

PJM INTERCONNECTION, L.L.C.

FOR THE QUARTER ENDED SEPTEMBER 30, 2014

INDEX

	PAGE
PART I – FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated Statement of Financial Position	2
Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income	3
Consolidated Statement of Cash Flows	4
Notes to Consolidated Financial Statements	5
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	15

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

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

	<u>Unaudited</u> <u>September 30, 2014</u>	<u>December 31, 2013</u>
<b>Assets</b>		
Current assets:		
Deposits on hand	\$ 1,136,805	\$ 861,647
Operating cash	8,007	14,728
Receivables	28,089	25,552
Study and interconnection receivables	48,412	78,306
Prepaid expenses and other current assets	9,337	7,705
Prepaid income taxes	2,189	3,770
Deferred FERC fees	950	3,802
Deferred income taxes, net of valuation allowance	8,276	10,048
Note receivable	694	398
	<u>1,242,759</u>	<u>1,005,956</u>
Non-current assets:		
Fixed assets, net of accumulated depreciation and amortization of \$506,252 and \$467,700	171,362	188,675
Land	1,420	1,420
Projects in development	16,754	20,590
Deferred income taxes, net of valuation allowance	21,148	17,813
Note receivable	2,695	-
Other	15,143	11,573
	<u>228,522</u>	<u>240,071</u>
Total assets	<u>\$ 1,471,281</u>	<u>\$ 1,246,027</u>
<b>Liabilities, paid in capital, retained earnings and accumulated other comprehensive income</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 50,729	\$ 24,730
Member prepayments	972	15,241
Study and interconnection payables	61,478	81,236
Accrued payroll and benefits	19,505	24,894
Revolving line of credit	1,811	31,396
Current portion of long-term debt	12,852	12,852
Current portion of capital lease	1,338	1,338
Deferred regulatory liability	8,720	9,798
Deferred revenue	837	3,152
Postretirement healthcare benefits liability	913	939
Other employee benefits	601	424
Deposits	1,136,805	861,647
	<u>1,296,561</u>	<u>1,067,647</u>
Non-current liabilities:		
Long-term debt	35,252	47,779
Long-term capital lease	21,859	22,855
Deferred regulatory liability	14,800	4,942
Interest rate swap	1,208	904
Deferred pension and postretirement healthcare benefits	17,348	20,452
Pension benefits liability	23,301	26,818
Postretirement healthcare benefits liability	39,520	36,689
Other employee benefits	14,773	11,920
	<u>168,061</u>	<u>172,359</u>
Total liabilities	<u>1,464,622</u>	<u>1,240,006</u>
Paid in capital	722	722
Retained earnings	5,546	4,908
Accumulated other comprehensive income	391	391
Total paid in capital, retained earnings and accumulated other comprehensive income	<u>6,659</u>	<u>6,021</u>
Total liabilities, paid in capital, retained earnings and accumulated other comprehensive income	<u>\$ 1,471,281</u>	<u>\$ 1,246,027</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>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
<b>Income</b>				
Revenue:				
Service fees	\$ 72,824	\$ 73,510	\$ 221,666	\$ 212,213
Deferred regulatory income	(8,568)	(14,291)	(25,004)	(22,334)
FERC fee reimbursement	14,021	13,351	41,895	37,762
Study and interconnection fees	878	825	2,460	2,723
Interest income	136	99	492	380
Membership fees	832	817	2,444	2,394
Other income	528	717	1,999	1,828
Total revenue	<u>80,651</u>	<u>75,028</u>	<u>245,952</u>	<u>234,996</u>
Operating expenses:				
Compensation	28,703	28,388	87,792	85,265
Depreciation and amortization expense, including deferral recovery	14,504	13,844	43,034	41,220
FERC fees	14,021	13,351	41,895	37,762
Outside services	11,687	12,363	38,374	36,271
Software licenses and fees	3,969	2,883	9,974	8,682
Other expense	2,334	2,334	6,757	6,702
Computer maintenance and office supplies	1,660	2,390	5,604	6,679
Pension benefits	1,777	2,686	4,934	8,153
Interest expense	326	393	1,926	1,633
Study and interconnection services	878	825	2,460	2,723
Lease expenses	347	578	1,405	1,668
Postretirement healthcare benefits	177	643	418	2,949
Total operating expenses	<u>80,383</u>	<u>80,678</u>	<u>244,573</u>	<u>239,707</u>
Income (loss) before income taxes	268	(5,650)	1,379	(4,741)
Income tax expense (benefit)	146	(5,925)	741	(5,372)
Net income	122	275	638	631
Other comprehensive income:				
Unrealized gain on securities, net of taxes	-	-	-	-
Comprehensive income, net	<u>\$ 122</u>	<u>\$ 275</u>	<u>\$ 638</u>	<u>\$ 631</u>
<b>Paid in capital, retained earnings and accumulated other comprehensive income</b>				
Beginning balance	\$ 6,537	\$ 5,355	\$ 6,021	\$ 4,999
Net income	122	275	638	631
Other comprehensive income	-	-	-	-
Ending balance	<u>\$ 6,659</u>	<u>\$ 5,630</u>	<u>\$ 6,659</u>	<u>\$ 5,630</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)

