

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**AUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE YEARS ENDED DECEMBER 31, 2020 AND 2019**

## GLOSSARY OF TERMS

The following abbreviations and acronyms may be used in these financial statements to identify The Potomac Edison Company and its current and former subsidiaries and affiliated companies:

ATSI	American Transmission Systems, Incorporated, formerly a direct subsidiary of FE that became a subsidiary of FET in April 2012, which owns and operates transmission facilities
CEI	The Cleveland Electric Illuminating Company, an Ohio electric utility operating affiliated company
FE	FirstEnergy Corp., a publicly owned holding company
FE Board	The Board of Directors of FirstEnergy Corp.
FENOC	Energy Harbor Nuclear Corp. (formerly known as FirstEnergy Nuclear Operating Company), a subsidiary of EH, which operates NG's nuclear generating facilities
FES	Energy Harbor LLC. (formerly known as FirstEnergy Solutions Corp.), a subsidiary of EH, which provides energy-related products and services
FESC	FirstEnergy Service Company, which provides legal, financial and other corporate support services
FET	FirstEnergy Transmission, LLC, formerly known as Allegheny Energy Transmission, LLC, which is the parent of ATSI, KATCo, MAIT and TrAIL and has a joint venture in PATH
FirstEnergy	FirstEnergy Corp., together with its consolidated subsidiaries
GPU	GPU, Inc., former parent of JCP&L, ME and PN, that merged with FE on November 7, 2001
JCP&L	Jersey Central Power & Light Company, a New Jersey electric utility operating affiliated company
KATCo	Keystone Appalachian Transmission Company, a subsidiary of FET
MAIT	Mid-Atlantic Interstate Transmission, LLC, a subsidiary of FET, which owns and operates transmission facilities
ME	Metropolitan Edison Company, a Pennsylvania electric utility operating affiliated company
MP	Monongahela Power Company, a West Virginia electric utility operating affiliated company
OE	Ohio Edison Company, an Ohio electric utility operating affiliated company
PATH	Potomac-Appalachian Transmission Highline, LLC, a joint venture between FE and a subsidiary of AEP
PE	The Potomac Edison Company, a Maryland and West Virginia electric utility operating company
Penn	Pennsylvania Power Company, a Pennsylvania electric utility operating subsidiary of OE
PN	Pennsylvania Electric Company, a Pennsylvania electric utility operating affiliated company
TE	The Toledo Edison Company, an Ohio electric utility operating affiliated company
TrAIL	Trans-Allegheny Interstate Line Company, a subsidiary of FET, which owns and operates transmission facilities
Transmission Companies	ATSI, MAIT and TrAIL
Utilities	OE, CEI, TE, Penn, JCP&L, ME, PN, MP, PE and WP
WP	West Penn Power Company, a Pennsylvania electric utility operating affiliated company

The following abbreviations and acronyms may be used to identify frequently used terms in these financial statements:

ADIT	Accumulated Deferred Income Taxes
AEP	American Electric Power Company, Inc.
AOCI	Accumulated Other Comprehensive Income (Loss)
AMT	Alternative Minimum Tax
CAA	Clean Air Act
COVID-19	Coronavirus disease 2019
CSR	Conservative Support Rider
D.C. Circuit	United States Court of Appeals for the District of Columbia Circuit
EDIS	Electric Distribution Investment Surcharge
EEl	Edison Electric Institute
EmPOWER Maryland	EmPOWER Maryland Energy Efficiency Act
ENEC	Expanded Net Energy Cost
ERO	Electric Reliability Organization
FASB	Financial Accounting Standards Board

FERC	Federal Energy Regulatory Commission
FMB	First Mortgage Bond
FPA	Federal Power Act
GAAP	Accounting Principles Generally Accepted in the United States of America
HB 6	Ohio House Bill 6
IRS	Internal Revenue Service
kV	Kilovolt
LIBOR	London Interbank Offered Rate
LOC	Letter of Credit
MATS	Mercury and Air Toxics Standards
MDPSC	Maryland Public Service Commission
MISO	Midcontinent Independent System Operator, Inc.
N.D. Ohio	Northern District of Ohio
NERC	North American Electric Reliability Corporation
NOL	Net Operating Loss
NOx	Nitrogen Oxide
NUG	Non-Utility Generation
OAG	Ohio Attorney General
OPEB	Other Post-Employment Benefits
PA DEP	Pennsylvania Department of Environmental Protection
PJM	PJM Interconnection, L.L.C.
PJM Region	The aggregate of the zones within PJM
PJM Tariff	PJM Open Access Transmission Tariff
POLR	Provider of Last Resort
PUCO	Public Utilities Commission of Ohio
PURPA	Public Utility Regulatory Policies Act of 1978
R&D	Research and Development
RFC	Reliability <i>First</i> Corporation
ROE	Return on Equity
RTEP	Regional Transmission Expansion Plan
S.D. Ohio	Southern District of Ohio
SEC	United States Securities and Exchange Commission
SIP	State Implementation Plan(s) Under the Clean Air Act
SO <sub>2</sub>	Sulfur Dioxide
SOS	Standard Offer Service
Tax Act	Tax Cuts and Jobs Act adopted December 22, 2017
TO	Transmission Owner
TTS	Temporary Transaction Surcharge
VIE	Variable Interest Entity
VSCC	Virginia State Corporation Commission
WVPSC	Public Service Commission of West Virginia

## **Report of Independent Auditors**

To Management and the Board of Directors  
of The Potomac Edison Company

We have audited the accompanying consolidated financial statements of The Potomac Edison Company and its subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of income, of comprehensive income, of common stockholder's equity, and of cash flows for the years then ended.

### ***Management's Responsibility for the Consolidated Financial Statements***

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

### ***Auditors' Responsibility***

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Potomac Edison Company and its subsidiaries as of December 31, 2020 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

/s/ PricewaterhouseCoopers LLP  
Cleveland, Ohio  
March 18, 2021

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

<i>(In millions)</i>	For the Years Ended December 31,	
	2020	2019
<b>REVENUES:</b>		
Electric sales	\$ 811	\$ 828
Excise and gross receipts tax collections	17	17
Total revenues	828	845
<b>OPERATING EXPENSES:</b>		
Purchased power from non-affiliates	273	240
Purchased power from affiliates	193	275
Other operating expenses	167	161
Provision for depreciation	70	67
Deferral (amortization) of regulatory liabilities, net	1	(28)
General taxes	48	47
Total operating expenses	752	762
<b>OPERATING INCOME</b>	76	83
<b>OTHER INCOME (EXPENSE):</b>		
Miscellaneous income, net	14	9
Pension and OPEB mark-to-market adjustment	(13)	8
Interest expense	(30)	(28)
Capitalized financing costs	4	3
Total other expense	(25)	(8)
<b>INCOME BEFORE INCOME TAXES</b>	51	75
<b>INCOME TAXES</b>	10	15
<b>NET INCOME</b>	\$ 41	\$ 60
<b>STATEMENTS OF COMPREHENSIVE INCOME</b>		
<b>NET INCOME</b>	\$ 41	\$ 60
<b>OTHER COMPREHENSIVE LOSS:</b>		
Pension and OPEB prior service costs	(1)	(3)
Other comprehensive loss	(1)	(3)
Income tax benefits on other comprehensive loss	—	(1)
Other comprehensive loss, net of tax	(1)	(2)
<b>COMPREHENSIVE INCOME</b>	\$ 40	\$ 58

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

<i>(In millions)</i>	December 31, 2020	December 31, 2019
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 100	\$ —
Restricted cash	6	6
Receivables-		
Customers	121	90
Less — Allowance for uncollectible customer receivables	10	2
	111	88
Affiliated companies	22	39
Other, net of allowance for uncollectible accounts	6	4
Prepaid taxes and other	21	19
	266	156
<b>UTILITY PLANT:</b>		
In service	2,039	1,920
Less — Accumulated provision for depreciation	332	281
	1,707	1,639
Construction work in progress	71	66
	1,778	1,705
<b>DEFERRED CHARGES AND OTHER ASSETS:</b>		
Prepaid purchased power	62	67
Other	47	40
	109	107
	<u>\$ 2,153</u>	<u>\$ 1,968</u>
<b>LIABILITIES AND CAPITALIZATION</b>		
<b>CURRENT LIABILITIES:</b>		
Currently payable long-term debt	\$ 7	\$ 7
Short-term borrowings - affiliated companies	34	26
Accounts payable-		
Affiliated companies	30	87
Other	27	23
Accrued taxes	16	11
Accrued interest	7	7
Customer deposits	20	22
Other	19	16
	160	199
<b>CAPITALIZATION:</b>		
Common stockholder's equity-		
Other paid-in capital	358	356
Accumulated other comprehensive income	2	3
Retained earnings	277	236
Total common stockholder's equity	637	595
Long-term debt and other long-term obligations	741	574
	1,378	1,169
<b>NONCURRENT LIABILITIES:</b>		
Accumulated deferred income taxes	258	242
Regulatory liabilities	263	268
Retirement benefits	13	12
Adverse power purchase contracts	30	33
Other	51	45
	615	600
<b>COMMITMENTS AND CONTINGENCIES (Note 12)</b>		
	<u>\$ 2,153</u>	<u>\$ 1,968</u>

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMMON STOCKHOLDER'S EQUITY**

<i>(In millions, except share amounts)</i>	Shares Outstanding	Other Paid-In Capital	AOCI	Retained Earnings	Total Stockholder's Equity
<b>Balance, January 1, 2019</b>	22,385,000	\$ 354	\$ 5	\$ 191	\$ 550
Net income				60	60
Other comprehensive loss, net of tax			(2)		(2)
Stock-based compensation		1			1
Consolidated tax benefit allocation		1			1
Cash dividends declared on common stock				(15)	(15)
<b>Balance, December 31, 2019</b>	22,385,000	\$ 356	\$ 3	\$ 236	\$ 595
Net income				41	41
Other comprehensive loss, net of tax			(1)		(1)
Stock-based compensation		2			2
<b>Balance, December 31, 2020</b>	22,385,000	\$ 358	\$ 2	\$ 277	\$ 637

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

<i>(In millions)</i>	For the Years Ended December 31,	
	2020	2019
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 41	\$ 60
Adjustments to reconcile net income to net cash from operating activities-		
Depreciation and amortization	72	39
Deferred income taxes	11	23
Pension trust contributions	—	(6)
Retirement benefits	(14)	(10)
Pension and OPEB mark-to-market adjustment	13	(8)
Changes in current assets and liabilities-		
Receivables	(8)	2
Prepaid taxes and other current assets	(2)	—
Accounts payable	(53)	35
Accrued taxes	5	(4)
Other current liabilities	(1)	(10)
Other	(9)	(20)
Net cash provided from operating activities	55	101
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
New financing -		
Long-term debt	175	—
Short-term borrowings - affiliated companies, net	8	26
Redemptions and repayments-		
Long-term debt	(6)	(6)
Common stock dividend payments	—	(15)
Other	(2)	—
Net cash provided from financing activities	175	5
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Property additions	(120)	(125)
Loans to affiliated companies, net	—	19
Asset removal costs	(10)	(10)
Other	—	1
Net cash used for investing activities	(130)	(115)
Net change in cash, cash equivalents, and restricted cash	100	(9)
Cash, cash equivalents, and restricted cash at beginning of period	6	15
Cash, cash equivalents, and restricted cash at end of period	\$ 106	\$ 6
<b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>		
Cash paid (received) during the year-		
Interest (net of amounts capitalized)	\$ 28	\$ 26
Income taxes, net of refunds	\$ (12)	\$ 6

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**1. ORGANIZATION AND BASIS OF PRESENTATION**

Unless otherwise indicated, defined terms and abbreviations used herein have the meanings set forth in the accompanying Glossary of Terms.

