PJM : 2004 Financial Review

WORKING : TOGETHER

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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 (RTO) 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's 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 2004, 2003 and 2002

Nature of Operations

PJM Interconnection, L.L.C. (PJM or company) currently coordinates a pooled generating capacity of more than 143,000 megawatts and operates a wholesale electricity market with more than 300 market buyers, sellers and traders of electricity. PJM enables the delivery of electric power to more than 45 million people in all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, 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 provides accounting, billing and collection services for these transactions totaling more than $28 billion since 1997. PJM also directs the pooled operation of approximately 474 million annual megawatt hours of electric power, of which approximately 154 million megawatt-hours are exchanged through PJM's electric energy markets.

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.

During February 2005, PJM Tech incorporated a non-FERC regulated, wholly-owned subsidiary, PJM Environmental Information Services, Inc. (PJMEIS). PJMEIS was formed to develop a simple, cost-effective, single information system that will track the attributes of generation produced in the PJM wholesale market and sold in or out of the PJM market. This system will ensure accurate accounting and reporting of generation attributes; facilitate bilateral transactions of the attributes via certificates between market participants; support the current renewable portfolio standards reporting requirements of various states; and, have the flexibility to accommodate varied evolving policies or programs.

Market Integrations

On April 1, 2002, Allegheny Power, the energy delivery business of Allegheny Energy, Inc. commenced operations with PJM, which expanded PJM's existing region to the west.

During 2002, American Electric Power (AEP); Commonwealth Edison (ComEd), a subsidiary of Exelon Corporation; Dayton Power and Light Company (DPL); and Dominion Virginia Power (DVP) (collectively, the market integration participants) announced their intent to join PJM, subject to regulatory and governmental approvals. On December 9, 2003, Duquesne Light Company (Duquesne) filed a plan before the Pennsylvania Public Utility Commission expressing its intent to join PJM by January 1, 2005.

In June 2003, PJM began providing third-party administrative services dealing with transmission functions under the existing ComEd and DPL Open Access Transmission Tariffs.

On May 1, 2004, the integration of ComEd into PJM's operations and markets was completed. On October 1, 2004, the integration of AEP's and DPL's operations and markets was completed.

On October 5, 2004, the FERC announced its approval of DVP's plans to integrate into PJM, with some conditions related to rate design and cost recovery for DVP. On November 10, 2004, the Virginia State Corporation Commission (VSCC) approved DVP's integration to PJM. The North Carolina Utilities Commission (NCUC) held hearings on DVP's integration into PJM during January 2005. The integration of DVP into PJM will occur upon approval by NCUC of the plan for bringing DVP into PJM.

As of December 31, 2004, PJM capitalized $62 million in costs associated with the addition of the market integration participants. These capitalized costs will be amortized through PJM's administrative charges to its members over the useful lives of the underlying assets constructed. All non-capitalized integration expenses are billed and collected directly from the market integration participants.

On January 1, 2005, the integration of Duquesne into PJM's operations and markets was completed.

Interregional Coordination

On March 15, 2002, PJM and the New York Independent System Operator (NYISO) entered into a formal coordination agreement, the Interregional Coordination and Issue Resolution Agreement. In this agreement, PJM and NYISO formalized procedures to address interregional markets coordination matters and to systematically plan and implement solutions. PJM and NYISO provide joint quarterly status reports to the FERC on activities under this agreement.

On January 21, 2002, PJM and the Midwest Independent Transmission System Operator, Inc. (Midwest ISO) announced an executed letter of intent to develop a joint and common market for electricity producers and consumers in all or part of 22 Midwest and Mid-Atlantic states, the District of Columbia and the Canadian province of Manitoba.

On May 13, 2002, PJM and the Midwest ISO executed a memorandum of cooperation (MOC) to facilitate the implementation of a joint and common market in the Midwest. The MOC outlines a collaborative process to identify and address issues that will allow for a more efficient transition to a joint and common energy market. The market is being developed through an open stakeholder process and is being designed to serve residents whether they reside in states with bundled or unbundled retail rates.

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. The memorandum of understanding executed by the three organizations initiates the first step of a process that would, when complete, facilitate a transparent market for a significant portion of the Eastern Interconnection. The Eastern Interconnection refers to North America's electric system east of the Rocky Mountains, excluding Texas.

On December 31, 2003, the Midwest ISO and PJM executed and filed with the FERC a joint operating agreement. 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.

On May 24, 2004, the Midwest ISO, PJM and TVA signed a data exchange agreement to pursue the development of a multi-regional approach that will strengthen coordination of their respective systems' electric transmission, operations and related transactions. The agreement advances the collaborative work that the three electric industry companies began with a memorandum of understanding in 2003.

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 and Income Tax Accounting.

Accounting for Deferred Depreciation and Amortization

Deferred depreciation and amortization expense is a result of a difference in the timing of incurring and recovering of certain expenses. 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 will be recovered from PJM's members from 2003 through 2005. Deferred expense recovery under this rate moderation plan totaled $12.2 million and $33.2 million at December 31, 2004 and 2003, respectively.

