

PJM INTERCONNECTION, L.L.C.

FOR THE QUARTER ENDED SEPTEMBER 30, 2010

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

Unaudited

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

	<u>September 30, 2010</u>	<u>December 31, 2009</u>
<b>Assets</b>		
Current assets:		
Deposits on hand	\$ 920,956	\$ 547,349
Operating cash	45,493	47,665
Receivables	28,731	7,725
Study and interconnection receivables	8,760	16,637
Deferred FERC fees	335	1,338
Prepaid income taxes	9,051	9,380
Prepaid expenses and other current assets	5,135	5,393
Deferred income taxes, net of valuation allowance	6,049	4,649
Note receivable	1,605	1,679
	<u>1,026,115</u>	<u>641,815</u>
Non-current assets:		
Fixed assets, net of accumulated depreciation and amortization of \$329,299 and \$314,454	80,680	79,534
Land	1,420	1,420
Projects in development	115,088	90,826
Deferred recovery of pension and postretirement costs	10,000	11,041
Deferred income taxes, net of valuation allowance	19,302	19,625
Note receivable	908	1,749
Other	688	1,112
	<u>228,086</u>	<u>205,307</u>
Total assets	<u>\$ 1,254,201</u>	<u>\$ 847,122</u>
<b>Liabilities, paid in capital, retained earnings and accumulated other comprehensive income</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 25,909	\$ 26,862
Member prepayment	43,875	21,510
Study and interconnection payables	8,910	22,869
Accrued payroll and benefits	14,215	19,371
Revolving line of credit	22,000	-
Current portion of long-term debt	13,872	8,103
Deferred regulatory liability	19,734	7,050
Deferred revenue	577	1,914
Postretirement healthcare benefits liability	642	442
Other employee benefits	73	346
Deposits	920,956	547,349
	<u>1,070,763</u>	<u>655,816</u>
Non-current liabilities:		
Long-term debt	87,248	100,537
Deferred regulatory liability	13,703	13,703
Interest rate swap	2,262	131
Pension benefits liability	28,756	29,147
Postretirement healthcare benefits liability	44,537	41,375
Other employee benefits	3,563	3,331
	<u>180,069</u>	<u>188,224</u>
Total liabilities	<u>1,250,832</u>	<u>844,040</u>
Paid in capital	722	722
Retained earnings	2,223	1,936
Accumulated other comprehensive income	424	424
Total paid in capital, retained earnings and accumulated other comprehensive income	<u>3,369</u>	<u>3,082</u>
Total liabilities, paid in capital, retained earnings and accumulated other comprehensive income	<u>\$ 1,254,201</u>	<u>\$ 847,122</u>

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

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Income</b>				
Revenue:				
Service fees	\$ 67,455	\$59,148	\$ 186,240	\$172,341
Deferred regulatory income	(20,453)	(15,362)	(42,662)	(59,933)
FERC fee reimbursement	12,833	10,320	35,373	30,003
Study and interconnection fees	578	816	1,916	2,664
Interest income	240	470	556	3,873
Membership fees	566	525	1,613	1,504
Other income	662	719	1,851	1,741
Total revenue	<u>61,881</u>	<u>56,636</u>	<u>184,887</u>	<u>152,193</u>
Operating expenses:				
Compensation	22,886	21,627	68,484	64,770
Depreciation and amortization expense	5,112	4,864	14,899	13,857
FERC fees	12,833	10,320	35,373	30,003
Outside services	9,406	8,424	29,782	30,109
Pension benefits	1,800	1,773	5,254	5,174
Postretirement healthcare benefits	1,106	931	3,484	4,586
Computer maintenance and office supplies	2,025	1,693	5,678	5,683
Software licenses and fees	2,670	2,373	7,581	6,617
Lease expenses	670	761	2,057	2,218
Study and interconnection services	578	816	1,916	2,664
Other expense	1,595	2,627	6,317	7,961
Interest expense	975	1,695	3,296	5,186
Total operating expenses	<u>61,656</u>	<u>57,904</u>	<u>184,121</u>	<u>178,828</u>
Income (loss) before income taxes	225	(1,268)	766	(26,635)
Income tax expense (benefit)	<u>110</u>	<u>(1,488)</u>	<u>479</u>	<u>(27,258)</u>
Net income	115	220	287	623
Other comprehensive income:				
Unrealized gain on securities, net of taxes	-	8	-	54
Comprehensive income, net	<u>\$ 115</u>	<u>\$ 228</u>	<u>\$ 287</u>	<u>\$ 677</u>
<b>Paid in capital, retained earnings and accumulated other comprehensive income</b>				
Beginning balance	3,254	\$ 2,715	3,082	\$ 2,266
Net income	115	220	287	623
Other comprehensive income	-	8	-	54
Ending balance	<u>\$ 3,369</u>	<u>\$ 2,943</u>	<u>\$ 3,369</u>	<u>\$ 2,943</u>