PE is a wholly owned subsidiary of FE, incorporated in Maryland and Virginia. PE owns transmission assets in Maryland, West Virginia and Virginia and provides distribution services to customers in Maryland and West Virginia. PE is subject to regulation by the MDPSC, the WVPSC, the VSCC and FERC.

The preparation of financial statements in conformity with GAAP requires management to make periodic estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. Actual results could differ from these estimates. The reported results of operations are not necessarily indicative of results of operations for any future period. PE has evaluated events and transactions for potential recognition or disclosure through March 18, 2021, the date the financial statements were issued.

Certain prior year amounts have been reclassified to conform to the current year presentation.

*COVID-19*

The outbreak of COVID-19 has become a global pandemic. PE is continuously evaluating the global pandemic and taking steps to mitigate known risks. The full impact on PE's business from the pandemic, including the governmental and regulatory responses, is unknown at this time and difficult to predict. PE provides a critical and essential service to its customers and the health and safety of its employees and customers is its first priority. PE is continuously monitoring its supply chain and is working closely with essential vendors to understand the continued impact of COVID-19 to its business and does not currently expect service disruptions or any material impact on its capital spending plan.

Currently, PE is effectively managing operations during the pandemic in order to continue to provide critical service to customers, however, the situation remains fluid and future impacts to PE that are presently unknown or unanticipated may occur. Furthermore, the likelihood of an impact to PE, and the severity of any impact that does occur, could increase the longer the global pandemic persists.

**RECEIVABLES**

PE's principal business is providing electric service to customers in Maryland and West Virginia. PE's retail customers are metered on a cycle basis. Electric revenues are recorded based on energy delivered through the end of the calendar month. An estimate of unbilled revenues is calculated to recognize electric service provided from the last meter reading through the end of the month. This estimate includes many factors, among which are historical customer usage, load profiles, estimated weather impacts, customer shopping activity and prices in effect for each class of customer. In each accounting period, PE accrues the estimated unbilled amount as revenue and reverses the related prior period estimate. Billed (net of uncollectibles) and unbilled customer receivables were \$46 million and \$65 million, respectively, as of December 31, 2020 and \$29 million and \$59 million, respectively, as of December 31, 2019. Receivables from customers include distribution and retail electric sales to residential, commercial and industrial customers.

FirstEnergy reviews its allowance for uncollectible customer receivables utilizing a quantitative and qualitative assessment, which includes consideration of the outbreak of COVID-19 and the impact on customer receivable balances outstanding and the ability of customers to continue payment since the pandemic began. The impact of COVID-19 on customers' ability to pay for service, along with the actions FirstEnergy has taken in response to the pandemic, is expected to result in an increase in customer receivable write-offs as compared to historically incurred losses. In order to estimate the additional losses and impacts expected, FirstEnergy analyzed the likelihood of loss based on increases in customer accounts in arrears since the pandemic began in mid-March 2020 as well as what collection methods are or were suspended, and that have historically been utilized to ensure payment. Based on this assessment, and consideration of other qualitative factors described above, PE recognized incremental uncollectible expense of \$9 million in the year 2020, all of which was deferred for future recovery.

In response to the COVID-19 pandemic, the MDPSC and WVPSC issued orders allowing PE to track and create a regulatory asset for future recovery of incremental costs, including uncollectible expenses, incurred as a result of the pandemic.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Activity associated with customer receivables is as follows:

<i>(In millions)</i>	<b>2020</b>	<b>2019</b>
<b>Customer Receivables</b>		
<b>Beginning of year balance</b>	\$ 2	\$ 2
Charged to income <sup>(1)</sup>	10	3
Charged to other accounts <sup>(2)</sup>	3	2
Write-offs	<u>(5)</u>	<u>(5)</u>
<b>End of year balance</b>	<b>\$ 10</b>	<b>\$ 2</b>

<sup>(1)</sup> Customer receivable amounts charged to income include approximately \$9 million associated with incremental uncollectible expense, discussed above, which was deferred for future recovery for the year ended December 31, 2020.

<sup>(2)</sup> Represents recoveries and reinstatements of accounts previously written off for uncollectible accounts.

Other receivables include PJM receivables resulting from transmission sales. PE's credit risk on PJM receivables is reduced due to the nature of PJM's settlement process whereby members of PJM legally agree to share the cost of defaults and as a result there is no allowance for doubtful accounts.

**ACCOUNTING FOR THE EFFECTS OF REGULATION**

Regulatory assets represent incurred costs that have been deferred because of their probable future recovery from customers through regulated rates. Regulatory liabilities represent amounts that are expected to be credited to customers through future regulated rates or amounts collected from customers for costs not yet incurred. PE nets its regulatory assets and liabilities based on federal and state jurisdictions. PE considers the entire regulatory asset balance as the unit of account for the purposes of balance sheet classification rather than the next years recovery and as such net regulatory assets and liabilities are presented in the non-current section on the PE Balance Sheets.

Management assesses the probability of recovery of regulatory assets at each balance sheet date and whenever new events occur. Factors that may affect probability relate to changes in the regulatory environment, issuance of a regulatory commission order or passage of new legislation. Management applies judgment in evaluating the evidence available to assess the probability of recovery of regulatory assets from customers, including, but not limited to evaluating evidence related to precedent for similar items at PE and information on comparable companies within similar jurisdictions, as well as assessing progress of communications between PE and regulators. Certain of these regulatory assets, totaling approximately \$3 million as of December 31, 2020 and December 31, 2019 are recorded based on prior precedent or anticipated recovery based on rate making premises without a specific order.

The following table provides information about the composition of net regulatory assets and liabilities as of December 31, 2020 and December 31, 2019, and the changes during the year ended December 31, 2020:

<b>Net Regulatory Assets (Liabilities) by Source</b>	<b>December 31, 2020</b>	<b>December 31, 2019</b>	<b>Change</b>
	<i>(In millions)</i>		
Asset removal costs	\$ (244)	\$ (241)	\$ (3)
Customer payables for future income taxes	(159)	(161)	2
Energy contract fair value	41	35	6
Deferred energy costs	(1)	21	(22)
Uncollectible and COVID-19 related costs	11	—	11
Other	89	78	11
<b>Net Regulatory Liabilities included on the Consolidated Balance Sheets</b>	<b><u>\$ (263)</u></b>	<b><u>\$ (268)</u></b>	<b><u>\$ 5</u></b>

The following is a description of the regulatory assets and liabilities described above:

**Asset removal costs** - Primarily represents the rates charged to customers that include a provision for the cost of future activities to remove assets, including obligations for which an asset retirement obligation has been recognized, that are expected to be incurred at the time of retirement.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Customer payables for future income taxes** - Reflects amounts to be recovered or refunded through future rates to pay income taxes that become payable when rate revenue is provided to recover items such as AFUDC-equity and depreciation of property, plant and equipment for which deferred income taxes were not recognized for ratemaking purposes, including amounts attributable to tax rate changes such as the Tax Act. These amounts are being amortized over the period in which the related deferred tax assets reverse, which is generally over the expected life of the underlying asset.

**Energy contract fair value** - Reflects the purchase accounting adjustment for certain contracts recorded during the merger of FE and Allegheny Energy, Inc. that is amortized over the life of the respective contract.

**Deferred energy costs** - Relates to the ENEC at PE. PE recovers net power supply costs, including fuel costs, purchased power costs and related expenses, net of related market sales revenue through the ENEC. The ENEC rate is updated annually.

**Uncollectible and COVID-19 related costs** - Includes the deferral of prudently incurred incremental costs arising from COVID-19, including uncollectible expenses under new and existing riders prior to the pandemic.

The following table provides information about the composition of net regulatory assets that do not earn a current return as of December 31, 2020 and 2019, of which approximately \$12 million and \$22 million, respectively, are currently being recovered through rates over varying periods depending on the nature of the deferral and the jurisdiction:

<b>Regulatory Assets by Source Not Earning a Current Return</b>	<b>December 31, 2020</b>	<b>December 31, 2019</b>	<b>Change</b>
	<i>(In millions)</i>		
Storm-related costs	\$ 3	\$ 3	\$ —
Deferred transmission costs	6	6	—
Deferred generation costs	5	15	(10)
Uncollectible and COVID-19 related costs	12	—	12
Other	2	1	1
Regulatory Assets Not Earning a Current Return	<u>\$ 28</u>	<u>\$ 25</u>	<u>\$ 3</u>

**PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment reflects original cost (net of any impairments recognized), including payroll and related costs such as taxes, employee benefits, administrative and general costs, and interest costs incurred to place the assets in service. The costs of normal maintenance, repairs and minor replacements are expensed as incurred. PE recognizes liabilities for planned major maintenance projects as they are incurred.

PE provides for depreciation on a straight-line basis at various rates over the estimated lives of property included in plant in service. Depreciation expense was approximately 2.8% of average depreciable property in both 2020 and 2019.

For the year ended December 31, 2020, capitalized financing costs on PE's Consolidated Statements of Income include \$3 million of allowance for equity funds used during construction and \$1 million of capitalized interest. For the year ended December 31, 2019, capitalized financing costs on PE's Consolidated Statements of Income include \$2 million of allowance for equity funds used during construction and \$1 million of capitalized interest.

PE evaluates long-lived assets classified as held and used for impairment when events or changes in circumstances indicate the carrying value of the long-lived assets may not be recoverable. First, the undiscounted future cash flows attributable to the assets is compared with the carrying value of the assets is greater than the undiscounted future cash flows, an impairment charge is recognized equal to the amount the carrying value of the assets exceeds its estimated fair value.

**INVESTMENTS**

All temporary cash investments purchased with an initial maturity of three months or less are reported as cash equivalents on the Consolidated Balance Sheets, at cost, which approximates their fair market value.

**PREPAID PURCHASE POWER**

In April 2007 and December 2009, MP Environmental Funding LLC, an indirect subsidiary of MP, and PE Environmental Funding LLC, an indirect subsidiary of PE, issued environmental control bonds. These bonds securitize the right to collect an environmental control surcharge that MP and PE impose on their retail customers in West Virginia. PE contributed its net bond proceeds from its issuances of these bonds to MP as a prepayment for power, with MP recording the receipt of the proceeds as unearned revenue. The carrying amount of this power prepayment is designated as "Prepaid purchased power" on PE's

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Consolidated Balance Sheets. This power expense is recognized to the same extent that PE depreciates the portion of the scrubber fixed assets financed by PE's bonds.

