

PJM 2012 FINANCIAL REPORT



PERFORMANCES

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- 4** Management's Discussion and Analysis
- 16** Management's Responsibility for Financial Reporting
- 18** Independent Auditor's Report
- 20** Consolidated Statement of Financial Position
- 21** Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income
- 22** Consolidated Statement of Cash Flows
- 23** Notes to the Consolidated Financial Statements



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.'s (PJM or the 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.

Nature of Operations

The Company currently coordinates a pooled generating capacity of more than 185,000 megawatts and operates wholesale electricity markets. More than 800 companies are eligible to transact in the markets PJM administers. PJM enables the delivery of electric power to more than 60 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.

PJM manages a sophisticated regional planning process for generation and transmission expansion to ensure continued reliability of the electric system. Using information technology, PJM provides real-time information to market participants to support their daily transactions and business decision-making. 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, financial transmission rights (FTRs), synchronized reserves and regulation services.

PJM Settlement, Inc. (PJM Settlement) is a wholly owned subsidiary of PJM, organized as a Pennsylvania nonprofit corporation, and is a FERC-regulated entity which began operations on January 1, 2011. PJM Settlement was formed to handle all of the credit, billing and settlement functions for PJM's members' transactions in the PJM markets and for transmission service. Prior to 2011, these functions were completed by PJM. PJM Settlement acts as a counterparty to members' pool transactions in the PJM markets. For the pool transactions in the PJM markets, flash title passes through PJM Settlement immediately prior to passing to the ultimate buyer and seller of the product. This arrangement reinforces PJM's authority to continue to net a member's offsetting financial positions in PJM markets for credit and billing purposes; provides clarity in PJM Settlement's legal standing to pursue collection from a bankrupt member; and, also complies with the FERC recommendation on credit policy requirements for competitive wholesale electricity 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 RTOs.

PJM Environmental Information Services, Inc. (PJM EIS) is a wholly owned subsidiary of PJM Tech 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. PJM EIS is not a FERC-regulated entity.

Tariff Cost Recovery

PJM recovers its administrative costs under the stated rate component of the Open Access Transmission Tariff (Tariff). The stated rate Tariff has three elements.

The first element is a composite rate. Beginning June 1, 2008, the composite rate was 31 cents per megawatt-hour (MWh); beginning January 1, 2011, 30 cents per MWh; and beginning October 1, 2011, 29 cents per MWh.

The second element is a rider for the Advanced Second Control Center (AC²). The Tariff establishes a specific mechanism for PJM to collect from its members the actual costs to construct and operate AC². The recovery of those costs is from a formula rate set forth in a separate schedule in the Tariff. The recovery is capped at the capitalized investment costs and operating costs of AC². PJM began to recover costs under this rider in July 2008. The rider will remain in effect until seven years from November 2011,

which was the in-service date of the AC² energy management system. During 2012, 2011 and 2010, \$28.8 million, \$16.9 million and \$9.3 million were billed under this rider, respectively.

The third element provides for accumulation of a financial reserve and subsequent refunds to PJM's members, if applicable.

PJM has the right to file with the FERC for prospective changes to these rates at any time, if necessary.

Market Integrations

On August 17, 2009, FirstEnergy Service Company, on behalf of American Transmission Systems, Inc. (ATSI), its transmission affiliate, filed with the FERC to withdraw its transmission assets from the Midwest Independent System Operator (MISO) and to place them into PJM as of June 1, 2011. In addition to its ATSI transmission assets, the filing includes the ATSI utilities, namely The Cleveland Electric Illuminating Company, Ohio Edison Company, The Toledo Edison Company, and Pennsylvania Power Company, as well as the generation affiliate, FirstEnergy Solutions. The FERC approved this filing on December 17, 2009. This integration was completed on June 1, 2011.

On June 25, 2010, Duke Energy Ohio, Inc. (Duke Ohio) and Duke Energy Kentucky, Inc. (Duke Kentucky), subsidiaries of Duke Energy Corporation, filed with the FERC to withdraw their transmission assets from the MISO and to place them into PJM as of January 1, 2012. In addition to the Duke Ohio and Duke Kentucky transmission assets, the filing includes the integration of certain Duke-owned and jointly owned generation assets. The FERC approved this filing on October 21, 2010. This integration was completed on January 1, 2012.

On May 3, 2012, Eastern Kentucky Power Cooperative (EKPC) filed a request with the Kentucky Public Service Commission (Kentucky PSC) for the cooperative to integrate its system into PJM. The Kentucky PSC approved EKPC's request on December 21, 2012, and is anticipated to be integrated into PJM on June 1, 2013.

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 principles involves judgments regarding many factors, which, in and of themselves, could materially affect 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: revenue recognition, accounting for deferred recovery of pension and postretirement costs, accounting for deferred regulatory liability, benefit plan accounting and assumptions, fixed asset capitalization, income tax accounting and study and interconnection activity.

Net Presentation of Member Activity

The Company has determined that although PJM has flash title to pooled transactions through PJM Settlement, all activity for which PJM Settlement is the central counterparty should be recorded on a net basis. The Company's determination is based on the fact that: (1) the member company, not PJM Settlement, is the primary obligor in each transaction; (2) PJM Settlement earns a fixed amount per transaction; and, (3) the member company has the credit risk, not PJM Settlement. As such, the Company presents member activity for which PJM Settlement is the central counterparty, including accounts receivable, accounts payable, FTRs, revenue and expense, on a net basis in its consolidated financial statements.

Deferred Recovery of Pension and Postretirement Costs

The Company recognizes the underfunded projected benefit obligation (PBO) of a defined benefit pension plan as a liability in the Consolidated Statement of Financial Position. The PBO represents the actuarial present value of benefits attributable to employee service rendered to date, including the effects of estimated future salary increases. In addition to recording the underfunded PBO as a liability, PJM has recorded a regulatory asset to reflect the anticipated future recovery of the amounts to be funded in the future through the Company's rate structure. This regulatory asset, which will be amortized each quarter as the net periodic benefit cost of the underfunded liability is recognized, was \$31.8 million and \$41.8 million at December 31, 2012 and 2011, respectively.

Deferred Regulatory Liability

PJM recovers as service fees its administrative costs under its Tariff.

The Tariff provides for the accumulation of a financial reserve. PJM is permitted to maintain a reserve as a deferred regulatory liability in an amount up to six percent of its annual service fee revenues, less the revenue collected under the AC² rider and PJM Settlement. The amount accumulated under the financial reserve provisions is classified as a non-current liability in the Company's Consolidated Statement of Financial Position. PJM refunds on a quarterly basis the deferred regulatory liability balance in excess of six percent of the annual revenue threshold. The quarterly refund rate is established after the financial close of each quarter, and refunds are distributed to the members on a prospective basis in the following quarter. For the twelve month periods ended December 31, 2012, December 31, 2011 and December 31, 2010, PJM made refunds of \$18.7 million, \$43.8 million and \$50.3 million, respectively.

Any under- or over-refund amounts will be reflected in the deferred regulatory liability activity in the following quarter. Beginning in 2011 and every third year thereafter, first quarter refunds will reduce the non-current liability balance to \$6 million.

For PJM Settlement, the deferred regulatory liability is defined in its rate schedule in the Tariff and is equal to revenues collected in excess of accrual-basis expenses. This balance is refunded quarterly. The quarterly refund rate is established after the financial close of each quarter, and refunds are distributed to the members on a prospective basis in the following quarter. There is not a financial reserve element to the PJM Settlement rate schedule.

PJM recognizes deferred regulatory income or expense in the revenue section of the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income for the amount by which revenues pursuant to the rate schedules exceed applicable expenses in the reporting period. The amount by which cumulative revenues under the rate schedules exceed cumulative expenses and refunds is reported as a deferred regulatory liability in the Consolidated Statement of Financial Position. Should there be periods in which revenues are less than expenses, PJM will reduce the deferred regulatory liability with an offset to deferred regulatory income.

At December 31, 2012, the deferred regulatory liability was \$13.2 million. At December 31, 2011, the deferred regulatory liability was \$14.4 million. At December 31, 2012 and December 31, 2011, the current portion of the deferred regulatory liability was \$2.6 million and \$0.5 million, respectively. The current portion at December 31, 2012, represents the amount to be refunded to members in the first quarter of 2013. The non-current portion of the deferred regulatory liability of \$10.6 million and \$13.9 million represents the amount of PJM's reserve at both December 31, 2012 and December 31, 2011, respectively.

Benefit Plan Accounting

PJM accrues the costs of providing future employee benefits based on assumptions 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 the effects of changes in benefit obligations and plan performance over the working lives of the employees who benefit under the plans.

In addition to recognizing the underfunded PBO of a defined benefit pension plan as an asset or liability in the balance sheet, PJM recognizes annual changes in gains or losses, prior service costs or other credits that have otherwise not been recognized as a part of the liability for pension benefits in the Consolidated Statement of Financial Position. A corresponding regulatory asset, Deferred Pension and Postretirement Costs, has been recognized in the Consolidated Statement of Financial Position. PJM's 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.

In selecting the discount rate assumption for the PJM retirement plan at December 31, 2012, the Company used a method that matches projected payouts from the plan with a yield curve that was produced from a universe containing over 500 U.S.-issued Aa-rated corporate bonds, all of which were noncallable (or callable with make-whole provisions), and excluding the 10 percent of the bonds with the highest yields and the 10 percent with the lowest yields. The discount rate was then developed as a level equivalent rate that would produce the same present value as would result using spot rates to discount the projected pension benefit payments. Based on this analysis, the discount rate for its pension plan and postretirement healthcare plan decreased to 4.20 percent at December 31, 2012. The results during 2012 were derived using a discount rate of 4.80 percent.

In selecting an expected return on plan assets, PJM considers past performance and economic forecasts for the types of investments held by the plans. During 2012, PJM used 7.25 percent as the expected rate of return. However, at December 31, 2012, the expected rate of return on assets decreased to 7.00 percent. The assumption for the expected rate for which compensation will increase remained at 4.50 percent at December 31, 2012. In selecting healthcare cost trend rates, PJM considers past performance and forecasts of healthcare costs. The rate selected at December 31, 2012, was 7.50 percent, declining to 5.00 percent over the next six years. During 2012, the rate had been 8.00 percent.

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. For example, the effect of a 1.00 percent increase in the assumed health care cost trend rate from 8.00 percent to 9.00 percent would increase the postretirement benefit obligation as of December 31, 2012, by \$3.5 million and the current year postretirement benefit cost by approximately \$0.7 million. A 1.00 percent decrease in the assumed healthcare cost trend rate from 8.00 percent to 7.00 percent would decrease the accumulated postretirement benefit obligation by approximately \$9.9 million and would decrease the postretirement benefit cost by approximately \$1.3 million annually.

During 2012, PJM expensed net periodic pension and other postretirement benefit costs of \$17.2 million. This amount represents a \$4.3 million increase in expense compared with the amount recognized during 2011. This increase was primarily due to a change in the plans' assumptions during 2012. The discount rate and expected rate of return factors were lower in 2012 as compared with 2011.

Fixed Asset Capitalization

PJM's fixed assets are comprised principally of software and capitalized software development costs, leasehold improvements, computer hardware and buildings. 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 10 years |
| Computer hardware | 3 to 5 years |
| Leasehold improvements | 10 years |
| Furniture and Fixtures | 10 years |
| Buildings | 25 years |
| Vehicles | 5 years |

Income Tax Accounting

PJM has elected to be taxed as a corporation. PJM and its subsidiaries file a consolidated federal income tax return. The Consolidated Financial Statements include prepaid income taxes, accrued income taxes and deferred income taxes. Prepaid income taxes relate to overpayments by PJM for the current federal tax period. These overpayments will be applied to future federal income tax liabilities. Accrued income taxes represent the amounts expected to be reported on PJM's and its subsidiaries' state income tax returns offset by estimated state payments. Deferred income tax assets represent the tax effects of temporary differences between the financial statement basis and tax basis of existing assets and liabilities and are measured using presently enacted tax rates. A valuation allowance has been provided in circumstances in which PJM believes that it is more likely than not that PJM will not realize such deferred tax assets in the future.