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

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

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

	<b>2010</b>	<b>2009</b>
Cash flows from operating activities:		
Net income	\$ 287	\$ 623
Adjustments:		
Depreciation and amortization expense	14,899	13,857
Deferred income taxes, net of valuation allowance	(1,077)	(23,328)
Deferred recovery of pension and postretirement costs	1,041	16,006
Deferred regulatory liability	42,662	59,933
Employee benefit expense greater than (less than) funding	2,930	(12,513)
Net fair value changes related to interest rate swap	2,131	660
Changes in assets and liabilities:		
(Increase) in receivables	(21,006)	(14,399)
Decrease (increase) in interconnection receivables	7,877	(1,454)
Decrease (increase) in prepaid expenses and other	628	(1,256)
Decrease (increase) in prepaid income taxes	329	(4,037)
(Decrease) in accounts payable and accrued expenses	(1,070)	(21,349)
(Decrease) increase in interconnection payables	(13,959)	1,397
(Decrease) in accrued payroll and benefits	(5,156)	(2,614)
Decrease in deferred FERC fees	1,003	-
(Decrease) in deferred revenue	(1,337)	(1,325)
Refunds to members	(29,978)	(30,308)
Net cash provided by operating activities	204	(20,107)
Cash flows used in investing activities:		
Cost of projects in development	(40,136)	(49,039)
Note receivable	915	445
Net cash used in investing activities	(39,221)	(48,594)
Cash flows from financing activities:		
Borrowings under long-term debt	-	35,000
Repayments under long-term debt	(7,520)	(777)
Borrowings under private placement agreement	-	75,000
Borrowings under line of credit	71,000	269,000
Repayments under line of credit	(49,000)	(289,000)
Repayments under non-recourse debt	-	(461)
Increase (decrease) in deposits received	373,607	(247,464)
Member prepayment utilized	22,365	(44,069)
Net cash provided by (used in) financing activities	410,452	(202,771)
Net increase (decrease) in cash and cash equivalents	371,435	(271,472)
Cash and cash equivalents balance, beginning of period	595,014	938,846
Cash and cash equivalents balance, end of period	\$ 966,449	\$ 667,374
Noncash Activity:		
Plant additions included in ending Accounts Payable and Accrued Expenses	117	(2,649)

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

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

**1. Company Overview**

On August 17, 2009, FirstEnergy Service Company, on behalf of American Transmission Systems, Inc. (ATSI), its transmission affiliate, filed with the Federal Energy Regulatory Commission (FERC) to withdraw its transmission assets from the Midwest Independent System Operator (Midwest ISO) and to place them into PJM Interconnection, L.L.C (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.

On June 25, 2010, Duke Energy Ohio, Inc. and Duke Energy Kentucky, Inc. subsidiaries of Duke Energy Corporation, filed with the FERC to withdraw their transmission assets from the Midwest ISO 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.

PJM is working with all of the companies listed above and interested stakeholders to ensure that these integrations are accomplished safely and reliably in accordance with all reliability standards and market rules.

**2. 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, 2010 and for the three-month and nine-month periods ended September 30, 2010 and September 30, 2009 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.