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. Those costs will be billed to PJM's members from 2005 through 2007. At December 31, 2004, and 2003, the recovery of $12.4 million and $0.4 million of depreciation and amortization expense related to the integration were deferred, respectively.

Deferred FERC Fees and Deferred FERC Fee Liability

The FERC charges an annual assessment to all public utilities based on kilowatt-hours sold. Deferred FERC items are the result of differences in the timing of payment of fees to the FERC and recovery of those fees from PJM's members. On July 29, 2003, PJM received the Annual Charges Billing from the FERC totaling $25.2 million, which reflected charges for the period October 1, 2002, through September 30, 2003, and an adjustment to the prior year fiscal charge. During 2003, PJM had billed and collected from its members $19.0 million of this charge. The remaining $6.2 million, which was reported as a deferred FERC asset at December 31, 2003, was billed to PJM's members during 2004.

On July 30, 2004, PJM received the Annual Charges Billing from the FERC totaling $13.4 million, which reflects charges for the period October 1, 2003, through September 30, 2004, and an adjustment to the prior year fiscal charge. During 2004, PJM billed and collected from its members $23.5 million. The deferred FERC fee liability of $7.2 million at December 31, 2004 will be amortized against the FERC fee charges billed to PJM's members during 2005. This liability represents deferrals for the 2004 and 2005 FERC Annual Charges.

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 2004, PJM made changes to its assumptions related to the discount rate and the healthcare cost trend rate. For the year ended December 31, 2004, PJM decreased the discount rate for its pension and postretirement benefit plans from 6.00 percent to 5.75 percent in view of current market interest rates. 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, 2004, PJM retained the expected return on plan assets at 8.00 percent.

In selecting healthcare cost trend rates, PJM considers past performance and forecasts of healthcare costs. The previous rates were 12.00 percent for 2003, gradually declining to 5.00 percent over eight years. The new rates are 11.00 percent for 2004, declining to 5.00 percent over seven 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 2004, PJM recognized net periodic pension and other postretirement benefit costs of $11.4 million. This amount represents a $3.1 million increase in expense compared with the amount recognized during 2003. This increase was primarily due to increased costs associated with additional employees, changes in actuarial assumptions and a reduction in the actual return on plan assets. See Note 9 to the financial statements for the year ended December 31, 2004, for further information on PJM's benefit plans.

Income Tax Accounting

PJM recognizes income taxes in accordance with the liability method. See Note 8 to the Consolidated Financial Statements for the year ended December 31, 2004. 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 In 2004, amounts billed and collected by PJM, in its role as the transmission provider and on behalf of the parties to the interconnection agreements, were not reflected in the company's Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income. 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. Prior year amounts reclassified to conform to current period presentation include study and interconnection services revenue and related costs of $79.3 million and $123.7 million for the years ended December 31, 2003, and 2002, respectively. Gross study and interconnection services revenue and related costs for the year ended December 31, 2004, were $26.7 million.

Revenues

PJM's total revenues increased $35.6 million, or 20 percent, to $215.4 million from 2003 to 2004, compared with an increase of $32.0 million, or 22 percent from 2002 to 2003. The primary factors contributing to the increase in revenues in 2004 were reimbursements of $15.7 for the cost of operating PJM's larger region, $9.3 million for administering greater market transaction volumes and $10.6 million for supporting PJM's growing membership.

Key information systems, system enhancements and improvements launched by PJM in 2004 included:

- EES Automated Scheduling Application, providing efficiencies through automating the manual process of scheduling energy;
- Market System Enhancements, providing increased performance of the market user interface and the market system architecture to support the expanded PJM Control Area. This improvement enhanced the existing modeling and analysis capability to incorporate salient characteristics of the expanded system;
- Mid-Atlantic Region Control Room Video Wall, providing an expanded display of the transmission system in order to react appropriately to system conditions;
- Information Technology Environment for Market Integration, providing advanced technologies and hardware for the eSuite application growth due to PJM's market integrations in 2004;
- EMS Model Expansion, providing increased modeling capability of the Energy Management System to support PJM's expanded control area; and,
- Super Regional Congestion Management, identifying a single method of congestion management across PJM's and the Midwest ISO's market areas.

Expenses

The following table summarizes the percentage of total expenses, excluding study and interconnection services, for the years ended December 31, 2004, 2003 and 2002:

Year Ended December 31,	2004	2003	2002
Compensation expense	28	31	31
Amortization and depreciation expense, net	24	27	18
FERC fees	11	6	7
Outside services	14	13	17
Lease expenses	4	5	5
Software licenses and fees	3	3	4
Pension and postretirement benefit expenses	6	5	4
Computer maintenance and office supplies	3	3	3
Other expense	3	3	5
Interest expense	3	4	6
Income taxes	1	–	–
Total	**100%**	**100%**	**100%**

Total expenses, excluding study and interconnection services, increased $35.9 million, or 20 percent, to $215.4 million in 2004 as compared with an increase of $31.7 million, or 22 percent 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 $5.2 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 more than 340 members at December 31, 2004, as compared with approximately 250 members at December 31, 2003.

