

THE POTOMAC EDISON COMPANY AND SUBSIDIARIES
AUDITED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2019 AND 2018

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:

AE	Allegheny Energy, Inc., a Maryland utility holding company that merged with a subsidiary of FirstEnergy on February 25, 2011, which subsequently merged with and into FE on January 1, 2014
AE Supply	Allegheny Energy Supply Company, LLC, an unregulated generation affiliated company
CEI	The Cleveland Electric Illuminating Company, an Ohio electric utility operating affiliated company
FE	FirstEnergy Corp., a publicly owned holding company
FES	FirstEnergy Solutions Corp., together with its consolidated subsidiaries, which provides energy-related products and services. On March 31, 2018, FES filed voluntary petitions under Chapter 11 of the United States Bankruptcy Code with the Bankruptcy Court. FES was deconsolidated from FirstEnergy's consolidated financial statements as of March 31, 2018.
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, 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
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
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
D.C. Circuit	United States Court of Appeals for the District of Columbia Circuit
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
IRS	Internal Revenue Service
MDPSC	Maryland Public Service Commission
NERC	North American Electric Reliability Corporation
NOL	Net Operating Loss

GLOSSARY OF TERMS, *Continued*

NUG	Non-Utility Generation
OPEB	Other Post-Employment Benefits
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
PURPA	Public Utility Regulatory Policies Act of 1978
RFC	Reliability <i>First</i> Corporation
ROE	Return on Equity
SOS	Standard Offer Service
Tax Act	Tax Cuts and Jobs Act adopted December 22, 2017
VIE	Variable Interest Entity
VSCC	Virginia State Corporation Commission
WPSC	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, 2019 and 2018, and the related consolidated statements of income and 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, 2019 and 2018, 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 4, 2020

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

<i>(In millions)</i>	For the Years Ended December 31,	
	2019	2018
REVENUES:		
Electric sales	\$ 828	\$ 886
Excise and gross receipts tax collections	17	18
Total revenues	845	904
OPERATING EXPENSES:		
Purchased power from non-affiliates	240	217
Purchased power from affiliates	275	305
Other operating expenses	161	163
Provision for depreciation	67	65
Deferral (amortization) of regulatory liabilities, net	(28)	15
General taxes	47	47
Total operating expenses	762	812
OPERATING INCOME	83	92
OTHER INCOME (EXPENSE):		
Miscellaneous income, net	9	12
Pension and OPEB mark-to-market adjustment	8	(14)
Interest expense	(28)	(28)
Capitalized financing costs	3	3
Total other expense	(8)	(27)
INCOME BEFORE INCOME TAXES	75	65
INCOME TAXES	15	13
NET INCOME	\$ 60	\$ 52
<u>STATEMENTS OF COMPREHENSIVE INCOME</u>		
NET INCOME	\$ 60	\$ 52
OTHER COMPREHENSIVE LOSS:		
Pension and OPEB prior service costs	(3)	(3)
Other comprehensive loss	(3)	(3)
Income tax benefits on other comprehensive loss	(1)	(2)
Other comprehensive loss, net of tax	(2)	(1)
COMPREHENSIVE INCOME	\$ 58	\$ 51