PJM has performed an evaluation of subsequent events through November 8, 2010 which is the date the financial statements were issued.

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

**3. 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 revenue collected 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. Beginning in 2009, 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 three-month and nine-month periods ended September 30, 2010, PJM made quarterly refunds of \$9.3 million and \$30.0 million, respectively.

There will not be a prior period adjustment; 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, 2010, the deferred regulatory liability was \$33.4 million. At December 31, 2009 the deferred regulatory liability was \$20.8 million. At September 30, 2010 and December 31, 2009, the current portion of the deferred regulatory liability was \$19.7 million and \$7.1 million, respectively. The current balance at September 30, 2010 represents the amount to be refunded to members in the fourth quarter of 2010. The non-current portion of the deferred regulatory liability of \$13.7 million represents the amount of PJM's reserve at both September 30, 2010 and December 31, 2009.

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

**4. 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, 2010 and December 31, 2009, the outstanding balance due from MA recorded by PJM as a note receivable was \$2.5 million and \$3.4 million, respectively.

**5. 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 April 2011. 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.

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, 2010 and December 31, 2009. At September 30, 2010 the outstanding balance was \$22.0 million. There were no outstanding borrowings under the revolving credit agreement at December 31, 2009. 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, 2010 and December 31, 2009, the interest rate was 6.05 percent.

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

**6. 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, 2010 and December 31, 2009. As of September 30, 2010 and December 31, 2009 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, 2010 and December 31, 2009, 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, 2010 and December 31, 2009, outstanding borrowings under this loan were \$31.9 million and \$33.6 million, respectively. 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, 2010, the interest rate was 1.609380 percent.

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, 2010 and December 31, 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 paid 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 September 30, 2010 and December 31, 2009, outstanding borrowings were \$69.2 million and \$75 million, respectively.

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, 2010 and December 31, 2009.

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

**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, 2010, the fair value of the swap of \$2.3 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, 2010, the unrealized loss of \$0.7 million and \$2.1 million, respectively, was recorded as interest expense in the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income.

For the three months and nine months ended September 30, 2010 and September 30, 2009, respectively, the amount of the derivative gains (losses) PJM recognized in earnings is provided in the table below:

	<b>Three months ended September 30, 2010</b>	<b>Three months ended September 30, 2009</b>
Unrealized mark-to-market losses	<u>(\$ 698)</u>	<u>(\$ 535)</u>
Total net mark-to-market losses	<u>(\$ 698)</u>	<u>(\$ 535)</u>
	<b>Nine months ended September 30, 2010</b>	<b>Nine months ended September 30, 2009</b>
Unrealized mark-to-market losses	<u>(\$2,131)</u>	<u>(\$ 660)</u>
Total net mark-to-market losses	<u>(\$2,131)</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**

PJM applies the FASB guidance which establishes a framework for measuring fair value and recently 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 assets and liabilities carried at fair value and their placement within the fair value hierarchy levels. At September 30, 2010, 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 is 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>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Components of net periodic benefit cost for the period July 1 to September 30</b>						
Service cost	\$ 1,390	\$ 1,079	\$ 53	\$ 43	\$ 832	\$ 774
Interest cost	1,233	1,157	55	54	616	514
Expected return on assets	(1,023)	(804)	-	-	-	-
Amortization of:						
Transition obligation	-	-	-	1	-	-
Prior service cost	(12)	(12)	40	80	(184)	(184)
Actuarial loss	226	348	(3)	-	-	-
<b>Total net periodic benefit cost</b>	<b>\$ 1,814</b>	<b>\$ 1,768</b>	<b>\$ 145</b>	<b>\$ 178</b>	<b>\$ 1,264</b>	<b>\$ 1,104</b>

For each of the three-month periods ended September 30, 2010 and September 30, 2009, \$0.3 million of total pension and postretirement benefits expense were included in capitalized project costs.