**NEW ACCOUNTING PRONOUNCEMENTS**

**Recently Adopted Pronouncements**

ASU 2016-13, "*Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*" (Issued June 2016 and subsequently updated): ASU 2016-13 removes all recognition thresholds and will require companies to recognize an allowance for credit losses for the difference between the amortized cost basis of a financial instrument and the amount of amortized cost that the company expects to collect over the instrument's contractual life. Prior to adoption, FirstEnergy analyzed its financial instruments within the scope of this guidance, primarily trade receivables and AFS debt securities. The adoption of this standard upon January 1, 2020 did not have a material impact to the financial statements and required additional disclosures within. Please see above for additional information on the allowance for uncollectible receivables.

ASU 2018-15, "*Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*" (Issued August 2018): ASU 2018-15 allows implementation costs incurred by customers in cloud computing arrangements to be deferred and recognized over the term of the arrangement, if those costs would be capitalized by the customers in a software licensing arrangement. This standard was adopted as of January 1, 2020, with no material impact to the financial statements.

ASU 2020-04, "*Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*" (Issued March 2020): ASU 2020-04 provides temporary optional expedients and exceptions to the current guidance on contract modifications to ease the financial reporting burdens related to the expected market transition from LIBOR and other interbank offered rates to alternative reference rates. FirstEnergy's \$3.5 billion Revolving Credit Facility bears interest at fluctuating interest rates based on LIBOR and contains provisions (requiring an amendment) in the event that LIBOR can no longer be used. As of December 31, 2020, none of the expedients discussed within this ASU have been utilized.

**Recently Issued Pronouncements** - The following new authoritative accounting guidance issued by the FASB has not yet been adopted. Unless otherwise indicated, PE is currently assessing the impact such guidance may have on its financial statements and disclosures, as well as the potential to early adopt where applicable. PE has assessed other FASB issuances of new standards not described below and has not included these standards based upon the current expectation that such new standards will not significantly impact PE's financing reporting.

ASU 2019-12, "Simplifying the Accounting for Income Taxes" (Issued in December 2019): ASU 2019-12 enhances and simplifies various aspects of the income tax accounting guidance including the elimination of certain exceptions related to the approach for intraperiod tax allocation, the methodology for calculating income taxes in an interim period and the recognition of deferred tax liabilities for outside basis differences. The new guidance also simplifies aspects of the accounting for franchise taxes and enacted changes in tax laws or rates and clarifies the accounting for transactions that result in a step-up in the tax basis of goodwill. The guidance will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020, with early adoption permitted. FirstEnergy continues to evaluate the new guidance, but currently does not expect a material impact upon adopting this standard.

**2. REVENUE**

PE accounts for revenues from contracts with customers under ASC 606, Revenue from Contracts with Customers. Revenue from leases, financial instruments, other contractual rights or obligations and other revenues that are not from contracts with customers are outside the scope of the standard and accounted for under other existing GAAP. PE has elected to exclude sales taxes and other similar taxes collected on behalf of third parties from revenue as prescribed in the new standard. As a result, tax collections and remittances within the scope of this election are excluded from recognition in the income statement and instead recorded through the balance sheet. Gross receipts taxes that are assessed on PE are not subject to the election and are included in revenue. PE has elected the optional invoice practical expedient for most of its revenues and utilizes the optional short-term contract exemption for transmission revenues due to the annual establishment of revenue requirements, which eliminates the need to provide certain revenue disclosures regarding unsatisfied performance obligations.

PE's principal business is providing electric service to customers in West Virginia and Maryland. PE's distribution customers are metered on a cycle basis. An estimate of unbilled revenues is calculated to recognize electric service provided from the last meter reading through the end of the month. This estimate includes many factors, among which are historical customer usage, load profiles, estimated weather impacts and prices in effect for each class of customer. In each accounting period, PE accrues the estimated unbilled amount as revenue and reverses the related prior period estimate. Customer payments are generally due within 30 days. Retail generation sales relate to generation sales in West Virginia and Maryland that are regulated by the WVPS and MDPSC, respectively.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

PE earns revenue from state-regulated rate tariffs under which it provides **distribution services** to residential, commercial and industrial customers in its service territory. PE is obligated under the regulated construct to deliver power to customers reliably, as it is needed, which creates an implied monthly contract with the end-use customer. See Note 11, "Regulatory Matters," for additional information on rate recovery mechanisms. Distribution and electric revenues are recognized over time as electricity is distributed and delivered to the customer and the customers consume the electricity immediately as delivery occurs.

**Retail generation sales** relate to generation sales in West Virginia that are regulated by the WVPSC. Retail generation revenues are recognized over time as electricity is delivered and consumed immediately by the customer.

**Wholesale sales** primarily consist of generation and capacity sales into the PJM market. PE may also purchase power from PJM to supply power to their customers. Generally, these power sales from generation and purchases to serve load are netted hourly and reported gross as either revenues or purchased power on the statements of income based on whether the entity was a net seller or buyer each hour. Capacity revenues are recognized ratably over the PJM planning year at prices cleared in the annual BRA and incremental auctions. Capacity purchases and sales through PJM capacity auctions are reported within revenues on the Income Statement. Certain capacity income (bonuses) and charges (penalties) related to the availability of units that have cleared in the auctions are unknown and not recorded in revenue until, and unless, they occur.

The following table represents a disaggregation of revenue from contracts with customers for the years ended December 31, 2020 and 2019, by type of service:

<b>Revenues by Type of Service</b>	<b>For the Year Ended December 31,</b>	
	<b>2020</b>	<b>2019</b>
	<i>(In millions)</i>	
Distribution services	\$ 263	\$ 266
Retail generation	480	482
Wholesale sales	25	38
Transmission	51	48
Other	7	8
Total revenues from contracts with customers <sup>(1)</sup>	<u>\$ 826</u>	<u>\$ 842</u>
Other non-customer revenue	<u>2</u>	<u>3</u>
Total revenues	<u><u>\$ 828</u></u>	<u><u>\$ 845</u></u>

<sup>(1)</sup> Includes \$2 million and \$1 million in reductions to revenue related to amounts subject to refund resulting from the Tax Act for the year ended December 31, 2020 and 2019.

The following table represents a disaggregation of PE's revenue from contracts with distribution service and retail generation customers for the years ended December 31, 2020 and 2019, by class:

<b>Revenues by Customer Class</b>	<b>For the Years Ended December 31,</b>	
	<b>2020</b>	<b>2019</b>
	<i>(In millions)</i>	
Residential	\$ 492	\$ 489
Commercial	157	165
Industrial	88	87
Other	6	7
Total Revenues	<u><u>\$ 743</u></u>	<u><u>\$ 748</u></u>

PE provides transmission infrastructure owned and operated by PE to transmit electricity from generation sources to distribution facilities. PE's transmission revenue is primarily derived from stated transmission rates. Revenue requirements under stated rates are calculated annually by multiplying the highest one-hour peak load in each respective transmission zone by the approved, stated rate in that zone. Revenues and cash receipts for the stand-ready obligation of providing transmission service are recognized ratably over time. On October 29, 2020, PE filed tariff amendments with FERC to convert its existing stated transmission rate to a forward-looking formula transmission rate, effective January 1, 2021. See Note 11, "Regulatory Matters," for additional information.

For the year ended December 31, 2020 and 2019, revenues include transmission revenue from contracts with customers of \$51 million and \$48 million, respectively.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The changes in AOCI, net of tax, for the years ended December 31, 2020 and 2019 for PE are shown in the following tables:

	<b>Defined Benefit Pension &amp; OPEB Plans</b>
	<i>(In millions)</i>
AOCI Balance, January 1, 2019	\$ 5
Amounts reclassified from AOCI	(3)
Other comprehensive loss	(3)
Income tax benefits on other comprehensive loss	(1)
Other comprehensive loss, net of tax	(2)
AOCI Balance, December 31, 2019	\$ 3
Amounts reclassified from AOCI	(1)
Other comprehensive loss	(1)
Income tax benefits on other comprehensive loss	—
Other comprehensive loss, net of tax	(1)
AOCI Balance, December 31, 2020	\$ 2

The following amounts were reclassified from AOCI for PE in the years ended December 31, 2020 and 2019:

<b>Reclassifications out of AOCI <sup>(1)</sup></b>	<b>For the Years Ended December 31,</b>		<b>Affected Line Item in the Consolidated Statements of Income</b>
	<b>2020</b>	<b>2019</b>	
	<i>(in millions)</i>		
Defined Benefit Pension and OPEB Plans			
Prior-service costs	\$ (1)	\$ (3) <sup>(2)</sup>	
	—	1	Income taxes
	\$ (1)	\$ (2)	Net of tax

<sup>(1)</sup> Amounts in parenthesis represent credits to the Consolidated Statements of Income from AOCI.

<sup>(2)</sup> These AOCI components are included in the computation of net periodic pension cost. See Note 4, "Pension and Other Postemployment Benefits," for additional details.

**4. PENSION AND OTHER POSTEMPLOYMENT BENEFITS**

FirstEnergy provides noncontributory qualified defined benefit pension plans that cover substantially all of its employees and non-qualified pension plans that cover certain employees, including employees of PE. The plans provide defined benefits based on years of service and compensation levels. Under the cash-balance portion of the Pension Plan (for employees hired on or after (January 1, 2014), FirstEnergy makes contributions to eligible employee retirement accounts based on a pay credit and an interest credit. In addition, FirstEnergy provides a minimum amount of noncontributory life insurance to retired employees in addition to optional contributory insurance. Health care benefits, which include certain employee contributions, deductibles and co-payments, are also available upon retirement to certain employees, their dependents and, under certain circumstances, their survivors. PE recognizes its allocated portion of the expected cost of providing pension and OPEB to employees and their beneficiaries and covered dependents from the time employees are hired until they become eligible to receive those benefits. PE also recognizes its allocated portion of obligations to former or inactive employees after employment, but before retirement, for disability-related benefits.

FirstEnergy recognizes a pension and OPEB mark-to-market adjustment for the change in the fair value of plan assets and net actuarial gains and losses annually in the fourth quarter of each fiscal year and whenever a plan is determined to qualify for a remeasurement. The remaining components of pension and OPEB expense, primarily service costs, interest on obligations, assumed return on assets and prior service costs, are recorded on a monthly basis.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Under the approved bankruptcy settlement agreement, upon emergence, FES and FENOC employees ceased earning years of service under the FirstEnergy pension and OPEB plans. The emergence on February 27, 2020, triggered a remeasurement of the affected pension and OPEB plans and as a result, FirstEnergy recognized a non-cash, pre-tax pension and OPEB mark-to-market adjustment of approximately \$423 million (\$11 million at PE) in the first quarter of 2020. The first quarter 2020 pension and OPEB mark-to-market adjustment primarily reflects a 38 bps decrease in the discount rate used to measure benefit obligations from December 31, 2019, partially offset by a slightly higher than expected return on assets. PE's pension and OPEB mark-to-market adjustments for the years ended December 31, 2020 and 2019, were \$13 million and \$(8) million, respectively. The fourth quarter 2020 pension and OPEB mark-to-market adjustment primarily reflects a 29 bps decrease in the discount rate used to measure benefit obligations from February 27, 2020, partially offset by higher than expected return on assets.

