0	22.2
Reactive Supply	172.5	110.6	79.3
Regulation Market	542.7	221.0	164.5
Spinning Reserve Market	78.7	55.9	49.9
Operating Reserves	731.4	413.7	290.8
Black Start Service	16.6	6.0	5.1
Network Transmission Service	959.1	613.1	559.4
Point-to-Point Transmission Service	56.8	72.9	45.2
Capacity	17.5	40.4	27.9
Transitional Market Expansion and Revenue Neutrality	–	62.4	27.2
Expansion Cost Recovery and RTO Startup Cost Recovery	4.3	–	–
Seams Elimination Cost Assignment (SECA)	305.4	–	–
Generation Deactivation	42.3	–	–
Transmission Losses (Point-to -Point)	70.9	38.1	16.8
FTR Auction Revenues	721.1	385.2	232.4
Mid-Atlantic Area Council	3.8	3.5	2.8
Distribution Facilities	13.1	8.8	7.6
Ramapo PAR (Phase Angle Regulator) Facilities	1.9	1.4	1.3
Load Response Program	13.9	1.6	0.7
Unscheduled Transmission Service	0.6	3.1	0.8
Emergency Energy	16.0	0.1	4.4
Miscellaneous	0.4	8.5	2.9
<b>Total</b>	<b>\$22,630.4</b>	<b>\$8,748.7</b>	<b>\$6,934.0</b>

### *Liquidity and Capital Resources*

Through December 31, 2005, PJM billed and collected sufficient funds to meet its annual operating expenses. PJM funded its 2005 and 2004 capital needs principally through working capital generated from operations. Depreciation and amortization charges related to completed projects are billed to all of PJM's members via its Tariff. The funds generated from those charges are used to reduce the principal balances on PJM's long-term debt and long-term project debt.

PJM has a five-year \$50 million working capital facility. Additionally, PJM has a \$110 million project development facility for which borrowings are collateralized by all of PJM's tangible and intangible property other than the assets acquired pursuant to the Facilities Agreement with a subset of PJM's members. At December 31, 2005, PJM had outstanding borrowings of \$35.9 million on the project development facility and no outstanding borrowings on the working capital facility. The FERC approval for borrowings under these facilities must be requested biennially. On April 21, 2005, the FERC approved borrowing against these two facilities through April 21, 2007. During 2005, PJM submitted a filing with the FERC requesting approval to increase the limit on the revolving credit facility from \$15 million to \$50 million. These changes were agreed to by the lender and approved by the FERC.

As of December 31, 2005, and 2004, PJM was assigned an Aa3 credit rating by Moody's Investors Service.

For study and interconnection work performed, PJM obtains liquid collateral from the transmission customer for the estimated costs of the transmission system modifications. PJM's study and interconnection receivables are comprised of billings to transmission customers for services performed under these interconnection service agreements. PJM's study and interconnection payables represent amounts due to the transmission owners for services performed under these interconnection service agreements. PJM held deposits related to study and interconnection activity totaling \$13.5 million and \$10.1 million at December 31, 2005, and 2004, respectively.

PJM requires deposits from various parties in connection with services to be performed or as collateral for market activity. PJM held credit deposits of \$181.0 million and \$100.5 million at December 31, 2005, and 2004, respectively.

Cash and cash equivalents are derived from operations and from financing activities. Net cash provided by operating activities in 2005 was \$67.3 million, compared with \$78.0 million in 2004. The increase in both years was primarily attributable to collections for depreciation and amortization.

Net cash provided by financing activities was \$28.4 million in 2005 as compared with net cash used in financing activities of \$9.4 million in 2004. The difference was due primarily to scheduled repayments under the long-term debt and long-term project debt facilities offset by increases in deposits.

For 2006, PJM's Board of Managers has approved a capital budget of \$22 million. These capital expenditures will be used for application replacements, system reliability applications, new products and services for PJM's membership, risk management and interregional coordination. PJM plans to fund its 2006 capital needs through working capital generated from operations and borrowings from its project development facility. Actual expenditures may differ from this amount as PJM continues to assess its capital needs, such as a potential development of a second control center which could have a significant increase on the currently approved capital budget.

## Risks and Uncertainties

PJM does not provide forecasts of future financial performance. While PJM management is optimistic about the company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its outlook.

### *Recent Regulatory Actions*

On August 14, 2003, a disturbance on the Eastern Interconnection electric grid caused massive electricity outages in the United States and Canada. The power outage interrupted less than seven percent of the load on the PJM grid. Affected areas in PJM were northeastern New Jersey and northwestern Pennsylvania. In August 2005, several lawsuits were filed by various insurance companies naming PJM as a defendant and seeking to recover losses paid out under their insurance policies. Separate actions were filed before the Ohio Public Utilities Commission (which have since been dismissed); the Court of Common Pleas for Cuyahoga County, Ohio (which have since been dismissed); and the Court of Common Pleas for Montgomery County, Pennsylvania. PJM has jurisdictional and factual defenses to the remaining claim, and will vigorously defend against such claim. PJM management cannot predict the outcome; however, it does not expect there to be material impact on financial position or results of operations.

On November 1, 2005, PJM was served with a complaint, which was filed on August 12, 2005, in Superior Court of New Jersey, Law Division Hudson County. The complaint alleges that PJM (among others including FirstEnergy Corporation, Midwest ISO and Public Service Electric and Gas Company) failed to fulfill its obligations incident to the operation of the electric transmission system at the time of the blackout on August 14, 2003, and is therefore liable for the death of an individual who was allegedly murdered during the blackout. PJM filed a motion to dismiss the case and on January 30, 2006, the plaintiff dismissed the complaint against PJM, without prejudice. Unless the plaintiff files the action anew in the interim, on or about August 21, 2006, the dismissal will be with prejudice.

On December 23, 2004, Exelon Corporation, on behalf of its subsidiary PECO Energy Company ("PECO"), filed a complaint with the FERC seeking reimbursement of congestion charges relating to PPL Electric Utilities Corporation's (PPL) Elroy bus in the approximate aggregate amount of \$39 million, plus interest. The complaint names PPL and PJM as respondents. PECO's claim is that these congestion charges were erroneously charged to PECO rather than to PPL. In the complaint, PECO states that it does not seek recovery of its claim from PJM independent of the pass through of any payment that PPL is ordered to make for the energy it used. On February 11, 2005, PJM filed a response to the complaint, stating that it has no objection to administering a pass through of payments from PPL to PECO and reserving the right to answer, respond and state defenses in the event that other relief subsequently is sought by any party against PJM. On the same day, PPL filed a response with the FERC denying liability for the congestion charges and asserting that if any entity other than PECO should bear responsibility for overcharges, it should be PJM, because the error alleged by PECO was made by PJM, not by PPL. On April 18, 2005, the FERC issued an Order finding that PECO is entitled to reimbursement for the amount it was overcharged. The Order also stated that the matter will be subject to proceedings and public hearings before a FERC settlement judge to determine how much PECO was overcharged and which parties were undercharged and in what amount. On September 16, 2005, PECO and PPL jointly filed an offer of settlement, wherein the PJM membership would contribute \$7.5 million to the settlement through a prospective transmission charge. PJM took no position on this proposed settlement, and several objections to the offer of settlement have been filed by PJM members. Because the settlement was contested, the settlement judge was not able to certify it and instead reported the proposed settlement to the FERC for action. At this stage of the proceedings, PJM management cannot determine the impact, if any, that final disposition of the issues raised in PECO's complaint may have on PJM's results of operations or financial position.