	<b>Pension Benefits</b>				<b>Other Post</b>	
	<b>Qualified</b>		<b>SERP</b>		<b>Retirement Benefits</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Components of net periodic benefit cost for the period January 1 to September 30</b>						
Service cost	\$ 3,948	\$ 3,320	\$ 134	\$ 131	\$ 2,599	\$ 3,068
Interest cost	3,892	3,489	164	141	1,952	2,208
Expected return on assets	(3,236)	(2,468)	-	-	-	-
Amortization of:						
Transition obligation	-	-	-	3	-	19
Prior service cost	(35)	(35)	122	105	(553)	(165)
Actuarial loss	772	1,032	5	-	-	-
<b>Total net periodic benefit cost</b>	<b>\$ 5,341</b>	<b>\$ 5,338</b>	<b>\$425</b>	<b>\$ 380</b>	<b>\$ 3,998</b>	<b>\$ 5,130</b>

For each of the nine-month periods ended September 30, 2010 and September 30, 2009, \$1.0 million of total pension and postretirement benefits expense were included in capitalized project costs.

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

	<u>Pension Benefits</u>				<u>Other Post</u>	
	<u>Qualified</u>		<u>SERP</u>		<u>Retirement Benefits</u>	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
<b>Assumptions used to determine net periodic benefit cost as of September 30</b>						
Discount rate	5.90%	6.10%	5.90%	6.10%	5.90%	6.10%
Expected return on plan assets	7.50%	7.50%	N/A	N/A	N/A	N/A
Rate of compensation increase	4.50%	4.50%	4.50%	4.50%	N/A	N/A
Health care cost trend on covered charges:	N/A	N/A	N/A	N/A		
Current					8.50%	8.50%
Ultimate					5.00%	5.00%
Years to ultimate					7	8

In March 2010, President Obama signed into law HR2590, the Patient Protection and Affordable Care Act, and HR4872, Reconciliation Act of 2010, which amends HR2590. With this healthcare reform, the cash Retiree Drug Subsidy previously provided under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 to sponsors of retiree healthcare benefit plans that provide a benefit that was at least actuarially equivalent to Medicare Part D, is no longer tax-free. The relevant accounting guidance requires that companies record the tax impacts of this healthcare reform on the date of enactment. PJM was not receiving the Retiree Drug Subsidy and therefore did not recognize any additional expense in the first quarter of 2010.

**10. Income Taxes**

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

	<u>Nine months ended</u>	
	<u>2010</u>	<u>2009</u>
Income tax (benefit) at the federal statutory rate	\$ 260	\$ (9,056)
Increase (decrease) resulting from:		
Change in valuation allowance	-	(14,395)
State income taxes, net of federal tax benefit	88	(2,957)
Additional deferred tax asset for		
fixed asset adjustment	-	(926)
Other	131	76
<u>Income tax expense</u>	<u>\$ 479</u>	<u>\$ (27,258)</u>

As of September 30, 2010, PJM did not have any liabilities or receivables including interest related to uncertain income tax positions.

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*

#### Consolidated Edison Wheel Proceeding

In 2001, Consolidated Edison Company of New York, Inc. (ConEd) filed a complaint with 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 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, 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 has claimed that PJM and the NYISO have 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 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 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, accepted all the informational reports filed and rejected ConEd's 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 the 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 filed settlement was contested. On February 19, 2010, the FERC found they are unable to approve the settlement because the current state of the record does not permit them to resolve the merits of some of the contested issues. Because these issues must be addressed before determining whether the settlement can be approved, the FERC will require the parties to brief these issues. On May 26, 2010, PJM filed an Answer in Opposition to the Motion to Intervene Out-of-Time and Comments of PJM's Independent Market Monitor (IMM) indicating that the IMM's untimely intervention fails all criteria for granting a late intervention and the IMM's participation would be considered disruptive and undermine the Commission's policy favoring the settlement in regards to the ConEd 1000 MW wheel proceeding. The IMM sought leave to intervene more than two years after the ConEd 1000 MW wheel proceeding commenced; over a year after the filing of a settlement agreement; and, after the Commission ordered the parties to file additional information which has been done.

