PJM INTERCONNECTION, L.L.C.

FOR THE QUARTER ENDED JUNE 30, 2016

INDEX

PART I . FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

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

	Unaudited June 30, 2016	December 31, 2015
Assets		
Current assets:		
Deposits on hand	$ 1,462,498	$ 1,142,789
Operating cash	113,699	171,831
Receivables	32,689	22,006
Study and interconnection receivables	17,206	21,277
Prepaid expenses and other current assets	10,406	8,710
Prepaid income taxes	1,625	45
Note receivable	1,853	1,704
	1,639,976	1,368,362
Non-current assets:		
Fixed assets, net of accumulated depreciation and amortization of $604,450 and $578,200	127,416	136,201
Land	1,420	1,420
Projects in development	18,687	23,065
Deferred recovery of pension and postretirement costs	12,141	11,935
Deferred income taxes, net of valuation allowance	43,293	41,371
Note receivable	2,003	2,436
Other	21,097	19,227
	226,057	235,655
Total assets	$ 1,866,033	$ 1,604,017
Liabilities, paid in capital, retained earnings and accumulated other comprehensive income		
Current liabilities:		
Accounts payable and accrued expenses	$ 49,091	$ 22,530
Due to members	146,030	198,205
Study and interconnection payables	17,477	22,710
Accrued payroll and benefits	14,204	25,192
Current portion of long-term debt	7,083	12,852
Current portion of capital lease	1,519	1,483
Deferred FERC fee liability	1,313	2,626
Deferred revenue	1,694	3,231
Postretirement healthcare benefits liability	1,048	978
Other employee benefits	1,112	2,133
Deposits	1,462,498	1,142,789
	1,703,069	1,434,729
Non-current liabilities:		
Long-term debt	21,409	22,067
Long-term capital lease	19,198	19,962
Deferred regulatory liability	4,103	7,159
Interest rate swap	2,271	1,444
Pension benefits liability	42,706	49,555
Postretirement healthcare benefits liability	45,390	44,193
Other employee benefits	19,829	16,852
	154,906	161,232
Total liabilities	1,857,975	1,595,961
Paid in capital	722	722
Retained earnings	6,746	6,744
Accumulated other comprehensive income	590	590
Total paid in capital, retained earnings and accumulated other comprehensive income	8,058	8,056
Total liabilities, paid in capital, retained earnings and accumulated other comprehensive income	$ 1,866,033	$ 1,604,017

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)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	**2015**	**2016**	**2015**
Income				
Revenue:				
Service fees	$ 65,139	$ 63,428	$ 134,641	$ 136,704
Deferred regulatory expense	4,376	4,634	3,460	1,018
FERC fee reimbursement	13,109	12,754	27,124	27,779
Study and interconnection fees	914	729	1,791	1,617
Interest income	609	166	1,362	407
Membership fees	843	840	1,664	1,733
Other income	598	800	1,218	1,457
Total revenue	85,588	83,351	171,260	170,715
Operating expenses:				
Compensation	30,637	29,761	63,275	62,837
FERC fees	13,109	12,754	27,124	27,779
Depreciation and amortization expense	13,131	13,772	26,041	27,499
Outside services	13,386	13,980	25,493	26,190
Software licenses and fees	4,255	3,402	7,806	7,333
Other expense	4,560	3,553	7,281	5,101
Pension benefits	2,345	2,603	4,689	5,248
Computer maintenance and office supplies	1,442	1,369	3,606	3,544
Interest expense	1,151	141	2,569	936
Study and interconnection services	914	729	1,791	1,617
Lease expenses	355	334	705	679
Postretirement healthcare benefits	277	410	552	861
Total operating expenses	85,562	82,808	170,932	169,624
Income before income taxes	26	543	328	1,091
Income tax expense	112	362	326	742
Net (loss)/income	(86)	181	2	349
Other comprehensive income:				
Unrealized gain on securities, net of taxes	-	-	-	-
Comprehensive income/(loss), net	$ (86)	$ 181	$ 2	$ 349
Paid in capital, retained earnings and accumulated other comprehensive income				
Beginning balance	$ 8,144	$ 7,247	$ 8,056	$ 7,079
Net (loss)/income	(86)	181	2	349
Other comprehensive income	-	-	-	-
Ending balance	$ 8,058	$ 7,428	$ 8,058	$ 7,428