For 2004, 2003 and 2002, settlements processed by PJM under the Tariff, Operating Agreement and Reliability Assurance Agreement were as follows:

(in millions)	2004 Amount Billed	2003 Amount Billed	2002 Amount Billed
Energy Markets	$5,682.4	$4,908.5	$3,185.3
Transmission Congestion	761.2	307.9	401.1
PJM Scheduling, System Control and Dispatch (Operating Expense Reimbursement)	211.8	176.4	144.7
RTO Scheduling, System Control and Dispatch (Transmission Owners' Control Center Expenses)	47.0	22.2	22.2
Reactive Supply	110.6	79.3	67.3
Regulation Market	221.0	164.5	140.1
Spinning Reserve Market	55.9	49.9	–
Operating Reserves	413.7	290.8	239.0
Black Start Service	6.0	5.1	–
Network Transmission Service	613.1	559.4	369.4
Point-to-Point Transmission Service	72.9	45.2	60.7
Capacity	40.4	27.9	52.5
Transitional Market Expansion and Revenue Neutrality	62.4	27.2	23.1
Transmission Losses (Point-to-Point)	38.1	16.8	12.9
FTR Auction Revenues	385.2	232.4	16.9
Mid-Atlantic Energy Council	3.5	2.8	2.4
Distribution Facilities	8.8	7.6	6.7
Ramapo PAR (Phase Angle Regulator) Facilities	1.4	1.3	1.3
Load Response Program	1.6	0.7	1.1
Unscheduled Transmission Service	3.1	0.8	0.8
Emergency Energy	0.1	4.4	–
Miscellaneous	8.5	2.9	1.7
Total	**$8,748.7**	**$6,934.0**	**$4,749.2**

Liquidity and Capital Resources

Through December 31, 2004, PJM billed and collected sufficient funds to meet its annual operating expenses. PJM funded its 2004 and 2003 capital needs through working capital generated from operations and borrowings from its $110 million project development facility. Amortization and depreciation 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.

PJM has a five-year $15 million revolving credit agreement. 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, 2004, PJM had outstanding borrowings of $66.0 million on the project development facility and no outstanding borrowings on the working capital facility. FERC approval for borrowings under these facilities must be requested biennially. On July 10, 2002, FERC approved borrowing against these two facilities through July 20, 2004. During February 2003, PJM submitted a filing with the FERC requesting approval to increase the limit on the project development facility from $75 million to $110 million and to convert this facility to a revolver. These changes were agreed to by the lender and approved by the FERC on May 1, 2003. On July 20, 2004, the FERC approved the renewal of PJM's borrowing against the $15 million revolving credit agreement through August 17, 2005.

As of December 31, 2004, 2003, and 2002, PJM has been assigned an Aa3 credit rating by Moody's Investors Service.

Under the Tariff, PJM's transmission provider role is to direct the operation and to 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. For work performed, PJM obtains liquid collateral from the transmission customer for the estimated costs of the 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 totaling $10.1 million and $18.6 million at December 31, 2004, and 2003, respectively.

In accordance with PJM's credit policy, PJM requires deposits from various parties in connection with services to be performed or as collateral for market activity. PJM held credit deposits of $100.5 million and $65.3 million at December 31, 2004, and 2003, respectively.

Cash and cash equivalents are derived from operations and from financing activities. Net cash provided by operating activities in 2004 was $104.8 million, compared with $11.9 million in 2003. The increase in cash from operating activities was primarily attributable to increases in deposits and payables and to billings for deferred depreciation and amortization.

Net cash used in financing activities was $36.2 million in 2004 as compared with net cash provided by financing activities of $28.8 million in 2003. The $65 million net difference was due primarily to only $6.3 million in borrowings under PJM's project development facility in 2004 as compared with $66.1 million in 2003.

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. On August 20, 2003, PJM announced its plan to combine a thorough review of events surrounding this outage with an examination of the reliability plans associated with the evolution of energy markets in the mid-western region. PJM is coordinating with state commissions, the FERC, the U.S. Department of Energy, the North American Electric Reliability Council and its respective regional reliability councils, local control centers and stakeholders to incorporate the applicable lessons learned. On November 14, 2003, the U.S.-Canada Power System Outage Task Force released its interim report on the events of August 14, 2003. At this time, PJM management cannot yet determine the impact these reviews may have on operations or its financial position.

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. PJM intends to respond to the PPL filing, denying its principal allegations and raising such other defenses as may be appropriate. At this time, PJM management cannot yet determine the impact, if any, that the FERC's review of the issues raised in PECO's complaint may have on PJM's operations or financial position.

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 FERC's jurisdiction. Proposed bills are likely to be introduced in Congress related to electric industry restructuring and national reliability issues.

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 2004, approximately 67 percent of PJM's operating expenses were billed to 25 of its members, each of which either has an investment-grade credit rating per the Standard & Poor's rating service or has 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 could 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 2004 and 2003.

