

PJM INTERCONNECTION, L.L.C.

FOR THE QUARTER ENDED SEPTEMBER 30, 2009

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**PART I . FINANCIAL INFORMATION**  
**ITEM 1. FINANCIAL STATEMENTS**

Unaudited

**PJM INTERCONNECTION, L.L.C.**  
**Consolidated Statements of Financial Position**  
(\$ in thousands)

	<u>September 30, 2009</u>	<u>December 31, 2008</u>
<b>Assets</b>		
Current assets:		
Deposits on hand	\$ 633,832	\$ 881,296
Operating cash	33,542	57,550
Receivables	19,380	4,981
Study and interconnection receivables	5,930	4,476
Prepaid income taxes	9,223	5,186
Prepaid expenses and other current assets	5,701	4,645
Deferred income taxes, net of valuation allowance	7,391	1,552
	<u>714,999</u>	<u>959,686</u>
Non-current assets:		
Fixed assets, net of accumulated depreciation and amortization of \$309,344 and \$295,504	76,306	63,791
Land	1,420	956
Projects in development	83,587	64,016
Deferred recovery of pension and postretirement costs	10,843	26,849
Deferred income taxes, net of valuation allowance	20,073	2,584
Note receivable	4,245	4,690
Other	1,073	836
	<u>197,547</u>	<u>163,722</u>
Total assets	<u>\$ 912,546</u>	<u>\$ 1,123,408</u>
<b>Liabilities, paid in capital, retained earnings and accumulated other comprehensive income</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 15,017	\$ 39,015
Member prepayment	-	44,069
Study and interconnection payables	7,223	5,826
Accrued payroll and benefits	12,803	15,417
Revolving line of credit	-	20,000
Current portion of long-term debt	8,103	-
Current portion of non-recourse debt	311	311
Deferred regulatory liability	43,991	14,366
Deferred revenue	528	1,853
Postretirement healthcare benefits liability	1,024	1,024
Other employee benefits	52	52
Deposits	633,832	881,296
	<u>722,884</u>	<u>1,023,229</u>
Non-current liabilities:		
Long-term debt	101,120	-
Non-recourse debt	274	735
Deferred regulatory liability	14,299	14,299
Interest rate swap	660	-
Pension benefits liability	28,766	30,378
Postretirement healthcare benefits liability	38,398	49,737
Other employee benefits	3,202	2,764
	<u>186,719</u>	<u>97,913</u>
Total liabilities	<u>909,603</u>	<u>1,121,142</u>
Paid in capital	722	722
Retained earnings	1,871	1,248
Accumulated other comprehensive income	350	296
Total paid in capital, retained earnings and accumulated other comprehensive income	<u>2,943</u>	<u>2,266</u>
Total liabilities, paid in capital, retained earnings and accumulated other comprehensive income	<u>\$ 912,546</u>	<u>\$ 1,123,408</u>

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

**PJM INTERCONNECTION, L.L.C.**  
**Consolidated Statements of Income, Comprehensive Income and Paid in Capital,**  
**Retained Earnings and Accumulated Other Comprehensive Income**  
(\$ in thousands)

	(Unaudited)			
	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2009	2008	2009	2008
<b>Income</b>				
Revenue:				
Service fees	\$ 59,148	\$ 64,170	\$ 172,341	\$ 182,404
Deferred regulatory income	(15,362)	(18,028)	(59,933)	(47,151)
FERC fee reimbursement	10,320	9,904	30,003	28,465
Study and interconnection fees	816	811	2,664	2,052
Interest income	470	4,633	3,873	15,882
Membership fees	525	486	1,504	1,382
Other income	719	490	1,741	1,169
Total revenue	<u>56,636</u>	<u>62,466</u>	<u>152,193</u>	<u>184,203</u>
Operating expenses:				
Compensation	21,627	21,061	64,770	63,957
Depreciation and amortization expense, including deferral recovery	4,864	3,821	13,857	11,117
FERC fees	10,320	9,904	30,003	28,465
Outside services	8,424	10,859	30,109	29,842
Pension benefits	1,773	1,027	5,174	3,108
Postretirement healthcare benefits	931	1,732	4,586	4,909
Computer maintenance and office supplies	1,693	1,584	5,683	5,060
Software licenses and fees	2,373	1,941	6,617	6,273
Lease expenses	761	803	2,218	2,258
Study and interconnection services	816	811	2,664	2,052
Other expense	2,627	3,024	7,961	8,036
Interest expense	1,695	4,079	5,186	13,787
Total operating expenses	<u>57,904</u>	<u>60,646</u>	<u>178,828</u>	<u>178,864</u>
(Loss) income before income taxes	(1,268)	1,820	(26,635)	5,339
Income tax (benefit) expense	<u>(1,488)</u>	<u>1,655</u>	<u>(27,258)</u>	<u>4,920</u>
Net income	220	165	623	419
Other comprehensive income:				
Unrealized gain (loss) on securities, net of taxes	8	(49)	54	(116)
Comprehensive income, net	<u>\$ 228</u>	<u>\$ 116</u>	<u>\$ 677</u>	<u>\$ 303</u>
<b>Paid in capital, retained earnings and accumulated other comprehensive income</b>				
Beginning balance	\$ 2,715	\$ 1,916	\$ 2,266	\$ 1,729
Net income	220	165	623	419
Other comprehensive income (loss)	8	(49)	54	(116)
Ending balance	<u>\$ 2,943</u>	<u>\$ 2,032</u>	<u>\$ 2,943</u>	<u>\$ 2,032</u>