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, NRG filed a Request for Rehearing appealing the September 16, 2010 Order. 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)**

Reliability Pricing Model Buyers

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. On November 12, 2009, an order was granted transferring the matter to the U.S. Court of Appeals for the District of Columbia Circuit Court. RPM Buyers, FERC, PJM and interveners filed briefs with the District Court and oral arguments are currently scheduled for November 15, 2010. PJM cannot predict the outcome of this matter, but does not foresee any material adverse impact on PJM's operations or financial position.

Market Flow Modeling Discrepancy

On June 26, 2009, PJM reported to the FERC that it discovered a Market Flow modeling discrepancy which affected the calculation of market-to-market coordination payments under the Joint Operating Agreement (JOA) between PJM and the (Midwest ISO). As a result of this discrepancy, the market-to-market coordination payments from PJM to the Midwest ISO have been significantly underpaid. The discrepancy has been rectified going forward, and PJM and Midwest ISO are working together to quantify the past underpayment. 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 by a settlement judge. The first settlement conferences were held on October 19 and October 20, 2009. Additional settlement conferences were held on December 10 and December 11, 2009 and during February 2010. The Midwest ISO subsequently terminated the settlement proceedings and on March 8, 2010, filed two complaints against PJM with the FERC. The first complaint seeks damages in the amount of \$130 million plus interest for the market flow modeling discrepancy for the period 2005 – June 2009. The second complaint alleges that PJM is in violation of the JOA because PJM allegedly demanded resettlement of amounts related to the Midwest ISO's use of substitute flowgates in the market-to-market processes under the JOA. The Midwest ISO has asked the FERC to order PJM to acknowledge the use of substitute flowgates under the JOA (on April 12, 2010, PJM filed with the FERC a complaint against Midwest ISO regarding Midwest ISO's use of surrogate flowgates in market-to-market coordination in violation of the JOA seeking damages in excess of \$25 million for the period April 2005 to June 2009). The Midwest ISO is seeking reimbursement of \$5 million under the second complaint. Answers to both complaints were filed on April 12, 2010. In the answer to the first complaint, PJM does not agree that Midwest ISO is entitled to relief under the JOA or that refunds are otherwise required or appropriate. PJM further disputes the amounts Midwest ISO claims that PJM owes. In the answer to the second complaint, PJM states that the FERC should dismiss the Complaint as barred by, among other things, Midwest ISO's failure to present the issue to dispute resolution before filing a complaint and the JOA's express limitation of any claims for failure to perform. PJM believes this complaint also is based on erroneous factual contentions.

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On April 12, 2010, PJM filed with the FERC a complaint against Midwest ISO regarding Midwest ISO's use of surrogate flowgates in market-to-market coordination in violation of the JOA (this is the same issue that Midwest ISO raised in the second complaint it filed referenced above). The precise amount of overpayment by PJM to Midwest ISO as a result of Midwest ISO's improper initiation of the JOA market-to-market process using substitute flowgates cannot be determined without discovery and access to additional data in Midwest ISO's possession. However, PJM believes the PJM overpayments may be in excess of \$25 million for the period April 2005 to June 2009, and may be higher when periods after June 2009 are considered. PJM requested FERC to consolidate this complaint with the two Midwest ISO complaints discussed above.

On June 29, 2010, after various answers, responses, motions and comments were filed by the parties to the complaints, FERC issued an Order consolidating the three complaint proceedings discussed above. The FERC also established hearing and settlement judge procedures and denied all requests for summary disposition as to any complaints. On July 2, 2010, the Commission issued an Order designating a settlement judge and scheduling of a settlement conference.

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

***Other***

**Seams Elimination Cost Adjustments**

At March 31, 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 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 Midwest ISO customer to comply with the Midwest ISO tariff and pay its allocated SECA charges. On November 9, 2007, PJM, the Indicated PJM Transmission Owners, 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 Midwest ISO has assessed Green Mountain SECA charges.