On July 1, 2005, PJM filed with the FERC a proposed "stated rate" tariff for the recovery of its administrative costs. Unlike the current tariff structure, in which PJM's administrative costs are passed through to members as they are incurred on a monthly basis, the proposed structure would commit PJM to state rates that would not vary with actual costs. PJM would therefore be required to manage administrative expenses against revenues generated at the stated rates from customer transaction volumes. If revenues were not sufficient to recover all administrative costs over time, PJM would have to seek FERC approval for an increase in the stated rate in a subsequent rate filing. On August 31, 2005, the FERC issued to PJM an order calling for PJM either to remedy certain deficiencies identified by the FERC in the rate filing or to withdraw the rate without prejudice and refile it in the future. On November 30, 2005, PJM filed a full set of rate case schedules required by the FERC. PJM also requested and the FERC granted expedited appointment of a FERC settlement judge to commence settlement discussions, which are currently in progress.

### *Other*

At December 31, 2005, PJM had a receivable due from the Midwest ISO of \$25.5 million for Seams Elimination Cost Adjustments (SECA) billed for the eight months ended December 31, 2005. While Midwest ISO has billed the Midwest ISO customer responsible for the unpaid SECA charges, it has not yet received payment from that customer. The PJM transmission owners filed a motion on January 26, 2006, asking the FERC to use its civil enforcement powers to compel the defaulting Midwest ISO customer to comply with the Midwest ISO tariff and pay its allocated SECA charges. The receivable from the Midwest ISO is offset in the Consolidated Statement of Financial Position by the \$25.5 million reported as payable by PJM to market participants for these SECA credits. Consequently on a net basis, there is no impact on the Consolidated Statement of Financial Position. Although PJM management cannot determine the impact, if any, of the final disposition of the amounts not yet collected by the Midwest ISO from its market participants, the resolution will not have any impact on PJM's results of operations as PJM's Tariff only obligates PJM to disperse to its members the actual SECA charges collected.

### *Legislative Activity*

From time to time, the United States Congress considers matters pertaining to the restructuring of the electric industry and could revise the existing regulatory scheme and the FERC's jurisdiction. On August 8, 2005, President George W. Bush signed the Energy Policy Act of 2005. Key highlights of the electricity portion of the legislation include the following: repeal of the Public Utility Holding Company Act; reform of the Public Utility Regulatory Policies Act to encourage the development of competitive wholesale markets; greater the FERC's authority over disposition of generating assets and over the siting of transmission; authorization for the FERC to make reliability standards mandatory and to establish a North American Electric Reliability Organization to promulgate and enforce reliability standards; tax incentives for new electric infrastructure; facilitation of price transparency in markets; and various studies as directed by the Department of Energy. This legislation will be implemented through actions to be undertaken by the FERC and the Department of Energy. PJM is reviewing this legislation but does not believe it will have an adverse impact on PJM's operations.

### *Third Party Relationships*

PJM engages third parties as suppliers in arrangements to provide services in areas other than core competencies to ensure the service and support of members and timely product development. Although PJM endeavors to establish strong working relationships with parties who share PJM's industry goals and have adequate resources to fulfill their responsibilities, these relationships lead to a number of risks. These suppliers may suffer financial or operational difficulties that may affect their performance, which could lead to delays in product development. Also, major companies from which PJM purchases components or services may be competitors in other areas, which could affect pricing, new product development or future performance. Finally, difficulties in coordinating activities may lead to gaps in delivery and performance of PJM services.

### *Credit Risks*

PJM bills and collects its operating expenses monthly from its members. Payment of all operating expense bills is due from PJM's members by the first business day after the nineteenth calendar day of the month in which their bills are received. During 2005, approximately 70 percent of PJM's operating expenses were billed to 19 of 390 of its members, each of which either have an investment grade credit rating or have provided a guaranty from an affiliate with an investment grade rating. In the event of default of any PJM members, the remaining PJM members would be billed a ratable portion of the operating expenses previously billed to the defaulting member.

In accordance with PJM's credit policy, PJM obtains collateral from certain of its members in order to secure their credit positions. The collateral can be in the form of a cash deposit or letter of credit. Corporate guaranties are also accepted from creditworthy affiliates. PJM believes this policy, considered in conjunction with the creditworthiness of its members, addresses the potential risk of a member payment default.

There were no member defaults during 2005 and 2004.

## Management's Responsibility for Financial Reporting

The management of PJM Interconnection, L.L.C. is responsible for the preparation and objectivity of the following consolidated financial statements and for their integrity. These financial statements have been prepared to conform to accounting principles generally accepted in the United States of America and, where required, include amounts that represent management's best judgments and estimates. PJM's management also is responsible for the preparation of other information in this annual report and for its accuracy and consistency with the financial statements.

PJM has established a system of internal accounting and financial controls and procedures designed to provide reasonable assurance as to the integrity and reliability of financial reporting. Management continually reviews the effectiveness and efficiency of this system, and takes actions when opportunities for improvement are identified.

This system includes a separate Internal Audit Department, which monitors internal controls and reports directly to the Audit Committee of the Board of Managers. Management views the purpose of internal auditing as an independent examination and assessment of PJM's activities related to compliance with policy, procedures and the law, as well as safeguarding of assets. The Audit Committee meets with management, internal auditors and the independent auditors on a regular basis to review financial information, internal controls and the internal audit process.

PJM's independent auditors, PricewaterhouseCoopers LLP, are engaged to conduct an independent audit of PJM's consolidated financial statements in accordance with generally accepted auditing standards.



Phillip G. Harris  
President & Chief Executive Officer



Suzanne Daugherty  
Vice President, Chief Financial Officer and Treasurer

## Report of Independent Auditors

To the Board of Managers of  
PJM Interconnection, L.L.C.

In our opinion, the accompanying consolidated statements of financial position and the related consolidated statements of income, comprehensive income and paid in capital, retained earnings and accumulated other comprehensive income and of cash flows present fairly, in all material respects, the financial position of PJM Interconnection, L.L.C. and its subsidiaries (the “Company”) at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.