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) Six months ended June 30, 2016	(Unaudited) Six months ended June 30, 2015
Cash flows from operating activities:		
Net income	$ 2	$ 349
Adjustments:		
Depreciation and amortization expense	26,041	27,499
Deferred income taxes, net of valuation allowance	(1,922)	(3,554)
Deferred recovery of pension and postretirement costs	(206)	191
Deferred regulatory liability	(3,056)	(797)
Employee benefit expense (less than) greater than funding	(3,626)	2,699
Net fair value changes related to interest rate swap	827	(61)
Changes in assets and liabilities:		
(Increase) in receivables	(10,683)	(3,160)
Decrease (increase) in interconnection receivables	4,071	(7,872)
(Increase) in prepaid expenses and other	(4,294)	(3,811)
(Increase) in prepaid income taxes	(1,580)	(3,255)
Increase in accounts payable and accrued expenses	26,008	14,669
(Decrease) increase in interconnection payables	(5,233)	8,361
(Decrease) in accrued payroll and benefits	(10,988)	(11,566)
Decrease in deferred FERC fees asset	-	204
(Decrease) in deferred FERC fee liability	(1,313)	-
(Decrease) in deferred revenue	(1,537)	(1,688)
Net cash provided by operating activities	12,511	18,208
Cash flows used in investing activities:		
Cost of projects in development	(12,325)	(11,942)
Note receivable	284	397
Net cash (used in) investing activities	(12,041)	(11,545)
Cash flows from financing activities:		
Repayments under long-term debt	(6,427)	(6,427)
Borrowings under line of credit	85,901	9,514
Repayments under line of credit	(85,901)	-
Increase (decrease) in deposits on hand	319,709	(567)
(Decrease) in net due to members	(52,175)	(40,066)
Net cash provided by (used in) financing activities	261,107	(37,546)
Net increase (decrease) in cash and cash equivalents	261,577	(30,883)
Cash and cash equivalents balance, beginning of period	1,314,620	1,124,460
Cash and cash equivalents balance, end of period	$ 1,576,197	$ 1,093,577
Noncash Activity:		
Changes in projects in development additions included in ending accounts payable and accrued expenses	$ 553	$ (2)

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

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 June 30, 2016 and for the three-months and six-months ended June 30, 2016 and June 30, 2015 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.

These footnotes should be read in conjunction with the Company's 2015 consolidated financial statements and footnotes.

PJM has performed an evaluation of subsequent events through August 11, 2016 which is the date the financial statements were issued.

Net Presentation of Member Activity

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

2. Deferred Regulatory Liability

PJM recovers as service fees its administrative costs under its stated rate tariff.

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 6 percent of its annual service fee revenues, less the revenue collected under the Advanced Second Control Center (AC^2) rider and the PJM Settlement rate schedule, except that beginning for 2014 and every third year thereafter, the financial reserve must be reduced to 2 percent of revenues under the stated rate tariff. The amount accumulated under the financial reserve provisions is classified as a non-current liability in the Company's Consolidated Statement of Financial Position. On a quarterly basis, PJM refunds the deferred regulatory liability balance in excess of 6 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. There were no refunds made during the first six months of 2016 and 2015.

Any under or over refund amounts will be reflected in the deferred regulatory liability activity in the following quarter.

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

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 service fee revenues pursuant to the rate schedules differ from applicable expenses in the reporting period. The amount by which cumulative revenues under the rate schedules exceed cumulative expenses and refunds is reported as a deferred regulatory liability in the Consolidated Statement of Financial Position. In circumstances in which revenues are less than expenses, PJM reduces the deferred regulatory liability with an offset to deferred regulatory expense.