	<b>(Unaudited)</b>	
	<b>Nine months ended</b>	
	<b>September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 638	\$ 631
<b>Adjustments:</b>		
Depreciation and amortization expense	43,034	41,220
Deferred income taxes, net of valuation allowance	(1,563)	(5,972)
Deferred recovery of pension and postretirement costs	(3,104)	12,094
Deferred regulatory liability	24,663	22,334
Employee benefit expense greater than (less than) funding	2,318	(8,375)
Net fair value changes related to interest rate swap	304	(763)
<b>Changes in assets and liabilities:</b>		
(Increase) decrease in receivables	(2,537)	6,768
Decrease (increase) in interconnection receivables	29,894	(62,412)
(Increase) in prepaid expenses and other	(6,198)	(8,101)
Decrease (increase) in prepaid income taxes	1,581	(3,638)
Decrease in deferred FERC fees	2,852	-
Increase (decrease) in accounts payable and accrued expenses	26,059	(17,504)
(Decrease) increase in interconnection payables	(19,758)	59,156
(Decrease) in accrued payroll and benefits	(5,389)	(5,196)
(Decrease) in deferred FERC fee liability	-	(831)
(Decrease) in deferred revenue	(2,315)	(2,059)
Refunds to members	(15,883)	(3,903)
Net cash provided by operating activities	<u>74,596</u>	<u>23,449</u>
<b>Cash flows used in investing activities:</b>		
Cost of projects in development	(21,945)	(23,867)
Note receivable	(2,991)	963
Net cash used in investing activities	<u>(24,936)</u>	<u>(22,904)</u>
<b>Cash flows from financing activities:</b>		
Repayments under long-term debt	(12,527)	(11,832)
Borrowings under line of credit	946,614	1,238,112
Repayments under line of credit	(976,199)	(1,176,897)
Increase in deposits on hand	275,158	140,110
(Decrease) in net member prepayments	(14,269)	(242,142)
Net cash provided by (used in) financing activities	<u>218,777</u>	<u>(52,649)</u>
Net increase (decrease) in cash and cash equivalents	268,437	(52,104)
Cash and cash equivalents balance, beginning of period	<u>876,375</u>	<u>1,119,157</u>
Cash and cash equivalents balance, end of period	<u><u>\$ 1,144,812</u></u>	<u><u>\$ 1,067,053</u></u>
<b>Noncash Activity:</b>		
Changes in projects in development additions included in ending		
Accounts Payable and Accrued Expenses	\$ (60)	\$ (2,562)

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

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

**1. Summary of Critical Accounting Policies**

***Basis of Presentation***

The accompanying consolidated financial statements have been prepared on an accrual basis in accordance with generally accepted accounting principles (GAAP) and include the accounts of PJM Interconnection, L.L.C. and its wholly-owned subsidiaries (collectively referred to herein as PJM or the Company). All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with GAAP in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying disclosures. These estimates are based on management's best knowledge of current events and actions the Company may undertake in the future. Actual results may ultimately differ from estimates.

The interim financial data as of September 30, 2014 and for the three-months and nine-months ended September 30, 2014 and September 30, 2013 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 2013 consolidated financial statements and footnotes.