Study and Interconnection Activity

Under 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. Billings and collections by PJM for work it performs as an agent for the counterparties to the specific interconnection agreements are reported on a net basis in the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income.

Results of Operations for 2012, 2011, 2010

Revenues

PJM's service fees increased \$20.8 million, or 8 percent, to \$278.2 million from 2011 to 2012. The increase is attributable to higher member transaction volumes and higher collections during 2012 under the AC² rider, which provides for the collection over time of actual costs to construct and operate AC². Collections under the AC² rider increased \$11.9 million, or 70 percent, to \$28.8 million from 2011 to 2012. The final AC² assets were placed into service on November 8, 2011. The increase in AC² rider charges is primarily attributable to higher depreciation and amortization charges relating to these systems. Transmission volumes for 2012 were 819 terawatt hours (TWhs) as compared with 778 TWhs for 2011. The increase in transmission volumes is primarily attributable to the integration of FirstEnergy Service Company on June 1, 2011, and Duke Ohio and Duke Kentucky on January 1, 2012.

PJM's service fees increased \$12.0 million, or 5 percent, to \$257.4 million from 2010 to 2011. The increase is attributable to higher member transaction volumes and higher collections during 2011 under the AC² rider, which provides for the collection over time of actual costs to construct and operate AC². Collections under the AC² rider increased \$7.6 million, or 82 percent, to \$16.9 million from 2010 to 2011. AC² went into service on November 8, 2011. The increase in AC² rider charges is primarily attributable to higher depreciation and amortization charges relating to these systems. Transmission volumes for 2011 were 778 TWhs as compared with 745 TWhs for 2010. The increase in transmission volumes is primarily attributable to higher customer demand due to warmer weather in the summer of 2011 and the ATSI integration in June 2011.

Deferred regulatory income represents PJM's stated rate tariff service fees in excess of expenses and is reported as an offset to total revenues. The variance for the 12 months ended December 31, 2012, as compared with December 31, 2011, is primarily due to lower stated rates in 2012 and to higher expenses specifically related to the depreciation and amortization of AC² assets placed in service in 2011.

Net income is derived from PJM's non-FERC regulated subsidiaries. Net income was \$0.8 million in 2012 as compared with \$0.7 million in 2011. The activity primarily relates to PJM EIS.

Expenses

Total expenses, excluding FERC fees, study and interconnection services, interest expense and income taxes, increased \$39.9 million, or 18 percent, to \$261.1 million in 2012 as compared with an increase of \$25.1 million, or 13 percent in 2011. The increase in 2012 resulted primarily from the following factors: (1) a \$21.4 million increase in net depreciation and amortization expense primarily due to AC² being placed into service in 2011; (2) a \$10.4 million increase in compensation expense, which is principally a result of lower capitalized labor in 2012 as compared with 2011; (3) a \$5.3 million increase in outside services resulting from higher legal expenses and various projects; and, (4) a \$3.5 million increase in pension costs due to a declining discount rate during 2012. For the years ended December 31, 2012 and 2011, outside services included amounts paid to PJM's independent auditor, PricewaterhouseCoopers LLP, totaling \$1.3 million and \$1.1 million, respectively, which were predominantly for audits of the PJM Consolidated Financial Statements and examination of certain internal control systems in accordance with Statement on Standards for Attestation Examination No. 16 (SSAE 16).

Key information systems, system enhancements and capital investments completed by PJM in 2012 include:

- Shortage Pricing, ensuring that the market price for energy accurately reflects the value of such energy during shortage periods;
- Performance-Based Regulation, enhancing PJM members participation in regulation programs;
- Price Responsive Demand, providing PJM members a process that will allow them to adjust their usage based upon a price signal; and
- Identity Management, improving the reliability and efficiency of PJM's processes for authorization and providing of access to information technology systems.

Total expenses, excluding FERC fees, study and interconnection services, interest expense and income taxes, increased \$25.1 million, or 13 percent, to \$221.2 million in 2011 as compared with an increase of \$3.5 million, or 2 percent in 2010. The increase in 2011 resulted primarily from the following factors: (1) a \$9.2 million increase in net depreciation and amortization expense primarily due to AC² being placed into service in 2011; (2) a \$6.4 million increase in compensation expense due to planned staffing levels and annual cost of living adjustments; and, (3) a \$4.2 million increase in outside services resulting from various projects. For the years ended December 31, 2011 and 2010, outside services included amounts paid to PJM's independent auditor, PricewaterhouseCoopers LLP, totaling \$1.1 million and \$0.9 million, respectively, which were predominantly for audits of the PJM Consolidated Financial Statements and examination of certain internal control systems in accordance with SSAE 16.

Billings for Services

Membership increased to approximately 800 members at December 31, 2012, as compared with approximately 750 members at December 31, 2011. The billings presented below are administered on behalf of the members; however, the associated receivables and payables are presented net in PJM's Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income. The only billings included in PJM's consolidated financial statements are PJM Scheduling, System Control and Dispatch, AC² Costs, PJM Settlement and the FERC Annual Recovery Charge. For 2012, 2011 and 2010, settlements processed by PJM under the Tariff, Operating Agreement and Reliability Assurance Agreement, which is a non-GAAP measure, were as follows:

| (in millions) | 2012 Amount Billed | 2011 Amount Billed | 2010 Amount Billed |
|--|--------------------|--------------------|--------------------|
| Energy Markets | \$ 16,448 | \$ 20,374 | \$ 17,319 |
| Capacity | 5,195 | 7,564 | 9,626 |
| Network Transmission Service | 2,323 | 1,846 | 1,410 |
| FTR Auction Revenues | 984 | 1,243 | 1,312 |
| Transmission Losses (Point-to-Point) | 982 | 1,380 | 1,635 |
| Transmission Congestion | 764 | 1,275 | 1,502 |
| Operating Reserves | 651 | 610 | 622 |
| Transmission Enhancement | 592 | 403 | 284 |
| Reactive Supply | 274 | 256 | 241 |
| PJM Scheduling, System Control and Dispatch (Operating Expense Reimbursement, Net of Stated Rate Refunds) | 231 | 196 | 186 |
| Regulation Market | 197 | 235 | 250 |
| Generation Deactivation | 96 | 83 | 16 |
| Point-to-Point Transmission Service | 72 | 62 | 75 |
| RTO Scheduling, System Control and Dispatch (Transmission Owners' Control Center Expenses) | 63 | 64 | 63 |
| FERC Annual Charge Recovery | 55 | 44 | 47 |
| Day-Ahead Scheduling Reserve Market | 36 | 37 | 7 |
| Spinning Reserve Market | 33 | 66 | 47 |
| Advanced Second Control Center Costs | 29 | 17 | 9 |
| Customer Default Allocation Assessments | 27 | – | 17 |
| Distribution Facilities | 21 | 21 | 21 |
| Load Response Program | 20 | 17 | 17 |
| Black Start Service | 18 | 14 | 12 |
| PJM Settlement | 12 | 9 | – |
| ReliabilityFirst Corporation (RFC) | 11 | 9 | 10 |
| Market Monitoring Unit Funding | 10 | 8 | 9 |
| Inadvertent Interchange | 9 | 28 | 13 |
| Expansion Cost Recovery and RTO Startup Cost Recovery | 9 | 9 | 9 |
| North American Electric Reliability Corporation (NERC) | 8 | 6 | 5 |
| Miscellaneous | 6 | 3 | 1 |
| Ramapo PAR (Phase Angle Regulator) Facilities | 2 | 1 | 1 |
| Michigan-Ontario Interface Phase Angle Regulators | 2 | – | – |
| Organization of PJM States, Inc. (OPSI) Fees | 1 | 1 | 1 |
| Seams Elimination Cost Assignment (SECA) | – | 6 | 3 |
| Total | \$ 29,181 | \$ 35,887 | \$ 34,770 |

Liquidity and Capital Resources

Under the Tariff, PJM collected 30 cents per MWh through September 30, 2011. Beginning October 1, 2011, PJM collected 29 cents per MWh. This rate was in effect for 2012 and will be in effect for 2013. In 2012, the accumulated financial reserve was \$13.2 million, \$2.6 million of which will be refunded to members during the first quarter of 2013. PJM is projected to refund \$5 to \$10 million to members during 2013, which would result in a projected accumulated financial reserve balance of approximately \$13 million at December 31, 2013.

In the event PJM's actual expenses are projected to exceed its revenues and financial reserve, PJM is empowered to and would need to file a rate case with the FERC.

On January 31, 2011, the FERC approved PJM's application to enter into a \$65 million revolving credit agreement with PNC Bank (PNC). During March 2012, PJM filed with the FERC requesting approval to amend the capacity of this facility from \$65 million to \$100 million. PJM received the FERC approval on May 11, 2012, and the increase to the facility was executed with PNC on June 18, 2012. The revolving credit agreement expires on May 31, 2014, but will be automatically extended by PNC to March 30, 2016, if PJM provides the FERC approval authorizing PJM to continue to borrow under the line of credit after May 31, 2014. The facility is unsecured and is available to fund short-term cash obligations. At December 31, 2012, there were no outstanding borrowings on this facility.

On March 31, 2009, the FERC approved PJM's application to enter into a \$35 million loan agreement with PNC Bank. The loan has a seven-year term and is secured by the AC² property in Milford, Pa. The closing on this loan facility occurred on April 30, 2009. At December 31, 2012, outstanding borrowings were \$26.6 million. PJM is expected to make \$2.3 million of principal payments during 2013.

On March 28, 2008, the FERC approved PJM's application to borrow up to \$115 million under a private placement master note agreement. On September 15, 2009, PJM issued senior unsecured notes with a seven-year term totaling \$75 million under this facility. At December 31, 2012, outstanding borrowings were \$46.2 million. The purpose of this borrowing was to fund the technology investment in AC². PJM is expected to make \$11.5 million of principal payments during 2013.

Under the loan covenants, PJM is required to provide unaudited financial statements 45 days after each quarter and audited financial statements 120 days after year-end. PJM is in compliance with these covenants.

As of December 31, 2012 and 2011, PJM and PJM Settlement were assigned an Aa3 issuer 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 \$232.5 million and \$296.4 million at December 31, 2012 and 2011, respectively.

PJM Settlement requires deposits from various parties in connection with services to be performed or as collateral for market activity. PJM Settlement held credit deposits of \$682.5 million and \$799.4 million at December 31, 2012 and 2011, respectively. These deposits are maintained in separate cash accounts that are not legally restricted. PJM Settlement also holds approximately \$1.1 billion in letters of credit as collateral for market activity.

For 2013, PJM's Board of Managers has approved a capital budget of \$32 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. Actual expenditures may differ from these amounts as PJM continues to assess its capital needs.

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

Consolidated Edison Wheel Proceeding

In 2001, Consolidated Edison Company of New York, Inc. (ConEd) filed a complaint with the FERC concerning the implementation by PJM, the New York Independent System Operator (NYISO), and Public Service Electric and Gas Company (PSEG) of certain contracts entered into in the 1970s between ConEd and PSEG. After the FERC issued a series of decisions, PJM, the NYISO, and PSEG filed with the FERC a set of operating protocols intended to resolve the proceeding and guide future operations under the contracts. Subsequently, ConEd claimed that PJM and the NYISO had not properly implemented the approved protocols and had jointly caused alleged damage to ConEd and its customers of \$111 million, of which \$9.5 million are described as direct losses.

On February 23, 2009, the parties to the complaint filed with the FERC a settlement offer to resolve all issues in this matter pending at the FERC and in the D.C. Circuit Court of Appeals. The settlement, if approved by the FERC, would provide "rolled over" service between ConEd and PSEG in accordance with transmission service agreements between PJM and ConEd and joint operating protocols between PJM and the NYISO. The filed settlement was contested.