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

**PJM INTERCONNECTION, L.L.C.**  
**Consolidated Statements of Cash Flows**  
(\$ in thousands)

(Unaudited)  
**Nine months ended**  
**September 30,**

	<b>2009</b>	<b>2008</b>
Cash flows from operating activities:		
Net income	\$ 623	\$ 419
Adjustments:		
Depreciation and amortization expense	13,857	11,117
Deferred income taxes, net of valuation allowance	(23,328)	3,223
Deferred recovery of pension and postretirement costs	16,006	1,601
Deferred regulatory liability	59,933	(19,771)
Employee benefit expense (less than) greater than funding	(12,513)	3,785
Net fair value changes related to interest rate swap	660	-
Changes in assets and liabilities:		
(Increase) decrease in receivables	(14,399)	25,237
(Increase) in interconnection receivables	(1,454)	(1,977)
(Increase) in prepaid expenses and other	(1,256)	(42)
(Increase) decrease in prepaid income taxes	(4,037)	875
(Decrease) in accounts payable and accrued expenses	(21,349)	(44,907)
Increase in interconnection payables	1,397	2,094
(Decrease) in accrued payroll and benefits	(2,614)	(940)
(Decrease) in deferred FERC fee liability	-	(4,600)
(Decrease) in deferred revenue	(1,325)	(1,177)
Refunds to members	(30,308)	-
Net cash used in operating activities	(20,107)	(25,063)
Cash flows from investing activities:		
Cost of projects in development	(49,039)	(42,805)
Note receivable	445	(5,467)
Net cash used in investing activities	(48,594)	(48,272)
Cash flows from financing activities:		
Repayments under project facility	-	(967)
Borrowings under line of credit	269,000	-
Repayments under line of credit	(289,000)	-
Borrowings under private placement agreement	75,000	-
Borrowings under long-term debt	35,000	-
Repayments under long-term debt	(777)	-
Repayments under non-recourse debt	(461)	(439)
(Decrease) increase in deposits held	(247,464)	388,347
Member prepayment applied	(44,069)	-
Net cash (used in) provided by financing activities	(202,771)	386,941
Net (decrease) increase in cash and cash equivalents	(271,472)	313,606
Cash and cash equivalents balance, beginning of period	938,846	657,460
Cash and cash equivalents balance, end of period	\$ 667,374	\$ 971,066
Noncash Activity:		
Plant additions included in ending Accounts Payable and Accrued Expenses	(2,649)	(4,738)

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

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

**1. Summary of Critical Accounting Policies**

***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 Interconnection, L.L.C. 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.

The interim financial data as of September 30, 2009 and for the three-month and nine-month periods ended September 30, 2009 and September 30, 2008 are unaudited; however, in the opinion of the Company, the interim data includes those adjustments of a normal recurring nature, necessary for a fair statement of the results of the interim periods.

The Financial Accounting Standards Board (FASB) has issued FASB Statement No. 168, *The "FASB Accounting Standards Codification™" and the Hierarchy of Generally Accepted Accounting Principles™* (Codification). SFAS No. 168 establishes the FASB Accounting Standards Codification™ (ASC) as the single source of authoritative United States of America GAAP recognized by the FASB. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. The Codification supersedes all existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the Codification will become nonauthoritative.

Following the Codification, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates, which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification.

GAAP is not intended to be changed as a result of the FASB's Codification project, but it will change the way the guidance is organized and presented. As a result, these changes will have a significant impact on how companies reference GAAP in their financial statements and in their accounting policies for financial statements issued for interim and annual periods ending after September 15, 2009. PJM has implemented the Codification in this quarterly report by providing references to the Codification topics alongside references to the ASC standards where applicable.

Authoritative guidance on Business Combinations (ASC 805) retains the fundamental requirements that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. However, this guidance expands the definition of a business and amends the authoritative guidance on accounting for Income Taxes, to require the acquirer to recognize changes in the amount of its deferred tax benefits that are realizable because of a business combination either in income from continuing operations or directly in contributed capital, depending on the circumstances. Guidance on Business Combinations applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. PJM adopted the authoritative Business Combinations guidance on January 1, 2009. Its adoption did not have any impact on PJM's overall financial condition, results of operations, or cash flows.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

Authoritative guidance on Noncontrolling Interests in Consolidated Financial Statements (ASC 810) establishes accounting and reporting standards that require (i) the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity, and the related consolidated net income to be presented separately on the face of the consolidated statement of earnings, (ii) the changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for as equity transactions, and (iii) when a subsidiary is deconsolidated, any retained non-controlling equity investment in the former subsidiary must be initially measured at fair value. This guidance was effective prospectively for financial statement reporting periods beginning January 1, 2009 for PJM. Its adoption on the effective date did not have any impact on PJM's overall financial condition, results of operations, or cash flows.

Authoritative guidance on Derivative Instruments and Hedging Activities (ASC 815) enhances the disclosure requirements for derivative instruments and hedging activities. Some of the new disclosures include derivative objectives and strategies, derivative volumes by product type, location and gross fair values of derivative assets and liabilities, location and amounts of gains and losses on derivatives and related hedged items, and credit-risk-related contingent features in derivatives. This guidance was effective for financial statement reporting periods beginning January 1, 2009 for PJM. PJM has adopted these provisions with disclosures related to PJM's interest rate swap within Footnote 7 "Derivative Financial Instrument".

Beginning with its second quarter 2009 financial statements, PJM adopted new FASB guidelines for Subsequent Events (ASC 855). This guidance establishes general standards of accounting for and disclosure of events that occurred after the balance sheet reporting date but before the financial statements are issued. The statement is based on the same principles as those that previously existed, however the new guidance requires the disclosure of the date through which subsequent events have been evaluated by Management, as well as whether the date is the date the financial statements were issued or the date the financial statements were available to be issued. The statement was effective for interim or annual financial periods ending after June 15, 2009, which began with the second quarter of 2009 for PJM.

PJM has performed an evaluation of subsequent events through November 4, 2009 which is the date the financial statements were issued.