Philadelphia, PA  
February 21, 2006

20  
05

## Consolidated Statement of Financial Position

December 31,

(\$ in thousands)

2005

2004

**Assets**

## Current assets:

Deposits on hand	\$ 194,485	\$ 114,758
Operating cash	7,654	3,518
Receivables	23,007	22,519
Study and interconnection receivables	5,167	9,014
Prepaid expenses	2,267	2,337
Other	8	93
	232,588	152,239

## Non-current assets:

Fixed assets, net of accumulated depreciation and amortization of \$208,751 and \$161,221	74,575	99,091
Projects in development	11,221	22,486
Deferred recovery of depreciation and amortization	8,241	24,635
Capitalized financing costs, net of accumulated amortization of \$1,092 and \$872	432	652
Other	1,705	1,164
	96,174	148,028

**Total assets****\$ 328,762** **\$ 300,267****Liabilities, paid in capital, retained earnings and accumulated other comprehensive income**

## Current liabilities:

Accounts payable and accrued expenses	\$ 16,552	\$ 16,275
Study and interconnection payables	6,367	11,672
Accrued payroll and benefits	14,591	12,615
Accrued income taxes	2,872	2,629
Current portion of long-term debt	10,056	23,426
Current portion of long-term project debt	17,098	30,145
Current portion of non-recourse debt	314	-
Deferred revenue	1,140	904
Deferred FERC fee liability	2,352	7,233
Deposits	194,485	114,758
	265,827	219,657

## Non-current liabilities:

Long-term debt	5,857	15,912
Long-term project debt	18,781	35,879
Non-recourse debt	1,886	-
Pension benefits liability	8,425	8,004
Postretirement healthcare benefits liability	24,767	17,626
Other employee benefits	2,765	1,979
	62,481	79,400

**Total liabilities****328,308** **299,057**

## Commitment and contingencies (Note 11)

Paid in capital	722	722
Retained (deficit) earnings	(443)	122
Accumulated other comprehensive income	175	366
Total paid in capital, retained earnings and accumulated other comprehensive income	454	1,210

**Total liabilities, paid in capital, retained earnings and accumulated other comprehensive income****\$ 328,762** **\$ 300,267**

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income

For the Years Ended December 31,

(\$ in thousands)	2005	2004	2003
<b>Income</b>			
Revenue:			
Reimbursements	\$ 260,041	\$ 211,846	\$ 176,404
Study and interconnection fees	1,075	815	1,210
Interest income	5,197	1,853	1,388
Membership fees	1,053	783	714
Other income	250	57	26
<b>Total revenue</b>	<b>267,616</b>	<b>215,354</b>	<b>179,742</b>
Operating expenses:			
Compensation	73,673	60,287	55,160
Depreciation and amortization, net of deferral recovery	64,116	51,726	48,469
FERC fees	28,034	23,518	11,033
Outside services	38,853	29,917	23,084
Software licenses and fees	7,605	7,430	6,330
Lease expenses	4,219	6,817	8,242
Computer maintenance and office supplies	7,451	6,634	6,063
Pension benefits	6,223	5,398	4,761
Postretirement healthcare benefits	7,325	5,972	3,510
Study and interconnection services	1,075	815	1,210
<b>Total operating expenses</b>	<b>238,574</b>	<b>198,514</b>	<b>167,862</b>
Other expenses	11,749	7,074	4,991
Interest expense	9,255	7,113	6,938
Income (loss) before income taxes	8,038	2,653	(49)
Income tax expense	8,603	2,629	–
Net (loss) income	\$ (565)	\$ 24	\$ (49)
Other comprehensive (loss) income:			
Additional minimum supplemental executive retirement plan liability	(271)	–	–
Unrealized gain on securities	80	142	224
<b>Comprehensive (loss) income, net</b>	<b>\$ (756)</b>	<b>\$ 166</b>	<b>\$ 175</b>
<b>Paid in capital, retained earnings and accumulated other comprehensive income</b>			
Beginning balance	\$ 1,210	\$ 1,044	\$ 869
Net (loss) income	(565)	24	(49)
Other comprehensive (loss) income	(191)	142	224
<b>Ending balance</b>	<b>\$ 454</b>	<b>\$ 1,210</b>	<b>\$ 1,044</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statement of Cash Flows

For the Years Ended December 31,

(\$ in thousands)	2005	2004	2003
Cash flows from operating activities:			
Net (loss)/income	\$ (565)	\$ 24	\$ (49)
Adjustments:			
Depreciation and amortization expense	47,750	30,723	46,116
Deferred depreciation and amortization	16,366	21,003	1,919
Deferred FERC fees	–	6,219	(6,219)
Deferred FERC fee liability	(4,881)	7,233	–
Employee benefit expense greater than funding	8,348	5,423	4,423
Changes in assets and liabilities:			
(Increase) in receivables	(488)	(4,829)	(9,852)
Decrease (increase) in study and interconnection receivables	3,847	(1,733)	4,677
(Increase) decrease in prepaid expenses and other	(549)	(1,192)	1,652
Increase (decrease) in accounts payable and accrued expenses	277	6,696	(11,361)
Increase in accrued income taxes	243	2,629	–
(Decrease) increase in study and interconnection payables	(5,305)	3,960	(5,335)
Increase in accrued payroll and benefits	1,976	1,619	2,377
Increase in deferred revenue	236	206	105
Net cash provided by operating activities	67,255	77,981	28,453
Cash flows from investing activities:			
Cost of projects in development	(11,749)	(40,359)	(58,268)
Purchase of investment	–	–	(1,009)
Net cash used in investing activities	(11,749)	(40,359)	(59,277)
Cash flows from financing activities:			
Borrowings under line of credit	10,000	25,000	45,000
Repayments under line of credit	(10,000)	(25,000)	(45,000)
Repayments of long-term debt	(23,425)	(27,183)	(26,520)
Borrowings under long-term project debt	–	6,331	66,092
Repayments under long-term project debt	(30,145)	(16,436)	(12,482)
Borrowings under non-recourse debt	2,200	–	–
Use of restricted cash, net of interest earned	–	1,070	1,752
Increase (decrease) in deposits	79,727	26,856	(16,509)
Net cash provided by (used in) financing activities	28,357	(9,362)	12,333
Net increase/(decrease) in cash and cash equivalents	83,863	28,260	(18,491)
Cash and cash equivalents balance, beginning of year	118,276	90,016	108,507
<b>Cash and cash equivalents balance, end of year</b>	<b>\$202,139</b>	<b>\$118,276</b>	<b>\$ 90,016</b>
Cash paid during the year for:			
Interest	\$ 5,448	\$ 8,327	\$ 7,832
Taxes	8,374	–	20

The accompanying notes are an integral part of these consolidated financial statements.

## Notes to the Consolidated Financial Statements December 31, 2005 and 2004 (\$ in tables in thousands)

### 1. Company Overview

#### *Background*

PJM Interconnection, L.L.C. (PJM or company) is responsible for the operation of wholesale electric markets and for centrally dispatching electric systems in the PJM region. The Federal Energy Regulatory Commission (FERC) issued an order on December 19, 2002, ruling PJM qualified for full Regional Transmission Organization (RTO) status and designating PJM as the sole RTO for the PJM region. PJM's services and the markets PJM operates are subject to regulation by the FERC.