FirstEnergy's pension and OPEB funding policy is based on actuarial computations using the projected unit credit method. On February 1, 2019, FirstEnergy made a \$500 million (\$6 million at PE) voluntary cash contribution to the qualified pension plan. As a result of this contribution, FirstEnergy expects no required contributions until 2022.

Pension and OPEB costs are affected by employee demographics (including age, compensation levels and employment periods), the level of contributions made to the plans and earnings on plan assets. Pension and OPEB costs may also be affected by changes in key assumptions, including anticipated rates of return on plan assets, the discount rates and health care trend rates used in determining the projected benefit obligations for pension and OPEB costs. FirstEnergy uses a December 31 measurement date for its pension and OPEB plans. The fair value of the plan assets represents the actual market value as of the measurement date.

FirstEnergy's assumed rate of return on pension plan assets considers historical market returns and economic forecasts for the types of investments held by the pension trusts. In 2020, FirstEnergy's qualified pension and OPEB plan assets experienced gains of \$1,225 million or 14.7%, compared to gains of \$1,492 million, or 20.2% in 2019. An assumed 7.50% rate of return in 2020 and 2019 generated \$651 million and \$569 million of expected return on plan assets, respectively. The expected return on pension and OPEB assets is based on the trusts' asset allocation targets and the historical performance of risk-based and fixed income securities. The gains or losses generated as a result of the difference between expected and actual returns on plan assets will decrease or increase future net periodic pension and OPEB cost as the difference is recognized annually in the fourth quarter of each fiscal year or whenever a plan is determined to qualify for remeasurement.

During 2020, the Society of Actuaries published new mortality tables that include more current data than the RP-2014 tables as well as new improvement scales. An analysis of FirstEnergy pension and OPEB plan mortality data indicated the use of the Pri-2012 mortality table with projection scale MP-2020 was most appropriate. As such, the Pri-2012 mortality table with projection scale MP-2020 was utilized to determine the 2020 benefit cost and obligation as of December 31, 2020 for the FirstEnergy pension and OPEB plans. The impact of using the Pri-2012 mortality table with projection scale MP-2020 resulted in a decrease to the projected benefit obligation of approximately \$74 million and \$2 million for the pension and OPEB plans, respectively, and was included in the 2020 pension and OPEB mark-to-market adjustment.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Effective in 2019, FirstEnergy changed the approach utilized to estimate the service cost and interest cost components of net periodic benefit cost for pension and OPEB plans. Historically, FirstEnergy estimated these components utilizing a single, weighted average discount rate derived from the yield curve used to measure the benefit obligation. FirstEnergy has elected to use a spot rate approach in the estimation of the components of benefit cost by applying specific spot rates along the full yield curve to the relevant projected cash flows, as this provides a better estimate of service and interest costs by improving the correlation between projected benefit cash flows to the corresponding spot yield curve rates. This election was considered a change in estimate and, accordingly, accounted for prospectively, and did not have a material impact on FirstEnergy's financial statements.

Service costs, net of capitalization, are reported within Other operating expenses on the Consolidated Statements of Income. Non-service costs, other than the pension and OPEB mark-to-market adjustment, which is separately shown, are reported within Miscellaneous income, net, within Other Income (Expense) on the Consolidated Statements of Income.

The following is a summary of the plan status:

For the years ended	Pension		OPEB	
	2020	2019	2020	2019
	<i>(in millions)</i>			
FirstEnergy benefit obligation	\$ 11,935	\$ 11,050	\$ 676	\$ 654
FirstEnergy fair value of plan assets	8,968	8,395	502	458
FirstEnergy funded status	<u>\$ (2,967)</u>	<u>\$ (2,655)</u>	<u>\$ (174)</u>	<u>\$ (196)</u>
FirstEnergy accumulated benefit obligation	\$ 11,376	\$ 10,439	\$ —	\$ —
FirstEnergy net periodic costs (credits) <sup>(1)</sup>	\$ 346	\$ 703	\$ (46)	\$ (20)
PE's share of net liability <sup>(2)</sup>	\$ (8)	\$ (7)	\$ 10	\$ 10
PE's share of net periodic costs (credits) <sup>(1)</sup>	\$ (2)	\$ (25)	\$ (1)	\$ 1

<sup>(1)</sup> Includes pension and OPEB mark-to-market adjustment.

<sup>(2)</sup> Excludes \$11 million and \$2 million as of December 31, 2020 and 2019, respectively, of affiliated non-current liabilities related to pension and OPEB mark-to-market costs allocated to PE.

	Pension		OPEB	
	2020	2019	2020	2019
<b>Assumptions Used to Determine Benefit Obligations (as of December 31)</b>				
Discount rate	2.67 %	3.34 %	2.45 %	3.18 %
Rate of compensation increase	4.10 %	4.10 %	N/A	N/A
Cash balance weighted average interest crediting rate	2.57 %	2.57 %	N/A	N/A

**Assumed Health Care Cost Trend Rates (as of December 31)**

Health care cost trend rate assumed (pre/post-Medicare)	N/A	N/A	6.0-5.5%	6.0-5.5%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	N/A	N/A	4.50 %	4.50 %
Year that the rate reaches the ultimate trend rate	N/A	N/A	2028	2028

**Assumptions Used to Determine Net Periodic Benefit Cost for Years Ended December 31 <sup>(1)</sup>**

Service cost weighted-average discount rate <sup>(2)</sup>	3.60%/3.24%	4.66 %	3.63%/3.29%	4.67 %
Interest cost weighted-average discount rate <sup>(3)</sup>	3.27%/2.90%	4.37 %	2.71%/2.30%	3.89 %
Expected long-term return on plan assets	7.50 %	7.50 %	7.50 %	7.50 %
Rate of compensation increase	4.10 %	4.10 %	N/A	N/A

<sup>(1)</sup> Excludes impact of pension and OPEB mark-to-market adjustment.

<sup>(2)</sup> Weighted-average discount rates in effect from January 1, 2020, through February 26, 2020, were 3.60% and 3.63% for pension and OPEB service cost, respectively. Discount rates were 3.24% and 3.29% for pension and OPEB service cost, respectively, for the period February 27, 2020 through December 31, 2020.

<sup>(3)</sup> Weighted-average discount rates in effect from January 1, 2020, through February 26, 2020, were 3.27% and 2.71% for pension and OPEB interest cost, respectively. Discount rates were 2.90% and 2.30% for pension and OPEB interest cost, respectively, for the period February 27, 2020, through December 31, 2020.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In selecting an assumed discount rate, FirstEnergy considers currently available rates of return on high-quality fixed income investments expected to be available during the period to maturity of the pension and OPEB obligations. The assumed rates of return on plan assets consider historical market returns and economic forecasts for the types of investments held by FirstEnergy's pension and OPEB trusts. The long-term rate of return is developed considering the portfolio's asset allocation strategy.

**5. TAXES**

PE records income taxes in accordance with the liability method of accounting. Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts recognized for tax purposes. Investment tax credits, which were deferred when utilized, are being amortized over the recovery period of the related property. Deferred income tax liabilities related to temporary tax and accounting basis differences and tax credit carryforward items are recognized at the statutory income tax rates in effect when the liabilities are expected to be paid. Deferred tax assets are recognized based on income tax rates expected to be in effect when they are settled.

PE is party to an intercompany income tax allocation agreement with FE that provides for the allocation of consolidated tax liabilities. Net tax benefits attributable to FirstEnergy, excluding any tax benefits derived from interest expense associated with acquisition indebtedness from the merger with GPU, are reallocated to the subsidiaries of FirstEnergy that have taxable income. That allocation is accounted for as a capital contribution to the company receiving the tax benefit.

On March 27, 2020, President Trump signed into law the CARES Act, an economic stimulus package in response to the COVID-19 pandemic containing several corporate income tax provisions, including making remaining AMT credits immediately refundable; providing a 5-year carryback of NOLs generated in tax years 2018, 2019, and 2020, and removing the 80% taxable income limitation on utilization of those NOLs if carried back to prior tax years or utilized in tax years beginning before 2021; and temporarily liberalizing the interest deductibility rules under Section 163(j) of the Tax Act, by raising the adjusted taxable income limitation from 30% to 50% for tax years 2019 and 2020 and giving taxpayers the election of using 2019 adjusted taxable income for purposes of computing 2020 interest deductibility. PE does not currently expect the provisions of the CARES Act to have a material effect on current income tax expense or the realizability of deferred income tax assets.

On December 27, 2020, President Trump signed into law the Consolidated Appropriations Act, 2021, an additional stimulus package providing financial relief for individuals and small businesses. The Appropriations Act contains a variety of tax provisions, including full expensing of business meals in 2021 and 2022, extensions of various energy tax incentives (including the Investment Tax Credit), and expansion of the employee retention tax credit. PE does not currently expect the Appropriations Act to have a material tax impact.

On July 28, 2020, the IRS issued final regulations implementing interest expense deduction limitation rules under section 163(j) of the Internal Revenue Code. The final regulations changed certain rules on the computation of interest expense and limitation amount, as well as rules relevant to status as a regulated utility business and the allocation of consolidated group interest expense between utility and non-utility businesses. On January 6, 2021, the IRS released an additional set of final regulations under Section 163(j) primarily addressing partnership, real estate, and certain controlled foreign corporation issues, which do not materially impact PE.

<b>INCOME TAXES:</b>	<b>For the Years Ended December 31,</b>	
	<b>2020</b>	<b>2019</b>
	<i>(In millions)</i>	
Currently payable		
Federal	\$ (1)	\$ (8)
State	—	—
	(1)	(8)
Deferred, net-		
Federal	7	17
State	4	6
	11	23
Total income taxes	\$ 10	\$ 15

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

PE's tax rates are affected by permanent items, such as AFUDC equity and other flow-through items, as well as discrete items that may occur in any given period, but are not consistent from period to period. The following table provides a reconciliation of federal income tax expense at the federal statutory rate to the total income taxes for the years ended December 31, 2020 and 2019:

<i>(In millions)</i>	<b>For the Years Ended December 31,</b>	
	<b>2020</b>	<b>2019</b>
Book income before income taxes	\$ 51	\$ 75
Federal income tax expense at statutory rate	\$ 11	\$ 16
Increases (reductions) in taxes resulting from-		
State income tax, net of federal income tax benefit	3	4
Excess deferred tax amortization due to the Tax Act	(3)	(5)
Other, net	\$ (1)	\$ —
Total income taxes	<u>\$ 10</u>	<u>\$ 15</u>
Effective income tax rate	19.6 %	20.0 %

PE's effective tax rate on pre-tax income for 2020 and 2019 was 19.6% and 20.0%, respectively.