At June 30, 2016, the deferred regulatory liability was $4.1 million. At December 31, 2015, the deferred regulatory liability was $7.2 million. The deferred regulatory liability for both periods is classified as a non-current liability representing PJM's reserve.

3. Note Receivable

On March 21, 2008, the Federal Energy Regulatory Commission (FERC) approved a 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 the Board of Managers. In order to facilitate the externalization of this function and as part of the settlement agreement approved by the FERC, PJM entered into a loan agreement with MA during March 2008. The original loan agreement was extended in March 2014 to March 31, 2020.

The purpose of the PJM loan to MA is to fund capital needs associated with MA's technology systems and working capital needs related to MA's responsibilities per Attachment M of the Tariff to monitor the markets administered by PJM. The loan is secured by MA's accounts receivable and future collections of accounts receivable. The loan agreement with MA has a capacity of $11 million. At June 30, 2016 and December 31, 2015, the interest rate on the loan agreement between PJM and MA was 3.50 percent. The interest rate on all loan advances is equal to the PNC Bank Base Rate. The PNC Bank Base Rate is the highest of (A) the Prime Rate, (B) the sum of the Federal Funds Rate plus fifty basis points (0.50%), or (C) the sum of the Daily LIBOR Rate plus one hundred basis points (1.0%).

At June 30, 2016 and December 31, 2015, the outstanding balance due from MA recorded by PJM as a note receivable was $3.9 million and $4.1 million, respectively. At June 30, 2016 and December 31, 2015, the current portion of the note receivable was $1.9 million and $1.7 million, respectively. The current balance at June 30, 2016 represents the amount to be repaid in the next twelve months. The non-current portion of the note receivable was $2.0 million at June 30, 2016 and $2.4 million at December 31, 2015, respectively.

4. Short-Term Debt

PNC Bank Revolving Line of Credit

PJM has a revolving credit agreement in the amount of $100 million with PNC Bank (PNC), which has been approved by the FERC. On February 16, 2016, PJM received approval from the FERC to continue to borrow under this facility. PJM and PNC executed amended loan documents on March 24, 2016 that extended the maturity date of the facility to March 23, 2018, but it can be extended automatically until March 23, 2021 as long as PJM provides FERC authorization to PNC. The revolving line of credit is unsecured and available to fund short-term cash obligations.

Under the loan covenants for the revolving credit agreement, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of June 30, 2016. At June 30, 2016 and December 31, 2015, there were no amounts outstanding under the revolving credit agreement. The interest rate on borrowings under this revolving credit agreement is based on the 30 day London Interbank Offered Rate (LIBOR). At June 30, 2016 and December 31, 2015, the interest rate was 1.216 percent and 1.329 percent, respectively.

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

5. Long-Term Debt

PNC Bank Loan Agreement

On March 31, 2009, FERC approved PJM's application to enter into a $35 million loan agreement with PNC. The loan had a seven-year term and is collateralized by the AC^2 property. The closing on this facility occurred on April 30, 2009.

On August 22, 2013, FERC approved PJM's application to amend and refinance at a lower interest rate the original loan with PNC, which had a balance of $26.3 million. The closing on this facility occurred on September 5, 2013. Under the amended loan, the maturity was extended from April 30, 2016 to September 1, 2021. Payments are due monthly.

On March 24, 2016 PJM and PNC amended the loan agreement to reduce the spread over LIBOR from 110 basis points to 75 basis points. The commitment amount of the loan and maturity date were not changed.

As of June 30, 2016 and December 31, 2015, outstanding borrowings under this loan were $22.7 million and $23.4 million, respectively. As defined in the loan agreement, the interest rate is based on the LIBOR in effect at each reset date plus a spread of 75 basis points. The reset date is monthly. As of June 30, 2016 and December 30, 2015, the interest rate was 1.207 percent and 1.344 percent, respectively.

Under the loan agreement, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of June 30, 2016 and December 31, 2015.