On September 16, 2010, the Commission issued an Order Approving Contested Settlement and Denying Rehearing and found that the settlement and the related non-conforming transmission service agreements and Joint Operating Agreement Protocol are just and reasonable. On October 18, 2010, the NRG Companies filed a Request for Rehearing appealing the September 16, 2010 Order. On April 18, 2011, the Commission issued an Order on Rehearing and Motions (the Rehearing Order). In this order, the Commission denies with only limited exception NRG's filing for a rehearing of the September 16, 2010 Order issued in this proceeding, approving the contested settlement and related transmission service agreements filed by PJM on behalf of the settling parties. On June 1, 2011, NRG filed an appeal of the Rehearing Order to the United States Court of Appeals for the District of Columbia. The outcome of this matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

Other Items

Member's Employee Lawsuit

In April 2009, an employee of PPL Electric Utilities (PPL) brought a negligence lawsuit in the Philadelphia Court of Common Pleas against PJM, PPL and several PJM members related to injuries that a PPL employee received while installing a wave trap at a PPL substation. PJM filed Preliminary Objections in June 2009, stating that it was wrongly named as a defendant because PJM does not own the equipment that the Plaintiff was working on and had no responsibility for the safety of a PPL employee working on such equipment. The other defendants in this lawsuit were ultimately dismissed from the case. PJM remains the only defendant in the case.

On October 5, 2011, in accordance with the procedural schedule, PJM filed a Motion for Summary Judgment. PJM raised three dispositive legal defenses in its motion, that: (1) PJM's FERC-approved filed tariff limits PJM's liability from, among other claims, third party negligence claims; (2) the Plaintiff's negligence claims are preempted by federal law as PJM is a FERC-regulated regional transmission organization that is not, and cannot be, responsible for, among other things, the safety of its transmission owning members' employees as such would be in conflict with the Federal Power Act and PJM's FERC-approved tariff; and (3) even if the court rejected PJM's first two arguments, the Plaintiff's claim should be dismissed because the Plaintiff failed to establish that PJM owed a duty to the Plaintiff or that PJM's actions were the cause of the Plaintiff's injuries.

In response, the Plaintiff argued the case must go before a jury to decide whether, based on PJM's operational and functional control of its transmission system, PJM had a duty to ensure the safety of PPL's employees. The court denied the motion for summary judgment in a one-sentence order on March 9, 2012. PJM has sought reconsideration and appeal of that order. The trial, which was set to begin on June 11, 2012, is being held in abeyance pending the appeal.

On March 12, 2012, PJM sought a Declaratory Order from the FERC asking the FERC to rule on two narrow, but important issues: (i) whether PJM has the responsibility under its tariffs to oversee worker safety in maintenance operations performed by employees of the Transmission Owners (TOs), and (ii) whether the bar to ordinary negligence claims set forth in PJM's Tariff applies when PJM executes its RTO functions of planning for future grid reliability and approving the request by one of its member TOs to schedule an outage of the TO's transmission facilities.

On June 7, 2012, the FERC granted PJM's Petition for Declaratory Order ruling that PJM does not have responsibility for worker safety in maintenance operations by its TOs' employees; and the limitation of liability in PJM's Tariff applies when PJM executes its RTO functions. The Plaintiff sought rehearing and clarification of the FERC's order. On January 8, 2013, the FERC denied the Plaintiff's rehearing request, affirming its June 7 Order. PJM lodged the FERC orders in the pending appeal in the PA Superior Court, as well as in the Philadelphia Court of Common Pleas.

On September 18, 2012, PJM filed its brief in the PA Superior Court asking the court to overturn Philadelphia Court of Common Pleas denial of PJM's Motion for Summary Judgment. The Plaintiff filed its brief on November 19, 2012, and PJM filed a reply brief on December 6, 2012. Oral arguments were held on February 5, 2013, and PJM is awaiting the court's decision. PJM cannot predict the outcome of this matter, but does not foresee any material adverse impact on PJM's operations or financial position.

Member Complaint

On October 2, 2012, North American Natural Resources, Inc. (NANR) filed a complaint with the FERC in Docket No. EL13-10-000 against American Electric Power Service Corporation and Indiana Michigan Power Company (together AEP) and PJM. The complaint alleged that AEP and PJM violated PJM's Tariff thereby requiring NANR to fund more upgrades than was the minimum necessary to interconnect its landfill gas generation project to the transmission system. NANR also complained that AEP and PJM required it to post more security than was necessary. The complaint asks for a refund of approximately \$2.5 million. On October 22, 2012, PJM filed a Motion for Summary Disposition and an answer to the complaint, defending that it did not violate its Tariff. AEP filed a similar answer asking FERC to dismiss the complaint. On January 17, 2013, FERC issued an order setting the complaint for hearing and settlement procedures. The outcome of this matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

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 or timely completion of projects. 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 three business days after the month-end bill is issued by PJM, generally within the first two weeks of each month. During 2012 and 2011, approximately 65 percent of PJM's operating expenses were billed to 20 of its 800 members and 22 of its 750 members, respectively, each of which either have an investment-grade credit rating or has provided a guaranty from an affiliate with an investment-grade rating. In the event of default of any PJM members, PJM has the right to bill the remaining PJM members 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 to fulfill certain credit requirements.

Lehman Brothers Commodities Services Default

On and before September 15, 2008, the activity in the PJM markets of Lehman Brothers Commodities Services (LBCS), a PJM member, was supported by a guaranty issued by the parent company of LBCS, Lehman Brothers Holdings, Inc. (LBHI). On September 15, 2008, LBHI filed a petition in bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York. PJM issued a collateral call to LBCS on September 15, 2008, given the adverse change to LBCS's guarantor. LBCS did not meet its collateral call, and on September 18, 2008, LBCS was declared to be in default of its obligations, and its transaction rights in PJM were terminated. LBCS ultimately filed its own bankruptcy petition on October 3, 2008. LBCS did not pay their regular monthly invoices for market activity from August 2008 through and including May 2009, for a total of approximately \$18 million. The aggregate payment defaults were billed to non-defaulting members in accordance with the default allocation assessment formula in PJM's Operating Agreement. LBCS has not had any open positions with the Company since June 1, 2009. On September 18, 2009, PJM filed Proofs of Claim, along with supporting documentation, with the Bankruptcy Court setting forth PJM's creditor claim against both LBCS and LBHI.

On December 18, 2012, PJM reached an agreement with Lehman's bankruptcy plan administrator to allow and approve \$17 million of PJM's original claim. PJM's original claim was reduced on the basis that Lehman challenged PJM's right to set off certain amounts from the claim that were due to Lehman prior to bankruptcy and because several PJM Members utilized their portion of the PJM assessed default allocation payment to set-off amounts they owed to Lehman. As a result of the agreement, PJM will qualify for distributions from the Lehman bankruptcy estate beginning in April 2013, and also will qualify at that time for two catch-up payments for past distributions. Any distributions received will be allocated to members based on their pro-rata share of the default assessment. The outcome of the matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

Marginal Line Loss Surplus Payment Reallocation

Between July 17, 2012 and July 20, 2012, 14 companies defaulted on payment obligations totaling \$28.0 million, net of collateral held by PJM Settlement. These obligations resulted from reallocations for previously ordered and provided refunds made to certain market participants for billing adjustments related to the marginal line loss payment surplus allocation methodology under PJM's Operating Agreement and Tariff, which was ordered by the FERC at Docket No. EL08-14 on July 21, 2011. These unpaid obligations

were collected during August 2012 from PJM Settlement's non-defaulting members. PJM Settlement is considering all alternatives to enforce its contract rights from all non-paying companies, and to this end, has filed two complaints in civil action alleging breach of contract in the state of Delaware against former members. The first complaint, naming City Power Marketing, L.L.C., Energy Endeavors, L.L.C., Energy Endeavors, LP and Crane Energy, LP, seeks the recovery of approximately \$23 million owed to PJM Settlement, while the second complaint, naming Round Rock Energy, L.L.C., Round Rock Energy, LP, Hunrise Energy Fund, L.L.C. and certain named principals individually, seeks the recovery of approximately \$4.25 million.

Under the terms of the PJM Operating Agreement, any payment defaults may be billed and collected from PJM's other member companies. The outcome of any defaults is not anticipated to have a material adverse effect on PJM's financial position, results of operations or cash flow.

Member Complaint

On October 19, 2012, Dominion Resources Services, Inc., on behalf of PJM Members Virginia Electric and Power Company (d/b/a Dominion Virginia Power) and Dominion Retail, Inc., filed a complaint against PJM with the FERC in Docket No. EL13-12-000. The complaint alleges that PJM's September 13, 2012 change in how it schedules resources needed for reliability in the Day-Ahead Energy Market resulted in an unjust and unreasonable increase in the allocation of Day-Ahead Operating Reserves charges to Load Serving Entities that did not benefit from the reliability services. Dominion Resources Services, Inc. asserts that as a result of this change, Dominion Virginia Power has sustained, and will continue to sustain, approximately \$40,000 per day in additional Day-Ahead Operating Reserve charges, and Dominion Retail, Inc. will incur an average of \$90,000 per month in additional Day-Ahead Operating Reserve charges. They expect these additional charges to total approximately \$7.5 million and \$0.5 million respectively, by the March 1, 2013 date on which it assumed PJM would seek to incorporate an amendment to its Tariff and Operating Agreement to change how these charges are allocated.

PJM filed an answer to the complaint on November 1, 2012, advising that it has initiated a stakeholder process to address the cost allocation issues raised in the complaint and argued that the complaint should not circumvent the stakeholder process. On November 30, 2012, after an expedited stakeholder process, PJM filed proposed revisions to its Day-Ahead Operating Reserves charges cost allocation provisions in the Tariff and Operating Agreement. The FERC approved this request on January 28, 2013, with an effective date of December 1, 2012, and dismissed the complaint.

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.

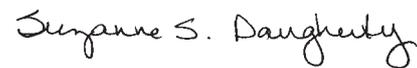
This system includes a separate Internal Audit Department, which monitors internal controls and reports directly to the Audit Committee of the Board of Managers. Management views the purpose of internal auditing to be an independent examination and assessment of PJM's activities related to compliance 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.



Terry Boston

President & Chief Executive Officer



Suzanne S. Daugherty

Vice President, Chief Financial Officer
and Treasurer

INDEPENDENT AUDITOR'S REPORT



Independent Auditor's Report

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

We have audited the accompanying consolidated financial statements of PJM Interconnection, L.L.C. and its subsidiaries, which comprise the consolidated statements of financial position as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income and paid in capital, retained earnings and accumulated other comprehensive income and of cash flows for each of the three years in the period ended December 31, 2012.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design 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. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PJM Interconnection, L.L.C. and its subsidiaries at December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in accordance with accounting principles generally accepted in the United States of America.



Philadelphia, PA
March 14, 2013

Consolidated Statement of Financial Position

| (\$ in thousands) | December 31, | |
|---|---------------------|---------------------|
| | 2012 | 2011 |
| Assets | | |
| Current assets: | | |
| Deposits on hand | \$ 914,964 | \$ 1,095,812 |
| Operating cash | 204,193 | 258,108 |
| Receivables | 35,279 | 32,065 |
| Study and interconnection receivables | 7,253 | 10,316 |
| Prepaid taxes | - | 1,738 |
| Deferred FERC fees | - | 3,525 |
| Prepaid expenses and other | 5,231 | 6,204 |
| Deferred income taxes, net of valuation allowance | 9,078 | 10,402 |
| Note receivable | 1,211 | 2,003 |
| | 1,177,209 | 1,420,173 |
| Non-current assets: | | |
| Fixed assets, net of accumulated depreciation and amortization of \$412,482 and \$362,790 | 218,244 | 195,312 |
| Land | 1,420 | 1,420 |
| Projects in development | 13,650 | 36,483 |
| Deferred recovery of pension and postretirement costs | 31,778 | 41,804 |
| Deferred income taxes, net of valuation allowance | 13,361 | 11,765 |
| Note receivable | 398 | 609 |
| Other | 6,882 | 5,675 |
| | 285,733 | 293,068 |
| Total assets | \$ 1,462,942 | \$ 1,713,241 |
| Liabilities, paid in capital, retained earnings and accumulated other comprehensive income | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 26,010 | \$ 23,960 |
| Member prepayment | 242,142 | 273,766 |
| Study and interconnection payables | 10,499 | 29,070 |
| Accrued payroll and benefits | 25,140 | 21,754 |
| Revolving line of credit | - | 35,000 |
| Current portion of long-term debt | 13,871 | 13,872 |
| Current portion of capital lease | 1,267 | - |
| Deferred FERC fee liability | 1,108 | - |
| Deferred regulatory liability | 2,649 | 528 |
| Deferred revenue | 2,889 | 2,665 |
| Postretirement healthcare benefits liability | 997 | 1,425 |
| Other employee benefits | 74 | 73 |
| Deposits | 914,964 | 1,095,812 |
| | 1,241,610 | 1,497,925 |
| Non-current liabilities: | | |
| Long-term debt | 58,921 | 72,793 |
| Long-term capital lease | 24,193 | - |
| Deferred regulatory liability | 10,552 | 13,850 |
| Interest rate swap | 2,030 | 2,263 |
| Pension benefits liability | 55,263 | 53,438 |
| Postretirement healthcare benefits liability | 54,494 | 58,450 |
| Other employee benefits | 10,880 | 10,203 |
| | 216,333 | 210,997 |
| Total liabilities | 1,457,943 | 1,708,922 |
| Commitments and contingencies (Note 13) | | |
| Paid in capital | 722 | 722 |
| Retained earnings | 3,954 | 3,135 |
| Accumulated other comprehensive income | 323 | 462 |
| Total paid in capital, retained earnings and accumulated other comprehensive income | 4,999 | 4,319 |
| Total liabilities, paid in capital, retained earnings and accumulated other comprehensive income | \$ 1,462,942 | \$ 1,713,241 |