Accumulated deferred income taxes as of December 31, 2020 and 2019 were as follows:

<i>(In millions)</i>	<b>As of December 31,</b>	
	<b>2020</b>	<b>2019</b>
Property basis differences	\$ 239	\$ 222
Regulatory asset/liability	35	34
Purchase accounting adjustments	(8)	(9)
Pension and OPEB	(4)	(1)
Other	(4)	(4)
Net deferred income tax liabilities	<u>\$ 258</u>	<u>\$ 242</u>

PE records as deferred income tax assets the effect of Federal NOLs and tax credits that will more likely than not be realized through future operations and through the reversal of existing temporary differences. As of December 31, 2020, PE's loss carryforwards consisted of \$17 million (\$4 million, net of tax) of federal NOL carryforwards that will begin to expire in 2032 and approximately \$66 million (\$4 million, net of tax) of state NOL carryforwards, of which approximately \$55 million (\$4 million, net of tax) is expected to be utilized based on current estimates and assumptions prior to expiration, which will begin in 2029.

PE accounts for uncertainty in income taxes recognized in its financial statements. Accounting guidance prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of tax positions taken or expected to be taken on a company's tax return. For the years ended December 31, 2020 and 2019, PE did not record any unrecognized tax benefits, nor does PE have a reserve for any uncertain tax positions.

PE recognizes interest expense or income and penalties related to uncertain tax positions in income taxes. That amount is computed by applying the applicable statutory interest rate to the difference between the tax position recognized and the amount previously taken or expected to be taken on the tax return. During 2020 and 2019, PE did not record any interest related to uncertain tax positions, nor does PE have a cumulative net interest payable recorded on its balance sheet.

For federal income tax purposes, PE files as a member of the FE consolidated group. Tax years 2018 and 2019 are currently under review by the IRS. PE has tax returns under review by state taxing authorities at the audit or appeals level of tax years 2017-2019.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*General Taxes*

Details of general taxes for the years ended 2020 and 2019 are shown below:

<i>(In millions)</i>	<b>2020</b>	<b>2019</b>
Kilowatt-hour excise	\$ 14	\$ 15
State gross receipts	6	4
Real and personal property	19	19
Business and occupation	4	4
Social security and unemployment	5	5
Total general taxes	<u>\$ 48</u>	<u>\$ 47</u>

**6. LEASES**

PE primarily leases vehicles as well as building space, office equipment, and other property and equipment under cancelable and noncancelable leases.

PE adopted ASU 2016-02, "Leases (Topic 842)" on January 1, 2019, and elected a number of transitional practical expedients provided within the standard. These included a "package of three" expedients that must be taken together and allowed entities to (1) not reassess whether existing contracts contain leases, (2) carryforward the existing lease classification, and (3) not reassess initial direct costs associated with existing leases. In addition, PE elected the option to apply the requirements of the standard in the period of adoption (January 1, 2019) with no restatement of prior periods. Adoption of the standard on January 1, 2019, did not result in a material cumulative effect adjustment upon adoption. PE did not evaluate land easements under the new guidance as they were not previously accounted for as leases. PE also elected not to separate lease components from non-lease components as non-lease components were not material.

Leases with an initial term of 12 months or less are recognized as lease expense on a straight-line basis over the lease term and not recorded on the balance sheet. Most leases include one or more, options to renew and certain leases include options to terminate. The exercise of lease renewal options is at PE 's sole discretion. Renewal options are included within the lease liability if they are reasonably certain based on various factors relative to the contract. Certain leases also include options to purchase the leased property. The depreciable life of leased assets and leasehold improvements are limited by the expected lease term, unless there is a transfer of title or purchase option reasonably certain of exercise.

For vehicles leased under master lease agreements, the lessor is guaranteed a residual value up to a stated percentage of the equipment cost at the end of the lease term. As of December 31, 2020, the maximum potential loss for these lease agreements at the end of the lease term is approximately \$1 million.

PE also has an affiliated full requirements agreement with MP in which MP provides power to PE for its default service requirements. Expense is based upon cost and, as such, is variable in nature. Since the lease is variable, no asset or liability was recognized upon adoption of ASC 842 on January 1, 2019. Expense related to this agreement was \$175 million and \$201 million for the years ended December 31, 2020 and 2019, respectively.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Finance leases for assets used in regulated operations are recognized in PE's Statement of Income such that amortization of the right-of-use asset and interest on lease liabilities equals the expense allowed for ratemaking purposes. All operating lease expenses are recognized in Other operating expense. The components of lease expense were as follows:

<i>(In millions)</i>	December 31, 2020	December 31, 2019
Operating lease costs <sup>(1)</sup>	\$ 3	\$ 2
Finance lease costs:		
Amortization of right-of-use assets	1	1
Total finance lease cost	1	1
Total lease cost	<u>\$ 4</u>	<u>\$ 3</u>

<sup>(1)</sup> Includes \$1 million of short-term lease costs as of December 31, 2020 and 2019.

Supplemental balance sheet information related to leases was as follows:

<i>(In millions)</i>	Financial Statement Line Item	As of December 31,	
		2020	2019
<b>Assets</b>			
Operating lease assets <sup>(1)</sup>	Deferred charges and other assets	\$ 14	\$ 13
Finance lease assets <sup>(2)</sup>	Property, plant and equipment	1	1
Total leased assets		<u>\$ 15</u>	<u>\$ 14</u>
<b>Liabilities</b>			
<i>Current:</i>			
Operating	Other current liabilities	\$ 2	\$ 2
Finance	Currently payable long-term debt	1	—
<i>Noncurrent:</i>			
Operating	Other noncurrent liabilities	12	11
Finance	Long-term debt and other long-term obligations	—	1
Total leased liabilities		<u>\$ 15</u>	<u>\$ 14</u>

<sup>(1)</sup> Operating lease assets are recorded net of accumulated amortization of \$3 million and \$1 million as of December 31, 2020 and 2019, respectively.

<sup>(2)</sup> Finance lease assets are recorded net of accumulated amortization of \$1 million as of December 31, 2020 and 2019.

Lease terms and discount rates were as follows:

	As of December 31, 2020	As of December 31, 2019
<i>Weighted-average remaining lease terms (years)</i>		
Operating leases	6.58	7.25
Finance leases	1.19	2.16
<i>Weighted-average discount rate <sup>(1)</sup></i>		
Operating leases	3.07 %	3.21 %
Finance leases	7.30 %	9.68 %

<sup>(1)</sup> When an implicit rate is not readily determinable, an incremental borrowing rate is utilized, determining the present value of lease payments. The rate is determined based on expected term and information available at the commencement date.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Supplemental cash flow information related to leases was as follows:

<i>(In millions)</i>	For the Years Ended,	
	12/31/2020	12/31/2019
<i>Cash paid for amounts included in the measurement of lease liabilities</i>		
Operating cash flows from operating leases	\$ 2	\$ 2
Operating cash flows from finance leases	—	—
Finance cash flows from finance leases	—	1
<i>Right-of-use assets obtained in exchange for lease obligations:</i>		
Operating leases	\$ 4	\$ 4
Finance leases	—	1

Maturities of lease liabilities as of December 31, 2020, were as follows:

<i>(In millions)</i>	Operating Leases	Finance Leases	Total
2021	\$ 3	\$ 1	\$ 4
2022	3	—	3
2023	2	—	2
2024	2	—	2
2025	2	—	2
Thereafter	4	—	4
<i>Total lease payments</i>	16	1	17
Less imputed interest	(2)	—	(2)
<i>Total net present value</i>	<u>\$ 14</u>	<u>\$ 1</u>	<u>\$ 15</u>

As of December 31, 2020, additional operating leases agreements, primarily for vehicles, that have not yet commenced are \$1 million. These leases are expected to commence within the next 18 months lease terms of 5 to 10 years.

## 7. VARIABLE INTEREST ENTITY

PE performs qualitative analyses based on control and economics to determine whether a variable interest classifies PE as the primary beneficiary (a controlling financial interest) of a VIE. An enterprise has a controlling financial interest if it has both power and economic control, such that an entity has (i) the power to direct the activities of a VIE that most significantly impact the entity's economic performance, and (ii) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. PE consolidates a VIE when it is determined that it is the primary beneficiary.

### Consolidated VIEs

VIEs in which PE is the primary beneficiary consist of the following (included in PE's consolidated financial statements):

- *PE Environmental Funding Companies* - The consolidated financial statements of PE include environmental control bonds issued by a bankruptcy remote, special purpose limited liability company that is an indirect subsidiary of PE. Proceeds from the bonds were used to construct environmental control facilities. The special purpose limited liability company owns the irrevocable right to collect non-bypassable environmental control charges from all customers who receive electric delivery service in PE's West Virginia service territory. Principal and interest owed on the environmental control bonds is secured by, and payable solely from, the proceeds of the environmental control charges. Creditors of PE, other than the special purpose limited liability company, have no recourse to any assets or revenues of the special purpose limited liability company. The cash collected from PE customers is used to service debt of the funding company. As of December 31, 2020 and 2019, \$75 million and \$81 million of environmental control bonds were outstanding, respectively.

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Unconsolidated VIEs**

PE is not the primary beneficiary of the following VIEs

- *Power Purchase Agreements* - As part of this process, PE evaluated its power purchase agreements and determined that its contract with a NUG entity may be a VIE as the NUG entity owns a plant that sells substantially all of its output to PE and the contract price for power may be correlated with the plant's variable costs of production. The agreement was entered into pursuant to the PURPA. PE was not involved in the creation of this entity. PE has applied the scope exception that exempts enterprises unable to obtain the necessary information to evaluate entities. Because PE has no equity or debt interests in the NUG entity, its maximum exposure to loss relates primarily to the above-market costs incurred for power. PE expects any above-market costs incurred to be recovered from customers. Purchased power costs related to the contract were \$113 million and \$116 million during the years ended December 31, 2020 and 2019, respectively.

**8. FAIR VALUE MEASUREMENTS**

All borrowings with initial maturities of less than one year are defined as short-term financial instruments under GAAP and are reported as Short-term borrowings on the Consolidated Balance Sheets at cost. Since these borrowings are short-term in nature, PE believes that their costs approximate their fair market value. The following table provides the approximate fair value and related carrying amounts of long-term debt, which excludes finance lease obligations, net unamortized debt issuance costs and unamortized fair value adjustments:

<i>(In millions)</i>	December 31, 2020		December 31, 2019	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Long-term debt	\$ 750	\$ 793	\$ 581	\$ 667

The fair values of long-term debt reflect the present value of the cash outflows relating to those securities based on the current call price, the yield to maturity or the yield to call, as deemed appropriate at the end of each respective period. The yields assumed were based on securities with similar characteristics offered by corporations with credit ratings similar to those of PE. PE classified short-term borrowings, long-term debt as Level 2 in the fair value hierarchy as of December 31, 2020 and December 31, 2019.

**9. CAPITALIZATION**

**COMMON STOCK**

PE is authorized to issue 26,000,000 shares of common stock, \$0.01 par value, as of December 31, 2020. As of December 31, 2020 and 2019, there were 22,385,000 common shares outstanding.