PJM is a limited liability, non-stock company incorporated in the state of Delaware. PJM's Board of Managers is constituted as an independent body, and PJM operates independently from its members.

#### *Nature of Operations*

The company currently coordinates a pooled generating capacity of more than 164,000 megawatts and operates a wholesale electricity market with more than 390 market buyers, sellers and traders of electricity. PJM enables the delivery of electric power to more than 51 million people in all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia.

In addition to ensuring the reliable supply of electricity, PJM administers Internet-based bid markets in which participants buy and sell day-ahead and spot market energy, capacity credits, fixed transmission rights, spinning reserves and regulation services.

PJM Technologies, Inc. (PJM Tech) is a wholly-owned subsidiary of PJM and is not a FERC-regulated entity. PJM Tech was formed to provide service and technology solutions pioneered by PJM to existing and emerging energy markets, system operators and regional transmission organizations.

On February 10, 2005, PJM Environmental Information Services Inc. (PJM EIS) was incorporated. PJM EIS is a wholly-owned subsidiary of PJM Tech and was formed to provide environmental and emissions attributes reporting and tracking services to its subscribers in support of renewable portfolio standards and other disclosure requirements that may be implemented by governmental agencies.

#### *Market Integrations*

During 2004, PJM completed the integration of Commonwealth Edison (ComEd), a subsidiary of Exelon Corporation, American Electric Power (AEP) and Dayton Power and Light Company (DPL) into PJM's operations and markets.

During 2005, the integrations of Duquesne Light Company's (Duquesne) and Dominion Virginia Power's (DVP) operations and markets were completed.

ComEd, AEP, DPL and DVP are collectively referred to herein as the market integration participants.

At December 31, 2005, PJM had capitalized \$62.4 million of costs associated with the addition of the market integration participants. These capitalized costs are amortized through PJM's administrative charges to its members over the useful lives of the underlying assets constructed. All non-capitalized integration expenses were billed and collected directly from the market integration participants.

### 2. Summary of Significant Accounting Policies and Selected Financial Information

#### *Basis of Presentation*

The accompanying consolidated financial statements have been prepared on an accrual basis in accordance with accounting principles generally accepted in the United States of America and include the accounts of PJM and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying disclosures. Those estimates are based on management's best knowledge of current events and actions the company may undertake in the future. Actual results may ultimately differ from estimates. Certain reclassifications have been made to conform previously reported data to the current presentation.

#### *Study and Interconnection Activity*

Under the PJM Open Access Transmission Tariff (the Tariff), PJM's transmission provider role is to direct the operation and coordinate the maintenance of the transmission system and indicate, based on studies conducted by PJM, necessary enhancements or modifications to the transmission system. The modifications that are performed on the transmission system, such as network upgrades and generation additions, are conducted principally by third-party vendors at the request of transmission customers. In its system planning capacity as transmission service provider, PJM provides billing and collection services in the interconnection service agreement process. The amounts reported on a net basis represent billings and collections for work performed by PJM as a conduit for the counterparties to the specific interconnection agreements.

#### *Cash Equivalents*

Highly liquid investments with maturities of three months or less when purchased are considered cash equivalents.

#### *Concentration of Credit Risk*

Financial instruments that subject PJM to credit risk consist primarily of accounts receivable relating to monthly operating expense billings. As provided in PJM's Operating Agreement, members are required to maintain either approved credit ratings or to post specified financial assurances to obtain credit within the PJM markets. During 2005, approximately 70 percent of PJM's operating expenses were billed to 19 of 390 of its members, each of which either have an investment-grade credit rating according to the Standard & Poor's rating service or have provided a guaranty from an affiliate with an investment-grade rating.

#### *Fixed Assets*

PJM's fixed assets are comprised principally of software and capitalized software development costs, leasehold improvements and computer hardware. The costs incurred to acquire and develop computer software for internal use, including financing costs, are capitalized. However, costs incurred prior to the determination of feasibility of developed software and costs incurred following the in-service date of developed software are expensed. Fixed assets are depreciated or amortized using the straight-line method over the useful lives of the assets as follows:

Software and capitalized software developments costs	3 to 7 years
Computer hardware	3 years
Leasehold improvements	10 years

#### *Deferred Depreciation and Amortization*

Deferred depreciation and amortization expense results from a difference in the timing of incurring and recovering of depreciation and amortization expense. A rate moderation plan approved by the FERC in July 2000 resulted in a portion of expenses related to the \$104.2 million asset purchase completed in December 2000 being deferred during the period 2000 to 2002. These expenses were recovered from PJM's members from 2003 through 2005. At December 31, 2005, all deferred expenses under this rate moderation plan had been recovered. At December 31, 2004, deferred expenses to be recovered under this rate moderation plan totaled \$12.2 million.

On November 1, 2003, the FERC approved PJM's request to defer, until January 1, 2005, billing of depreciation and amortization expense related to certain capital costs required for market integration totaling \$12.4 million. Those costs will be billed to PJM's members from 2005 through 2007. At December 31, 2005, and 2004, deferred depreciation and amortization expense related to market integration totaled \$8.2 million and \$12.4 million, respectively.

#### *Deferred FERC Fees and Deferred FERC Liability*

The FERC charges an annual assessment to all public utilities based on kilowatt-hours sold. Deferred FERC fees result from PJM's fixed-rate tariff schedule for recovery from PJM's members of annual charges from the FERC. At December 31, 2005, and 2004, PJM had a \$2.4 million and \$7.2 million deferred FERC fee liability, respectively. This liability, which represents the difference between amounts collected from PJM members and amounts ultimately assessed by the FERC, is considered in determining the FERC fee charges billed to PJM members during the subsequent year.

#### *Deferred Revenue*

PJM membership fees, billed and collected in advance of the year for which they apply, are amortized ratably over the related annual membership period.

#### *Deposits*

At December 31, 2005, the deposits balance was comprised of \$13.5 million received for study and interconnection fees and \$181.0 million held by PJM to support customer credit. At the end of 2004, PJM held deposits of \$10.1 million for study and interconnection fees, \$100.5 million for customer credit, and \$4.2 million from market integration participants.

#### *Income Taxes*

PJM has elected to be taxed as a corporation. Certain expense items, primarily relating to the treatment of software development costs, pension, postretirement healthcare and other employee benefits are included in expense in different time periods for financial reporting than for income tax reporting purposes. Deferred income taxes have been provided on the difference between the tax bases of assets and liabilities and the amounts at which they are carried in the financial statements. These deferred income taxes are based on the enacted tax rates anticipated to be in effect when such temporary differences are expected to reverse.

#### *Fair Values of Financial Instruments*

The carrying amounts reported in the Consolidated Statement of Financial Position for current assets and liabilities approximate their fair values.