Private Placement Loan Agreement

On March 28, 2008, the FERC approved PJM's application to borrow up to $115 million under a private placement master note agreement. On September 15, 2009, PJM issued senior unsecured notes with a seven-year term totaling $75 million. These notes bear interest at 3.60 percent per annum. Payments are due semi-annually on March 15 and September 15 with the first principal payment having been made on September 15, 2010. The notes mature on September 15, 2016.

As of June 30, 2016 and December 31, 2015, outstanding borrowings under the private placement were $5.8 million and $11.5 million, respectively. Under the loan agreement for the $75 million private placement, PJM is required to meet certain non-financial covenants. PJM was in compliance with these covenants as of June 30, 2016 and December 31, 2015.

6. Derivative Financial Instrument – Interest Rate Swap

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

To manage interest rate risk associated with the $35 million loan agreement with PNC, the Company entered into an interest rate swap agreement with PNC on May 1, 2009. This interest rate swap agreement effectively fixed the interest payments on the Company's floating rate debt instrument at a rate of 4.45 percent through April 30, 2016. The term of the interest rate swap matched the term of the loan.

To manage interest rate risk associated with the amended loan agreement of $26.3 million with PNC, the Company entered into a new interest rate swap agreement with PNC on September 5, 2013. The interest rate swap agreement effectively fixed the interest payments on the Company’s floating rate debt instrument at a rate of 2.85 percent plus the spread over LIBOR through September 1, 2021. The April 2016 amendment of the loan agreement reduced the effective interest rate on the outstanding principal amount of the loan to 3.60 percent. 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 elected to not 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 non-current liability section of the Consolidated Statement of Financial Position with changes in fair value recorded through earnings. At June 30, 2016 and December 31, 2015, the fair value of the swap was a liability of $2.3 million and $1.4 million, respectively.

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

	Three months ended June 30, 2016	**Three months ended June 30, 2015**
Mark-to-market gains (losses), net	$ (407)	$ 340
Total net mark-to-market gains (losses), net	$ (407)	$ 340

	Six months ended June 30, 2016	**Six months ended June 30, 2015**
Mark-to-market gains (losses), net	$ (827)	$ 61
Total net mark-to-market gains (losses), net	$ (827)	$ 61

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

7. Derivative Financial Instrument – Financial Transmission Rights (FTRs)

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

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

The gross fair value of both the FTR assets and FTR liabilities as of June 30, 2016, was $766 million. A total of 278 members were FTR holders related to a total of 1,910,053 megawatt hours. As of June 30, 2016, PJM held $1,505.9 million in collateral related to these FTR transactions. The collateral is based on the calculated net value of the positions held in each member's FTR portfolio. The collateral can be in the form of cash or a letter of credit.

Roll-forward of FTR activity for the quarter ended June 30, 2016:

($ in millions)	
Estimated fair value at April 1, 2016	$ 144
Auction results	1,002
Settlement and change in fair value	(380)
Estimated fair value at June 30, 2016	$ 766

8. Fair Value Disclosures

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

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

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

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

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

At June 30, 2016 and December 31, 2015, those financial assets and liabilities measured at fair value using Level 1 inputs were deposits on hand, operating cash and short-term debt. PJM's interest rate swap agreement associated with the bank loan from PNC has been accounted for at fair value on a recurring basis based on Level 2 inputs within the fair value hierarchy.

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

9. Benefit Plans

	Pension Benefits				Other Post Retirement Benefits	
	Qualified		SERP*			
	2016	2015	2016	2015	2016	2015
Components of net periodic benefit cost for the period April 1 to June 30						
Service cost	$ 2,354	$ 2,600	$ 46	$ 72	$ 374	$ 501
Interest cost	2,026	1,866	45	62	553	522
Expected return on assets	(2,404)	(2,326)	-	-	(78)	(41)
Amortization of:						
Prior service cost	(5)	(5)	2	2	(322)	(322)
Actuarial loss (gain)	368	481	9	20	(155)	(81)
Total net periodic benefit cost	$ 2,339	$ 2,616	$ 102	$ 156	$ 372	$ 579

For each the of three months ended June 30, 2016 and June 30, 2015, $0.2 million and $0.3 million of total pension and postretirement benefits costs were included in capitalized project costs, respectively.