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

| (\$ in thousands) | For the Years Ended December 31, | | |
|--|----------------------------------|------------|------------|
| | 2012 | 2011 | 2010 |
| Income | | | |
| Revenue: | | | |
| Service fees | \$ 278,168 | \$ 257,375 | \$ 245,352 |
| Deferred regulatory income | (17,484) | (37,977) | (49,743) |
| FERC fees reimbursement | 53,877 | 49,011 | 44,780 |
| Study and interconnection fees | 3,365 | 3,002 | 2,559 |
| Interest income | 1,067 | 1,107 | 796 |
| Membership fees | 2,792 | 2,664 | 2,209 |
| Other income | 2,495 | 2,401 | 2,219 |
| Total revenue | 324,280 | 277,583 | 248,172 |
| Expenses: | | | |
| Compensation | 108,559 | 98,178 | 91,764 |
| FERC fees | 53,877 | 49,011 | 44,780 |
| Depreciation and amortization | 51,337 | 29,971 | 20,815 |
| Outside services | 50,941 | 45,650 | 41,493 |
| Software licenses and fees | 11,835 | 11,738 | 10,978 |
| Pension benefits | 11,194 | 7,703 | 6,962 |
| Other expenses | 9,466 | 10,536 | 8,097 |
| Computer maintenance and office supplies | 9,254 | 9,313 | 8,543 |
| Postretirement healthcare benefits | 5,974 | 5,200 | 4,603 |
| Interest expense | 4,130 | 2,309 | 2,735 |
| Study and interconnection services | 3,365 | 3,002 | 2,559 |
| Lease expenses | 2,498 | 2,890 | 2,781 |
| Total expenses | 322,430 | 275,501 | 246,110 |
| Income before income taxes | 1,850 | 2,082 | 2,062 |
| Income tax expense | 1,031 | 1,348 | 1,597 |
| Net income | \$ 819 | \$ 734 | \$ 465 |
| Other comprehensive (loss) income: | | | |
| Unrealized (loss) gain on securities, net | (139) | 26 | 12 |
| Comprehensive income, net | \$ 680 | \$ 760 | \$ 477 |
| Paid in capital, retained earnings and accumulated other comprehensive income | | | |
| Beginning balance | \$ 4,319 | \$ 3,559 | \$ 3,082 |
| Net income | 819 | 734 | 465 |
| Other comprehensive (loss) income | (139) | 26 | 12 |
| Ending balance | \$ 4,999 | \$ 4,319 | \$ 3,559 |

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

Consolidated Statement of Cash Flows

| (\$ in thousands) | For the Years Ended December 31, | | |
|---|----------------------------------|--------------|------------|
| | 2012 | 2011 | 2010 |
| Cash flows from (used in) operating activities: | | | |
| Net income | \$ 819 | \$ 734 | \$ 465 |
| Adjustments: | | | |
| Depreciation and amortization expense | 51,337 | 29,971 | 20,815 |
| Deferred income taxes, net of valuation allowance | (272) | 901 | 1,206 |
| Deferred recovery of pension and postretirement costs | 10,026 | (23,585) | (7,178) |
| Deferred regulatory liability | 17,484 | 37,977 | 49,742 |
| Employee benefit expense greater than (less than) funding | (1,881) | 33,406 | 15,542 |
| Net fair value changes related to interest rate swap | (233) | 853 | 1,279 |
| Changes in assets and liabilities: | | | |
| (Increase) in receivables | (3,214) | (7,154) | (17,186) |
| Decrease in study and interconnection receivables | 3,063 | 2,002 | 4,319 |
| (Increase) in prepaid expenses and other | (426) | (947) | (4,537) |
| Decrease (increase) in deferred FERC fees | 3,525 | (3,525) | 1,338 |
| Decrease in prepaid income taxes | 1,738 | 476 | 7,166 |
| Increase (decrease) in accounts payable and accrued expenses | 804 | (9,276) | 8,673 |
| (Decrease) increase in study and interconnection payables | (18,571) | 12,925 | (6,724) |
| Increase in accrued payroll and benefits | 3,386 | 2,022 | 361 |
| Increase (decrease) in deferred FERC fee liability | 1,108 | (1,700) | 1,700 |
| Increase in deferred revenue | 224 | 234 | 517 |
| Refunds to members | (18,661) | (43,784) | (50,310) |
| Net cash provided by operating activities | 50,256 | 31,530 | 27,188 |
| Cash flows from (used in) investing activities: | | | |
| Cost of projects in development | (24,679) | (55,328) | (59,043) |
| Note receivable | 1,003 | (552) | 1,368 |
| Net cash (used in) investing activities | (23,676) | (55,880) | (57,675) |
| Cash flows from (used in) financing activities: | | | |
| Borrowings under line of credit | 1,078,000 | 448,903 | 115,000 |
| Repayments under line of credit | (1,113,000) | (413,903) | (115,000) |
| Repayments of long-term debt | (13,871) | (13,872) | (8,104) |
| Member prepayment received | 242,142 | 273,766 | 100,274 |
| Member prepayment utilized | (273,766) | (100,274) | (21,510) |
| (Decrease) increase in deposits | (180,848) | 351,575 | 196,888 |
| Net cash (used in) provided by financing activities | (261,343) | 546,195 | 267,548 |
| Net (decrease) increase in cash and cash equivalents | (234,763) | 521,845 | 237,061 |
| Cash and cash equivalents balance (including customer deposits), beginning of year | 1,353,920 | 832,075 | 595,014 |
| Cash and cash equivalents balance (including customer deposits), end of year | \$ 1,119,157 | \$ 1,353,920 | \$ 832,075 |
| Cash paid during the year for: | | | |
| Interest | \$ 4,017 | \$ 5,545 | \$ 5,545 |
| Taxes | 446 | 1,017 | 2,102 |
| Noncash activity: | | | |
| Changes in projects in development additions included in ending accounts payable and accrued expenses | \$ 1,246 | \$ (283) | \$ (2,016) |

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

Notes to the Consolidated Financial Statements

December 31, 2012 (\$ in tables in thousands)

1. Company Overview

Background

PJM Interconnection, L.L.C. (PJM or Company) is a Regional Transmission Organization (RTO) responsible for the operation of wholesale electric markets and for centrally dispatching electric systems in the PJM region. PJM's services and the markets PJM operates are subject to regulation by the Federal Energy Regulatory Commission (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 185,000 megawatts and operates wholesale electricity markets. More than 800 companies are eligible to transact in the markets PJM administers. PJM enables the delivery of electric power to more than 60 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.

PJM manages a sophisticated regional planning process for generation and transmission expansion to ensure continued reliability of the electric system. Using information technology, PJM provides real-time information to market participants to support their daily transactions and business decision-making. 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, financial transmission rights (FTRs), synchronized reserves and regulation services.

PJM Settlement, Inc. (PJM Settlement) is a wholly owned subsidiary of PJM, organized as a Pennsylvania nonprofit corporation, and is a FERC-regulated entity which began operations on January 1, 2011. PJM Settlement was formed to handle all of the credit, billing and settlement functions for PJM's members' transactions in the PJM markets and for transmission service. Prior to 2011, these functions were completed by PJM. PJM Settlement acts as a

counterparty to members' pool transactions in the PJM markets. For the pool transactions in the PJM markets, flash title passes through PJM Settlement immediately prior to passing to the ultimate buyer and seller of the product. This arrangement reinforces PJM's authority to continue to net a member's offsetting financial positions in PJM markets for credit and billing purposes; provides clarity in PJM Settlement's legal standing to pursue collection from a bankrupt member; and, also complies with the FERC recommendation on credit policy requirements for competitive wholesale electricity 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 RTOs.

PJM Environmental Information Services, Inc. (PJM EIS) is a wholly owned subsidiary of PJM Tech 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. PJM EIS is not a FERC-regulated entity.

Tariff Cost Recovery

PJM recovers its administrative costs under the stated rate component of the Open Access Transmission Tariff (Tariff). The stated rate Tariff has three elements.

The first element is a composite rate. Beginning June 1, 2008, the composite rate was 31 cents per megawatt-hour (MWh); beginning January 1, 2011, 30 cents per MWh; and beginning October 1, 2011, 29 cents per MWh.

The second element is a rider for the Advanced Second Control Center (AC²). The Tariff establishes a specific mechanism for PJM to collect from its members the actual costs to construct and operate AC². The recovery of those costs is from a formula rate set forth in a separate schedule in the Tariff. The recovery is capped at the capitalized investment costs and operating costs of AC². PJM began to recover costs under this rider in July 2008. The rider will remain in effect until seven years from November 2011, which was the in-service date of the AC² energy management system.

The third element provides for accumulation of a financial reserve and subsequent refunds to PJM's members, if applicable. See further discussion in Footnote 2.

Summary of Service Fees

| | 2012 | 2011 | 2010 |
|---------------------------|-------------------|-------------------|-------------------|
| PJM Stated rate revenues | \$ 237,757 | \$ 230,836 | \$ 236,010 |
| PJM AC ² Rider | 28,792 | 16,941 | 9,342 |
| PJM Settlement revenues | 11,619 | 9,598 | – |
| Total Service Fees | \$ 278,168 | \$ 257,375 | \$ 245,352 |

PJM and PJM Settlement have the right to file with the FERC for prospective changes to these rates at any time, if necessary.

Market Integrations

On August 17, 2009, FirstEnergy Service Company, on behalf of American Transmission Systems, Inc. (ATSI), its transmission affiliate, filed with the FERC to withdraw its transmission assets from the Midwest Independent System Operator (MISO) and to place them into PJM as of June 1, 2011. In addition to its ATSI transmission assets, the filing includes the ATSI utilities, namely The Cleveland Electric Illuminating Company, Ohio Edison Company, The Toledo Edison Company, and Pennsylvania Power Company, as well as the generation affiliate, FirstEnergy Solutions. The FERC approved this filing on December 17, 2009. This integration was completed on June 1, 2011.

On June 25, 2010, Duke Energy Ohio, Inc. (Duke Ohio) and Duke Energy Kentucky, Inc. (Duke Kentucky), subsidiaries of Duke Energy Corporation, filed with the FERC to withdraw their transmission assets from the MISO and to place them into PJM as of January 1, 2012. In addition to the Duke Ohio and Duke Kentucky transmission assets, the filing includes the integration of certain Duke-owned and jointly owned generation assets. The FERC approved this filing on October 21, 2010. This integration was completed on January 1, 2012.

On May 3, 2012, Eastern Kentucky Power Cooperative (EKPC) filed a request with the Kentucky Public Service Commission (Kentucky PSC) for the cooperative to integrate its system into PJM. The Kentucky PSC approved EKPC's request on December 21, 2012, and is anticipated to be integrated into PJM on June 1, 2013.

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 generally accepted accounting principles (GAAP) and include the accounts of PJM and its wholly owned subsidiaries (collectively referred to herein as PJM or the Company). All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with GAAP 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. These 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.