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, 2019	December 31, 2018
ASSETS		
CURRENT ASSETS:		
Restricted cash	\$ 6	\$ 15
Receivables-		
Customers, net of allowance for uncollectible accounts of \$2 in 2019 and 2018	88	101
Affiliated companies	39	25
Other, net of allowance for uncollectible accounts of less than \$1 in 2019 and \$1 in 2018	4	5
Notes receivable from affiliates	—	19
Prepaid taxes and other	19	19
	<u>156</u>	<u>184</u>
UTILITY PLANT:		
In service	1,920	1,813
Less — Accumulated provision for depreciation	281	243
	<u>1,639</u>	<u>1,570</u>
Construction work in progress	66	54
	<u>1,705</u>	<u>1,624</u>
DEFERRED CHARGES AND OTHER ASSETS:		
Prepaid purchased power	67	73
Other	40	28
	<u>107</u>	<u>101</u>
	<u>\$ 1,968</u>	<u>\$ 1,909</u>
LIABILITIES AND CAPITALIZATION		
CURRENT LIABILITIES:		
Currently payable long-term debt	\$ 7	\$ 6
Short-term borrowings - affiliated companies	26	—
Accounts payable-		
Affiliated companies	87	40
Other	23	35
Accrued taxes	11	15
Accrued interest	7	7
Customer deposits	22	23
Other	16	24
	<u>199</u>	<u>150</u>
CAPITALIZATION:		
Common stockholder's equity-		
Other paid-in capital	356	354
Accumulated other comprehensive income	3	5
Retained earnings	236	191
Total common stockholder's equity	595	550
Long-term debt and other long-term obligations	574	581
	<u>1,169</u>	<u>1,131</u>
NONCURRENT LIABILITIES:		
Accumulated deferred income taxes	242	212
Regulatory liabilities	268	320
Retirement benefits	12	33
Adverse power purchase contracts	33	36
Other	45	27
	<u>600</u>	<u>628</u>
COMMITMENTS AND CONTINGENCIES (Note 12)		
	<u>\$ 1,968</u>	<u>\$ 1,909</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
Balance, January 1, 2018	22,385,000	\$ 352	\$ 6	\$ 175	\$ 533
Net income				52	52
Other comprehensive loss, net of tax			(1)		(1)
Stock-based compensation		1			1
Consolidated tax benefit allocation		1			1
Impact of adopting ASU 2018-02 ⁽¹⁾				(1)	(1)
Cash dividends declared on common stock				(35)	(35)
Balance, December 31, 2018	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)
Balance, December 31, 2019	22,385,000	\$ 356	\$ 3	\$ 236	\$ 595

⁽¹⁾ PE early adopted ASU 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income" during the first quarter of 2018. Upon adoption, PE recorded a cumulative effect adjustment for stranded tax effects, such as pension and OPEB prior service costs to retained earnings.

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,	
	2019	2018
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 60	\$ 52
Adjustments to reconcile net income to net cash from operating activities-		
Depreciation and amortization	39	93
Deferred income taxes, net	23	9
Pension trust contributions	(6)	(17)
Retirement benefits	(10)	(12)
Pension and OPEB mark-to-market adjustment	(8)	14
Changes in current assets and liabilities-		
Receivables	2	9
Accounts payable	35	(1)
Accrued taxes	(4)	(17)
Other current liabilities	(10)	11
Other	(20)	5
Net cash provided from operating activities	<u>101</u>	<u>146</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
New financing-		
Short-term borrowings - affiliated companies, net	26	—
Redemptions and repayments-		
Long-term debt	(6)	(6)
Common stock dividend payments	(15)	(35)
Other	—	(1)
Net cash provided from (used for) financing activities	<u>5</u>	<u>(42)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property additions	(125)	(121)
Loans to affiliated companies, net	19	35
Asset removal costs	(10)	(9)
Other	1	—
Net cash used for investing activities	<u>(115)</u>	<u>(95)</u>
Net change in cash, cash equivalents, and restricted cash	(9)	9
Cash, cash equivalents, and restricted cash at beginning of period	15	6
Cash, cash equivalents, and restricted cash at end of period	<u>\$ 6</u>	<u>\$ 15</u>
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid during the year-		
Interest (net of amounts capitalized)	\$ 26	\$ 27
Income taxes, net of refunds	\$ 6	\$ 19

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 4, 2020, the date the financial statements were issued.

CUSTOMER 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.

Receivables from customers include distribution and retail electric sales to residential, commercial and industrial customers. The allowance for uncollectible customer receivables is based on historical loss information comprised of a rolling 36-month average net write-off percentage of revenues. Billed and unbilled customer receivables were \$29 million and \$59 million, respectively, as of December 31, 2019 and \$42 million and \$59 million, respectively, as of December 31, 2018. There was no material concentration of receivables as of December 31, 2019 and 2018, with respect to any particular segment of PE's customers.