*Supplemental Executive Retirement Plan

	Pension Benefits				Other Post Retirement Benefits	
	Qualified		SERP*			
	2016	2015	2016	2015	2016	2015
Components of net periodic benefit cost for the period January 1 to June 30						
Service cost	$ 4,707	$ 5,201	$ 92	$ 144	$ 748	$ 1,001
Interest cost	4,053	3,733	90	124	1,105	1,043
Expected return on assets	(4,808)	(4,652)	-	-	(156)	(81)
Amortization of:						
Prior service cost	(10)	(11)	3	5	(643)	(643)
Actuarial loss (gain)	735	961	19	40	(310)	(162)
Total net periodic benefit cost	$ 4,677	$ 5,232	$ 204	$ 313	$ 744	$ 1,158

For each the of six months ended June 30, 2016 and June 30, 2015, $0.4 million and $0.6 million of total pension and postretirement benefits costs were included in capitalized project costs, respectively.

	Pension Benefits				Other Post Retirement Benefits	
	Qualified		SERP*			
	2016	2015	2016	2015	2016	2015
Assumptions used to determine net periodic benefit cost as of June 30						
Discount rate	4.50%	4.10%	4.50%	4.10%	4.50%	4.10%
Expected return on plan assets	7.00%	7.00%	N/A	N/A	7.00%	7.00%
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					7.78%	7.20%
Ultimate					4.45%	4.50%
Years to ultimate					22	14

*Supplemental Executive Retirement Plan

10. Income Taxes

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

	Six months ended June 30,	
	2016	2015
Income tax at the federal statutory rate	$ 111	$ 382
Changes resulting from:		
State income taxes net of federal tax benefit	37	106
Permanent items	199	187
Other	(21)	67
Income tax expense	$ 326	$ 742

PJM and its subsidiaries file a U.S. consolidated federal income tax return and separate company tax returns in the state of Pennsylvania (PA). The statute of limitations has expired for tax years prior to 2012 for Federal purposes and state purposes. There are no ongoing income tax audits at this time.

11. Commitment and Contingencies

Other Items

Lehman Brothers Commodities Services Default

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

On December 18, 2012, PJM reached an agreement with Lehman's bankruptcy plan administrator to allow and approve $17 million of PJM's original claim. PJM's original claim was reduced on the basis that Lehman challenged PJM's right to set-off certain amounts from the claim that were due to Lehman prior to bankruptcy and because several PJM Members utilized their portion of the PJM assessed default allocation payment to set-off amounts they owed to Lehman. As a result of the agreement, PJM qualified for distributions from the Lehman bankruptcy estate beginning in April, 2013. To date, PJM has received approximately $16.8 million, or nearly 99%, of PJM's approved claim from the Lehman estate. PJM expects to receive additional smaller distributions as the remaining net assets in this bankruptcy estate are liquidated.

Marginal Line Loss Surplus Payment Re-allocation

Between July 17, 2012 and July 20, 2012, fourteen companies defaulted on payment obligations totaling $28.0 million, net of collateral held by PJM. These obligations resulted from reallocations for previously ordered, and provided, refunds made to certain market participants for billing adjustments related to the marginal line loss payment surplus allocation methodology under PJM's Operating Agreement and Tariff which was ordered by the FERC at Docket No. EL08-14 on July 21, 2011. PJM Settlement is considering all alternatives to enforce its contract rights from all non-paying companies, and to this end, has filed two complaints in civil action alleging breach of contract in the state of Delaware against former members. The first complaint, filed on November 7, 2012, naming City Power Marketing, LLC, Energy Endeavors, LLC, Energy Endeavors, LP and Crane Energy, LP, seeks the recovery of approximately $23 million owed to PJM Settlement, while the second complaint, filed on December 6, 2012, naming Round Rock Energy, LLC, Round Rock Energy, LP, Huntrise Energy Fund, LLC and certain named principals individually, seeks the recovery of approximately $4.25 million.