**Notes to Consolidated Financial Statements**  
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On May 21, 2010, the Commission issued two orders. First, in the Order on Rehearing, the Commission denies all rehearing requests of the prior orders issued in this proceeding. Second, in the Order on Initial Decision the Commission reverses, in part, and affirms, in part, the initial decisions of the Administrative Law Judge. The Commission also approved three settlements that were certified as contested during the hearing and were held in abeyance pending action on the initial decisions and requests for rehearing. The Commission also approved a fourth settlement that was filed on October 29, 2009. The Commission in this order reverses the conclusion that the Midwest ISO properly assessed Green Mountain SECA charges as a customer under the Midwest ISO tariff.

Instead, the Commission finds BP Energy (BP) is responsible for the SECA charges as the entity that took transmission service on behalf of Green Mountain through December 2005.

The Commission required the PJM Transmission Owners and the Midwest ISO Transmission Owners to submit revised SECA charges to reflect the adjustments adopted here in 90 day compliance filings. Once the compliance filings are submitted by the Transmission Owners and accepted by the Commission, the Midwest ISO should begin collection of the BP SECA charges previously billed to Green Mountain. Once paid, the Midwest ISO will be required to remit the BP SECA payments to PJM for distribution to PJM's Transmission Owners. On October 18, 2010, however, protests were filed by several parties to the PJM Transmission Owners' and the Midwest ISO Transmission Owners' compliance filings and FERC action is pending.

The receivable from 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 Midwest ISO from its market participants, the resolution will not have any impact on PJM's results of operations as PJM's Tariff only obligates PJM to disburse to its members the actual SECA charges collected.

Power Edge Default

On April 16, 2008, PJM, in its own name and pursuant to authority granted by the PJM members, filed a civil complaint against Power Edge and its affiliates (collectively the Tower Affiliates), in the U.S. District Court for the District of Delaware (the Delaware Case). In the complaint, PJM sought 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 subsequently was able to remove the case to the United States District Court for the Eastern District of Pennsylvania (the Pennsylvania Case). On June 12, 2009, pursuant to an order of the U.S. District Court for the District of Delaware, the Delaware Case was transferred to the U. S. District Court for the Eastern District of Pennsylvania where, on July 13, 2009, it was consolidated with the Pennsylvania Case.

**Notes to Consolidated Financial Statements**  
**(dollars in tables in thousands)**  
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Effective July 15, 2010, PJM and the Tower Affiliates settled all claims between themselves within the Federal Court litigation and before FERC. The Tower Affiliates executed a \$20 million promissory note in return for PJM withdrawing its civil complaint and the remainder of its complaint at the FERC related to this matter. The three-year promissory note executed on July 15, 2010 provided the Tower Affiliates the option to satisfy the note in full by prepaying \$18 million within twelve months or \$19 million within twenty-four months. The Tower Affiliates elected to prepay the note in full by paying PJM \$18 million on July 22, 2010. This amount was refunded to PJM market participants in August 2010. PJM has recorded this activity on a net basis in the Company's Consolidated Statement of Financial Position and the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income in the third quarter as this litigation was initiated to pursue collection of amounts the non-defaulting members had been assessed.

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.

Under the terms of the PJM Operating Agreement, any payment defaults for which collection efforts are unsuccessful 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.

***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**

##### *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 (Midwest ISO) and to place them into PJM Interconnection, L.L.C (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.

On June 25, 2010, Duke Energy Ohio, Inc. and Duke Energy Kentucky, Inc. subsidiaries of Duke Energy Corporation, filed with the FERC to withdraw their transmission assets from the Midwest ISO 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.

PJM is working with all of the companies listed above and interested stakeholders to ensure that these integrations are accomplished safely and reliably in accordance with all reliability standards and market rules.

##### *Revenues*

PJM's service fees increased \$8.3 million, or 14 percent, to \$67.4 million for the three months ended September 30, 2010 compared with the three months ended September 30, 2009; and \$13.9 million, or 8 percent for the nine months ended September 30, 2010 as compared with the nine months ended September 30, 2009. The increase is attributable to higher volumes and higher 2010 collections under the Advanced Control Center (AC<sup>2</sup>) rider under the stated rate tariff than in 2009. This rider is for the collection of actual costs to construct and operate AC<sup>2</sup>.