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. Similarly, Management records regulatory liabilities when a determination is made that a refund is probable or when ordered by a commission. Factors that may affect probability include changes in the regulatory environment, issuance of a regulatory commission order or passage of new legislation. If recovery of a regulatory asset is no longer probable, that regulatory asset is written off as a charge against earnings. 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 the Company and information on comparable companies within similar jurisdictions, as well as assessing progress of communications between the Company and regulators. Certain of these regulatory assets, totaling approximately \$3 million as of December 31, 2019, are recorded based on prior precedent or anticipated recovery based on rate making premises without a specific order.

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

The following table provides information about the composition of net regulatory assets and liabilities as of December 31, 2019 and 2018, and the changes during the year ended December 31, 2019:

Net Regulatory Assets (Liabilities) by Source	December 31, 2019	December 31, 2018	Change
	<i>(In millions)</i>		
Asset removal costs	\$ (241)	\$ (235)	\$ (6)
Customer payables for future income taxes	(161)	(170)	9
Energy contract fair value	35	18	17
Deferred energy costs	21	22	(1)
Other	78	45	33
Net Regulatory Liabilities included on the Consolidated Balance Sheets	<u>\$ (268)</u>	<u>\$ (320)</u>	<u>\$ 52</u>

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.

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 asset reverse, which is generally over the expected life of the underlying asset. See Note 5, "Taxes" for further discussion on the Tax Act.

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.

The following table provides information about the composition of net regulatory assets that do not earn a current return as of 2019 and 2018, of which approximately \$22 million and \$25 million, respectively, are currently being recovered through rates over varying periods depending on the nature of the deferral and the jurisdiction:

Regulatory Assets by Source Not Earning a Current Return	December 31, 2019	December 31, 2018	Change
Storm-related costs	\$ 3	\$ 1	\$ 2
Deferred transmission costs	6	17	(11)
Deferred generation costs	15	8	7
Other	1	—	1
Regulatory Assets Not Earning a Current Return	<u>\$ 25</u>	<u>\$ 26</u>	<u>\$ (1)</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% and 2.9% of average depreciable property in 2019 and 2018, respectively.

For the years ended December 31, 2019 and 2018, 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

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

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.

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 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 2016-02, "*Leases (Topic 842)*" (Issued February 2016 and subsequently updated to address implementation questions): The new guidance requires organizations that lease assets with lease terms of more than 12 months to recognize assets and liabilities for the rights and obligations created by those leases on their balance sheets as well as new qualitative and quantitative disclosures. PE implemented a third-party software tool that assisted with the initial adoption and will assist with ongoing compliance. PE chose to apply the requirements of the standard in the period of adoption (January 1, 2019) with no restatement of prior periods. Upon adoption, on January 1, 2019, PE increased assets and liabilities by \$10 million, with no impact to results of operations or cash flows. See Note 6, "Leases," for additional information on PE's leases.

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 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. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. PE has analyzed its financial instruments within the scope of this guidance, primarily trade receivables, and does not expect a material impact to its financial statements upon adoption in 2020.

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 requires 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. The guidance will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. PE does not expect a material impact to its financial statements upon adoption in 2020.

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.

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 new 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.

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

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 WVPSC and MDPSC, respectively.

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, 2019 and 2018, by type of service:

Revenues by Type of Service	For the Year Ended December 31,	
	2019	2018
	<i>(In millions)</i>	
Distribution services	\$ 266	\$ 261
Retail generation	482	535
Wholesale sales	38	53
Transmission	48	44
Other	8	8
Total revenues from contracts with customers ⁽¹⁾	<u>842</u>	<u>901</u>
Other non-customer revenue	3	3
Total revenues	<u>\$ 845</u>	<u>\$ 904</u>

⁽¹⁾ Includes \$1 million and \$7 million in reductions to revenue related to amounts subject to refund resulting from the Tax Act for the year ended December 31, 2019 and 2018.