**PREFERRED STOCK**

PE is authorized to issue 10,000,000 shares of preferred stock, \$0.01 par value, as of December 31, 2020. As of December 31, 2020 and 2019, there were no preferred shares outstanding.

**LONG-TERM DEBT AND OTHER LONG-TERM OBLIGATIONS**

The following table presents outstanding long-term debt and finance lease obligations for PE as of December 31, 2020 and 2019:

<i>(Dollar amounts in millions)</i>	As of December 31, 2020		As of December 31,	
	Maturity Date	Interest Rate	2020	2019
FMBs	2032 - 2051	2.670% - 4.470%	\$ 675	\$ 500
Secured notes - fixed rate	2026 - 2031	5.127% - 5.523%	75	81
Finance lease obligations			1	1
Unamortized fair value adjustments			2	2
Unamortized debt issuance costs			(5)	(3)
Currently payable long-term debt			(7)	(7)
Total long-term debt and other long-term obligations			<u>\$ 741</u>	<u>\$ 574</u>

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On June 29, 2020, PE issued \$75 million of 2.67% FMBs due 2032 and \$100 million of 3.43% FMBs due 2051. Proceeds of the issuance of the FMBs were used to repay short-term borrowings under the FirstEnergy regulated money pool, to fund capital expenditures, and for general corporate purposes.

The following table presents scheduled debt repayments for outstanding long-term debt, excluding finance leases, fair value purchase accounting adjustments and unamortized debt discounts and premiums, for the next five years as of December 31, 2020.

Year	PE
	<i>(In millions)</i>
2021	\$ 6
2022	7
2023	7
2024	8
2025	8

*Environmental Control Bonds*

The consolidated financial statements of PE include environmental control bonds issued by a bankruptcy remote, special purpose limited liability company that is an indirect subsidiary of PE. Proceeds from the bonds were used to construct environmental control facilities. Principal and interest owed on the environmental control bonds is secured by, and payable solely from, the proceeds of the environmental control charges. As of December 31, 2020 and 2019, \$75 million and \$81 million of environmental control bonds were outstanding, respectively.

See Note 7, "Variable Interest Entity" for additional information on securitized bonds.

*Debt Covenant Default Provisions*

PE has various debt covenants under certain financing arrangements, including its revolving credit facility. The most restrictive of the debt covenants relate to the nonpayment of interest and/or principal on such debt and the maintenance of certain financial ratios. The failure by PE to comply with the covenants contained in any of its financing arrangements could result in an event of default, which may have an adverse effect on PE's financial condition.

Additionally, there are cross-default provisions in certain financing arrangements of FE and its subsidiaries, including PE. These provisions generally trigger a default in the applicable financing arrangement of an entity if it or any of its significant subsidiaries default under another financing arrangement in excess of a certain principal amount, typically \$100 million. Although such defaults by PE would generally cross-default FE financing arrangements containing these provisions, defaults by FE would generally not cross-default applicable PE financing arrangements.

As of December 31, 2020, PE was in compliance with all debt covenant default provisions.

**10. SHORT-TERM BORROWINGS AND BANK LINES OF CREDIT**

PE had \$34 million and \$26 million of outstanding short-term borrowings as of December 31, 2020 and 2019, respectively.

*Revolving Credit Facilities*

FE and the Utilities, including PE, participate in a five-year syndicated revolving credit facility, which was amended on October 19, 2018, providing for aggregate commitments of \$2.5 billion (Facility), which are available through December 6, 2022. Under the amended Facility, FE and the Utilities may use borrowings under their respective facility for working capital and other general corporate purposes, including intercompany loans and advances by a borrower to any of its subsidiaries. Generally, borrowings under the Facility are available to each borrower separately and mature on the earlier of 364 days from the date of borrowing or the commitment termination date, as the same may be extended. The Facility contains financial covenants requiring each borrower to maintain a consolidated debt-to-total-capitalization ratio (as defined under the Facility) of no more than 65% measured at the end of each fiscal quarter.

On November 17, 2020, FE and the Utilities entered into an amendment to the FE credit facility. The amendment provides for modifications and/or waivers of: (i) certain representations and warranties, and (ii) certain affirmative and negative covenants, contained therein, which allowed FirstEnergy to regain compliance with such provisions.

On November 23, 2020, FE and its regulated distribution subsidiaries, JCP&L, ME, Penn, TE, and WP, borrowed \$950 million in the aggregate under the FE Revolving Facility, bringing the outstanding principal balance under the FE Revolving Facility to \$1.2

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billion, with \$1.3 billion of remaining availability under the FE Revolving Facility. Borrowings were increased under the Revolving Facility as a proactive measure to increase the respective cash position and preserve financial flexibility.

Under the Facility, PE may borrow up to its sub-limit of \$150 million, all of which was available to PE as of December 31, 2020. PE has regulatory and other short-term debt limitations of \$150 million which includes amounts that may be borrowed under the regulated companies' money pool.

The Facility does not contain provisions that restrict the ability to borrow or accelerate payment of outstanding advances in the event of any change in credit ratings of the borrowers. Pricing is defined in "pricing grids," whereby the cost of funds borrowed under the Facility is related to the credit ratings of the company borrowing the funds. Additionally, borrowings under the Facility are subject to the usual and customary provisions for acceleration upon the occurrence of events of default, including a cross-default for other indebtedness in excess of \$100 million.

***FirstEnergy Money Pool***

FE's utility and transmission operating subsidiary companies, including PE, also have the ability to borrow from each other and the holding company to meet their short-term working capital requirements. FESC administers this money pool and tracks surplus funds of FE and the respective regulated subsidiaries, as well as proceeds available from bank borrowings. Companies receiving a loan under the money pool agreement must repay the principal amount of the loan, together with accrued interest, within 364 days of borrowing the funds. The rate of interest is the same for each company receiving a loan from the regulated pool and is based on the average cost of funds available through the pool. The average interest rate for borrowings in 2020 was 0.89% per annum.

**11. REGULATORY MATTERS**

**STATE REGULATION**

PE's retail rates, conditions of service, issuance of securities and other matters are subject to regulation in Maryland by the MDPSC and in West Virginia by the WVPSC. The transmission operations of PE in Virginia are subject to certain regulations of the VSCC. The key terms of PE's current rate orders for distribution customer billings, which have been effective since February 2015 and March 2019 for West Virginia and Maryland, respectively, include allowed debt/equity ratios of 54%/46% and 47%/53%, respectively, and an allowed ROE of 9.65% for Maryland. The WVPSC-approved settlement agreement for its West Virginia rates did not disclose ROE.

**MARYLAND**

PE operates under MDPSC approved base rates that were effective as of March 23, 2019. PE also provides SOS pursuant to a combination of settlement agreements, MDPSC orders and regulations, and statutory provisions. SOS supply is competitively procured in the form of rolling contracts of varying lengths through periodic auctions that are overseen by the MDPSC and a third-party monitor. Although settlements with respect to SOS supply for PE customers have expired, service continues in the same manner until changed by order of the MDPSC. PE recovers its costs plus a return for providing SOS.

The EmPOWER Maryland program requires each electric utility to file a plan to reduce electric consumption and demand 0.2% per year, up to the ultimate goal of 2% annual savings, for the duration of the 2018-2020 and 2021-2023 EmPOWER Maryland program cycles, to the extent the MDPSC determines that cost-effective programs and services are available. PE's approved 2018-2020 EmPOWER Maryland plan continues and expands upon prior years' programs, and adds new programs, for a projected total cost of \$116 million over the three-year period. PE recovers program costs through an annually reconciled surcharge, with most costs subject to a five-year amortization. Maryland law only allows for the utility to recover lost distribution revenue attributable to energy efficiency or demand reduction programs through a base rate case proceeding, and to date, such recovery has not been sought or obtained by PE. On September 1, 2020, PE filed its proposed plan for the 2021-2023 EmPOWER Maryland program cycle. The new plan largely continues PE's existing programs and is estimated to cost approximately \$148 million over the three-year period. The MDPSC approved the plan on December 18, 2020.

On January 19, 2018, PE filed a joint petition along with other utility companies, work group stakeholders and the MDPSC electric vehicle work group leader to implement a statewide electric vehicle portfolio in connection with a 2016 MDPSC proceeding to consider an array of issues relating to electric distribution system design, including matters relating to electric vehicles, distributed energy resources, advanced metering infrastructure, energy storage, system planning, rate design, and impacts on low-income customers. PE proposed an electric vehicle charging infrastructure program at a projected total cost of \$12 million, to be recovered over a five-year amortization. On January 14, 2019, the MDPSC approved the petition subject to certain reductions in the scope of the program. The MDPSC approved PE's compliance filing, which implements the pilot program, with minor modifications, on July 3, 2019.

On August 24, 2018, PE filed a base rate case with the MDPSC, which it supplemented on October 22, 2018, to update the partially forecasted test year with a full twelve months of actual data. The rate case requested an annual increase in base distribution rates of \$19.7 million, plus creation of an EDIS to fund four enhanced service reliability programs. In responding to

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discovery, PE revised its request for an annual increase in base rates to \$17.6 million. The proposed rate increase reflected \$7.3 million in annual savings for customers resulting from the recent federal tax law changes. On March 22, 2019, the MDPSC issued a final order that approved a rate increase of \$6.2 million, approved three of the four EDIS programs for four years, directed PE to file a new depreciation study within 18 months, and ordered the filing of a new base rate case in four years to correspond to the ending of the approved EDIS programs. On September 22, 2020, PE filed its depreciation study reflecting a depreciation expense of \$36.2 million, which represented a slight increase, and as a result, is seeking the difference in depreciation be deferred for future recovery in PE's next base rate case. The MDPSC has set the matter for hearing and delegated it to a public utility law judge. On November 6, 2020, an order was issued scheduling evidentiary hearings in April 2021. On January 29, 2021, the Maryland Office of People's Counsel filed testimony recommending a reduction in depreciation expense of \$10.8 million, and the staff of the MDPSC filed testimony recommending a reduction of \$9.6 million. PE's rebuttal testimony was filed on March 2, 2021.

Maryland's Governor issued an order on March 16, 2020, forbidding utilities from terminating residential service or charging late fees for non-payment for the duration of the COVID-19 pandemic. On April 9, 2020, the MDPSC issued an order allowing utilities to track and create a regulatory asset for future recovery of all prudently incurred incremental costs arising from the COVID-19 pandemic, including incremental uncollectible expense, incurred from the date of the Governor's order (or earlier if the utility could show that the expenses related to suspension of service terminations). On July 8, 2020, the MDPSC issued a notice opening a public conference to collect information from utilities and other stakeholders about the impacts of the COVID-19 pandemic on the utilities and their customers. The MDPSC subsequently issued orders allowing Maryland electric and gas utilities to resume residential service terminations for non-payment on November 15, 2020, subject to various restrictions, and clarifying that utilities could resume charging late fees on October 1, 2020.

### **WEST VIRGINIA**

PE provides electric service to all customers through traditional cost-based, regulated utility ratemaking and operates under rates approved by the WVPSC effective February 2015. PE recovers net power supply costs, including fuel costs, purchased power costs and related expenses, net of related market sales revenue through the ENEC. PE's ENEC rate is updated annually.