#### *Benefit Plan Accounting*

Based on actuarial calculations, PJM accrues costs of providing future employee benefits in accordance with Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions" and Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." Under these accounting standards, assumptions are made regarding the valuation of benefit obligations and performance of plan assets. Delayed recognition of differences between actual results and those assumed is a guiding principle of these standards. This approach allows for a relatively even recognition of changes in benefit obligations and plan performance over the working lives of the employees who benefit under the plans.

PJM uses a third-party consultant to assist in evaluating the amounts provided for future employee benefits. PJM's ultimate selection of the discount rate, healthcare cost trend rate and expected rate of return on pension assets is based on its review of available current, historical and projected rates, as applicable.

#### *Derivatives*

PJM has not engaged in any derivative transactions.

#### *Revenue Recognition*

PJM recognizes as revenue amounts both billed and unbilled for which PJM has incurred costs as of the period end and has the authority to be reimbursed under the Tariff, Operating Agreement, Reliability Assurance Agreement or Mid-Atlantic Area Council (MAAC) Agreement.

Revenues recorded as study and interconnection fees arise from billing and collection services in the interconnection service agreement process performed by PJM. These revenues are offset by the corresponding interconnection expenses for payment of this activity.

PJM EIS recognizes as revenues amounts billed to customers of the Generation Attributes Tracking System (GATS). All receivables for PJM EIS are billed as of December 31, 2005.

### 3. Accounts Receivable

PJM's receivables at December 31, 2005, and 2004, consisted of the following (\$ in thousands):

	2005	2004
<b>Billed:</b>		
Membership fees	\$ 177	\$ 126
PJM EIS	111	-
	288	126
<b>Unbilled:</b>		
Operating expenses	22,423	22,142
MAAC and other	296	251
	22,719	22,393
	<b>\$23,007</b>	<b>\$22,519</b>

PJM's member companies are billed on a monthly basis for the preceding month's operating expenses. PJM bills members for services used under eight distinct service categories.

All study and interconnection receivables were billed at December 31, 2005, and 2004.

### 4. Fixed Assets and Projects in Development

A summary of fixed assets by classification as of December 31, 2005, and 2004, follows (\$ in thousands):

	2005	2004
Leasehold improvements	\$ 16,704	\$ 15,384
Software development	216,528	202,102
Computer hardware	49,326	42,058
Furniture and fixtures	768	768
Sub-total	283,326	260,312
Accumulated depreciation	(208,751)	(161,221)
Total fixed assets, net of accumulated depreciation	74,575	99,091
Projects in development	11,221	22,486
<b>Total</b>	<b>\$ 85,796</b>	<b>\$ 121,577</b>

Amortization of software development costs for the years ended December 31, 2005, and 2004, were \$35.9 million and \$24.4 million, respectively.

Total interest costs incurred for the year ended December 31, 2005, was \$10.0 million of which \$0.7 million attributable to assets under construction was capitalized.

### 5. Short-Term Debt

During 2005, PJM increased its working capital facility with National Cooperative Services Corporation (NCSC) from \$15 million to \$50 million. The working capital facility has a five-year term and will expire in May 2010. The facility is unsecured and is available to fund short-term cash obligations. The FERC approval for borrowings under this facility must be requested biennially. On April 21, 2005, the FERC approved borrowing against this facility through August 21, 2007.

As of December 31, 2005, and 2004, there were no outstanding borrowings under the working capital facility. The interest rate on borrowings under this revolving credit agreement is based on NCSC's variable interest rate. This variable interest rate can change effective the first or 16th of any month. The weighted average rate was 5.94% and 3.78% for the years ended December 31, 2005, and 2004, respectively.

### 6. Long-Term Debt

On December 19, 2000, PJM issued senior unsecured notes with a seven-year term totaling \$110.5 million. These notes bear interest at 7.163% per annum. Payments are due semi-annually on June 15 and December 15. In order to compensate for the timing difference between when the semi-annual note payments are due and when PJM's members remit their monthly settlement, PJM deposited \$4.7 million of the proceeds in a trustee account. Through December 31, 2004, PJM had used all of this restricted cash to pay portions of its semi-annual senior note payments.

PJM incurred a total of \$1.5 million in closing costs to obtain this financing. These costs have been capitalized and are being amortized on a straight-line basis over the seven-year term of the notes.

Repayments of principal under PJM's senior notes to be funded by payments for depreciation charges from its members in accordance with the Tariff are scheduled as follows (\$ in thousands):

Year Ending December 31,	Senior Notes
2006	\$ 10,056
2007	5,857
<b>Total</b>	<b>\$ 15,913</b>

### 7. Long-Term Project Debt

PJM has a \$110 million project development facility with NCSC. This facility is available for asset development, has a four-year drawdown period with a 10-year amortization period and is collateralized by all of PJM's tangible and intangible property other than the assets acquired pursuant to an agreement (the Facilities Agreement) between PJM and a subset of PJM's members (the Facility Owners). This facility will expire on June 30, 2017. The FERC approval for borrowings under this facility must be requested biennially. On April 21, 2005, the FERC approved borrowing against this facility through August 21, 2007.

As of December 31, 2005, and 2004, outstanding borrowings under the project development facility were \$35.9 million and \$66.0 million, respectively. During February 2005, PJM fixed the interest rate at 6.25% on \$34.9 million of the outstanding long-term project debt for a 3-year period. Of the \$35.9 million of outstanding borrowings under the project facility at December 31, 2005, \$25.2 million represents the remaining borrowings under this fixed interest rate. The interest rate on the remaining borrowings is based on NCSC's variable interest rate. The rate can change effective the first or 16th of any month. The interest rate on these borrowings at December 31, 2005, and 2004, was 6.90% and 4.85%, respectively.

Repayments of principal under PJM's project development facility that are to be funded by depreciation charges to its members in accordance with the Tariff are scheduled as follows (\$ in thousands):

**Year Ending December 31,**

2006	\$ 17,098
2007	12,599
2008	1,700
2009	732
2010	732
2011	732
2012	732
2013	707
2014	578
2015	48
Other*	221
<b>Total</b>	<b>\$ 35,879</b>

\* *Timing of remaining payments will be determined when assets are placed into service.*

## **8. Non-recourse Debt**

On March 24, 2005, PJM EIS entered into a seven-year term loan for up to \$2.2 million with the New Jersey Board of Public Utilities. The loan was established to fund the GATS, which assists subscribers in tracking various data associated with promoting and advancing energy efficiency and renewable energy programs. Seven equal principal payments are due annually commencing October 1, 2006. The loan is comprised of a term loan for \$1.6 million for the capital costs of the GATS and a \$0.6 million revolver to fund operating needs. These borrowings, which are collateralized by the software and hardware used in implementing the GATS and by their terms are without recourse to PJM Tech or the company, are expected to be repaid from fees charged to the users of the GATS.