PJM has performed an evaluation of subsequent events through November 4, 2014 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 the wholly-owned subsidiary PJM Settlement Inc. (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 (FTR), 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 six percent of its annual service fee revenues, less the revenue collected under the Advanced Control Center (AC<sup>2</sup>) rider and the PJM Settlement rate schedule, except that beginning in 2011 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. 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 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.

For the three month periods ended September 30, 2014 and September 30, 2013, PJM made refunds of \$3.3 million and \$2.3 million, respectively. For the nine month periods ended September 30, 2014 and September 30, 2013, PJM made refunds of \$15.9 million and \$3.9 million, respectively.

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

PJM recognizes deferred regulatory income or expense in the revenue section of the Consolidated Statement of Income, Comprehensive Income and Paid in Capital, Retained Earnings and Accumulated Other Comprehensive Income for the amount by which revenues pursuant to the rate schedule 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. 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, 2014, the deferred regulatory liability was \$23.5 million. At December 31, 2013, the deferred regulatory liability was \$14.7 million. At September 30, 2014 and December 31, 2013, the current portion of the deferred regulatory liability was \$8.7 million and \$9.8 million, respectively. The non-current portion of the deferred regulatory liability of \$14.8 million and \$4.9 million represent the amount of PJM's reserve at both September 30, 2014 and December 31, 2013, respectively.

### **3. Note Receivable**

On March 21, 2008, the Federal Energy Regulatory Commission (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 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 during March 2008 with MA. The original loan agreement was extended in March 2014 to March 31, 2020. The purpose of the loan 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 with MA has a capacity of \$11 million. At September 30, 2014 and December 31, 2013, the outstanding balance due from MA recorded by PJM as a note receivable was \$3.4 million and \$0.4 million, respectively. At September 30, 2014 and December 31, 2013, the current portion of the note receivable was \$0.7 million and \$0.4 million, respectively. The current balance at September 30, 2014 represents the amount to be repaid in the next twelve months. The non-current portion of the note receivable was \$2.7 million at September 30, 2014.

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

#### *PNC 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. The facility expires March 30, 2016, and is unsecured and is available to fund short-term cash obligations.

Under the loan covenants for the revolving credit agreement, PJM is required to meet certain financial and non-financial covenants. PJM was in compliance with these covenants as of September 30, 2014 and December 31, 2013. At September 30, 2014 and December 31, 2013, there was \$1.8 million and \$31.4 million, respectively, 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 September 30, 2014 and December 31, 2013, the interest rate was 1.056 percent and 1.068 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 secured by the AC<sup>2</sup> 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.

As of September 30, 2014 and December 31, 2013, outstanding borrowings under this loan were \$25 million and \$26 million, respectively. As part of the loan amendment, the interest rate is based on the LIBOR in effect at each reset date plus a spread of 110 basis points. Prior to the amendment, the interest rate was based on the LIBOR in effect at each reset date plus a spread of 135 basis points. The reset date is monthly. As of September 30, 2014 and December 31, 2013, the interest rate was 1.255 percent and 1.265 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 September 30, 2014 and December 31, 2013.

### 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 September 30, 2014 and December 31, 2013, outstanding borrowings under the private placement were \$23.1 million and \$34.6 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 September 30, 2014 and December 31, 2013.



## 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. PJM terminated this interest rate swap agreement on September 5, 2013 when the loan was amended with PNC. In connection with the termination, PJM paid termination costs of \$1.5 million, which have been recorded as a deferred regulatory asset on the Company's Consolidated Statement of Financial Position. The accumulated unrealized loss associated with the interest rate swap was reversed upon termination, resulting in a gain of \$1.5 million.

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 fixes the interest payments on the Company's floating rate debt instrument at a rate of 3.95 percent through September 1, 2021. 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 Consolidated Statement of Financial Position with changes in fair value recorded through earnings. At September 30, 2014 and December 31, 2013, the fair value of the swap of \$1.2 million and \$0.9 million, respectively, was reported as an interest rate swap in the non-current liability section of the Consolidated Statement of Financial Position.