PJM has performed an evaluation of subsequent events through March 14, 2013, which is the date the financial statements were issued.

Net Presentation of Member Activity

The Company has determined that although PJM has flash title to pooled transactions through PJM Settlement, all activity for which PJM Settlement is the central counterparty should be recorded on a net basis. The Company's determination is based on the fact that: (1) the member company, not PJM Settlement, is the primary obligor in each transaction; (2) PJM Settlement earns a fixed amount per transaction; and, (3) the member company has the credit risk, not PJM Settlement. As such, the Company presents member activity for which PJM Settlement is the central counterparty, including accounts receivable, accounts payable, FTRs, revenue and expense on a net basis in its consolidated financial statements.

Lease Transactions

The Company accounts for lease transactions as either capital leases or operating leases, depending on the terms of the underlying lease agreements.

Assets leased under a capital lease are recorded at cost which is the net present value of the future lease payments. Such assets are included in fixed assets in the Company's Consolidated Statement of Financial Position, and depreciated using the straight-line method over their estimated useful lives. The aggregate lease payments are recorded as a capital lease obligation, net

of interest charges as determined by the excess of lease payments over the cost of the leased asset. This implicit interest cost is charged to expense over the lease term using the effective interest rate method.

The lease payments under an operating lease are recognized as current expenses on an accrual basis over the term of the lease agreement.

Study and Interconnection Activity

Under 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. Billings and collections by PJM for work it performs as an agent for the counterparties to the specific interconnection agreements are reported on a net basis in the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income.

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 security to obtain credit within the PJM markets. During 2012 and 2011, approximately 65 percent of PJM's operating expenses were billed to 20 and 22 of its members, respectively, each of which either has an investment-grade credit rating according to at least one of the three major rating services or has provided a guaranty from an affiliate with an investment-grade rating. PJM had approximately 800 members at year-end 2012 and approximately 750 members at year-end 2011.

Under the terms of the PJM Operating Agreement, any payment defaults may be billed to and collected from PJM's other member companies.

Fixed Assets

PJM's fixed assets are comprised principally of software and capitalized software development costs, leasehold improvements, computer hardware, and buildings. 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 10 years |
| Computer hardware | 3 to 5 years |
| Leasehold improvements | 10 years |
| Furniture and Fixtures | 10 years |
| Buildings | 25 years |
| Vehicles | 5 years |

Deferred Recovery of Pension and Postretirement Costs

The Company recognizes the underfunded projected benefit obligation (PBO) of its defined benefit pension plan as a liability in the Consolidated Statement of Financial Position. The PBO represents the actuarial present value of benefits attributable to employee service rendered to date, including the effects of estimated future salary increases. In addition to recording the underfunded PBO as a liability, PJM has recorded a regulatory asset to reflect the anticipated future recovery of the amounts to be funded in the future through the Company's rate structure. This regulatory asset, which will be amortized each quarter as the net periodic benefit cost of the underfunded liability is recognized, was \$31.8 million and \$41.8 million, at December 31, 2012 and 2011, respectively.

Deferred FERC Fees and Deferred FERC Fee Liability

The FERC charges an annual assessment to all public utilities based on kilowatt-hours of interstate transmission service provided. PJM recovers from its members the annual charges from the FERC. At December 31, 2012, PJM had a \$1.1 million deferred FERC fee liability. This liability represents the difference between amounts collected from PJM members and amounts ultimately assessed by the FERC during 2012 and is a factor considered in determining the FERC fee charges billed to PJM members during the subsequent year.

At December 31, 2011, PJM had a \$3.5 million deferred FERC fee asset that resulted from under-collections during 2011 and was reflected in the amounts billed to PJM's members during 2012.

Deferred Regulatory Liability

PJM recovers as service fees its administrative costs under its Tariff.

The Tariff provides for the accumulation of a financial reserve. PJM is permitted to maintain a reserve as a deferred regulatory liability in an amount up to six percent of its annual service fee revenues, less the revenue collected under the AC² rider and the PJM Settlement rate schedule. The amount accumulated under the financial reserve provisions is classified as a non-current liability in the Company's Consolidated Statement of Financial Position. PJM refunds on a quarterly basis the deferred regulatory liability balance in excess of six percent of the annual revenue threshold. The quarterly refund rate is established after the financial close of each quarter and refunds are distributed to the members on a prospective basis in the following quarter. For the twelve month periods ended December 31, 2012, December 31, 2011 and December 31, 2010, PJM made refunds of \$18.7 million, \$43.8 million and \$50.3 million, respectively.

Any under or over refund amounts will be reflected in the deferred regulatory liability activity in the following quarter. Beginning in 2011 and every third year thereafter, first quarter refunds will reduce the non-current liability balance to \$6 million.

For PJM Settlement, the deferred regulatory liability is defined in its rate schedule in the Tariff and is equal to revenues collected in excess of accrual-basis expenses. This balance is refunded quarterly. The quarterly refund rate is established after the financial close of each quarter and refunds are distributed to the members on a prospective basis in the following quarter. There is not a financial reserve element to the PJM Settlement rate schedule.

PJM recognizes deferred regulatory income or expense in the revenue section of the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income for the amount by which revenues pursuant to the rate schedules exceed applicable expenses in the reporting period. The amount by which cumulative revenues under the rate schedules exceed cumulative expenses and refunds is reported as a deferred regulatory liability in the Consolidated Statement of Financial Position. Should there be periods in which revenues are less than expenses, PJM will reduce the deferred regulatory liability with an offset to deferred regulatory income.

At December 31, 2012, the deferred regulatory liability was \$13.2 million. At December 31, 2011, the deferred regulatory liability was \$14.4 million. At December 31, 2012 and December 31, 2011, the current portion of the deferred regulatory liability was \$2.6 million and \$0.5 million, respectively. The current portion at December 31, 2012, represents the amount to be refunded to members in the first quarter of 2013. The non-current portion of the deferred regulatory liability of \$10.6 million and \$13.9 million represents the amount of PJM's reserve at both December 31, 2012 and December 31, 2011, respectively.

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, 2012, the deposits balance was comprised of \$232.5 million received for study and interconnection fees and PJM Settlement held deposits of \$682.5 million for customer credit. At the end of 2011, PJM held deposits of \$296.4 million for study and interconnection fees, and PJM Settlement held deposits of \$799.4 million for customer credit. These deposits are maintained in separate cash accounts that are not legally restricted.

Income Taxes

PJM has elected to be taxed as a corporation for both federal and state income tax purposes. PJM and its subsidiaries file a consolidated federal income tax return. The Consolidated Financial Statements include prepaid income taxes, accrued income taxes and deferred income taxes. Prepaid income taxes relate to federal and state overpayments on deposit with taxing authorities. These overpayments will be applied to future federal and state income tax liabilities. Deferred income tax assets represent the temporary differences between the Company's financial statement basis and tax basis in existing assets and liabilities measured using presently enacted tax rates. A valuation allowance has been provided against certain deferred tax assets in which Management has concluded it is more likely than not the Company will be unable to recognize the income tax benefit associated with those future tax deductions.

Fair Values of Financial Instruments

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

Benefit Plan Accounting

PJM accrues the costs of providing future employee benefits based on assumptions made regarding the valuation of benefit obligations and performance of plan assets. Delayed recognition of differences between actual results and those assumed allows for a relatively even recognition of the effects of changes in benefit obligations and plan performance over the working lives of the employees who benefit under the plans.

In addition to recognizing the underfunded PBO of a defined benefit pension plan as an asset or liability in the balance sheet, PJM recognizes annual changes in gains or losses, prior service costs, or other credits that have otherwise not been recognized as a part of the liability for pension benefits in the Consolidated Statement of Financial Position. A corresponding regulatory asset, Deferred Pension and Postretirement Costs, has been recognized in the Consolidated Statement of Financial Position.

PJM's 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 currently has one interest rate swap that qualifies as a derivative instrument. The Company accounts for this derivative as either an asset or liability at fair value in the Consolidated Statement of Financial Position with changes in fair value recorded through earnings. Refer to Footnote 8 for additional details related to PJM's interest rate swap.

An FTR is a financial instrument that enables market participants to reduce their congestion-related price risk when delivering or selling energy on the grid. PJM Settlement is neither the buyer nor seller of FTRs, but as FTR auctions clear and charges and credits accumulate, PJM Settlement believes it is temporarily the counterparty to both the FTR buyer and FTR seller. Refer to Footnote 9 for additional details related to FTR derivative disclosures.

Revenue Recognition

PJM recognizes as revenue amounts billed and unbilled under PJM and PJM Settlement's Tariff rate schedules.

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 directly by the corresponding interconnection expenses.

PJM EIS recognizes as revenues amounts both billed and unbilled for the customers of the Generation Attributes Tracking System.

3. Accounts Receivable

PJM's receivables at December 31, 2012 and 2011 consisted of the following:

| | 2012 | 2011 |
|-----------------|------------------|------------------|
| Billed: | | |
| Membership fees | \$ 169 | \$ 277 |
| PJM EIS | 222 | 185 |
| | 391 | 462 |
| Unbilled: | | |
| Service fees | 34,748 | 31,274 |
| PJM EIS | 140 | 329 |
| | 34,888 | 31,603 |
| | \$ 35,279 | \$ 32,065 |

PJM's member companies are billed on a monthly basis for recovery of PJM's and PJM Settlement's administrative costs under the Tariff. PJM bills members for services under eight distinct service categories and the AC² rider.

All study and interconnection receivables were billed at December 31, 2012 and 2011.

4. Fixed Assets

A summary of fixed assets by classification as of December 31, 2012 and 2011 follows:

| | 2012 | 2011 |
|--|-------------------|-------------------|
| Buildings | \$ 18,812 | \$ 18,812 |
| Leasehold improvements | 49,312 | 35,399 |
| Capitalized lease | 24,608 | – |
| Software development | 428,778 | 404,254 |
| Computer hardware | 106,057 | 98,813 |
| Furniture and fixtures | 3,033 | 784 |
| Vehicles | 126 | 40 |
| Sub-total | 630,726 | 558,102 |
| Accumulated depreciation and amortization | (412,482) | (362,790) |
| Total fixed assets, net of accumulated depreciation and amortization | \$ 218,244 | \$ 195,312 |

Amortization of software development costs for the years ended December 31, 2012, 2011 and 2010, were \$34.3 million, \$18.7 million and \$13.4 million, respectively.

Total interest costs incurred for the year ended December 31, 2012, was \$4.7 million of which \$0.6 million attributable to assets under construction was capitalized.

Total interest costs incurred for the year ended December 31, 2011, was \$5.5 million of which \$3.2 million attributable to assets under construction was capitalized.

Total interest costs incurred for the year ended December 31, 2010, was \$5.5 million of which \$2.8 million attributable to assets under construction was capitalized.

5. Note Receivable

On March 21, 2008, the FERC approved the settlement to restructure the relationship between PJM and PJM's former Market Monitoring Unit (MMU). As part of the settlement, the MMU and its functions transitioned from being an internal PJM department to an external firm, Monitoring Analytics, L.L.C. (MA). MA operates independent of PJM management and the Board of Managers. In order to facilitate the externalization of this function and as part of the settlement agreement approved by the FERC, PJM entered into a loan agreement on March 14, 2008 with MA. The purpose of the loan was

to fund capital needs associated with MA's technology systems and working capital needs related to MA's responsibilities per Attachment M of the Tariff to monitor the markets administered by PJM. The loan is secured by MA's accounts receivable and future collections of accounts receivable. The loan matures no later than 80 months from the date that MA began providing services to PJM pursuant to the Market Monitor Services Agreement, which was effective August 1, 2008. At December 31, 2012 and December 31, 2011, the outstanding balance due from MA recorded by PJM as a note receivable was \$1.6 million and \$2.6 million, respectively. At December 31, 2012 and December 31, 2011, the current portion of the note receivable was \$1.2 million and \$2.0 million, respectively. The current balance at December 31, 2012, represents the amount to be repaid in the next 12 months. The non-current portion of the note receivable was \$0.4 million and \$0.6 million at December 31, 2012 and December 31, 2011, respectively.