## **2. Deferred Regulatory Liability**

PJM recovers its administrative costs under its stated rate tariff effective since June 1, 2006.

The stated rate 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 expenses incurred under the Advanced Second Control Center (AC<sup>2</sup>) rider. The amount accumulated under those provisions is classified as a non-current liability in the Company's Consolidated Statement of Financial Position. As the stated rate tariff was originally filed for the years 2006 through 2010, to the extent that such deferred regulatory liability exceeded six percent of PJM's revenues during any calendar year, PJM was to and did until 2008 refund such excess ratably over a nine-month period commencing April 1 of the following year. Refunds in any year were to be limited to amounts that would not reduce the regulatory liability balance below an amount equal to two percent of revenues collected in the previous year.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

On January 31, 2008, PJM filed with the Federal Energy Regulatory Commission (FERC) a proposal to accelerate the stated rate refund mechanism for deferred regulatory liabilities accumulating in 2008 and forward. The FERC approved this proposal on March 12, 2008 with an effective date of April 1, 2008. Beginning in 2009, the original refund mechanism was discontinued. PJM now 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 three month and nine month periods ended September 30, 2009, PJM made refunds of \$3.9 million and \$30.3 million, respectively.

There will not be a true-up mechanism; any under or over refund amounts will be reflected in the deferred regulatory liability balance in the following quarter. In 2011 and every third year thereafter, refunds will not reduce the non-current liability balance below \$6 million.

In accordance with the authoritative guidance for Regulatory Accounting (ASC 980), 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 stated rate tariff exceed expenses in the reporting period. The amount by which cumulative revenues under the stated rate tariff exceed cumulative expenses and stated rate 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 September 30, 2009 the deferred regulatory liability was \$58.3 million. At December 31, 2008 the deferred regulatory liability was \$28.7 million. At September 30, 2009 and December 31, 2008, the current portion of the deferred regulatory liability was \$44.0 million and \$14.4 million, respectively. The current balance at September 30, 2009 represents the amount to be refunded to members in the fourth quarter of 2009. The non-current portion of the deferred regulatory liability of \$14.3 million represents the amount of PJM's reserve at both September 30, 2009 and December 31, 2008.

### **3. 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, LLC (MA). MA operates independent of PJM management and Board of Managers oversight. 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 PJM Open Access Transmission tariff (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 September 30, 2009 and December 31, 2008, the outstanding balance due from MA recorded by PJM as a note receivable was \$4.2 million and \$4.7 million, respectively.

### **4. Short-Term Debt**

PJM has a \$50 million revolving credit agreement with National Cooperative Services Corporation (NCSC). The revolving credit agreement has a five-year term and will expire in May 2010. The facility is unsecured and is available to fund short-term cash obligations. FERC approval for borrowings under this facility must be requested biennially. On January 30, 2009, PJM filed with the

FERC to extend the draw date and the maturity of this revolving credit facility through April 2011. The FERC approved this extension application on March 31, 2009.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

Under the loan covenants for the \$50 million revolving credit agreement, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of September 30, 2009. At September 30, 2009, there were no outstanding borrowings under the revolving credit agreement. There was \$20 million in outstanding borrowings under the revolving credit agreement as of December 31, 2008. The interest rate on borrowings under this revolving credit agreement is based on NCSC's variable interest rate. This variable interest rate can change effective the first or 16th of any month. At September 30, 2009 and December 31, 2008, the interest rate was 6.05 percent and 5.00 percent, respectively.

**5. Long-term debt**

*NSCS Project Development Facility*

PJM has a \$110 million project development facility with NCSC. This facility is available for asset development and has a four-year drawdown period and a 10-year amortization period. The drawdown period under the long-term project development facility will expire in April 2011. FERC approval for borrowings under this facility must be requested biennially. On January 30, 2009, PJM filed with the FERC for its approval to extend the draw date and the maturity of this revolving credit facility through April 2011. The FERC approved this extension application on March 31, 2009. The facility is collateralized by all of PJM's tangible and intangible property other than the assets acquired pursuant to an agreement (the Facilities Agreement) between PJM and a subset of PJM's members (the Facility Owners) and the AC<sup>2</sup> property.

Under the loan agreement for the \$110 million project development facility, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of September 30, 2009. As of September 30, 2009 and December 31, 2008 there were no outstanding borrowings under this facility. The interest rate on borrowings under this project development facility is based on NCSC's variable interest rate. The variable interest rate can change effective the first or 16th of any month. At September 30, 2009 and December 31, 2008, the interest rate was 6.05 percent.

*PNC Bank Loan Agreement*

On March 31, 2009, FERC approved PJM's application to enter into a \$35 million loan agreement with PNC Bank (PNC). The loan has a seven-year term and is secured by the AC<sup>2</sup> 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 September 30, 2009, outstanding borrowings under this loan were \$34.2 million. The interest rate is based on the London Interbank Offered Rate (LIBOR) in effect at each reset date plus a spread of 135 basis points. The reset date is monthly. As of September 30, 2009, the interest rate was 1.60875%.

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 September 30, 2009.

*Private Placement Loan Agreement*

On March 28, 2008, 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% per annum. Payments are due semi-annually on March 15 and September 15 with the first principal payment due 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.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

As of September 30, 2009, outstanding borrowings were \$75 million.

Under the loan agreement for the \$75 million private placement, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of September 30, 2009.

**6. Non-recourse Debt**

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

Outstanding borrowings were \$0.6 million and \$1.0 million at September 30, 2009 and December 31, 2008, respectively. The interest rate on the outstanding principal is fixed at 3 percent per year. There is no commitment fee for this loan.

**7. Derivative Financial Instrument**

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. PJM accounts for its derivative activity in accordance with the derivative accounting guidance issued by the FASB (ASC 815). This guidance requires companies to recognize all derivative instruments as either assets or liabilities at fair value in the Consolidated Statement of Financial Position.