Several parties affected by the Commission's underlying ruling in this matter sought judicial review of the FERC's decision in the DC Circuit Court of Appeals, and, in the ruling issued in August, 2013, the Court of Appeals directed FERC to provide additional support for its determination to recoup the previously ordered refunds. On February 20, 2014, FERC issued an order establishing a schedule for parties to brief the issue of whether it should have ordered recoupment of the refunds. Initial briefs were submitted by several parties, including PJM, on April 7, 2014. Reply briefs were submitted by PJM and several parties on May 6-7, 2014. On November 19, 2015, the FERC issued an order affirming its decision ordering recoupment of refunds. Collection actions referenced above remain stayed in the Delaware courts, and PJM is considering its options in light of the FERC's November 2015 order. Under the terms of the PJM Operating Agreement, any payment defaults may be billed and collected from PJM Settlement's other member companies. The outcome of any defaults is not anticipated to have a material adverse effect on PJM's financial position, results of operations or cash flow.

TranSource Matter

On June 23, 2015, TranSource, LLC ("Transource") filed a complaint ("Complaint") against PJM with the FERC. In the Complaint, TranSource asks the FERC to order PJM to provide work papers used to determine the cost estimates for each individual system upgrade specified in System Impact Studies and to suspend all tariff deadlines otherwise applicable to its Incremental Auction Revenue Rights ("IARR") request, pending receipt of the demanded information. On September 24, 2015, the FERC issued an order (the "September 24 Order") setting the Complaint for a trial-type evidentiary hearing. The FERC encouraged the parties to settle their disputes and held the hearing in abeyance and directed appointment of a settlement judge. As directed by FERC, PJM, TranSource and the affected PJM transmission owners (which had intervened in the case), engaged in settlement discussions with the assistance of the assigned settlement judge. On February 10, 2016, while in settlement discussions, TranSource filed an amendment to the Complaint (the "Amended Complaint"). In the Amended Complaint, TranSource claims it incurred $72 million in lost profit opportunities from monthly IARRs during calendar year 2015. On February 25, 2016, the settlement judge declared an impasse and is expected to issue a report appointing a hearing judge. PJM believes the claim for monetary damages in the Amended Complaint is speculative and without merit because TranSource cannot show that PJM failed to meet any obligation owed to TranSource or that such alleged failure provides any basis to award TranSource monetary relief. Furthermore, as a signatory to the System Impact Study Agreement, TranSource expressly agreed that they are not entitled to consequential damages or lost profits from any asserted delay or non-performance by PJM or the associated transmission owner. PJM will seek to dismiss the Amended Complaint with prejudice on procedural and substantive grounds. On March 22, 2016, the Chief Judge granted the motion filed by PJM and the PJM Transmission Owners to hold the proceeding in abeyance pending the Commission's decision on PJM's request for dismissal of the Amended Complaint. On May 10, 2016, the Commission issued an order establishing hearing procedures finding that the issues addressed in the Amended Complaint should allow persons not currently parties to the proceeding an opportunity to intervene. A prehearing conference is schedule for August 2, 2016. PJM does not believe that this matter will have a material adverse effect on its financial position.

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 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 and Expenses

PJM's service fees increased $1.7 million, or 3 percent, to $65.1 million for the three months ended June 30, 2016 compared with the three months ended June 30, 2015; and decreased $2.1 million, or 2 percent, to $134.6 million for the six months ended June 30, 2016 compared with the six months ended June 30, 2015. The variance in service fees is primarily attributable to bidding and volume activity for the respective periods, which is strongly correlated to weather conditions. Transmission volume for the three and six months ended June 30, 2016 were 192 terawatt hours (TWhs) and 397 TWhs as compared with 192 TWhs and 418 TWhs for the three and six months ended June 30, 2015.