6. Short-Term Debt

PNC Revolving Line of Credit

On January 31, 2011, the FERC approved PJM's application to enter into a \$65 million revolving credit agreement with PNC Bank (PNC). During March 2012, PJM filed with the FERC requesting approval to amend the capacity of this facility from \$65 million to \$100 million. PJM received the FERC approval on May 11, 2012, and the increase to the facility was executed with PNC on June 18, 2012. The revolving credit agreement expires on May 31, 2014, but will be automatically extended by PNC to March 30, 2016, if PJM provides FERC approval authorizing PJM to continue to borrow under the line of credit after May 31, 2014. The facility is unsecured and is available to fund short-term cash obligations.

Under the loan covenants for the revolving credit agreement, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of December 31, 2012 and December 31, 2011. At December 31, 2012, there were no amounts outstanding under the revolving credit agreement. The interest rate on borrowings under this revolving credit agreement is based on the 30-day London Interbank Offered Rate (LIBOR).

The facility also has a commitment fee of 10 basis points on the unused balance. This fee is calculated daily and paid quarterly.

7. Long-Term Debt

PNC Bank Loan Agreement

On March 31, 2009, the FERC approved PJM's application to enter into a \$35 million loan agreement with PNC. The loan has a seven-year term and is secured by the AC² property. The closing on this facility occurred on April 30, 2009. PJM incurred a total of \$0.2 million in closing costs to obtain this financing. These costs were capitalized and are being amortized on a straight-line basis over the seven-year term of the loan.

As of December 31, 2012 and December 31, 2011, outstanding borrowings under this loan were \$26.6 million and \$28.9 million, respectively. The interest rate is based on the LIBOR in effect at each reset date plus a spread of 135 basis points. The reset date is monthly. As of December 31, 2012 and December 31, 2011, the interest rate was 1.5635 percent and 1.6202 percent, respectively.

Under the loan agreement for the \$35 million loan, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of December 31, 2012, and December 31, 2011.

Repayments of principal under the PNC Bank Loan Agreement are scheduled as follows:

| Year Ending December 31, | |
|--------------------------|------------------|
| 2013 | \$ 2,333 |
| 2014 | 2,333 |
| 2015 | 2,333 |
| 2016 | 19,642 |
| Total | \$ 26,641 |

Private Placement Loan Agreement

On March 28, 2008, the FERC approved PJM's application to borrow up to \$115 million under a private placement master note agreement. On September 15, 2009, PJM issued senior unsecured notes with a seven-year term totaling \$75 million. These notes bear interest at 3.60 percent per annum. Payments are due semi-annually on March 15 and September 15 with the first principal payment having been made on September 15, 2010. The notes mature on September 15, 2016. PJM incurred a total of \$0.3 million in closing costs to obtain this financing. These costs were capitalized and are being amortized on a straight-line basis over the seven-year term of the notes.

As of December 31, 2012 and December 31, 2011, outstanding borrowings under the private placement were \$46.2 million and \$57.7 million, respectively. Under the loan agreement for the \$75 million private placement, PJM is required to meet certain non-financial covenants. PJM was in compliance with these covenants as of December 31, 2012, and December 31, 2011.

Repayments of principal under the Private Placement Loan Agreement are scheduled as follows:

| Year Ending December 31, | |
|--------------------------|------------------|
| 2013 | \$ 11,538 |
| 2014 | 11,538 |
| 2015 | 11,538 |
| 2016 | 11,539 |
| Total | \$ 46,153 |

National Cooperative Services Corporation (NCSC) Project Development Facility

PJM had a \$110 million project development facility with NCSC. This facility was available for asset development and had a four-year drawdown period and a 10-year amortization period. The drawdown period under the long-term project facility terminated on March 31, 2011.

8. Derivative Financial Instrument - Interest Rate Swap

The Company is exposed to certain risks relating to ongoing business operations, including the effect of changes in interest rates. PJM manages interest rate risk on a portion of its variable rate debt using an interest rate swap, which is a derivative financial instrument.

To manage interest rate risk associated with the \$35 million loan agreement with PNC, the Company entered into an interest rate swap agreement with PNC on May 1, 2009. This interest rate swap agreement effectively fixes the interest payments on the Company's floating rate debt instrument at a rate of 4.45 percent through April 30, 2016. The term of the interest rate swap matches the term of the loan. While PJM has entered into an economic hedge of its interest rate, the Company has not elected to designate this instrument as a cash flow or fair value hedge for accounting purposes. Accordingly, the interest rate swap is carried at fair value in the Consolidated Statement of Financial Condition with changes in fair value recorded through earnings. At December 31, 2012 and December 31, 2011, the fair value of the swap of \$2.0 million and \$2.3 million, respectively, was reported as an interest rate swap in the non-current liability section of the Consolidated Statement of Financial Position.

The amount of the derivative gains (losses) PJM recognized in earnings is provided in the table below:

| | Year ended December 31, 2012 | Year ended December 31, 2011 | Year ended December 31, 2010 |
|--|---------------------------------|---------------------------------|---------------------------------|
| Unrealized mark-to-market gains (losses) | \$ 233 | (\$ 853) | (\$ 1,279) |
| Total net mark-to-market gains (losses) | \$ 233 | (\$ 853) | (\$ 1,279) |

The Company does not hold or issue financial instruments for speculative or trading purposes.

9. Derivative Financial Instrument - FTRs

Beginning January 1, 2011, PJM Settlement is the central counterparty to member's pool transactions. Accordingly, PJM Settlement has flash title pass through it when markets settle and as charges / credits are assessed on pool transactions.

An FTR is a financial instrument that enables market participants to reduce their congestion-related price risk when delivering or selling energy on the grid. It provides an economic hedging mechanism against congestion charges that can be transacted by members separately from transmission service. Ultimately, PJM Settlement is neither the buyer nor seller of FTRs, but as FTR auctions clear and charges and credits accumulate, PJM Settlement believes it is temporarily the counterparty to both the FTR Buyer and the FTR Seller. For reporting purposes, these positions net to zero in the Consolidated Statement of Financial Position and the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income and do not represent a credit risk to PJM. As such, the Company does not designate these instruments as PJM Settlement hedges. However, because FTRs have ongoing open positions at period end, the Company is disclosing information related to these derivative positions.

The gross fair value of both the FTR assets and liabilities as of December 31, 2012, was \$0.6 billion. These derivatives are not designated as hedging instruments. A total of 230 members are FTR holders related to a total of 2,129,297 megawatt hours. As of December 31, 2012, PJM held \$815.9 million in collateral related to these FTR transactions. The collateral is based on the calculated net value of the positions held in each member's FTR portfolio. The collateral can be in the form of cash or a letter of credit.

Roll-forward of FTR activity for the year ended December 31, 2012 and 2011:

(\$ in millions)

| | | |
|-------------------------------------|----|---------|
| Balance at January 1, 2012 | \$ | 875 |
| Auction additions | | 2,058 |
| Settlement and change in fair value | | (2,307) |
| Balance at December 31, 2012 | \$ | 626 |
| Balance at January 1, 2011 | \$ | – |
| Auction additions | | 1,725 |
| Settlement | | (850) |
| Balance at December 31, 2011 | \$ | 875 |

10. Fair Value Disclosures

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). In determining fair values, PJM utilizes market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. The authoritative guidance pertaining to fair value establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurement). The three levels of the fair value hierarchy defined by this guidance are as follows:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using broker quotes in liquid markets, and other observable pricing data. Level 2 also includes those financial instruments that are valued using internally developed methodologies that have been corroborated by observable market data through correlation or by other means. Significant assumptions are observable in the marketplace throughout the full term of the instrument, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace.

Level 3 – Pricing inputs include significant inputs that are generally less observable than those from objective sources.

PJM utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. PJM is able to classify fair value balances based on the observability of the inputs. In accordance with the authoritative guidance, financial assets and liabilities are classified in their entirety based on the lowest level of observability for an input that is significant to the fair value measurement. PJM's assessment of the significance of a particular input to the fair value measurement requires the exercise of judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

At December 31, 2012 and 2011, those financial assets and liabilities measured at fair value using Level 1 inputs were deposits on hand, operating cash and short-term debt. PJM's interest rate swap agreement associated with the loan from PNC of \$35 million was accounted for at fair value on a recurring basis based on Level 2 inputs within the fair value hierarchy.

The fair value of FTR assets and liabilities for which PJM Settlement is the counterparty for an instant are determined on a recurring basis based on Level 3 inputs within the fair value hierarchy. The valuation model used is based on a three year weighted average of historical Location Marginal Prices by month by node. The model also calculates separate historic values for on-peak, off-peak and 24-hour FTRs.

11. Income Taxes

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:

| Year ended December 31, | 2012 | 2011 | 2010 |
|-------------------------------------|-----------------|-----------------|-----------------|
| Federal income taxes: | | | |
| Current | \$ 324 | \$ 345 | \$ 290 |
| Deferred | 439 | 577 | 304 |
| Valuation allowance | 1 | (126) | 16 |
| | 764 | 796 | 610 |
| State income taxes: | | | |
| Current | 1,116 | 76 | 131 |
| Deferred | (848) | 151 | 205 |
| Valuation allowance | (1) | 325 | 651 |
| | 267 | 552 | 987 |
| Income tax expense (benefit) | \$ 1,031 | \$ 1,348 | \$ 1,597 |

Consistent with the prior year, Management has concluded it is more likely than not, due to enacted statutory restrictions, that certain Pennsylvania net operating loss carry-forwards will expire before being utilized and, therefore, the Company continues to report a valuation allowance against these deferred tax assets and certain other deferred tax assets with an indefinite future reversal period.

The effects of temporary differences giving rise to deferred income tax assets at December 31, 2012 and 2011, consisted of the following:

| | 2012 | 2011 |
|---|------------------|------------------|
| Deferred tax liabilities: | | |
| Fixed assets | \$ (27,169) | \$ (25,931) |
| Deferred pension and postretirement costs | (12,908) | (17,108) |
| | (40,077) | (43,039) |
| Deferred tax assets: | | |
| Pension | 24,519 | 23,843 |
| Postretirement healthcare | 22,540 | 24,331 |
| Deferred regulatory liability | 4,726 | 5,628 |
| Net operating loss carryforwards | 7,084 | 9,036 |
| Accrued expenses | 9,811 | 8,532 |
| | 68,680 | 71,370 |
| Net deferred income tax assets | 28,603 | 28,331 |
| Valuation allowance | (6,164) | (6,164) |
| Deferred income tax assets, net | \$ 22,439 | \$ 22,167 |

The income tax rate on PJM's operating activities differed from the federal statutory rate as follows:

| Year ended December 31, | 2012 | 2011 | 2010 |
|--|-----------------|-----------------|-----------------|
| Income tax at the federal statutory rate | \$ 629 | \$ 708 | \$ 701 |
| Increase (decrease) resulting from: | | | |
| Change in valuation allowance | – | – | 16 |
| Meals and entertainment | 318 | 342 | 142 |
| State income taxes, net of federal tax benefit | 174 | 300 | 651 |
| Other | (90) | (2) | 87 |
| Income tax expense (benefit) | \$ 1,031 | \$ 1,348 | \$ 1,597 |

PJM has net operating loss carryforwards of \$74.5 million for Pennsylvania state tax purposes that begin expiring in 2021. PJM also had net operating losses for federal income tax purposes that were carried back to prior periods.

PJM and its subsidiaries file a U.S. consolidated federal income tax return and separate company tax returns in the state of Pennsylvania. The statute of limitations is in effect for tax years prior to 2009 for federal purposes and state purposes. There are no ongoing audits at this time.

12. Benefit Plans

Pension Plan

PJM sponsors a defined benefit pension plan (the plan) that covers all regular full-time employees and part-time employees. Benefits under the plan are based on years of service and the employee's compensation. PJM's funding of 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, 2012 and 2011, the actuarially computed benefit obligation of the SERP included in the other employee benefits liability amounted to \$5.1 million and \$5.2 million, respectively. Pension expense for this plan was \$0.7 million, \$0.7 million and \$0.6 million for each of the years ended December 31, 2012, 2011 and 2010, respectively. 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. During 2012,

PJM began to make additional contributions to the SERP. The investment is included in other non-current assets at its market value of \$ 1.1 million and \$0.7 million as of December 31, 2012 and December 31, 2011, respectively.