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

	<b>Three months ended September 30, 2014</b>	<b>Three months ended September 30, 2013</b>
Mark-to-market gains, net	<u>\$ 163</u>	<u>\$ 281</u>
Total net mark-to-market gains, net	<u>\$ 163</u>	<u>\$ 281</u>
	<b>Nine months ended September 30, 2014</b>	<b>Nine months ended September 30, 2013</b>
Mark-to-market (losses) gains, net	<u>\$ (304)</u>	<u>\$ 762</u>
Total net mark-to-market (losses) gains, net	<u>\$ (304)</u>	<u>\$ 762</u>

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

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

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

An FTR is a financial instrument that enables market participants to reduce their congestion-related price risk when delivering or selling energy on the grid. It provides an economic hedging mechanism against congestion charges that can be transacted by members separately from transmission service. Ultimately, PJM Settlement is neither the buyer nor seller of FTRs but, as FTR auctions clear and charges and credits accumulate, PJM Settlement believes it is temporarily the counterparty to both the FTR Buyer and the FTR Seller. For reporting purposes, these positions net to zero on 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 information related to these derivative positions.

The gross fair value of the derivatives assets and liabilities as of September 30, 2014 is \$0.4 billion. These derivatives are not designated as hedging instruments. As of September 30, 2014 a total of 209 members were FTR holders relating to a total of 2,050,901 megawatt hours. As of September 30, 2014, PJM held \$1,005.1 million in collateral for 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 September 30, 2014:***

*(\$ in millions)*

Estimated fair value at July 1, 2014	\$ 575
Auction results	88
Settlement and change in fair value	(275)
Estimated fair value at September 30, 2014	\$ 388

## 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 September 30, 2014 and December 31, 2013, 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

	<b>Pension Benefits</b>				<b>Other Post Retirement Benefits</b>	
	<b>Qualified</b>		<b>SERP*</b>		<b>2014</b>	<b>2013</b>
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>		
<b>Components of net periodic benefit cost for the period July 1 to September 30</b>						
Service cost	\$ 2,148	\$ 2,186	\$ 55	\$ 67	\$ 415	\$ 700
Interest cost	1,711	1,688	63	57	516	568
Expected return on assets	(2,027)	(1,746)	-	-	(37)	(34)
Amortization of:						
Prior service cost	(5)	(12)	2	25	(322)	(306)
Actuarial loss (gain)	-	581	6	15	(221)	(110)
<b>Total net periodic benefit cost</b>	<b>\$ 1,827</b>	<b>\$ 2,697</b>	<b>\$ 126</b>	<b>\$ 164</b>	<b>\$ 351</b>	<b>\$ 818</b>

For each the of three months ended September 30, 2014 and September 30, 2013, \$0.8 million and \$0.4 million of total pension and postretirement benefits costs were included in capitalized project costs, respectively.

	<b>Pension Benefits</b>				<b>Other Post</b>	
	<b>Qualified</b>		<b>SERP*</b>		<b>Retirement Benefits</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
<b>Components of net periodic benefit cost for the period January 1 to September 30</b>						
Service cost	\$ 6,037	\$ 6,559	\$ 181	\$ 200	\$ 1,218	\$ 2,552
Interest cost	5,106	5,065	180	173	1,488	1,801
Expected return on assets	(6,089)	(5,240)	-	-	(111)	(99)
Amortization of:						
Prior service cost	(16)	(35)	7	76	(965)	(716)
Actuarial loss (gain)	-	1,743	6	44	(735)	(157)
<b>Total net periodic benefit cost</b>	<b>\$ 5,038</b>	<b>\$ 8,092</b>	<b>\$ 374</b>	<b>\$ 493</b>	<b>\$ 895</b>	<b>\$ 3,381</b>

For each the of nine months ended September 30, 2014 and September 30, 2013, \$1.0 million and \$0.9 million of total pension and postretirement benefits costs were included in capitalized project costs, respectively.