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% 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 September 30, 2009, the fair value of the swap of \$0.7 million was reported as an interest rate swap in the non-current liability section of the Consolidated Statement of Financial Position. For the three months and nine months ended September 30, 2009, the unrealized loss of \$0.5 million and \$0.7 million was recorded as interest expense in the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income, respectively.

For the three months and nine months ended September 30, 2009, the amount of the derivative gains (losses) PJM recognized in earnings is provided in the table below:

	<b>Three months ended September 30, 2009</b>	<b>Nine months ended September 30, 2009</b>
Unrealized mark-to-market losses	<u>(\$ 535)</u>	<u>(\$ 660)</u>
Total net mark-to-market losses	<u>(\$ 535)</u>	<u>(\$ 660)</u>

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

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

**8. Fair Value Disclosures**

Effective January 1, 2008, PJM adopted the FASB guidance which establishes a framework for measuring fair value and expanded the required disclosures about fair value instruments (ASC 820).

Under this guidance, 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 does not have any instruments valued based on level 3 pricing inputs.

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 September 30, 2009, those financial assets and liabilities measured at fair value using level one 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.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

**9. Benefit Plans**

	<b>Pension Benefits</b>				<b>Other Post</b>	
	<b>Qualified</b>		<b>SERP</b>		<b>Retirement Benefits</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Components of net periodic benefit cost for the period July 1 to September 30</b>						
Service cost	\$ 1,079	\$ 1,078	\$ 43	\$ 43	\$ 774	\$ 1,124
Interest cost	1,157	1,091	54	43	514	780
Expected return on assets	(804)	(1,049)	-	-	-	-
Amortization of:						
Transition obligation	-	-	1	1	-	9
Prior service cost	(12)	(12)	80	23	(184)	10
Actuarial loss	348	-	-	(25)	-	-
<b>Total net periodic benefit cost</b>	<b>\$ 1,768</b>	<b>\$ 1,108</b>	<b>\$ 178</b>	<b>\$ 85</b>	<b>\$ 1,104</b>	<b>\$ 1,923</b>

For each the three months ended September 30, 2009 and September 30, 2008, \$0.3 million of total pension and postretirement benefits expense were included in capitalized project costs, respectively.

	<b>Pension Benefits</b>				<b>Other Post</b>	
	<b>Qualified</b>		<b>SERP</b>		<b>Retirement Benefits</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Components of net periodic benefit cost for the period January 1 to September 30</b>						
Service cost	\$ 3,320	\$ 3,270	\$ 131	\$ 132	\$ 3,068	\$ 3,175
Interest cost	3,489	3,295	141	130	2,208	2,200
Expected return on assets	(2,468)	(3,224)	-	-	-	-
Amortization of:						
Transition obligation	-	-	3	3	19	29
Prior service cost	(35)	(35)	105	38	(165)	29
Actuarial loss	1,032	-	-	-	-	-
<b>Total net periodic benefit cost</b>	<b>\$ 5,338</b>	<b>\$ 3,306</b>	<b>\$ 380</b>	<b>\$ 303</b>	<b>\$ 5,130</b>	<b>\$ 5,433</b>

For the nine months ended September 30, 2009 and September 30, 2008, \$1.1 million and \$0.7 million of total pension and postretirement benefits expense were included in capitalized project costs, respectively.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

	<b>Pension Benefits</b>				<b>Other Post Retirement Benefits</b>	
	<b>Qualified</b>		<b>SERP</b>		<b>2009</b>	<b>2008</b>
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>		
<b>Assumptions used to determine net periodic benefit cost as of September 30</b>						
Discount rate	6.10%	6.20%	6.10%	6.20%	6.10%	6.20%
Expected return on plan assets	7.75%	7.75%	N/A	N/A	N/A	N/A
Rate of compensation increase	4.50%	4.50%	5.00%	5.00%	N/A	N/A
Health care cost trend on covered charges:	N/A	N/A	N/A	N/A		
Current					9.25%	10.00%
Ultimate					5.00%	5.00%
Years to ultimate					7	8

On June 24, 2009, the PJM Board of Managers approved changes to the Company's Other Post Retirement Benefits (OPEB) Plan. The OPEB Plan provides certain healthcare and other benefits to retired employees and their spouses and dependents. The revisions to the OPEB Plan were for post-65 medical coverage. 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 will be closed to new hires as of January 1, 2010.

A revaluation of the OPEB plan occurred on June 30, 2009. The underlying assumptions were reviewed at revaluation and the discount rate was changed to 6.20%. The effect of this plan change determined by the revaluation has been recorded in the second quarter financial statements. The impact of the plan changes and assumptions was a reduction of \$11.3 million in the OPEB liability and related deferred pension and post-retirement costs.

## **10. Income Taxes**

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

	<b>Nine months ended</b>	
	<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>
Income (benefit) tax at the federal statutory rate	\$ (9,056)	\$ 1,868
Increase (decrease) resulting from:		
Change in valuation allowance	(14,395)	1,863
State income taxes, net of federal tax benefit	(2,957)	800
Additional deferred tax asset for fixed asset adjustment	(926)	-
Additional tax for 2005/2006 tax years	-	159
Other	76	230
<b>Income tax (benefit) expense</b>	<b>\$ (27,258)</b>	<b>\$ 4,920</b>

**Notes to Consolidated Financial Statements**  
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As discussed in Note 10, during 2009, PJM revised the OPEB Plan to limit the amount of benefit employees will receive in the future as well as closing the Plan to new hires beginning January 1, 2010. Along with the revisions in benefits, PJM will begin funding future benefits through a 401 (h) plan. Due to these changes, PJM reassessed the recoverability of certain deferred tax assets related to OPEB. Management concluded it was more likely than not the income tax benefit related to these future tax deductions would be realized and therefore released the valuation allowance previously established. Similarly, PJM released the valuation allowance associated with the Supplemental Executive Retirement Plan because Management believes it is more likely than not that these deferred tax assets will be utilized in the future. 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 record a valuation allowance against these deferred tax assets and certain other deferred tax assets with an indefinite future reversal period.