Transmission volumes for the three and nine months ended September 30, 2010 were 206 terawatt hours (TWhs) and 567 TWhs as compared with 185 TWhs and 538 TWhs for the three and nine months ended September 30, 2009. The increase is primarily attributable to higher customer demand due to warmer summer 2010 weather and economic improvements. Collections under the AC<sup>2</sup> rider for the three and nine months ended September 30, 2010 were \$2.9 million and \$7.6 million as compared with \$2.0 million and \$4.2 million for the three and nine months ended September 30, 2009. The increase is primarily attributable to depreciation and amortization charges.

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 three and nine months ended September 30, 2010 as compared with September 30, 2009 is primarily due to the Company recording an income tax benefit in the second quarter of 2009. The income tax benefit was a result of the Company releasing the valuation allowance on certain deferred tax assets. This was a one-time tax adjustment.

### ***Expenses***

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b><u>September 30,</u></b>		<b><u>September 30,</u></b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Compensation expense	38%	39%	38%	38%
Depreciation and amortization, net	9	9	8	8
FERC fees	21	19	20	18
Outside services	15	15	17	18
Pension and postretirement expenses	5	5	5	6
Computer maintenance and office supplies	3	3	3	3
Software licenses and fees	4	4	4	4
Lease expenses	2	2	1	1
Other expense	3	4	4	4
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Total expenses, excluding study and interconnection services, interest expense and income taxes, increased \$4.7 million, or 9%, to \$60.1 million for the three months ended September 30, 2010 as compared with the three months ended September 30, 2009; and \$7.9 million, or 5%, to \$178.9 million for the nine months ended September 30, 2010 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 and FERC fees 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, 2010, PJM has \$28 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, 2010, outstanding borrowings were \$31.9 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, 2010, outstanding borrowings were \$69.2 million. The purpose of this borrowing is to fund the technology investment in AC<sup>2</sup>. The first principal payment of \$5.8 million was made on September 15, 2010.

On April 2, 2010, FERC approved PJM's application to utilize the remaining \$40 million under the private placement master agreement, if needed.

### ***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 in the future. 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. 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***

#### **Consolidated Edison Wheel Proceeding**

In 2001, Consolidated Edison Company of New York, Inc. (ConEd) filed a complaint with 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 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, 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 has claimed that PJM and the NYISO have 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 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 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, accepted all the informational reports filed and rejected ConEd's 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.

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

### ***Credit Risks***

PJM bills its service fees to its members monthly under the stated rate tariff. During the first nine months of 2010 sixty-five percent of PJM's service fees were billed to sixteen 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.

### **Power Edge Default**

On April 16, 2008, PJM, in its own name and pursuant to authority granted by the PJM members, filed a civil complaint against Power Edge and its affiliates (collectively the Tower Affiliates), in the U.S. District Court for the District of Delaware (the Delaware Case). In the complaint, PJM sought 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 subsequently was able to remove the case to the United States District Court for the Eastern District of Pennsylvania (the Pennsylvania Case). On June 12, 2009, pursuant to an order of the U.S. District Court for the District of Delaware, the Delaware Case was transferred to the U. S. District Court for the Eastern District of Pennsylvania where, on July 13, 2009, it was consolidated with the Pennsylvania Case.

Effective July 15, 2010, PJM and the Tower Affiliates settled all claims between themselves within the Federal Court litigation and before FERC. The Tower Affiliates executed a \$20 million promissory note in return for PJM withdrawing its civil complaint and the remainder of its complaint at the FERC related to this matter. The three-year promissory note executed on July 15, 2010 provided the Tower Affiliates the option to satisfy the note in full by prepaying \$18 million within twelve months or \$19 million within twenty-four months. The Tower Affiliates elected to prepay the note in full by paying PJM \$18 million on July 22, 2010. This amount was refunded to PJM market participants in August 2010. PJM has recorded this activity on a net basis in the Company's Consolidated Statement of Financial Position and the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income in the third quarter as this litigation was initiated to pursue collection of amounts the non-defaulting members had been assessed.

### **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.

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.