Total expenses, excluding FERC fees, study and interconnection services, interest expense and income taxes, increased $1.2 million, or 2 percent, to $70.4 million for the three months ended June 30, 2016 as compared with the three months ended June 30, 2015; and $0.2 million, to $139.4 million for the six months ended June 30, 2016 as compared with the six months ended June 30, 2015. For the six months ended June 30, 2016, the increase in other expenses is partially offset by the decrease in depreciation and amortization expense and outside services. The increase in other expense is primarily due to the timing of member and employee training and associated travel costs.

Liquidity and Capital Resources

PJM has a revolving credit agreement with PNC for $100 million, which expires on March 23, 2018. At March 31, 2016, there were no outstanding borrowings under the revolving credit agreement.

On March 31, 2009, FERC approved PJM's application to enter into a $35 million loan agreement with PNC. On August 23, 2013, FERC approved PJM's application to amend and refinance at a lower interest rate the original loan with PNC for $26.3 million. The closing of this facility occurred on September 5, 2013. Under the amended loan agreement, the maturity was extended from April 30, 2015 to September 1, 2021. At June 30, 2016 the outstanding borrowings under the amended loan were $22.7 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 June 30, 2016, outstanding borrowings were $5.8 million. The notes will mature on September 15, 2016. The purpose of this borrowing was to fund the technology investment in AC^2. There is no additional borrowing capacity under this facility.

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:

Credit Risks
PJM bills its service fees to its members monthly under the stated rate tariff. For the six months ended June 30, 2016, sixty percent of PJM's service fees were billed to twenty 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.

Anticipated Rate Filing
PJM's stated rate tariff has been in effect since June 1, 2006. The current structure allows for three components: (1) stated rates that aggregate to a composite rate of 29 cents per MWh; (2) formula rate rider for AC^2 recovery; and, (3) a financial reserve up to 6 percent of annual revenues. During the fourth quarter of 2016, PJM expects to file with the FERC to amend this rate tariff. The filing will seek to combine the formula rate for AC^2 into the stated rates to be effective January 1, 2017.

Recent Regulatory Actions

<u>Lehman Brothers Commodities Services Default</u>

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

On December 18, 2012, PJM reached an agreement with Lehman's bankruptcy plan administrator to allow and approve $17 million of PJM's original claim. PJM's original claim was reduced on the basis that Lehman challenged PJM's right to set-off certain amounts from the claim that were due to Lehman prior to bankruptcy and because several PJM Members utilized their portion of the PJM assessed default allocation payment to set-off amounts they owed to Lehman. As a result of the agreement, PJM qualified for distributions from the Lehman bankruptcy estate beginning in April, 2013. To date, PJM has received approximately $16.8 million, or nearly 99%, of PJM's approved claim from the Lehman estate. PJM expects to receive additional smaller distributions as the remaining net assets in this bankruptcy estate are liquidated.

Marginal Line Loss Surplus Payment Re-allocation

Between July 17, 2012 and July 20, 2012, fourteen companies defaulted on payment obligations totaling $28.0 million, net of collateral held by PJM. These obligations resulted from reallocations for previously ordered, and provided, refunds made to certain market participants for billing adjustments related to the marginal line loss payment surplus allocation methodology under PJM's Operating Agreement and Tariff which was ordered by the FERC at Docket No. EL08-14 on July 21, 2011. PJM Settlement is considering all alternatives to enforce its contract rights from all non-paying companies, and to this end, has filed two complaints in civil action alleging breach of contract in the state of Delaware against former members. The first complaint, filed on November 7, 2012, naming City Power Marketing, LLC, Energy Endeavors, LLC, Energy Endeavors, LP and Crane Energy, LP, seeks the recovery of approximately $23 million owed to PJM Settlement, while the second complaint, filed on December 6, 2012, naming Round Rock Energy, LLC, Round Rock Energy, LP, Huntrise Energy Fund, LLC and certain named principals individually, seeks the recovery of approximately $4.25 million.

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