Guidance for accounting for income taxes (ASC 740) requires that the impact of a tax position be recognized if that position is more likely than not of being sustained on tax authority audit, based on the technical merits of the position. As of September 30, 2009, PJM does not have a FIN 48 (ASC 740) liability or receivable recorded.

PJM and its subsidiary file a U.S. consolidated federal income tax return and separate company tax returns in the state of Pennsylvania. The statute of limitations has expired for tax years prior to 2005 for Federal purposes and state purposes. There are no ongoing audits at this time.

## **11. Commitment and Contingencies**

### ***Regulatory Items***

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 FERC a set of operating protocols intended to resolve the proceeding and guide future operations under the contracts. In approving these protocols, the FERC required a series of post-implementation reports to be submitted. Subsequently, in reports submitted by ConEd on September 30, 2005, December 30, 2005, and January 19, 2007, ConEd had claimed that PJM and the NYISO had not properly implemented the approved protocols and have jointly caused alleged damage to ConEd and its customers of \$111 million, of which \$9.5 million are described as direct losses. ConEd asked the FERC to initiate further proceedings and to make a determination of the amount of refunds necessary to make ConEd whole for these alleged economic consequences. PJM and the NYISO have responded to ConEd's allegations and denied ConEd's right to the refunds it seeks. On April 20, 2007, the FERC dismissed all of ConEd's requests for relief as procedurally insufficient and rejected its request that the FERC institute hearing and settlement procedures. On May 21, 2007, ConEd filed a Petition for Rehearing of the FERC's April 20, 2007 Order. PSEG and ConEd filed appeals with the D.C. Circuit Court of Appeals on June 18, 2007, and June 19, 2007, respectively. On February 23, 2009, the parties to this complaint filed with the FERC a settlement offer to resolve all issues in this matter pending at 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 outcome of this matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
**(Unaudited)**

On May 30, 2008, eighteen PJM Members, calling themselves the Reliability Pricing Model (RPM) Buyers filed with the FERC a complaint against PJM asking the FERC to find that PJM's RPM, as implemented through the "transitional" base residual auctions, has produced unjust and unreasonable capacity prices and to order refunds from the PJM members that received RPM revenues. PJM filed its answer on July 11, 2008, requesting that the FERC dismiss the complaint because the requested relief violates the filed rate doctrine, represents a collateral attack on the FERC's prior RPM orders, and is contrary to the FERC's policy not to order the re-running of markets. The FERC dismissed the RPM Buyers' complaint on September 19, 2008. On October 20, 2008, the RPM Buyers filed a request for rehearing at FERC on this matter. On November 18, 2008, the FERC issued an order granting rehearing for further consideration for the limited purpose of giving itself additional time to consider the matters raised in the RPM Buyers' request for rehearing. Thereafter, the FERC issued an order on June 18, 2009 denying the RPM Buyers' request for rehearing, denying their request for oral argument, and reaffirming its September 19, 2008 order dismissing their complaint filed against PJM. On August 14, 2009, two of the eighteen RPM Buyers, the Maryland Public Service Commission and New Jersey Board of Public Utilities, filed a Petition for Review and Notice in the Fourth Circuit Court of Appeals to appeal the FERC's September 19, 2008 and June 18, 2009 orders. PJM cannot predict the outcome of this matter, but does not foresee any material adverse impact on PJM's operations or financial position.

On June 26, 2009, PJM reported to the FERC that it discovered a potential discrepancy in the data used in the calculation of market-to-market coordination payments under the Joint Operating Agreement (JOA) between PJM and the Midwest Independent Transmission System Operator, Inc. (Midwest ISO). As a result of this discrepancy, the market-to-market coordination payments from PJM to the Midwest ISO have been underpaid from spring 2005 through summer 2009. The discrepancy has been rectified going forward, and PJM and Midwest ISO are working together to quantify the past underpayment. PJM has estimated its data corrections at approximately \$77.5 million. The Midwest ISO has not agreed with PJM's estimate, and PJM has requested data from the Midwest ISO that may offset a portion of PJM's estimate. Thus, PJM and Midwest ISO initiated alternative dispute resolution under the JOA in September 2009. On September 15, 2009, this dispute was submitted to the FERC for dispute resolution under a settlement judge as required by the JOA. The first settlement conference was held on October 19 and October 20, 2009. The settlement proceedings continue and additional settlement conferences will be held in December 2009. PJM cannot predict the outcome of this matter, but does not believe a material adverse impact on PJM's operations or financial position is likely.

***Other***

At September 30, 2009, PJM had a receivable due from the Midwest ISO of \$33.4 million for Seams Elimination Cost Adjustments (SECA) billed for the eleven months ended March 31, 2006. While the Midwest ISO has billed Green Mountain Energy Trading (Green Mountain), the Midwest ISO customer responsible for the unpaid SECA charges, it has not yet received payment from that customer. The PJM transmission owners filed a motion on January 26, 2006, asking FERC to use its civil enforcement powers to compel the defaulting MISO customer to comply with the Midwest ISO tariff and pay its allocated SECA charges. On November 9, 2007, PJM, the Indicated PJM Transmission Owners, the Midwest ISO and the Indicated Midwest ISO Transmission Owners, submitted a motion for enforcement of effective Commission orders, approved provisions of the Midwest ISO Tariff, and accepted contracts and rate schedules under which the Midwest ISO has assessed Green Mountain SECA charges. The receivable from the Midwest ISO is offset by the \$33.4 million payable by PJM to market participants for these SECA credits. Consequently, on a net basis, there are no amounts reported in the Consolidated Statement of Financial Position related to these items. Although PJM management cannot determine the impact, if any, of the final disposition of the amounts not yet collected by the Midwest ISO from its market participants, the resolution will not have any impact on

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
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PJM's results of operations as PJM's Tariff only obligates PJM to disburse to its members the actual SECA charges collected.