Deferred Compensation Plan

PJM also sponsors a Deferred Compensation Plan to provide an opportunity to certain members of senior management and the PJM Board of Managers to defer a portion or all of their salary. At December 31, 2012 and 2011, the value of this employee liability amounted to \$5.8 million and \$5.0 million, respectively. This amount is included in Other Employee Benefits in the Consolidated Statement of Financial Position.

Postretirement Benefits

The OPEB Plan provides certain healthcare and other benefits to retired employees and their spouses and dependents. The amount of benefit at retirement will henceforth be dependent upon the employee's age and years of service as of January 1, 2016. The OPEB Plan was closed to new hires as of January 1, 2010.

The schedules that follow show the changes in the benefit obligations, plan assets and funded status as of December 31, 2012 and 2011, and components of net periodic pension and postretirement healthcare costs of these plans for the years ended December 31, 2012, 2011 and 2010.

| | Pension Benefits | | | | Other Postretirement Benefits | |
|---|----------------------------|-------------------|----------------------------|-----------------|-------------------------------|------------------|
| | Qualified | | SERP | | As of December 31, | |
| | As of December 31, 2012 | 2011 | As of December 31, 2012 | 2011 | 2012 | 2011 |
| CHANGE IN BENEFIT OBLIGATION | | | | | | |
| Net benefit obligation at beginning of year | \$ 128,361 | \$ 102,246 | \$ 5,236 | \$ 3,866 | \$ 61,443 | \$ 51,053 |
| Service cost | 7,503 | 6,000 | 260 | 213 | 4,341 | 3,877 |
| Interest cost | 6,378 | 5,727 | 244 | 245 | 2,916 | 2,893 |
| Plan participants' contributions | - | - | - | - | 157 | 167 |
| Actuarial loss/(gain) | 10,906 | 16,476 | (568) | 985 | (10,737) | 4,205 |
| Gross benefits paid | (1,010) | (2,088) | (73) | (73) | (785) | (752) |
| Net obligation at end of year | \$ 152,138 | \$ 128,361 | \$ 5,099 | \$ 5,236 | \$ 57,335 | \$ 61,443 |

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, 2012 | 2011 | As of December 31, 2012 | 2011 | 2012 | 2011 |
| CHANGE IN PLAN ASSETS | | | | | | |
| Fair value of plan assets at beginning of year | \$ 74,923 | \$ 70,377 | \$ - | \$ - | \$ 1,568 | \$ 1,513 |
| Actual return on plan assets | 12,962 | 2,634 | - | - | 276 | 55 |
| Employer contributions | 10,000 | 4,000 | 73 | 73 | 628 | 585 |
| Plan participants' contributions | - | - | - | - | 157 | 167 |
| Gross benefits paid | (1,010) | (2,088) | (73) | (73) | (785) | (752) |
| Fair value of plan assets at end of year | 96,875 | 74,923 | - | - | 1,844 | 1,568 |
| Funded status at end of year | (55,263) | (53,438) | (5,099) | (5,236) | (55,491) | (59,875) |
| Unrecognized net actuarial loss | - | - | - | - | - | - |
| Unrecognized prior service cost | - | - | - | - | - | - |
| Unrecognized net transition obligation | - | - | - | - | - | - |
| Net amount recognized at end of year and amounts recognized in the statement of financial position | \$ (55,263) | \$ (53,438) | \$ (5,099) | \$ (5,236) | \$ (55,491) | \$ (59,875) |

| | Pension Benefits | | | | Other Postretirement Benefits | |
|---|----------------------------|------------------|----------------------------|-----------------|-------------------------------|--------------------|
| | Qualified | | SERP | | As of December 31, | |
| | As of December 31, 2012 | 2011 | As of December 31, 2012 | 2011 | 2012 | 2011 |
| AMOUNTS RECOGNIZED IN DEFERRED PENSION AND POSTRETIREMENT COSTS: | | | | | | |
| Net actuarial loss | \$ 43,017 | \$ 42,129 | \$ 971 | \$ 1,609 | \$ (4,687) | \$ 6,213 |
| Prior service (gain) cost | (151) | (198) | 102 | 262 | (7,474) | (8,211) |
| Total | \$ 42,866 | \$ 41,931 | \$ 1,073 | \$ 1,871 | \$ (12,161) | \$ (1,998) |

| | Pension Benefits | | | | Other Postretirement Benefits | |
|---|----------------------------|--------------------|----------------------------|-------------------|-------------------------------|--------------------|
| | Qualified | | SERP | | As of December 31, | |
| | As of December 31, 2012 | 2011 | As of December 31, 2012 | 2011 | 2012 | 2011 |
| Amounts recognized in the statement of financial position consist of: | | | | | | |
| Current liability | \$ - | \$ - | \$ (75) | \$ (73) | \$ (997) | \$ (1,425) |
| Noncurrent liability | (55,263) | (53,438) | (5,024) | (5,163) | (54,494) | (58,450) |
| Net amount recognized at end of Year | \$ (55,263) | \$ (53,438) | \$ (5,099) | \$ (5,236) | \$ (55,491) | \$ (59,875) |

At the end of 2012 and 2011, the projected benefit obligation, the accumulated benefit obligation and the fair value of plan assets for all of PJM's pension and postretirement benefit plans are as follows:

| | Qualified | | SERP | | Other Postretirement Benefits | |
|--------------------------------|------------|------------|---------|---------|-------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| End of Year | | | | | | |
| Projected benefit obligation | \$ 152,138 | \$ 128,361 | \$5,099 | \$5,236 | \$ 57,335 | \$ 61,443 |
| Accumulated benefit obligation | 111,052 | 93,613 | 3,704 | 3,470 | 57,335 | 61,443 |
| Fair value of plan assets | 96,875 | 74,923 | - | - | 1,844 | 1,568 |

Expected Cash Flows

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

| | Qualified Benefits | SERP Benefits | Other Postretirement Benefits |
|---|--------------------|---------------|-------------------------------|
| Employer Contributions | | | |
| Expected employer contributions for 2013 to plan trusts | \$ 9,000 | \$ 1,700 | \$ – |
| Expected employer contributions in form of direct benefit payments for 2013 | – | 75 | 997 |
| Expected Benefit Payments | | | |
| 2013 | 4,148 | 75 | 997 |
| 2014 | 4,112 | 76 | 1,166 |
| 2015 | 4,513 | 612 | 1,330 |
| 2016 | 4,761 | 490 | 1,493 |
| 2017 | 5,032 | 346 | 1,696 |
| 2018-2022 | 36,886 | 1,413 | 12,878 |

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 amounts to be contributed by PJM 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, | | |
| | 2012 | 2011 | 2010 | 2012 | 2011 | 2010 | 2012 | 2011 | 2010 |
| COMPONENTS OF NET PERIODIC BENEFIT COST | | | | | | | | | |
| Service cost | \$ 7,503 | \$ 6,000 | \$ 5,265 | \$ 260 | \$ 213 | \$ 179 | \$ 4,341 | \$ 3,877 | \$ 3,465 |
| Interest cost | 6,378 | 5,727 | 5,189 | 244 | 245 | 219 | 2,915 | 2,893 | 2,602 |
| Expected return on assets | (5,476) | (5,055) | (4,315) | – | – | – | (114) | (110) | – |
| Prior service cost | (47) | (47) | (47) | 161 | 162 | 163 | (737) | (737) | (737) |
| Actuarial loss | 2,533 | 1,123 | 1,029 | 70 | 58 | 7 | – | – | – |
| Total net periodic benefit cost | \$ 10,891 | \$ 7,748 | \$ 7,121 | \$ 735 | \$ 678 | \$ 568 | \$ 6,405 | \$ 5,923 | \$ 5,330 |

For each of the years ended December 31, 2012, 2011 and 2010, \$0.9 million, \$1.4 million and \$1.4 million of total pension and postretirement benefits expense were included in capitalized project costs, respectively.

The following schedule shows the assumptions used to calculate the pension and postretirement benefit expense for the years ended December 31, 2012, 2011 and 2010.

| | Pension Benefits | | | Postretirement Benefits | | |
|--------------------------------|------------------|-------|-------|-------------------------|-------|-------|
| | 2012 | 2011 | 2010 | 2012 | 2011 | 2010 |
| Discount rate | 4.80% | 5.50% | 5.90% | 4.80% | 5.50% | 5.90% |
| Expected return on plan assets | 7.25% | 7.25% | 7.50% | 7.25% | N/A | N/A |
| Rate of compensation increase | 4.50% | 4.50% | 4.50% | N/A | N/A | N/A |
| Medical care cost trend rate | | | | | | |
| Current | | | | 8.00% | 8.50% | 8.50% |
| Ultimate | | | | 5.00% | 5.00% | 5.00% |
| Years to ultimate | | | | 6 | 7 | 7 |

The effect of a 1.00 percent increase in the assumed health care cost trend rate from 8.00 percent to 9.00 percent would increase the postretirement benefit obligation as of December 31, 2012 by \$3.5 million and the current year postretirement benefit cost by approximately \$0.7 million. A 1.00 percent decrease in the assumed healthcare cost trend rate from 8.00 percent to 7.00 percent would decrease the accumulated postretirement benefit obligation by approximately \$9.9 million and would decrease the postretirement benefit cost by approximately \$1.3 million annually.

The asset allocation for PJM's pension plan at the end of 2012 and 2011, and the target allocation for 2012 by asset category, follows. The fair value of plan assets for this plan was \$96.9 million and \$74.9 million, at the end of 2012 and 2011, respectively. In addition, the expected long-term rate of return assumption on the plan assets was 7.25 percent in 2012 and 2011.

| Asset Category | Target Allocation | 2012 | 2011 |
|-------------------|-------------------|--------|--------|
| Equity securities | 50% - 65% | 55.0% | 60.0% |
| Debt securities | 39% - 49% | 44.0% | 39.0% |
| Other | 0% - 2% | 1.0% | 1.0% |
| Total | 100.0% | 100.0% | 100.0% |

The assets of the Trust are invested to provide a source of retirement income for participants and beneficiaries in the Plan. The financial objectives of the pension 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 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 pension Trust are invested in accordance with all relevant legislation and regulation, in a manner consistent with fiduciary standards of ERISA and other applicable laws. Specifically, the investment program includes such safeguards and diversity to which a prudent investor would adhere, and all transactions undertaken on behalf of the Trust are in the sole interest of plan participants and their beneficiaries.

Fair Value Measurements

The following table presents PJM's pension assets measured at fair value and their respective levels within the fair value hierarchy as of December 31, 2012 and 2011:

| As of December 31, 2012 (a) | Level 1 | Level 2 | Level 3 | Total |
|----------------------------------|---------------|------------------|-------------|------------------|
| Pension Plan Assets: | | | | |
| Cash Equivalents | \$ 940 | \$ – | \$ – | \$ 940 |
| Commingled Funds | – | 76,124 | – | 76,124 (b) |
| Fixed Income | – | 21,655 | – | 21,655 (c) |
| Total Pension Plan Assets | \$ 940 | \$ 97,779 | \$ – | \$ 98,719 |

As of December 31, 2011 (a)

| | | | | |
|----------------------------------|---------------|------------------|-------------|------------------|
| Pension Plan Assets: | | | | |
| Cash Equivalents | \$ 594 | \$ – | \$ – | \$ 594 |
| Commingled Funds | – | 45,330 | – | 45,330 (b) |
| Fixed Income | – | 30,567 | – | 30,567 (c) |
| Total Pension Plan Assets | \$ 594 | \$ 75,897 | \$ – | \$ 76,491 |

(a) See Footnote 10 for a description of levels within fair value hierarchy.

(b) The benefit plans own commingled funds that invest in equity and fixed income securities.

(c) This category predominantly represents diverse issues of domestic, investment-grade fixed income securities.

Valuation Techniques Used to Determine Fair Value

Cash equivalents – Investments with maturities of three months or less when purchased, including certain short-term fixed-income securities, are considered cash equivalents and are included in the recurring fair value measurements hierarchy as Level 1.