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 S. Daugherty
Vice President, Chief Financial Officer and Treasurer

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 subsidiary (the "Company") at December 31, 2004, and 2003, and the results of their operations and their cash flows for the years then ended 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 16, 2005

($ in thousands)	December 31, 2004	2003
Assets		
Current assets:		
Deposits on hand	$ 114,758	$ 87,902
Operating cash	3,518	2,114
Receivables	22,519	17,690
Study and interconnection receivables	9,014	7,281
Deferred FERC fees	–	6,219
Prepaid expenses	2,337	1,096
Other	93	98
	152,239	122,400
Non-current assets:		
Fixed assets, net of accumulated depreciation and amortization of $161,221 and $118,977	99,091	80,585
Projects in development	22,486	42,877
Deferred recovery of depreciation and Amortization	24,635	33,683
Restricted cash	–	1,070
Capitalized financing costs, net of accumulated amortization of $872 and $652	652	872
Other	1,164	1,280
	148,028	160,367
Total assets	$ 300,267	$ 282,767
Liabilities, Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income		
Current liabilities:		
Accounts payable and accrued expenses	$ 16,275	$ 9,579
Study and interconnection payables	11,672	7,712
Accrued payroll and benefits	12,615	10,996
Accrued income taxes	2,629	–
Current portion of long-term debt	23,426	27,183
Current portion of long-term project debt	30,145	15,051
Deferred revenue	904	698
Deferred FERC fee liability	7,233	–
Deposits	114,758	87,902
	219,657	159,121
Non-current liabilities:		
Long-term debt	15,912	39,338
Long-term project debt	35,879	61,078
Pension benefits liability	8,004	8,353
Postretirement healthcare benefits liability	17,626	11,807
Other employee benefits	1,979	2,026
	79,400	122,602
Total liabilities	299,057	281,723
Commitment and contingencies (Note 10)		
Paid in capital	722	722
Retained earnings	122	98
Accumulated other comprehensive income	366	224
Total paid in capital, retained earnings and accumulated other comprehensive income	1,210	1,044
Total liabilities, paid in capital, retained earnings and accumulated other comprehensive income	$ 300,267	$ 282,767

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

($ in thousands)	2004	2003	2002
	For the Years Ended December 31,		
Income			
Revenue:			
Reimbursements	$ 211,846	$ 176,404	$143,798
Study and interconnection fees	815	1,210	799
Interest income	1,853	1,388	2,127
Membership fees	783	714	598
Other income	57	26	386
Total revenue	215,354	179,742	147,708
Operating expenses:			
Compensation	60,287	55,160	46,573
Depreciation and amortization, net of deferral recovery	51,726	48,469	26,758
FERC fees	23,518	11,033	9,800
Outside services	29,917	23,084	24,416
Software licenses and fees	7,430	6,330	6,879
Lease expenses	6,817	8,242	6,982
Computer maintenance and office supplies	6,634	6,063	4,197
Pension benefits	5,398	4,761	2,760
Postretirement healthcare benefits	5,972	3,510	2,495
Study and interconnection services	815	1,210	799
Total operating expenses	198,514	167,862	131,659
Other expenses	7,074	4,991	7,322
Interest expense	7,113	6,938	9,081
Income (loss) before income taxes	2,653	(49)	(354)
Income tax expense (benefit)	2,629	–	(402)
Net income (loss)	$ 24	$ (49)	$ 48
Other comprehensive income:			
Unrealized gain on securities	142	224	–
Comprehensive income, net	$ 166	$ 175	$ 48
Paid in capital, retained earnings and accumulated other comprehensive income			
Beginning balance	$ 1,044	$ 869	$ 821
Net income/(loss)	24	(49)	48
Other comprehensive income	142	224	–
Ending balance	$ 1,210	$ 1,044	$ 869