On December 20, 2007, PJM members were notified that, Power Edge LLC (Power Edge) was in default for its November obligations related to its annual Financial Transmission Rights (FTRs) net counterflow portfolio of positions acquired in Spring 2007. Power Edge's aggregate payment default is \$51.7 million.

On March 7, 2008, PJM filed a complaint with the FERC against Power Edge and its affiliates (collectively the Tower Affiliates) that transacted in the PJM markets alleging market manipulation, fraudulent distribution of Tower Affiliates' funds, and fraudulent nonpayment of bills. In this complaint, PJM requested that the FERC order a public investigation, disgorgement of unjust revenues and profits of the Tower Affiliates, civil penalties, and a bar on participation of the Tower Affiliates in PJM's markets. The Tower Affiliates filed an answer to PJM's complaint on March 27, 2008, and on April 30, 2008, the FERC issued an order holding the complaint in abeyance pending the completion of the FERC Office of Enforcement's non-public investigation.

On March 28, 2008, the Tower Affiliates filed a complaint against PJM at the FERC alleging that PJM was in violation of its Tariff by retaining collateral and revenues that they alleged should be paid to the Tower Affiliates. The Tower Affiliates requested that the FERC order PJM to remit to them \$11.0 million of collateral and \$14.7 million of net revenues plus interest. On April 17, 2008, PJM filed a response to the Tower Affiliates' complaint requesting that the FERC deny Tower Affiliates' request and allow PJM to retain the collateral and net revenues of Tower Affiliates until the FERC has completed its investigation into PJM's March 7, 2008 complaint and the civil complaint described below has been resolved.

On April 2, 2009, the FERC issued an order in the pending FERC proceedings directing PJM to return all collateral and trading revenues funds being held to the Tower Affiliates within 120 days but subject to PJM seeking an order from the Eastern District of Pennsylvania or the District of Delaware during such period permitting the continued holding of such funds. On April 15, 2009, PJM filed a request for clarification or rehearing in connection with this FERC order. Pursuant to the FERC order, PJM returned \$37 million to Tower Affiliates on July 31, 2009. This included all collateral and trading revenues previously held.

On July 2, 2008, the Tower Affiliates filed a civil complaint against PJM in the Philadelphia County, Pennsylvania, Court of Common Pleas seeking return of the funds being withheld by PJM and compensatory and punitive damages for alleged interference with the Tower Affiliates' business relationships and defamation. PJM removed the case to the United States District Court for the Eastern District of Pennsylvania, and obtained a dismissal of all claims other than for compensatory and punitive damages. PJM believes the remaining Tower Affiliates' claims are without merit, and intends to vigorously defend against such claims.

On June 12, 2009, pursuant to an order of court, the Delaware Case was transferred from the U.S. District Court for the District of Delaware, to the U. S. District Court for the Eastern District of Pennsylvania where, on July 13, 2009, it was consolidated with the Pennsylvania Case.

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

**Notes to Consolidated Financial Statements**  
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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.

Under the terms of the PJM Operating Agreement, any payment defaults may be billed and collected from PJM's other member companies. Any subsequent collections on payment defaults, net of PJM's costs of collection, are refunded to PJM's members who paid the defaulting member's unpaid invoices. The outcome of any defaults is not anticipated to have an adverse effect on PJM's financial position, results of operations or cash flow.

***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.

## **PART I. FINANCIAL INFORMATION (continued)**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

#### **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, availability of credit, liquidity and general economic conditions; changes in accounting principles and practices; acts of terrorists; the actions of adjacent control areas and other Regional Transmission Organizations (RTO) and other operational conditions that could arise on the power system. For a description of these and other factors that may cause actual results to differ, reference is made hereby to PJM's Consolidated Financial Statements, Notes thereto and other documents filed by the Company from time to time with the Federal Energy Regulatory Commission (FERC).

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

#### **Results of Operations**

##### ***Revenues***

Total revenues decreased \$5.8 million, or 9 percent, to \$56.6 million for the three months ended September 30, 2009 as compared with the three months ended September 30, 2008; and \$32.0 million, or 17 percent to \$152.2 million for the nine months ended September 30, 2009 as compared with the nine months ended September 30, 2008. Changes in service fees, deferred regulatory income and interest income were the primary drivers of these changes.

PJM's service fees decreased \$5.0 million, or 8 percent, to \$59.1 million for the three months ended September 30, 2009 compared with the three months ended September 30, 2008; and \$10.1 million, or 6 percent for the nine months ended September 30, 2009 as compared with the nine months ended September 30, 2008. The decline is primarily attributable to a decline in volumes. Transmission volumes for the three and nine months ended September 30, 2009 were 185 terawatt hours (TWhs) and 538 TWhs as compared with 203 TWhs and 578 TWhs for the three and nine months ended September 30, 2008.

Deferred regulatory income represents PJM's stated rate tariff service fees in excess of expenses and is reported as an offset to total revenues. For the three months ended September 30, 2009, deferred regulatory income declined by \$2.6 million due principally to lower service fees that were not offset by comparable decreases in expenses. For the nine months ended September 30, 2009, the increase in the deferred regulatory income is primarily due to the Company recording an income tax benefit in the second quarter of 2009. The income tax benefit is a result of the Company releasing valuation allowances on certain deferred tax assets. See Note 8 to the third quarter financial statements for additional information.