On March 13, 2020, the WVPSC urged all utilities to suspend utility service terminations except where necessary as a matter of safety or where requested by the customer. On May 15, 2020, the WVPSC issued an order to authorize MP and PE to record a deferral of additional, extraordinary costs directly related to complying with the various COVID-19 government shut-down orders and operational precautions, including impacts on uncollectible expense and cash flow related to temporary discontinuance of service terminations for non-payment and any credits to minimum demand charges associated with business customers adversely impacted by shut-downs or temporary closures related to the pandemic. MP and PE resumed disconnection activity for commercial and industrial customers on September 15, 2020, and for residential customers on November 4, 2020.

On August 28, 2020, MP and PE filed with the WVPSC their annual ENEC case requesting a decrease in ENEC rates of \$55 million beginning January 1, 2021, representing a 4% decrease in rates compared to those in effect on August 28, 2020. The decrease in the ENEC rates is net of recovering approximately \$10.5 million in previously deferred, incremental uncollectible and other related costs resulting from the COVID-19 pandemic. The WVPSC approved a unanimous settlement by the parties on December 16, 2020 with rates effective January 1, 2021.

Also, on August 28, 2020, MP and PE filed with the WVPSC for recovery of costs associated with modernization and improvement program for their coal-fired boilers. The proposed annual revenue increase for these environmental compliance projects is \$5 million beginning January 1, 2021. The WVPSC approved a unanimous settlement by the parties on December 16, 2020 approving the recovery of those costs.

On December 30, 2020, MP and PE filed an integrated resource plan with the WVPSC. The plan projects a small capacity deficit but an energy surplus in MP's and PE's supply resources when compared with current WV load demand and projects the capacity deficit growing over the next 15 years. The plan does not recommend additional supply-side resources with a possible exception for small utility-scale solar resources and recommends that the capacity deficit be met through the PJM capacity market. MP currently expects to seek approval in 2021 to construct solar generation sources of up to 50 MWs.

On December 30, 2020, MP and PE filed with the WVPSC a determination of the rate impact of the Tax Act with respect to ADIT. The filing proposes an annual revenue reduction of \$2.6 million annually, effective January 1, 2022, with reconciliation and any resulting adjustments incorporated into the annual ENEC proceedings.

### **FERC REGULATORY MATTERS**

Under the FPA, FERC regulates rates for interstate wholesale sales, transmission of electric power, accounting and other matters. With respect to its wholesale services and rates, PE is subject to regulation by FERC. FERC regulations require PE to provide open access transmission service at FERC-approved rates, terms and conditions. Transmission facilities of PE are subject to functional control by PJM and transmission service using PE's transmission facilities is provided by PJM under the PJM Tariff. PE provides transmission service under a stated transmission rate pursuant to a FERC-approved settlement

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agreement that did not specify an allowed capital structure or ROE; although as noted below, on January 1, 2021, PE implemented a forward-looking formula rate, which has been accepted by FERC, subject to refund, pending further hearing and settlement procedures.

FERC regulates the sale of power for resale in interstate commerce in part by granting authority to public utilities to sell wholesale power at market-based rates upon showing that the seller cannot exert market power in generation or transmission or erect barriers to entry into markets. PE has been authorized by FERC to sell wholesale power in interstate commerce at market-based rates and have a market-based rate tariff on file with FERC, although major wholesale purchases remain subject to review and regulation by the relevant state commissions.

Federally-enforceable mandatory reliability standards apply to the bulk electric system and impose certain operating, record-keeping and reporting requirements on PE. NERC is the Electric Reliability Organization designated by FERC to establish and enforce these reliability standards, although NERC has delegated day-to-day implementation and enforcement of these reliability standards to six regional entities, including RFC. All of the facilities that FirstEnergy operates, including those of PE, are located within the RFC region. FirstEnergy actively participates in the NERC and RFC stakeholder processes, and otherwise monitors and manages its companies, including PE, in response to the ongoing development, implementation and enforcement of the reliability standards implemented and enforced by RFC.

FirstEnergy, including PE, believes that it is in material compliance with all currently-effective and enforceable reliability standards. Nevertheless, in the course of operating its extensive electric utility systems and facilities, FirstEnergy, including PE, occasionally learns of isolated facts or circumstances that could be interpreted as excursions from the reliability standards. If and when such occurrences are found, FirstEnergy, including PE, develops information about the occurrence and develops a remedial response to the specific circumstances, including in appropriate cases “self-reporting” an occurrence to RFC. Moreover, it is clear that NERC, RFC and FERC will continue to refine existing reliability standards as well as to develop and adopt new reliability standards. Any inability on FirstEnergy's, including PE's, part to comply with the reliability standards for its bulk electric system could result in the imposition of financial penalties, or obligations to upgrade or build transmission facilities, that could have a material adverse effect on PE's financial condition, results of operations and cash flows.

*FERC Actions on Tax Act*

On March 15, 2018, FERC initiated proceedings on the question of how to address possible changes to ADIT and bonus depreciation as a result of the Tax Act. Such possible changes could impact FERC-jurisdictional rates, including transmission rates. On November 21, 2019, FERC issued a final rule (Order No. 864). Order No. 864 requires utilities with transmission formula rates to update their formula rate templates to include mechanisms to (i) deduct any excess ADIT from or add any deficient ADIT to their rate base; (ii) raise or lower their income tax allowances by any amortized excess or deficient ADIT; and (iii) incorporate a new permanent worksheet into their rates that will annually track information related to excess or deficient ADIT. PE (as holder of a “stated” transmission rate) is addressing these requirements in the transmission formula rates amendments that were filed on October 29, 2020.

*Transmission ROE Methodology*

FERC's methodology for calculating electric transmission utility ROE has been in transition as a result of an April 14, 2017 ruling by the D.C. Circuit that vacated FERC's then-effective methodology. On May 21, 2020, FERC issued Opinion No. 569-A that changed FERC's ROE methodology. Under this methodology FERC established an ROE that is based on three financial models – discounted cash flow, capital-asset pricing, and risk premium – to calculate a composite zone of reasonableness. FERC noted that utilities could, in utility-specific proceedings, ask to have the expected earnings methodology included in calculating the utility's authorized ROE. FERC also noted that, going forward, it will divide that zone into three equal parts, to be used for high risk, normal risk, and low risk utilities. A given utility will be assigned to one of these three parts of the zone of reasonableness, and its ROE will be set at the median or midpoint of the other utilities that are in the applicable third of the zone. FirstEnergy filed a request for rehearing, which FERC denied on July 22, 2020. On November 19, 2020, FERC issued Opinion No. 569-B, which affirmed the Opinion No. 569-A rulings. FirstEnergy initiated, but subsequently withdrew, appeals of these orders. Appeals of Opinion Nos. 569, 569-A and 569-B are pending before the D.C. Circuit. Any changes to FERC's transmission rate ROE and incentive policies would be applied on a prospective basis.

On March 20, 2020, FERC initiated a rulemaking proceeding on the transmission rate incentives provisions of Section 219 of the 2005 Energy Policy Act. Initial comments were submitted July 1, 2020, and reply comments were filed on July 16, 2020. FirstEnergy participated through EEI and through a consortium of PJM Transmission Owners. This proceeding is pending before FERC.

*Allegheny Power Zone Transmission Formula Rate Filings*

On October 29, 2020, MP, PE and WP filed tariff amendments with FERC to convert their existing stated transmission rate to a forward-looking formula transmission rate, effective January 1, 2021. In addition, on October 30, 2020, KATCo filed a proposed new tariff to establish a forward-looking formula rate, and requested that the new rate become effective January 1, 2021. In its

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filing, KATCo explained that while it currently owns no transmission assets, it may build new transmission facilities in the Allegheny zone, and that it may seek required state and federal authorizations to acquire transmission assets from PE and WP by January 1, 2022. These transmission rate filings were approved by FERC on December 31, 2020, subject to refund, pending further hearing and settlement proceedings. MP, PE and WP, and KATCo are engaged in settlement negotiations with the other parties to the formula rate proceedings.

## **12. COMMITMENTS AND CONTINGENCIES**

### **ENVIRONMENTAL MATTERS**

Various federal, state and local authorities regulate PE with regard to air and water quality, hazardous and solid waste disposal, and other environmental matters. While PE's environmental policies and procedures are designed to achieve compliance with applicable environmental laws and regulations, such laws and regulations are subject to periodic review and potential revision by the implementing agencies. PE cannot predict the timing or ultimate outcome of any of these reviews or how any future actions taken as a result thereof may materially impact its business, results of operations, cash flows and financial condition.

### **OTHER LEGAL PROCEEDINGS**

#### *United States v. Larry Householder, et al.*

On July 21, 2020, a complaint and supporting affidavit containing federal criminal allegations were unsealed against the now former Ohio House Speaker Larry Householder and other individuals and entities allegedly affiliated with Mr. Householder. Also, on July 21, 2020, and in connection with the investigation, FirstEnergy received subpoenas for records from the U.S. Attorney's Office for the S.D. Ohio. FirstEnergy was not aware of the criminal allegations, affidavit or subpoenas before July 21, 2020. No contingency has been reflected in FirstEnergy's consolidated financial statements as a loss is neither probable, nor is a loss or range of a loss reasonably estimable.

#### *Legal Proceedings Relating to United States v. Larry Householder, et al.*

In addition to the subpoenas referenced above under "—United States v. Larry Householder, et. al.", certain FE stockholders and FirstEnergy customers filed several lawsuits against FirstEnergy and certain current and former directors, officers and other employees, and the complaints in each of these suits is related to allegations in the complaint and supporting affidavit relating to HB 6 and the now former Ohio House Speaker Larry Householder and other individuals and entities allegedly affiliated with Mr. Householder.