As of December 31, 2005, outstanding borrowings were \$1.6 million under the term portion of this loan and \$0.6 million under the revolver portion of this financing vehicle. The interest rate on the advanced and outstanding principal is fixed at 3% per year. There is no commitment fee for this loan.

## **9. Income Taxes**

PJM recognizes income taxes in accordance with the liability method. The liability method requires that deferred income tax assets be reduced by a valuation allowance if it is more likely than not that portions or all of the deferred income tax assets will not be realized. PJM believes sufficient uncertainty exists regarding the ability to realize its net deferred income tax assets to warrant a valuation allowance on those items.

Income tax expense shown on the Consolidated Statement of Income and Paid In Capital, Retained Earnings and Accumulated Other Comprehensive Income consisted of the following (\$ in thousands):

Year Ended December 31,	2005	2004	2003
State income taxes:			
Current	\$ 4,853	\$ 2,589	\$ –
Deferred	(2,694)	(2,375)	65
Valuation allowance	2,694	2,375	(65)
	4,853	2,589	–
Federal income taxes:			
Current	3,750	40	–
Deferred	(2,320)	(153)	174
Valuation allowance	2,320	153	(174)
	3,750	40	–
<b>Income tax expense</b>	<b>\$ 8,603</b>	<b>\$ 2,629</b>	<b>\$ –</b>

The effects of temporary differences giving rise to deferred income tax assets at December 31, 2005, and 2004, consisted of the following (\$ in thousands):

	2005	2004
Deferred tax assets:		
Pension	\$ 3,667	\$ 4,160
Postretirement healthcare	10,936	7,754
Net operating loss carryforwards	3,773	17,254
Accrued expenses	1,987	1,159
	20,363	30,327
Deferred tax liabilities:		
Fixed assets	(11,194)	(26,831)
Other benefits	–	660
	(11,194)	(26,171)
Net deferred income tax assets	9,169	4,156
Valuation allowance	(9,169)	(4,156)
<b>Deferred income taxes, net</b>	<b>\$ –</b>	<b>\$ –</b>

The income tax rate on PJM's operating activities differed from the federal statutory rate as follows (\$ in thousands):

Year Ended December 31,	2005	2004	2003
Income tax at the federal statutory rate	\$ 2,733	\$ 902	\$ (17)
Increase (decrease) resulting from:			
Change in valuation allowance	2,320	(115)	(91)
Meals and entertainment	133	109	107
State income taxes, net of federal tax benefit	3,203	1,708	–
Other	214	25	1
<b>Income tax expense</b>	<b>\$ 8,603</b>	<b>\$ 2,629</b>	<b>\$ –</b>

PJM has net operating loss carryforwards of \$43 million for Pennsylvania state tax purposes that expire in 2022, but anticipate \$9 million to expire before they can be utilized. PJM's federal net operating loss carryforwards were fully utilized in 2005.

In 2004, the Internal Revenue Service concluded its audit of PJM's tax returns for the years 2000 and 2001. The resulting adjustments changed the timing of depreciation and amortization deductions and as a result adjusted PJM's net operating loss carryforwards for the 2000 and 2001 tax years. There were no changes in PJM's tax liability, tax benefit or tax expense for 2000 and 2001.

## 10. Benefit Plans

### *Pension Plan*

PJM sponsors a defined benefit pension plan (the plan), which covers all regular full-time and part-time employees. Benefits under the plan are based on years of service and the employee's compensation. PJM's contribution to the plan is determined according to the funding requirements set forth by the Employee Retirement Income Security Act of 1974 (ERISA). Plan assets are invested primarily in stocks and bonds and are monitored by PJM's Benefits Administration Committee.

### *Supplemental Executive Retirement Plan*

PJM also sponsors a Supplemental Executive Retirement Plan (SERP) to provide certain members of senior management with benefits in excess of normal pension benefits. At December 31, 2005, and 2004, the actuarially computed benefit obligation of the SERP amounted to \$3.2 million and \$1.6 million, respectively. Pension expense for this plan was \$0.4 million, \$0.3 million and \$0.3 million for each of the years ended December 31, 2005, 2004 and 2003, respectively. The accrued pension costs associated with the SERP included in the other employee benefits liability at December 31, 2005, and 2004, were \$1.8 million and \$1.5 million, respectively. The SERP is not funded. However, PJM invested \$1.0 million in equity securities in January 2003 with the intention to use the proceeds to offset future obligations under the SERP. The investment is included in other non-current assets at its market value of \$1.2 million as of December 31, 2005.

### *Postretirement Benefits*

PJM provides certain healthcare and other benefits to retired employees and their spouses and dependents. Substantially all of PJM's employees may become eligible for these benefits provided they have been credited with at least five years of service or 10 years in the case of early retirement at the age of 55. PJM elected to amortize, over a 20-year period, the transition obligation resulting from the adoption of FAS 106 which was \$3.4 million as of January 1, 1995.

The schedules that follow show the change in the benefit obligations, plan assets and funded status as of December 31, 2005, and 2004, and components of net periodic pension and postretirement healthcare costs of these plans for the years ended December 31, 2005, 2004 and 2003 (\$ in thousands).

	Pension Benefits				Other Postretirement Benefits	
	Qualified		SERP		As of December 31,	
	As of December 31, 2005	2004	As of December 31, 2005	2004	2005	2004
<b>CHANGE IN BENEFIT OBLIGATION</b>						
Net benefit obligation at beginning of year	\$ 65,988	\$ 56,648	\$ 1,554	\$ 2,243	\$ 33,716	\$ 24,487
Service cost	4,443	3,890	174	102	4,358	3,546
Interest cost	3,988	3,573	162	125	2,171	1,741
Plan participants' contributions (estimated)	–	–	–	–	32	20
Plan amendments	–	–	–	–	–	(776)
Actuarial (gain)/loss	9,170	3,928	1,347	(682)	2,809	4,871
Gross benefits paid	(1,741)	(2,051)	(7)	(234)	(216)	(173)
<b>Net obligation at end of year</b>	<b>\$ 81,848</b>	<b>\$ 65,988</b>	<b>\$ 3,230</b>	<b>\$ 1,554</b>	<b>\$ 42,870</b>	<b>\$ 33,716</b>

PJM uses a measurement date of December 31 for all of its pension and postretirement benefit plans.