	<b>Pension Benefits</b>				<b>Other Post</b>	
	<b>Qualified</b>		<b>SERP*</b>		<b>Retirement Benefits</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
<b>Assumptions used to determine net periodic benefit cost as of September 30</b>						
Discount rate	4.95%	4.20%	4.95%	4.20%	4.95%	4.20%
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					7.40%	7.50%
Ultimate					4.50%	5.00%
Years to ultimate					15	5

\*Supplemental Executive Retirement Plan

## 10. Income Taxes

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

	<b>Nine months ended</b>	
	<b>2014</b>	<b>2013</b>
Income tax (benefit) at the federal statutory rate	\$ 469	\$ (1,612)
Increase resulting from:		
State income taxes (benefit), net of federal tax benefit	119	(3,967)
Permanent items	198	207
Other	(45)	-
<b>Income tax expense</b>	<b>\$ 741</b>	<b>\$ (5,372)</b>

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 2010 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. PJM has received approximately \$15.2 million, or nearly 90 percent, of PJM's approved claim from the Lehman estate to date. 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 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 \$4.3 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, and reply briefs were submitted by PJM and several parties on May 6-7, 2014. Some parties, including the Independent Market Monitor for PJM, filed answers to reply comments, and answers to such answers, between May 28, 2014 and June 19, 2014. An order from FERC is pending and the collection actions referenced above have been stayed in the Delaware courts pending a determination before FERC. 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.

*Legal*

PJM is routinely involved in legal actions. In the opinion of management, none of these matters will have a material adverse effect, if any, on the financial position, results of operations or liquidity of PJM.

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

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

#### **Forward-Looking Statements**

In addition to the historical information presented throughout this report, there are forward-looking statements that reflect management's expectations for the future. Sometimes the words, "estimate," "plan," "expect," "believe," or similar expressions will be used to identify such forward-looking statements. These forward-looking statements are based on current expectations. These statements are not guarantees of future performance and are subject to certain risks and uncertainties.

Many factors could cause actual results to differ materially from these statements. These factors include, but are not limited to, the results of regulatory proceedings, the conditions of the capital markets, interest rates, availability of credit, liquidity and general economic conditions; changes in accounting principles and practices; acts of terrorists; the actions of adjacent control areas and other Regional Transmission Organizations (RTO) and other operational conditions that could arise on the power system. For a description of these and other factors that may cause actual results to differ, reference is made hereby to PJM's Consolidated Financial Statements, Notes thereto and other documents filed by the Company from time to time with the Federal Energy Regulatory Commission (FERC).

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

#### **Results of Operations**

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

PJM's service fees decreased \$0.7 million, or 1 percent, to \$72.8 million for the three months ended September 30, 2014 compared with the three months ended September 30, 2013; and increased \$9.5 million, or 4 percent, to \$221.7 million for the nine months ended September 30, 2014 compared with the nine months ended September 30, 2013. The year-to-date increase is attributable to increased member transaction activity. Transmission volume for the three and nine months ended September 30, 2014 were 213 terawatt hours (TWhs) and 637 TWhs as compared with 220 TWhs and 621 TWhs for the three and nine months ended September 30, 2013.

Total expenses, excluding FERC fees, study and interconnection services, interest expense and income taxes, decreased \$1 million, or 1 percent, to \$65.1 million for the three months ended September 30, 2014 as compared with the three months ended September 30, 2013; and increased \$0.7 million or 0.4 percent, to \$198.3 for the nine months ended September 30, 2014 as compared with the nine months ended September 30, 2013. For the nine months ended September 30, 2014, the increases in compensation expense, software maintenance and licenses; and, the cost of outside services were offset by a decrease of \$5.8 million in the expenses associated with pension and postretirement healthcare benefits. The increase in compensation expense is primarily the result of normal cost of living adjustments. The increase in outside services is principally attributable to consulting expenses for various projects. The increase in software license and maintenance is primarily due to timing of renewals. The decrease in expenses related to pension and postretirement healthcare benefits is primarily attributable to an increase in the discount rate for the related liabilities effective December 31, 2013.

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

PJM has a revolving credit agreement with PNC Bank (PNC) for \$100 million, which expires on March 30, 2016. At September 30, 2014, PJM had \$98.2 million of capacity under this facility.

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, the maturity was extended from April 30, 2015 to September 1, 2021. At September 30, 2014, the outstanding borrowings under the amended loan were \$25 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, 2014, outstanding borrowings were \$23.1 million. The purpose of this borrowing was to fund the technology investment in AC<sup>2</sup>. 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 nine months ended September 30, 2014, sixty-five percent of PJM's service fees were billed to twenty-six 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.

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claim from the Lehman estate to date. PJM expects to receive additional smaller distributions as the remaining net assets in this bankruptcy estate are liquidated.

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