- *Owens v. FirstEnergy Corp. et al. and Frand v. FirstEnergy Corp. et al.* (Federal District Court, S.D. Ohio); on July 28, 2020 and August 21, 2020, purported stockholders of FE filed putative class action lawsuits against FE and certain FE officers, purportedly on behalf of all purchasers of FE common stock from February 21, 2017 through July 21, 2020, asserting claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, alleging misrepresentations or omissions by FirstEnergy concerning its business and results of operations. These actions have been consolidated and a lead plaintiff has been appointed by the court. A Consolidated Complaint was filed on February 26, 2021.
- *Gendrich v. Anderson, et al. and Sloan v. Anderson, et al.* (Common Pleas Court, Summit County, OH); on July 26, 2020 and July 31, 2020, respectively, purported stockholders of FE filed shareholder derivative action lawsuits against certain FE directors and officers, alleging, among other things, breaches of fiduciary duty. These actions have been consolidated.
- *Miller v. Anderson, et al.* (Federal District Court, N.D. Ohio); *Bloom, et al. v. Anderson, et al.*; *Employees Retirement System of the City of St. Louis v. Jones, et al.*; *Electrical Workers Pension Fund, Local 103, I.B.E.W. v. Anderson et al.*; *Massachusetts Laborers Pension Fund v. Anderson et al.*; *The City of Philadelphia Board of Pensions and Retirement v. Anderson et al.*; *Atherton v. Dowling et al.*; *Behar v. Anderson, et al.* (U.S. District Court, S.D. Ohio, all actions have been consolidated); beginning on August 7, 2020, purported stockholders of FE filed shareholder derivative actions alleging the board and officers breached their fiduciary duties and committed violations of Section 14(a) of the Securities Exchange Act of 1934. The cases in the Southern District of Ohio have been consolidated and co-lead plaintiffs have been appointed by the court.
- *Smith v. FirstEnergy Corp. et al., Buldas v. FirstEnergy Corp. et al., and Hudock and Cameo Countertops, Inc. v. FirstEnergy Corp. et al.* (Federal District Court, S.D. Ohio); on July 27, 2020, July 31, 2020, and August 5, 2020, respectively, purported customers of FirstEnergy filed putative class action lawsuits against FE and FESC, as well as certain current and former FirstEnergy officers, alleging civil Racketeer Influenced and Corrupt Organizations Act violations and related state law claims. These actions have been consolidated.
- *State of Ohio ex rel. Dave Yost, Ohio Attorney General v. FirstEnergy Corp., et al. and City of Cincinnati and City of Columbus v. FirstEnergy Corp.* (Common Pleas Court, Franklin County, OH); on September 23, 2020 and October 27, 2020, the OAG and the cities of Cincinnati and Columbus, respectively, filed complaints against several parties including FE, each alleging civil violations of the Ohio Corrupt Activity Act in connection with the passage of HB 6. The OAG sought a preliminary injunction to prevent each of the defendants, including FE, through the end of 2020, from: (i) contributing to any groups whose purpose is to keep or modify HB 6; (ii) making any public statements for or against any repeal or modification legislation concerning HB 6; (iii) lobbying, consulting, or advising on these matters; or (iv)

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contributing to any Ohio legislative candidates. The court denied the OAG's request for preliminary injunctive relief on October 2, 2020. On January 13, 2021, the OAG filed a motion for a temporary restraining order and preliminary injunction against FirstEnergy seeking to enjoin FirstEnergy from collecting the Ohio Companies' decoupling rider. On January 31, 2021, FE reached a partial settlement with the OAG and the cities of Cincinnati and Columbus with respect to the temporary restraining order and preliminary injunction request and related issues. In connection with the partial settlement, the Ohio Companies filed an application on February 1, 2021, with the PUCO to set their respective decoupling riders (CSR) to zero. On February 2, 2021, the PUCO approved the application of the Ohio Companies setting the rider to zero and no additional customer bills will include new decoupling rider charges after February 8, 2021. The cities of Dayton and Toledo have also been added as plaintiffs to the action. These actions have been consolidated.

- *Emmons v. FirstEnergy Corp. et al.* (Common Pleas Court, Cuyahoga County, OH); on August 4, 2020, a purported customer of FirstEnergy filed a putative class action lawsuit against FE, FESC, OE, TE and CEI, along with FES, alleging several causes of action, including negligence and/or gross negligence, breach of contract, unjust enrichment, and unfair or deceptive consumer acts or practices. On October 1, 2020, plaintiffs filed a First Amended Complaint, adding as a plaintiff a purported customer of FirstEnergy and alleging a civil violation of the Ohio Corrupt Activity Act and civil conspiracy against FE, FESC and FES.

The plaintiffs in each of the above cases, seek, among other things, to recover an unspecified amount of damages (unless otherwise noted). In addition, on August 10, 2020, the SEC, through its Division of Enforcement, issued an order directing an investigation of possible securities laws violations by FE, and on September 1, 2020, issued subpoenas to FE and certain FE officers. Further, in letters dated January 26 and February 22, 2021, staff of FERC's Division of Investigations notified FirstEnergy that the Division is conducting an investigation of FirstEnergy's lobbying and governmental affairs activities concerning HB 6, and staff directed FirstEnergy to preserve and maintain all documents and information related to the same as such have been developed as part of an ongoing audit that is being conducted by FERC's Division of Audits and Accounting. The outcome of any of these lawsuits, investigations and audit are uncertain and could have a material adverse effect on FE's or its subsidiaries' financial condition, results of operations and cash flows. No contingency has been reflected in FirstEnergy's consolidated financial statements as a loss is neither probable, nor is a loss or range of a loss reasonably estimable.

*Internal Investigation Relating to United States v. Larry Householder, et al.*

As previously disclosed, a committee of independent members of the FE Board is directing an internal investigation related to ongoing government investigations. In connection with FirstEnergy's internal investigation, such committee determined on October 29, 2020, to terminate FirstEnergy's Chief Executive Officer, Charles E. Jones, together with two other executives: Dennis M. Chack, Senior Vice President of Product Development, Marketing, and Branding; and Michael J. Dowling, Senior Vice President of External Affairs. Each of these terminated executives violated certain FirstEnergy policies and its code of conduct. These executives were terminated as of October 29, 2020. Such former members of senior management did not maintain and promote a control environment with an appropriate tone of compliance in certain areas of FirstEnergy's business, nor sufficiently promote, monitor or enforce adherence to certain FirstEnergy policies and its code of conduct. Furthermore, certain former members of senior management did not reasonably ensure that relevant information was communicated within our organization and not withheld from our independent directors, our Audit Committee, and our independent auditor. Among the matters considered with respect to the determination by the committee of independent members of the FE Board that certain former members of senior management violated certain FirstEnergy policies and its code of conduct related to a payment of approximately \$4 million made in early 2019 in connection with the termination of a purported consulting agreement, as amended, which had been in place since 2013. The counterparty to such agreement was an entity associated with an individual who subsequently was appointed to a full-time role as an Ohio government official directly involved in regulating the Ohio Companies, including with respect to distribution rates. FirstEnergy believes that payments under the consulting agreement may have been for purposes other than those represented within the consulting agreement. Immediately following these terminations, the independent members of its Board appointed Mr. Steven E. Strah to the position of Acting Chief Executive Officer and Mr. Christopher D. Pappas, a current member of the Board, to the temporary position of Executive Director, each effective as of October 29, 2020. Mr. Donald T. Misheff will continue to serve as Non-Executive Chairman of the Board. Additionally, on November 8, 2020, Robert P. Reffner, Senior Vice President and Chief Legal Officer, and Ebony L. Yeboah-Amankwah, Vice President, General Counsel, and Chief Ethics Officer, were separated from FirstEnergy due to inaction and conduct that the Board determined was influenced by the improper tone at the top. The matter is a subject of the ongoing internal investigation as it relates to the government investigations. Additionally, on February 17, 2021, the FE Board appointed Mr. John Somerhalder to the positions of Vice Chairperson of the FE Board and Executive Director of FE, each effective as of March 1, 2021. Mr. Misheff will continue to serve as Non-Executive Chairman of the FE Board and Mr. Pappas will continue to serve on the FE Board as an independent director. Mr. Somerhalder will help lead efforts to enhance FirstEnergy's reputation. On March 7, 2021, the FE Board appointed Mr. Steven E. Strah to the position of Chief Executive Officer of FirstEnergy, effective as of March 8, 2021. On March 7, 2021, at the recommendation of the FirstEnergy Corporate Governance and Corporate Responsibility Committee, the FE Board also elected Mr. Strah as a Director of FirstEnergy, effective as of March 8, 2021, increasing the size of the FE Board from 11 to 12 members. Mr. Strah has been elected to the FE Board to serve for a term expiring at the FirstEnergy's 2021 Annual Meeting of Shareholders and until his successor shall have been elected. Also, in connection with the internal investigation, FirstEnergy recently identified certain transactions, which, in some instances, extended back ten years or more, including vendor services, that were either improperly classified, misallocated to certain of the Utilities and Transmission Companies, or lacked proper supporting documentation. These transactions resulted in amounts collected from customers that were immaterial to

**THE POTOMAC EDISON COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

FirstEnergy and PE. The Utilities and Transmission Companies will be working with the appropriate regulatory agencies to address these amounts.

*Other Legal Matters*

There are various lawsuits, claims (including claims for asbestos exposure) and proceedings related to PE's normal business operations pending against PE and its subsidiaries. The loss or range of loss in these matters is not expected to be material to PE or its subsidiaries. The other potentially material items not otherwise discussed above are described under Note 11, "Regulatory Matters."

PE accrues legal liabilities only when it concludes that it is probable that it has an obligation for such costs and can reasonably estimate the amount of such costs. In cases where PE determines that it is not probable, but reasonably possible that it has a material obligation, it discloses such obligations and the possible loss or range of loss if such estimate can be made. If it were ultimately determined that PE or its subsidiaries have legal liability or are otherwise made subject to liability based on any of the matters referenced above, it could have a material adverse effect on PE's or its subsidiaries' financial condition, results of operations and cash flows.

**13. TRANSACTIONS WITH AFFILIATED COMPANIES**

PE's operating revenues, operating expenses, miscellaneous income and interest expenses include transactions with affiliated companies. These affiliated company transactions include affiliated company power sales agreements between FirstEnergy's regulated companies, support service billings, interest on affiliated company notes including the money pool, and other transactions.

The primary affiliated company transactions for PE during the years ended December 31, 2020 and 2019 are as follows:

	<b>For the Years Ended December 31,</b>	
	<b>2020</b>	<b>2019</b>
	<i>(In millions)</i>	
Revenues	\$ 2	\$ 2
Expenses:		
Purchased power from affiliates <sup>(1)</sup>	193	275
Support services	57	54
Miscellaneous Income	1	1
Interest income from affiliates	1	—

<sup>(1)</sup> Primarily related to purchases from FES prior to emergence.

FirstEnergy does not bill directly or allocate any of its costs to any subsidiary company. Costs are allocated from FESC, a subsidiary of FE. The majority of costs are directly billed or assigned at no more than cost. The remaining costs are for services that are provided on behalf of more than one company, or costs that cannot be precisely identified and are allocated using formulas developed by FESC. The current allocation or assignment formulas used and their bases include multiple factor formulas: each company's proportionate amount of FirstEnergy's aggregate direct payroll, number of employees, asset balances, revenues, number of customers, other factors and specific departmental charge ratios. Intercompany transactions with FirstEnergy and its other subsidiaries are generally settled under commercial terms within thirty days.

Affiliate accounts receivable and accounts payable balances relate to intercompany transactions that have not yet settled through the FirstEnergy money pool (see Note 10, "Short-Term Borrowings and Bank Lines of Credit").

PE and FirstEnergy's other subsidiaries are parties to an intercompany income tax allocation agreement with FE and its other subsidiaries that provides for the allocation of consolidated tax liabilities. Net tax benefits attributable to FE are generally reallocated to the subsidiaries of FirstEnergy that have taxable income. That allocation is accounted for as a capital contribution to the company receiving the tax benefit (see Note 5, "Taxes").

Additionally, PE purchases power from MP to meet a portion of its POLR and default service requirements as well as provide power to certain facilities. See Note 6, "Leases," for additional information on the agreement with MP.