Commingled funds – Commingled funds are maintained by investment companies and hold certain investments in accordance with a stated set of fund objectives, which are consistent with PJM's overall investment strategy. The values of the majority of commingled funds are not publicly quoted and must trade through a broker. For equity and fixed-income commingled funds traded through a broker, the fund administrator values the fund using the net asset value per fund share, derived from quoted prices in active markets of the underlying securities. These funds have been categorized as Level 2.

Fixed income – For fixed income securities, multiple prices and price types are obtained from pricing vendors whenever possible, which enables cross-provider validations in addition to checks for unusual daily movements. A primary price source is identified based on asset type, class or issue for each security. Fidelity Investments, the fund manager, monitors prices supplied by pricing services and may use a supplemental price source or change the primary price source of a given security if the portfolio managers challenge an assigned price and Fidelity determines that another price source is considered to be preferable. The fixed income securities have been categorized as Level 2.

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 \$3.0 million, \$2.8 million and \$2.6 million for the years ended December 31, 2012, 2011 and 2010, respectively. This expense is included in compensation in the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income.

13. Commitments and Contingencies

Leases

PJM leases office space, furniture, computer and copier equipment under operating and capital leases with various vendors. These leases are noncancelable and expire during the period from 2013 to 2099.

Future minimum rentals under noncancelable lease agreements are as follows:

| Year Ending December 31, | |
|--------------------------|------------------|
| 2013 | \$ 2,847 |
| 2014 | 2,484 |
| 2015 | 2,521 |
| 2016 | 2,566 |
| Remaining | 29,345 |
| Total | \$ 39,763 |

Regulatory Items

Consolidated Edison Wheel Proceeding

In 2001, Consolidated Edison Company of New York, Inc. (ConEd) filed a complaint with the FERC concerning the implementation by PJM, the New York Independent System Operator (NYISO), and Public Service Electric and Gas Company (PSEG) of certain contracts entered into in the 1970s between ConEd and PSEG. After the FERC issued a series of decisions, PJM, the NYISO, and PSEG filed with the FERC a set of operating protocols intended

to resolve the proceeding and guide future operations under the contracts. Subsequently, ConEd claimed that PJM and the NYISO had not properly implemented the approved protocols and had jointly caused alleged damage to ConEd and its customers of \$111 million, of which \$9.5 million are described as direct losses.

On February 23, 2009, the parties to the complaint filed with the FERC a settlement offer to resolve all issues in this matter pending at the FERC and in the D.C. Circuit Court of Appeals. The settlement, if approved by the FERC, would provide "rolled over" service between ConEd and PSEG in accordance with transmission service agreements between PJM and ConEd and joint operating protocols between PJM and the NYISO. The filed settlement was contested.

On September 16, 2010, the Commission issued an Order Approving Contested Settlement and Denying Rehearing and found that the settlement and the related non-conforming transmission service agreements and Joint Operating Agreement Protocol are just and reasonable. On October 18, 2010, the NRG Companies filed a Request for Rehearing appealing the September 16, 2010 Order. On April 18, 2011, the Commission issued an Order on Rehearing and Motions (the Rehearing Order). In this order, the Commission denies with only limited exception NRG's filing for a rehearing of the September 16, 2010 Order issued in this proceeding, approving the contested settlement and related transmission service agreements filed by PJM on behalf of the settling parties. On June 1, 2011, NRG filed an appeal of the Rehearing Order to the United States Court of Appeals for the District of Columbia. The outcome of this matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

Other Items

Member's Employee Lawsuit

In April 2009, an employee of PPL Electric Utilities (PPL) brought a negligence lawsuit in the Philadelphia Court of Common Pleas against PJM, PPL and several PJM members related to injuries that a PPL employee received while installing a wave trap at a PPL substation. PJM filed Preliminary Objections in June 2009, stating that it was wrongly named as a defendant because PJM does not own the equipment that the Plaintiff was working on and had no responsibility for the safety of a PPL employee working on such equipment. The other defendants in this lawsuit were ultimately dismissed from the case. PJM remains the only defendant in the case.

On October 5, 2011, in accordance with the procedural schedule, PJM filed a Motion for Summary Judgment. PJM raised three dispositive legal defenses in its motion, that: (1) PJM's FERC-approved filed tariff limits PJM's liability from, among other claims, third party negligence claims; (2) the Plaintiff's negligence claims are preempted by federal law as PJM is a FERC-regulated regional transmission organization that is not, and cannot be, responsible for, among other things, the safety of its transmission owning members' employees as such would be in conflict with the Federal Power Act and PJM's FERC-approved tariff; and (3) even if the court rejected PJM's first two arguments, the Plaintiff's claim should be dismissed because the Plaintiff failed to establish that PJM owed a duty to the Plaintiff or that PJM's actions were the cause of the Plaintiff's injuries.

In response, the Plaintiff argued the case must go before a jury to decide whether, based on PJM's operational and functional control of its transmission system, PJM had a duty to ensure the safety of PPL's employees. The court denied the motion for summary judgment in a one-sentence order on March 9, 2012. PJM has sought reconsideration and appeal of that order. The trial, which was set to begin on June 11, 2012, is being held in abeyance pending the appeal.

On March 12, 2012, PJM sought a Declaratory Order from the FERC asking the FERC to rule on two narrow, but important issues: (i) whether PJM has the responsibility under its tariffs to oversee worker safety in maintenance operations performed by employees of the Transmission Owners (TOs), and (ii) whether the bar to ordinary negligence claims set forth in PJM's Tariff applies when PJM executes its RTO functions of planning for future grid reliability and approving the request by one of its member TOs to schedule an outage of the TO's transmission facilities.

On June 7, 2012, the FERC granted PJM's Petition for Declaratory Order ruling that PJM does not have responsibility for worker safety in maintenance operations by its TOs' employees; and the limitation of liability in PJM's tariff applies when PJM executes its RTO functions. The Plaintiff sought rehearing and clarification of the FERC's order. On January 8, 2013, the FERC denied the Plaintiff's rehearing request, affirming its June 7 Order. PJM lodged the FERC orders in the pending appeal in the PA Superior Court, as well as in the Philadelphia Court of Common Pleas.

On September 18, 2012, PJM filed its brief in the PA Superior Court asking the court to overturn Philadelphia Court of Common Pleas denial of PJM's Motion for Summary Judgment. The Plaintiff filed its brief on November 19, 2012, and PJM filed a reply brief on December 6, 2012. Oral arguments were held on February 5, 2013, and PJM is awaiting the court's decision.

PJM cannot predict the outcome of this matter, but does not foresee any material adverse impact on PJM's financial position, results of operations or cash flow.

Lehman Brothers Commodities Services Default

On and before September 15, 2008, the activity in the PJM markets of Lehman Brothers Commodities Services (LBCS), a PJM member, was supported by a guaranty issued by the parent company of LBCS, Lehman Brothers Holdings, Inc. (LBHI). On September 15, 2008, LBHI filed a petition in bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York. PJM issued a collateral call to LBCS on September 15, 2008, given the adverse change to LBCS's guarantor. LBCS did not meet its collateral call, and on September 18, 2008, LBCS was declared to be in default of its obligations, and its transaction rights in PJM were terminated. LBCS ultimately filed its own bankruptcy petition on October 3, 2008. LBCS did not pay their regular monthly invoices for market activity from August 2008 through and including May 2009, for a total of approximately \$18 million. The aggregate payment defaults were billed to non-defaulting members in accordance with the default allocation assessment formula in PJM's Operating Agreement. LBCS has not had any open positions with the Company since June 1, 2009. On September 18, 2009, PJM filed Proofs of Claim, along with supporting documentation, with the Bankruptcy Court setting forth PJM's creditor claim against both LBCS and LBHI.

On December 18, 2012, PJM reached an agreement with Lehman's bankruptcy plan administrator to allow and approve \$17 million of PJM's original claim. PJM's original claim was reduced on the basis that Lehman challenged PJM's right to set off certain amounts from the claim that were due to Lehman prior to bankruptcy and because several PJM Members utilized their portion of the PJM assessed default allocation payment to set-off amounts they owed to Lehman. As a result of the agreement, PJM will qualify for distributions from the Lehman bankruptcy estate beginning in April, 2013, and also will qualify at that time for two catch-up payments for past distributions. Any distributions received will be allocated to members based on their pro-rata share of the default assessment. The outcome of the matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

Marginal Line Loss Surplus Payment Reallocation

Between July 17, 2012 and July 20, 2012, 14 companies defaulted on payment obligations totaling \$28.0 million, net of collateral held by PJM Settlement. These obligations resulted from reallocations for previously ordered and provided refunds made to certain market participants for billing adjustments related to the marginal line loss payment surplus allocation methodology under PJM's Operating Agreement and Tariff, which was ordered by the

FERC at Docket No. EL08-14 on July 21, 2011. These unpaid obligations were collected during August 2012 from PJM Settlement's non-defaulting members. PJM Settlement is considering all alternatives to enforce its contract rights from all non-paying companies, and to this end, has filed two complaints in civil action alleging breach of contract in the state of Delaware against former members. The first complaint, naming City Power Marketing, L.L.C., Energy Endeavors, L.L.C., Energy Endeavors, LP and Crane Energy, LP, seeks the recovery of approximately \$23 million owed to PJM Settlement, while the second complaint, naming Round Rock Energy, L.L.C., Round Rock Energy, LP, Huntrise Energy Fund, L.L.C. and certain named principals individually, seeks the recovery of approximately \$4.25 million.

Under the terms of the PJM Operating Agreement, any payment defaults may be billed and collected from PJM Settlement's other member companies. The outcome of any defaults is not anticipated to have a material adverse effect on PJM's financial position, results of operations or cash flow.

Member Complaint

On October 2, 2012, North American Natural Resources, Inc. (NANR) filed a complaint with the FERC in Docket No. EL13-10-000 against American Electric Power Service Corporation and Indiana Michigan Power Company (together AEP) and PJM. The complaint alleged that AEP and PJM violated PJM's Tariff thereby requiring NANR to fund more upgrades than was the minimum necessary to interconnect its landfill gas generation project to the transmission system. NANR also complained that AEP and PJM required it to post more security than was necessary. The complaint asks for a refund of approximately \$2.5 million. On October 22, 2012, PJM filed a Motion for Summary Disposition and an Answer to the complaint, defending that it did not violate its Tariff. AEP filed a similar Answer asking the FERC to dismiss the complaint. On January 17, 2013, the FERC issued an order setting the complaint for hearing and settlement procedures. The outcome of this matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

Member Complaint

On October 19, 2012, Dominion Resources Services, Inc., on behalf of PJM Members Virginia Electric and Power Company (d/b/a Dominion Virginia Power) and Dominion Retail, Inc., filed a complaint against PJM with the FERC in Docket No. EL13-12-000. The complaint alleges that PJM's September 13, 2012 change in how it schedules resources needed for reliability in the Day-Ahead Energy Market resulted in an unjust and unreasonable increase in the allocation of Day-Ahead Operating Reserves charges to Load Serving Entities that did not benefit from the reliability

services. Dominion Resources Services, Inc. asserts that as a result of this change, Dominion Virginia Power has sustained, and will continue to sustain, approximately \$40,000 per day in additional Day-Ahead Operating Reserve charges, and Dominion Retail, Inc. will incur an average of \$90,000 per month in additional Day-Ahead Operating Reserve charges. They expect these additional charges to total approximately \$7.5 million and \$0.5 million, respectively, by the March 1, 2013 date on which it assumed PJM would seek to incorporate an amendment to its Tariff and Operating Agreement to change how these charges are allocated.

PJM filed an answer to the complaint on November 1, 2012, advising that it has initiated a stakeholder process to address the cost allocation issues raised in the complaint and argued that the complaint should not circumvent the stakeholder process. On November 30, 2012, after an expedited stakeholder process, PJM filed proposed revisions to its Day-Ahead Operating Reserves charges cost allocation provisions in the Tariff and Operating Agreement. The FERC approved this request on January 28, 2013, with an effective date of December 1, 2012, and dismissed the complaint.

Legal

PJM is routinely involved in legal actions. 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.

14. Related Party Transactions

PJM occupies two buildings that are owned by a subset of PJM's members. 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 one of PJM's Control Centers 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, 2012 or 2011, respectively.



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