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

($ in thousands)	2004	2003	2002
	For the Years Ended December 31,		
Cash flows from operating activities:			
Net income/(loss)	$ 24	$ (49)	$ 48
Adjustments:			
Depreciation and amortization expense	30,723	46,116	38,875
Deferred depreciation and amortization	21,003	1,919	(12,117)
Deferred FERC fees	6,219	(6,219)	–
Deferred FERC fee liability	7,233	–	–
Employee benefit expense greater than funding	5,423	4,423	4,331
Deferred tax expense	–	–	573
Changes in assets and liabilities:			
(Increase) decrease in receivables	(4,829)	(9,852)	2,675
(Increase) decrease in study and interconnection receivables	(1,733)	4,677	(9,829)
(Increase) decrease in prepaid expenses and other	(1,192)	1,652	(972)
Increase (decrease) in accounts payable and accrued expenses	6,696	(11,361)	5,317
Increase in accrued income taxes	2,629	–	–
Increase (decrease) in study and interconnection payables	3,960	(5,335)	10,570
Increase in accrued payroll and benefits	1,619	2,377	2,264
Increase in deferred revenue	206	105	83
Increase (decrease) in deposits	26,856	(16,509)	7,514
Net cash provided by operating activities	104,837	11,944	49,332
Cash flows from investing activities:			
Cost of projects in development	(40,359)	(58,268)	(35,020)
Purchase of investment	–	(1,009)	–
Net cash used in investing activities	(40,359)	(59,277)	(35,020)
Cash flows from financing activities:			
Borrowings under long-term project debt	6,331	66,092	8,273
Repayments under long-term project debt	(16,436)	(12,482)	(3,945)
Borrowings under line of credit	25,000	45,000	17,000
Repayments under line of credit	(25,000)	(45,000)	(20,000)
Repayments of long-term debt	(27,183)	(26,520)	(14,365)
Use of restricted cash, net of interest earned	1,070	1,752	1,819
Net cash (used in) provided by financing activities	(36,218)	28,842	(11,218)
Net increase/(decrease) in cash and cash equivalents	28,260	(18,491)	3,094
Cash and cash equivalents balance, beginning of year	90,016	108,507	105,413
Cash and cash equivalents balance, end of year	$118,276	$ 90,016	$ 108,507
Cash paid during the year for:			
Interest	$ 8,327	$ 7,832	$ 9,971
Income taxes	–	–	–

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

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 143,000 megawatts and operates a wholesale electricity market with more than 340 market buyers, sellers and traders of electricity. PJM enables the delivery of electric power to more than 45 million people in all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, 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.

Market Integrations

On April 1, 2002, Allegheny Power, the energy delivery business of Allegheny Energy, Inc., commenced operations with PJM, which expanded PJM's existing region to the West.

During 2002, American Electric Power (AEP); Commonwealth Edison (ComEd), a subsidiary of Exelon Corporation; Dayton Power and Light Company (DPL); and Dominion Virginia Power (DVP) (collectively, the market integration participants) announced their intent to join PJM, subject to regulatory and governmental approvals. On December 9, 2003, Duquesne Light Company (Duquesne) filed a plan before the Pennsylvania Public Utility Commission expressing its intent to join PJM by January 1, 2005.

In June, 2003, PJM began providing third-party administrative services dealing with transmission functions under the existing ComEd and DPL Open Access Transmission Tariffs.

On May 1, 2004, the integration of ComEd into PJM's operations and markets was completed. On October 1, 2004, the integration of AEP's and DPL's operations and markets was completed.

On October 5, 2004, the FERC announced its approval of DVP's plans to integrate into PJM, with some conditions related to rate design and cost recovery for DVP. On November 10, 2004, the Virginia State Corporation Commission (VSCC) approved DVP's integration into PJM. During January 2005, the North Carolina Utilities Commission (NCUC) held hearings on DVP's request for approval to integrate into PJM. The integration of DVP into PJM will occur upon approval by NCUC of the plan for bringing DVP into PJM.

As of December 31, 2004, PJM capitalized $62 million in costs associated with the addition of the market integration participants. These capitalized costs will be amortized through PJM's administrative charges to its members over the useful lives of the underlying assets constructed. All non-capitalized integration expenses are billed and collected directly from the market integration participants.

On January 1, 2005, the integration of Duquesne into PJM's operations and markets was completed.

Interregional Coordination

On March 15, 2002, PJM and the New York Independent System Operator (NYISO) entered into a formal coordination agreement, the Interregional Coordination and Issue Resolution Agreement. In this agreement, PJM and NYISO formalized procedures to address interregional markets coordination matters and to systematically plan and implement solutions. PJM and NYISO provide joint quarterly status reports to the FERC on activities under this agreement.

On January 21, 2002, PJM and the Midwest Independent Transmission System Operator, Inc. (Midwest ISO) announced an executed letter of intent to develop a joint and common market for electricity producers and consumers in all or part of 22 Midwest and Mid-Atlantic states, the District of Columbia and the Canadian province of Manitoba.

On May 13, 2002, PJM and the Midwest ISO executed a memorandum of cooperation to facilitate the implementation of a joint and common market in the Midwest. The market is being developed through an open stakeholder process and is being designed to serve residents whether they reside in states with bundled or unbundled retail rates.

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.

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 subsidiary. 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. In 2004, amounts billed and collected by PJM, in its role as the transmission provider and on behalf of the parties to the interconnection agreements, were not reflected in the company's Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income. 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. Prior-year amounts reclassified to conform to current period presentation include study and interconnection services revenue and related costs of $79.4 million and $123.7 million for the years ended December 31, 2003, and 2002, respectively. Gross study and interconnection services revenue and related costs for the year ended December 31, 2004, were $26.7 million.

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 2004, approximately 67 percent of PJM's operating expenses were billed to 25 of its members, each of which either has an investment-grade credit rating according to the Standard & Poor's rating service or has 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 is a result of a difference in the timing of incurring and recovering of certain expenses. 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 will be recovered from PJM's members from 2003 through 2005. Deferred expenses recovered under this rate moderation plan totaled $12.2 million and $33.3 million at December 31, 2004, and 2003, respectively.