Interest income was \$4.2 million, or 90 percent lower for the three months ended September 30, 2009 as compared with the three months ended September 30, 2008; and \$12.0 million or 76 percent lower for the nine months ended September 30, 2009 as compared with the nine months ended September 30, 2008. The decreases are due to lower cash and deposit balances on hand, resulting principally from accelerated billing settlements from monthly to weekly, and declining interest rates. Interest income primarily represents interest on customer deposits, which is credited back to members that have customer deposits. Those credits to members are included in interest expense.

### ***Expenses***

The following table summarizes the percentage of total expenses, excluding study and interconnection services, interest expense and income taxes:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Compensation expense	39%	38%	38%	39%
Depreciation and amortization, net	9	7	8	7
FERC fees	19	18	18	18
Outside services	15	19	18	18
Pension and postretirement expenses	5	5	6	5
Computer maintenance and office supplies	3	3	3	3
Software licenses and fees	4	3	4	4
Lease expenses	2	2	1	1
Other expense	4	5	4	5
Total	100%	100%	100%	100%

Total expenses, excluding study and interconnection services, interest expense and income taxes, decreased \$0.4 million, or 1 percent, to \$55.4 million for the three months ended September 30, 2009 as compared with the three months ended September 30, 2008; and increased \$8.0 million, or 5 percent, to \$171.0 million for the nine months ended September 30, 2009 as compared with the nine months ended September 30, 2009. The increase for the nine-month period resulted primarily from an increase in depreciation and amortization, outside services and pension and postretirement benefit expense as compared with prior periods.

### ***Liquidity and Capital Resources***

On March 31, 2009, the FERC approved PJM's ability to continue to borrow under the revolving line of credit facility and project facility with NCSC through March 31, 2011. At September 30, 2009, PJM has \$50 million of capacity under the revolving line of credit facility and \$110 million of capacity under the project facility.

On March 31, 2009, FERC approved PJM's application to enter into a \$35 million loan agreement with PNC Bank (PNC). The loan has a seven-year term and is secured by the AC<sup>2</sup> property in Milford, PA. The closing on this loan facility occurred on April 30, 2009. As of September 30, 2009, outstanding borrowings were \$34.2 million.

On March 28, 2008, 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. As of September 30, 2009, outstanding borrowings were \$75 million. The purpose of this borrowing is to fund the technology investment in AC<sup>2</sup>.

### ***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 risks and uncertainties, among others, should be considered in evaluating its outlook:

### ***Legislative Activity***

From time to time, the U. S. Congress considers matters pertaining to the restructuring of the electric industry and revises the existing regulatory scheme and the FERC's jurisdiction. A variety of proposals are presently under consideration for inclusion in possible energy legislation to be introduced this year. In the transmission area, these proposals are principally designed to reform the process for planning and allocating the costs of new transmission to serve renewable generation. Some of these proposals call for creation of new interconnection-wide planning entities that would receive information from individual regional plans and develop an interconnection-wide plan. Other proposals call for a national renewable portfolio standard. Additional proposals may be introduced through the legislative process in development of energy legislation this year. Although these proposals could have a material impact on the wholesale price of electricity in the PJM region, PJM does not believe these proposals, if enacted into law as they are presently described, will have a material adverse impact on PJM's financial position.

### ***Regulatory Items***

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 FERC a set of operating protocols intended to resolve the proceeding and guide future operations under the contracts. In approving these protocols, the FERC required a series of post-implementation reports to be submitted. Subsequently, in reports submitted by ConEd on September 30, 2005, December 30, 2005, and January 19, 2007, ConEd had claimed that PJM and the NYISO had not properly implemented the approved protocols and have jointly caused alleged damage to ConEd and its customers of \$111 million, of which \$9.5 million are described as direct losses. ConEd asked the FERC to initiate further proceedings and to make a determination of the amount of refunds necessary to make ConEd whole for these alleged economic consequences. PJM and the NYISO have responded to ConEd's allegations and denied ConEd's right to the refunds it seeks. On April 20, 2007, the FERC dismissed all of ConEd's requests for relief as procedurally insufficient and rejected its request that the FERC institute hearing and settlement procedures. On May 21, 2007, ConEd filed a Petition for Rehearing of the FERC's April 20, 2007 Order. PSEG and ConEd filed appeals with the D.C. Circuit Court of Appeals on June 18, 2007, and June 19, 2007, respectively. On February 23, 2009, the parties to this complaint filed with the FERC a settlement offer to resolve all issues in this matter pending at 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 outcome of this matter is not anticipated to have any material adverse impact on PJM's financial position, results of operations or cash flow.

On May 30, 2008, eighteen PJM Members, calling themselves the Reliability Pricing Model (RPM) Buyers filed with the FERC a complaint against PJM asking the FERC to find that PJM's RPM, as implemented through the "transitional" base residual auctions, has produced unjust and unreasonable capacity prices and to order refunds from the PJM members that received RPM revenues. PJM filed its answer on July 11, 2008, requesting that the FERC dismiss the complaint because the requested relief violates the filed rate doctrine, represents a collateral attack on the FERC's prior RPM orders, and is contrary to the FERC's policy not to order the re-running of markets. The FERC dismissed the RPM Buyers' complaint on September 19, 2008. On October 20, 2008, the RPM Buyers filed a request for rehearing at FERC on this matter. On November 18, 2008, the FERC issued an order granting rehearing for further consideration for the limited purpose of giving itself additional time to consider the matters raised in the RPM Buyers' request for rehearing. Thereafter, the FERC issued an order on June 18, 2009 denying the RPM Buyers' request for rehearing, denying their request for oral argument, and reaffirming its September 19, 2008 order dismissing their complaint filed against PJM. On August 14, 2009, two of the eighteen RPM Buyers, the Maryland Public Service Commission and New Jersey Board of Public Utilities, filed a Petition for Review and Notice in the Fourth Circuit Court of Appeals to appeal the FERC's September 19, 2008 and June 18, 2009 orders. PJM cannot predict the outcome of this matter, but does not foresee any material adverse impact on PJM's operations or financial position.