	Pension Benefits				Other Postretirement Benefits	
	Qualified		SERP		As of December 31,	
	As of December 31,		As of December 31,		2005	2004
	2005	2004	2005	2004	2005	2004
<b>CHANGE IN PLAN ASSETS</b>						
Fair value of plan assets at beginning of year	\$ 42,442	\$ 34,526	\$ –	\$ –	\$ –	\$ –
Actual return on plan assets	3,090	4,232	–	–	–	–
Employer contributions	5,527	5,735	7	234	184	153
Plan participants' contributions	–	–	–	–	32	20
Gross benefits paid	(1,741)	(2,051)	(7)	(234)	(216)	(173)
Fair value of plan assets at end of year	49,318	42,442	–	–	–	–
Funded status at end of year	(32,530)	(23,546)	(3,230)	(1,554)	(42,870)	(33,716)
Unrecognized net actuarial (gain)/loss	23,280	14,605	1,390	490	17,760	15,709
Unrecognized prior service cost	825	937	(27)	(419)	–	–
Unrecognized net transition obligation (asset)	–	–	25	31	343	381
<b>Net amount recognized at end of year and amounts recognized in the statement of financial position</b>						
	\$ (8,425)	\$ (8,004)	\$ (1,842)	\$ (1,452)	\$ (24,767)	\$ (17,626)

	Pension Benefits				Other Postretirement Benefits	
	Qualified		SERP		As of December 31,	
	As of December 31,		As of December 31,		2005	2004
	2005	2004	2005	2004	2005	2004
Amounts recognized in the statement of financial position consist of:						
Accrued benefit cost	\$ (8,425)	\$ (8,004)	\$ (1,842)	\$ (1,452)	\$ (24,767)	\$ (17,626)
Additional minimum liability	(461)	–	(271)	–	N/A	N/A
Intangible asset	461	–	–	–	N/A	N/A
Accumulated other comprehensive income	–	–	271	–	N/A	N/A
<b>Net amount recognized at end of Year</b>	<b>\$ (8,425)</b>	<b>\$ (8,004)</b>	<b>\$ (1,842)</b>	<b>\$ (1,452)</b>	<b>\$ (24,767)</b>	<b>\$ (17,626)</b>

At the end of 2005 and 2004, the projected benefit obligation and the accumulated benefit obligation exceed the fair value of plan assets, for the qualified pension and SERP as follows (\$ in thousands):

	Qualified		SERP	
	2005	2004	2005	2004
<b>End of Year</b>				
Projected benefit obligation	\$ 81,848	\$ 65,988	\$ 3,230	\$ 1,554
Accumulated benefit obligation	58,204	46,846	2,113	923
Fair value of plan assets	49,318	42,442	–	–

The accumulated postretirement benefit obligation was \$42.9 million and \$33.7 million at December 31, 2005, and 2004, respectively. There were no plan assets for PJM's other postretirement benefit plan.

On December 8, 2003, the Medicare Drug, Improvement and Modernization Act of 2003 was passed which expands Medicare to include an outpatient prescription drug benefit beginning in 2006. The benefits currently provided by the plan are not expected to qualify for any federal subsidy and, therefore, no impact on the plan has been reflected.

### Expected Cash Flows

Information about expected cash flows for the pension and postretirement benefit plans follows (\$ in thousands):

	Qualified Benefits	SERP Benefits	Other Postretirement Benefits
<b>Employer Contributions</b>			
Expected employer contributions for 2006 to plan trusts	\$ 5,339	N/A	N/A
Expected employer contributions in form of direct benefit payments for 2006	4,739	69	581
<b>Expected Benefit Payments</b>			
2006	4,739	69	581
2007	4,756	91	779
2008	5,005	266	1,038
2009	4,647	411	1,349
2010	3,685	743	1,656
2011-2015	28,096	1,797	13,291

The above table reflects the benefits expected to be paid from the plan or from PJM's assets for PJM's share of the benefit cost. The participants' share of the cost, which is funded by participant contributions to the plan, is not included in this table. Expected contributions to plan trusts reflect expected required amounts to be contributed to the fund.

	Pension Benefits				Other Postretirement Benefits	
	Qualified		SERP		As of December 31,	
	As of December 31,		As of December 31,		As of December 31,	
	2005	2004	2005	2004	2005	2004
<b>COMPONENTS OF NET PERIODIC BENEFIT COST</b>						
Service cost	\$ 4,443	\$ 3,890	\$ 174	\$ 102	\$ 4,358	\$ 3,546
Interest cost	3,988	3,573	163	125	2,171	1,741
Expected return on assets	(3,276)	(2,745)	–	–	–	–
Amortization of:						
Transition obligation (asset)	–	–	6	6	38	38
Prior service cost	112	112	(63)	(101)	39	–
Actuarial (gain) loss	680	557	117	121	719	647
<b>Total net periodic benefit cost</b>	<b>\$ 5,947</b>	<b>\$ 5,387</b>	<b>\$ 397</b>	<b>\$ 253</b>	<b>\$ 7,325</b>	<b>\$ 5,972</b>

For the years ended December 31, 2005, 2004, and 2003, respectively, \$0.1 million, \$0.2 million and \$0.7 million of total pension and postretirement benefits expense were included in capitalized project costs.

The following schedule shows the assumptions used to calculate the pension and postretirement benefit obligations as of December 31, 2005, 2004, and 2003.

	Pension Benefits			Other Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Discount rate	5.50%	5.75%	6.00%	5.50%	5.75%	6.00%
Expected return on plan assets	7.75%	8.00%	8.00%	N/A	N/A	N/A
Rate of compensation increase	5.00%	5.00%	5.50%	N/A	N/A	N/A
Medical Trend						
Current				10.00%	11.00%	12.00%
Ultimate				5.00%	5.00%	5.00%
Years to Ultimate				6	7	8

The effect of a 1% increase in the assumed health care cost trend rate from 10% to 11% would increase the postretirement benefit obligation as of December 31, 2005, by \$9.9 million and the current year postretirement benefit cost by approximately \$1.8 million. A 1% decrease in the assumed healthcare cost trend rate from 10% to 9% would decrease the accumulated postretirement benefit obligation by approximately \$7.6 million and would decrease the postretirement benefit cost by approximately \$1.4 million annually.

The asset allocation for PJM's pension plan at the end of 2005 and 2004, and the target allocation for 2006, by asset category, follows.

Asset Category	Target Allocation	2005	2004
Equity Securities	56% - 64%	60%	61%
Debt Securities	37% - 41%	39%	38%
Other	0% - 2%	1%	1%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

The assets of the plan trust are invested to provide a source of retirement income for participants and beneficiaries in the plan. The financial objectives of the plan trust have been established in conjunction with the comprehensive review of the current and projected financial requirements of the plan. The financial objective of the plan trust is to maximize assets in order to minimize contributions over time.

The assets of the plan trust are invested in accordance with all relevant legislation and regulation, in a manner consistent with fiduciary standards of ERISA and other applicable law. Specifically, the investment program shall include such safeguards and diversity to which a prudent investor would adhere, and all transactions undertaken on behalf of the plan trust shall be in the sole interest of plan participants and their beneficiaries.

#### *Savings Plan*

PJM also sponsors a 401(k) savings plan (the savings plan) for all eligible employees of the company who have completed six months of service. The savings plan permits employees to contribute up to 15 percent of their gross compensation on a pretax basis, subject to limitations as described in the savings plan. PJM makes matching contributions equal to 100 percent of the employee's first 5 percent of gross salaries contributed. PJM contributions to the savings plan were approximately \$2.2 million, \$1.9 million and \$1.6 million for the years ended December 31, 2005, 2004, and 2003.