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. Those costs will be billed to PJM's members from 2005 through 2007. At December 31, 2004, and 2003, the recovery of $12.4 million and $0.4 million of depreciation and amortization expense related to the integration had been deferred, 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 the recovery from PJM's members of annual charges from the FERC. At December 31, 2004, PJM has a $7.2 million deferred FERC fee liability, which will be amortized against the FERC fee charges billed to PJM members during 2005. At December 31, 2003, PJM had a $6.2 million deferred FERC fee asset that was billed to PJM's members during 2004.

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, 2004, the deposits balance was comprised of $10.1 million received for study and interconnection fees, $100.5 million held by PJM to support customer credit and $4.2 million received from market integration participants. At the end of 2003, PJM held deposits of $18.6 million for study and interconnection fees, $65.3 million for customer credit and $4.0 million from market integration participants.

Income Taxes

PJM has elected to be taxed as a corporation. Certain income and expense items primarily relating to the treatment of software development costs, pension, postretirement healthcare and other employee benefits are accounted for 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. Valuation allowances are provided to the extent that the realization of deferred tax assets is not likely. During the third quarter of 2002, the company increased its valuation allowance so as to reserve fully its deferred tax assets because management believes it is not likely that the deferred tax assets will be realized.

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*" (FAS 106). 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 represent 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.

3. Accounts Receivable

PJM's receivables at December 31, 2004, and 2003, consisted of the following (amounts in thousands):

	2004	2003
Billed:		
Membership fees	$ 126	$ 121
	126	121
Unbilled:		
Operating expenses	22,142	17,346
MAAC and other	251	223
	22,393	17,569
	$ 22,519	$ 17,690

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

All interconnection receivables were billed at December 31, 2004, and 2003.

4. Fixed Assets and Projects in Development

A summary of fixed assets by classification as of December 31, 2004, and 2003, is as follows (amounts in thousands):

	2004	2003
Leasehold improvements	$ 15,384	$ 9,605
Software development	202,102	159,835
Computer hardware	42,058	29,370
Furniture and fixtures	768	752
Sub-total	260,312	199,562
Accumulated depreciation	(161,221)	(118,977)
Total fixed assets, net of accumulated depreciation	99,091	80,585
Projects in development	22,486	42,877
Total	$121,577	$123,462

Amortization of software development costs for the years ended December 31, 2004, and 2003, were $24.4 million and $38.7 million, respectively.

Total interest expense incurred for the year ended December 31, 2004, was $8.3 million of which $1.2 million was capitalized while assets were being constructed as of December 31, 2004.

5. Short-Term Debt

PJM has a $15 million revolving credit agreement with National Cooperative Services Corporation (NCSC). The revolving credit agreement has a five-year term and will expire in August 2005. The facility is unsecured and is available to fund short-term cash obligations. FERC approval for borrowings under this facility must be requested biennially. On July 20, 2004, the FERC approved borrowing against this facility through August 17, 2005.

As of December 31, 2004, and 2003, 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 3.78 percent and 3.66 percent for the years ended December 31, 2004, and 2003, 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 percent 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 (amounts in thousands):

Year Ending December 31,	Senior Notes
2005	$ 23,426
2006	10,056
2007	5,856
Total	$ 39,338

7. Long-Term Project Debt

On July 21, 2000, the FERC approved PJM's application to enter into a $75 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). FERC approval for borrowings under this facility must be requested biennially. During February 2003, PJM submitted a filing with the FERC requesting approval to increase the limit on the project development facility to $110 million and to convert this facility to a revolver. These changes were agreed to by the lender and approved by the FERC on May 1, 2003. This facility will expire on June 30, 2017.

As of December 31, 2004, and 2003, outstanding borrowings under the project development facility were $66.0 million and $76.1 million, respectively. During first quarter 2005, PJM fixed the interest rate at 6.25 percent for $34.9 million of the December 31, 2004, outstanding borrowings under this facility to be repaid during 2005 through 2007. 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, 2004, and 2003, was 4.85 percent and 3.20 percent, 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 (amounts in thousands):

Year Ending December 31,	Project Development Facility
2005	$ 30,145
2006	17,098
2007	12,599
2008	1,700
2009	732
2010	732
2011	732
2012	732
2013	707
2014	578
Other*	269
Total	$ 66,024

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

8. 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 realizability of certain deferred income tax assets to warrant a valuation allowance on those items.