On June 26, 2009, PJM reported to the FERC that it discovered a potential discrepancy in the data used in the calculation of market-to-market coordination payments under the Joint Operating Agreement (JOA)

between PJM and the Midwest Independent Transmission System Operator, Inc. (Midwest ISO). As a result of this discrepancy, the market-to-market coordination payments from PJM to the Midwest ISO have been underpaid from spring 2005 through summer 2009. The discrepancy has been rectified going forward, and PJM and Midwest ISO are working together to quantify the past underpayment. PJM has estimated its data corrections at approximately \$77.5 million. The Midwest ISO has not agreed with PJM's estimate, and PJM has requested data from the Midwest ISO that may offset a portion of PJM's estimate. Thus, PJM and Midwest ISO initiated alternative dispute resolution under the JOA in September 2009. On September 15, 2009, this dispute was submitted to the FERC for dispute resolution under a settlement judge as required by the JOA. The first settlement conference was held on October 19 and October 20, 2009. The settlement proceedings continue and additional settlement conferences will be held in December 2009. PJM cannot predict the outcome of this matter, but does not believe a material adverse impact on PJM's operations or financial position is likely.

#### ***Credit Risks***

PJM bills its service fees to its members monthly under the stated rate tariff. During the first nine months of 2009, seventy percent of PJM's service fees were billed to seventeen of its members, each of which has an investment grade credit rating per the Standard & Poor's rating service. In the event of default by any PJM member(s), the remaining PJM members would be billed a ratable portion of the default.

In accordance with PJM's credit policy, PJM obtains collateral from its members 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.

On December 20, 2007, PJM members were notified that Power Edge LLC (Power Edge) was in default for its November obligations related to its annual Financial Transmission Rights (FTRs) net counterflow portfolio of positions acquired in Spring 2007. Power Edge's aggregate payment default is \$51.7 million.

On March 7, 2008, PJM filed a complaint with the FERC against Power Edge and its affiliates (collectively the Tower Affiliates) that transacted in the PJM markets alleging market manipulation, fraudulent distribution of Tower Affiliates' funds, and fraudulent nonpayment of bills. In this complaint, PJM requested that the FERC order a public investigation, disgorgement of unjust revenues and profits of the Tower Affiliates, civil penalties, and a bar on participation of the Tower Affiliates in PJM's markets. The Tower Affiliates filed an answer to PJM's complaint on March 27, 2008, and on April 30, 2008, the FERC issued an order holding the complaint in abeyance pending the completion of the FERC Office of Enforcement's non-public investigation.

On March 28, 2008, the Tower Affiliates filed a complaint against PJM at the FERC alleging that PJM was in violation of its Tariff by retaining collateral and revenues that they alleged should be paid to the Tower Affiliates. The Tower Affiliates requested that the FERC order PJM to remit to them \$11.0 million of collateral and \$14.7 million of net revenues plus interest. On April 17, 2008, PJM filed a response to the Tower Affiliates' complaint requesting that the FERC deny Tower Affiliates' request and allow PJM to retain the collateral and net revenues of Tower Affiliates until the FERC has completed its investigation into PJM's March 7, 2008 complaint and the civil complaint described below has been resolved.

On April 16, 2008, PJM, in its own name and pursuant to authority granted by the PJM members, filed a civil complaint against the Tower Affiliates, in the U.S. District Court for the District of Delaware. In the complaint, PJM seeks to recover losses suffered by the PJM membership and damages for harm to the PJM markets arising out of Power Edge's default in the FTR market, the forfeiture of profits derived by the Tower Affiliates from the PJM markets, actual and punitive damages and the cost of the suit, plus interest.

On July 2, 2008, the Tower Affiliates filed a civil complaint against PJM in the Philadelphia County, Pennsylvania, Court of Common Pleas seeking return of the funds being withheld by PJM and compensatory and punitive damages for alleged interference with the Tower Affiliates' business relationships and defamation. PJM removed the case to the United States District Court for the Eastern District of Pennsylvania, and obtained a dismissal of all claims other than for compensatory and punitive damages. PJM believes the remaining Tower Affiliates' claims are without merit, and intends to vigorously defend against such claims.

On April 2, 2009, the FERC issued an order in the pending FERC proceedings directing PJM to return all collateral and trading revenues funds being held to the Tower Affiliates within 120 days but subject to PJM seeking an order from the Eastern District of Pennsylvania or the District of Delaware during such period

permitting the continued holding of such funds. On April 15, 2009, PJM filed a request for clarification or rehearing in connection with this FERC order. Pursuant to the FERC order, PJM returned \$37 million to Tower Affiliates on July 31, 2009. This included all collateral and trading revenues previously held. On August 21, 2009, the Tower Affiliates filed a protest at FERC, seeking additional \$1,629,820 of interest. On October 2, 2009, the FERC issued an order, directing PJM to pay the Tower Affiliates additional interest, in the amount of \$0.8 million. PJM paid such amount to the Tower Affiliates on October 19, 2009.

On June 12, 2009, pursuant to an order of court, the Delaware Case was transferred from the U.S. District Court for the District of Delaware, to the U. S. District Court for the Eastern District of Pennsylvania where, on July 13, 2009, it was consolidated with the Pennsylvania Case.

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.

Under the terms of the PJM Operating Agreement, any payment defaults may be billed and collected from PJM's other member companies. Any subsequent collections on payment defaults, net of PJM's costs of collection, are refunded to PJM's members who paid the defaulting member's unpaid invoices. The outcome of any defaults is not anticipated to have an adverse effect on PJM's financial position, results of operations or cash flow.