## **11. Commitments and Contingencies**

#### *Leases*

PJM leases office space, furniture, computer and copier equipment under operating leases with various vendors. These leases are noncancelable and expire during the period from 2006 to 2013.

Future minimum rentals under noncancelable lease agreements are as follows (\$ in thousands):

<b>Year Ending December 31,</b>	
2006	2,436
2007	1,914
2008	1,771
2009	1,618
2010	917
Remaining	2,357
<b>Total</b>	<b>\$11,013</b>

#### *Regulatory Items*

On August 14, 2003, a disturbance on the Eastern Interconnection electric grid caused massive electricity outages in the United States and Canada. The power outage interrupted less than seven percent of the load on the PJM grid. Affected areas in PJM were northeastern New Jersey and northwestern Pennsylvania. In August 2005, several lawsuits were filed by various insurance companies naming PJM as a defendant and seeking to recover losses paid out under their insurance policies. Separate actions were filed before the Ohio Public Utilities Commission (which have since been dismissed); the Court of Common Pleas for Cuyahoga County, Ohio (which have since been dismissed); and the Court of Common Pleas for Montgomery County, Pennsylvania. PJM has jurisdictional and factual defenses to the remaining claim, and will vigorously defend against such claim. PJM management cannot predict the outcome; however, it does not expect there to be material impact on its financial position or results of operations.

On November 1, 2005, PJM was served with a complaint, which was filed on August 12, 2005, in Superior Court of New Jersey, Law Division Hudson County. The complaint alleges that PJM (among others including FirstEnergy Corporation, Midwest Independent Transmission System Operator, Inc. (Midwest ISO) and Public Service Electric and Gas Company) failed to fulfill its obligations incident to the operation of the electric transmission system at the time of the blackout on August 14, 2003, and is therefore liable for the death of an individual who was allegedly murdered during the blackout. PJM filed a motion to dismiss the case and on January 30, 2006, the plaintiff dismissed the complaint against PJM, without prejudice. Unless the plaintiff files the action anew in the interim, on or about August 21, 2006, the dismissal will be with prejudice.

On December 23, 2004, Exelon Corporation, on behalf of its subsidiary PECO Energy Company (PECO), filed a complaint with the FERC seeking reimbursement of congestion charges relating to PPL Electric Utilities Corporation's (PPL) Elroy bus in the approximate aggregate amount of \$39 million, plus interest. The complaint names PPL and PJM as respondents. PECO's claim is that these congestion charges were erroneously charged to PECO rather than to PPL. In the complaint, PECO states that it does not seek recovery of its claim from PJM independent of the pass through of any payment that PPL is ordered to make for the energy it used. On February 11, 2005, PJM filed a response to the complaint, stating that it has no objection to administering a pass through of payments from PPL to PECO and reserving the right to answer, respond and state defenses in the event that other relief subsequently is sought by any party against PJM. On the same day, PPL filed a response with the FERC denying liability for the congestion charges and asserting that if any entity other than PECO should bear responsibility for overcharges, it should be PJM, because the error alleged by PECO was made by PJM, not by PPL. On April 18, 2005, the FERC issued an order finding that PECO is entitled to reimbursement for the amount it was overcharged. The order also stated that the matter will be subject to proceedings and public hearings before a FERC settlement judge to determine how much PECO was overcharged and which parties were undercharged and in what amount. On September 16, 2005, PECO and PPL jointly filed an offer of settlement, wherein the PJM membership would contribute \$7.5 million to the settlement through a prospective transmission charge. PJM took no position on this proposed settlement, and several objections to the offer of settlement have been filed by PJM members. Because the settlement was contested, the settlement judge was not able to certify it and instead reported the proposed settlement to the FERC for action. At this stage of the proceedings, PJM management cannot determine the impact, if any, that final disposition of the issues raised in PECO's complaint may have on PJM's results of operations or financial position.

On July 1, 2005, PJM filed with the FERC a proposed "stated rate" tariff for the recovery of its administrative costs. Unlike the current tariff structure, in which PJM's administrative costs are passed through to members as they are incurred on a monthly basis, the proposed structure would commit PJM to a stated rate that would not vary with actual costs. PJM would therefore be required to manage administrative expenses against revenues generated at the stated rates from customer transaction volumes. If revenues were not sufficient to recover all administrative costs over time, PJM would have to seek the FERC approval for an increase in the stated rates in a subsequent rate filing. On August 31, 2005, the FERC issued to PJM an order calling for PJM either to remedy certain deficiencies identified by the FERC in the rate filing or to withdraw the rate without prejudice and refile it in the future. On November 30, 2005, PJM filed a full set of rate case schedules required by the FERC. PJM also requested and the FERC granted expedited appointment of a FERC settlement judge to commence settlement discussions, which are currently in progress.

*Other*

At December 31, 2005, PJM had a receivable due from the Midwest ISO of \$25.5 million for Seams Elimination Cost Adjustments (SECA) billed for the eight months ended December 31, 2005. While Midwest ISO has billed the Midwest ISO customer responsible for the unpaid SECA charges, it has not yet received payment from that customer. The PJM transmission owners filed a motion on January 26, 2006, asking the FERC to use its civil enforcement powers to compel the defaulting Midwest ISO customer to comply with the Midwest ISO tariff and pay its allocated SECA charges. The receivable from the Midwest ISO is offset in the Consolidated Statement of Financial Position by the \$25.5 million reported as a payable by PJM to market participants for these SECA credits. Consequently, on a net basis, there is no impact on the Consolidated Statement of Financial Position. Although PJM management cannot determine the impact, if any, of the final disposition of the amounts not yet collected by the Midwest ISO from its market participants, the resolution will not have any impact on PJM's results of operations as PJM's Tariff only obligates PJM to disperse to its members the actual SECA charges collected.

*Legal*

PJM is routinely involved in regulatory proceedings. In the opinion of management, none of these matters will have a material adverse effect, if any, on the financial position, results of operations or liquidity of PJM.

**12. Related Party Transactions**

PJM occupies two buildings that are owned by the Facilities Owners. One of the buildings was purchased in 1992 at a cost of \$2.9 million. This building was subsequently renovated at a cost of \$2.9 million. A second building occupied by PJM and used as the PJM Control Center was purchased in July 1995 at a cost of \$4.8 million. Through December 31, 2000, the Facilities Owners elected not to charge PJM rent for the use of these facilities. Effective January 1, 2001, PJM commenced paying a nominal rent of two dollars per year for the use of these facilities. PJM is responsible for facility maintenance, property taxes, insurance and other related costs associated with these two buildings. Estimated annual market rent for these two buildings is approximately \$1.6 million.

In accordance with PJM's policies, PJM allows for cash advances to relocating employees. There were no advances outstanding at December 31, 2005, or 2004, respectively.



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