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

	2004	2003	2002
State income taxes:			
Current	$ 2,589	$ –	$ (2)
Deferred	(2,375)	65	(56)
Valuation allowance	2,375	(65)	56
	2,589	–	(2)
Federal income taxes:			
Current	40	–	(974)
Deferred	(153)	174	787
Valuation allowance	153	(174)	(213)
	40	–	(400)
Income tax (benefit) expense	$ 2,629	$ –	$ (402)

The effects of temporary differences giving rise to deferred income tax assets at December 31, 2004, and 2003, consisted of the following (amounts in thousands):

	2004	2003
Deferred tax assets:		
Pension	$ 4,160	$ 3,862
Postretirement healthcare	7,754	5,259
Net operating loss carryforwards	17,254	39,132
Accrued expenses	1,159	780
	30,327	49,033
Deferred tax liabilities:		
Fixed assets	(26,831)	(47,639)
Other benefits	660	235
	(26,171)	(47,404)
Net deferred income tax assets	4,156	1,629
Valuation allowance	(4,156)	(1,629)
Deferred income taxes, net	$ –	$ –

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

	2004	2003	2002
Income tax at the 34% federal statutory rate	$ 902	$ (17)	$ (120)
Increase (decrease) resulting from:			
Change in valuation allowance	153	(174)	(213)
Meals and entertainment	109	107	70
Net operating loss benefit	(268)	83	(162)
State income taxes, net of federal tax benefit	1,708	–	(1)
Other	25	1	24
Income tax (benefit) expense	$ 2,629	$ –	$ (402)

PJM has operating loss carryforwards of $37.6 million and $44.7 million, respectively, for federal and Pennsylvania state tax purposes. The federal and state carryforwards expire in 2023.

During the third quarter of 2002, PJM recorded a federal tax refund of $0.9 million resulting from changes in tax statutes that allowed PJM to carryback a deduction for project development costs to the 1997 through 1999 tax periods. Also, during the third quarter of 2002, the company increased its valuation allowance so as to reserve fully its deferred tax assets because management believes it is more likely than not that the deferred tax assets will not be realized. The valuation allowance at the end of 2003 and 2004 was $1.6 million and $4.1 million respectively.

At December 31, 2004, PJM's current state tax liability of $2.6 million was due primarily to the combination of the reversal of the temporary difference associated with PJM's recovery of the deferred depreciation and amortization resulting from the $104.2 million asset purchase completed in December 2000 and the limitation by Pennsylvania on the use of Net Operating Losses to $2.0 million per year.

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.

9. Benefit Plans

Pension Plan

PJM sponsors a defined benefit pension plan (the plan), which covers all full-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, 2004, and 2003, the actuarially computed benefit obligation of the SERP amounted to $1.6 million and $2.2 million, respectively. Pension expense for this plan was $0.3 million for each of the years ended December 31, 2004, 2003 and 2002. The accrued pension costs associated with the SERP included in the other employee benefits liability at December 31, 2004, and 2003, were $1.5 million and $1.4 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 $1.1 million as of December 31, 2004.

Postretirement Benefits

PJM provides certain healthcare and other benefits to retired employees and their spouses. 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, 2004, and 2003, and components of net periodic pension and postretirement healthcare costs of these plans for the years ended December 31, 2004, 2003, and 2002, (amounts in thousands).

	Pension Benefits				Other Postretirement Benefits	
	Qualified As of December 31,		SERP As of December 31,		As of December 31,	
	2004	2003	2004	2003	2004	2003
CHANGE IN BENEFIT OBLIGATION						
Net benefit obligation at beginning of year	$ 56,648	$ 45,150	$ 2,243	$ 1,854	$ 24,487	$ 17,015
Service cost	3,890	3,090	102	90	3,546	1,897
Interest cost	3,573	2,957	125	122	1,741	1,179
Plan participants' contributions (estimated)	–	–	–	–	20	22
Plan amendments	–	467	–	19	(776)	–
Actuarial (gain)/loss	3,928	5,809	(682)	164	4,871	4,543
Gross benefits paid	(2,051)	(825)	(234)	(6)	(173)	(169)
Net obligation at end of year	$ 65,988	$ 56,648	$ 1,554	$ 2,243	$ 33,716	$ 24,487

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

	Pension Benefits				Other Postretirement Benefits	
	Qualified As of December 31,		SERP As of December 31,		As of December 31,	
	2004	2003	2004	2003	2004	2003
CHANGE IN PLAN ASSETS						
Fair value of plan assets at beginning of year	$ 34,526	$ 25,888	$ –	$ –	$ –	$ –
Actual return on plan assets	4,232	5,840	–	–	–	–
Employer contributions	5,735	3,623	234	6	153	148
Plan participants' contributions	–	–	–	–	20	21
Gross benefits paid	(2,051)	(825)	(234)	(6)	(173)	(169)
Fair value of plan assets at end of year	42,442	34,526	–	–	–	–
Funded status at end of year	(23,546)	(22,122)	(1,554)	(2,243)	(33,716)	(24,487)
Unrecognized net actuarial (gain)/loss	14,605	12,720	490	1,292	15,709	11,485
Unrecognized prior service cost	937	1,049	(419)	(519)	–	514
Unrecognized net transition obligation (asset)	–	–	31	37	381	681
Net amount recognized at end of year and amounts recognized in the statement of financial position	$ (8,004)	$ (8,353)	$ (1,452)	$ (1,433)	$ (17,626)	$ (11,807)

At the end of 2004 and 2003, the projected benefit obligation and the accumulated benefit obligation exceed the fair value of plan assets, for the qualified pension and SERP as follows (amounts in thousands):

	Qualified		SERP	
	2004	2003	2004	2003
End of Year				
Projected benefit obligation	$ 65,989	$ 56,648	$ 1,554	$ 2,243
Accumulated benefit obligation	46,846	39,478	923	1,217
Fair value of plan assets	42,442	34,526	–	–

The accumulated postretirement benefit obligation was $33.7 million and $24.5 million at December 31, 2004, and 2003, 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 (amounts in thousands):

	Qualified Benefits	SERP Benefits	Other Benefits
Employer Contributions			
Expected employer contributions for 2005 to plan trusts	$ 5,527	N/A	N/A
Expected employer contributions in form of direct benefit payments for 2005	3,795	46	358
Expected Benefit Payments			
2005	3,795	46	358
2006	3,907	57	489
2007	3,999	79	628
2008	4,036	143	799
2009	4,423	438	1,004
2010-2014	24,258	1,914	8,194

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 As of December 31,		SERP As of December 31,		As of December 31,	
	2004	2003	2004	2003	2004	2003
COMPONENTS OF NET PERIODIC BENEFIT COST						
Service cost	$ 3,890	$ 3,090	$ 102	$ 90	$ 3,546	$ 1,897
Interest cost	3,573	2,957	125	122	1,741	1,179
Expected return on assets	(2,745)	(2,065)	–	–	–	–
Amortization of:						
Transition obligation (asset)	–	–	6	6	38	62
Prior service cost	112	112	(101)	(100)	–	80
Actuarial (gain) loss	557	526	121	127	647	293
Total net periodic benefit cost	$ 5,387	$ 4,620	$ 253	$ 245	$ 5,972	$ 3,511

For the years ended December 31, 2004, 2003, and 2002, respectively, $0.2 million, $0.7 million and $0.6 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, 2004, 2003 and 2002.

	Pension Benefits			Postretirement Benefits		
	2004	2003	2002	2004	2003	2002
Discount rate	5.75%	6.00%	6.50%	5.75%	6.00%	6.50%
Expected return on plan assets	8.00%	8.00%	8.00%	N/A	N/A	N/A
Rate of compensation increase	5.00%	5.50%	5.50%	N/A	N/A	N/A
Medical Trend						
Current				11.00%	12.00%	13.00%
Ultimate				5.00%	5.00%	5.00%
Years to Ultimate				7	8	9

The effect of a 1 percent increase in the assumed healthcare cost trend rate from 11 percent to 12 percent would increase the postretirement benefit obligation as of December 31, 2004, by $7.4 million and the current year postretirement benefit cost by approximately $1.5 million. A 1 percent decrease in the assumed healthcare cost trend rate from 11 percent to 10 percent would decrease the accumulated postretirement benefit obligation by approximately $5.7 million and would decrease the postretirement benefit cost by approximately $1.2 million annually.

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, 2004, PJM retained the expected return on plan assets at 8.00 percent, which was also utilized in 2003.

The asset allocation for PJM's pension plan at the end of 2004 and 2003, and the target allocation for 2005, by asset category, follows. The fair value of plan assets for these plans is $42.4 million and $34.5 million, at the end of 2004 and 2003, respectively.

Asset Category	Target Allocation	2004	2003
Equity Securities	56% - 64%	61%	62%
Debt Securities	37% - 41%	38%	36%
Other	0% - 2%	1%	2%
Total	100.0%	100.0%	100.0%

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 objectives of the plan trust are to maximize assets in order to consistently and materially exceed the accumulated benefit obligation under the plan and to reduce 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 the 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 contributes to 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 five percent contributed. PJM contributions to the savings plan were approximately $1.9 million, $1.6 million and $1.3 million for the years ended December 31, 2004, 2003, and 2002.

10. Commitments and Contingencies

Leases

PJM leases office space, furniture, computer and copier equipment under operating leases with various vendors. These leases are non-cancelable and expire during the period from 2005 to 2013.

Future minimum rentals under non-cancelable lease agreements are as follows:

Year Ending December 31,	
2005	$ 2,281
2006	1,802
2007	1,675
2008	1,604
2009	1,437
Remaining	3,003
Total	$ 11,802

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. On August 20, 2003, PJM announced its plan to combine a thorough review of events surrounding this outage with an examination of the reliability plans associated with the evolution of energy markets in the mid-western region. PJM is coordinating with state commissions, the FERC, the U.S. Department of Energy, the North American Electric Reliability Council and its respective regional reliability councils, local control centers and stakeholders to incorporate the applicable lessons learned. At this time, PJM management cannot yet determine the impact these reviews may have on operations or its financial position.

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. PJM intends to respond to the PPL filing, denying its principal allegations and raising such other defenses as may be appropriate. At this time, PJM management cannot yet determine the impact, if any, that FERC's review of the issues raised in PECO's complaint may have on PJM's operations or financial position.

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.

11. 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, 2004 or 2003, respectively.

Working to Perfect the Flow of Energy

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