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, 2019 and 2018, by class:

Revenues by Customer Class	For the Years Ended December 31,	
	2019	2018
	<i>(In millions)</i>	
Residential	\$ 489	\$ 521
Commercial	165	175
Industrial	87	94
Other	7	6
Total Revenues	<u>\$ 748</u>	<u>\$ 796</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

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

rate in that zone. Revenues and cash receipts for the stand-ready obligation of providing transmission service are recognized ratably over time.

For the year ended December 31, 2019 and 2018, revenues include transmission revenue from contracts with customers of \$48 million and \$44 million, respectively.

3. ACCUMULATED OTHER COMPREHENSIVE INCOME

The changes in AOCI, net of tax, for the years ended December 31, 2019 and 2018 for PE are shown in the following tables:

	Defined Benefit Pension & OPEB Plans
	<i>(In millions)</i>
AOCI Balance, January 1, 2018	\$ 6
Amounts reclassified from AOCI	(3)
Other comprehensive loss	(3)
Income tax benefits on other comprehensive loss	(2)
Other comprehensive loss, net of tax	(1)
AOCI Balance, December 31, 2018	\$ 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

The following amounts were reclassified from AOCI for PE in the years ended December 31, 2019 and 2018:

Reclassifications out of AOCI ⁽¹⁾	For the Years Ended December 31,		Affected Line Item in the Consolidated Statements of Income
	2019	2018 ⁽²⁾	
	<i>(In millions)</i>		
Defined Benefit Pension and OPEB Plans			
Prior-service costs	\$ (3)	\$ (3) ⁽³⁾	
	1	2	Income taxes
	\$ (2)	\$ (1)	Net of tax

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

⁽²⁾ Includes stranded tax amounts reclassified from AOCI in connection with the adoption of ASU 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income."

⁽³⁾ 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

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

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. In 2019, the pension and OPEB mark-to-market adjustment primarily reflects a 110 bps decrease in the discount rate used to measure benefit obligations and higher than expected asset returns. PE's pension and OPEB mark-to-market adjustments for the years ended December 31, 2019 and 2018, were (\$8) million and \$14 million, respectively.

FirstEnergy's pension and OPEB funding policy is based on actuarial computations using the projected unit credit method. In January 2018, FirstEnergy satisfied its minimum required funding obligations to its qualified pension plan of \$500 million and addressed anticipated required funding obligations through 2020 to its pension plan with an additional contribution of \$750 million (\$17 million at PE). On February 1, 2019, FirstEnergy made a \$500 million (\$6 million at PE) voluntary cash contribution to the qualified pension plan. FirstEnergy expects no required contributions through 2021.

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 2019, FirstEnergy's pension and OPEB plan assets experienced gains of \$1,492 million, or 20.2%, compared to losses of \$371 million, or (4.0)%, in 2018, and assumed a 7.5% rate of return for 2019 and 2018 which generated \$569 million and \$605 million of expected returns 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 2019, 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-2019 was most appropriate. As such, the Pri-2012 mortality table with projection scale MP-2019 was utilized to determine the 2019 benefit cost and obligation as of December 31, 2019 for the FirstEnergy pension and OPEB plans. The impact of using the Pri-2012 mortality table with projection scale MP-2019 resulted in a decrease to the projected benefit obligation approximately \$29 million and \$3 million for the pension and OPEB plans, respectively, and was included in the 2019 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 is considered a change in estimate and, accordingly, accounted for prospectively, and did not have a material impact on FirstEnergy's financial statements.

Following adoption of ASU 2017-07, "Compensation-Retirement Benefits: Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost" in 2018, service costs, net of capitalization, continue to be reported within Other operating expenses on the PE Consolidated Statements of Income. Non-service costs are reported within Miscellaneous income, net, within Other Income (Expense).

The following is a summary of the plan status:

For the years ended	Pension		OPEB	
	2019	2018	2019	2018
	<i>(In millions)</i>			
FirstEnergy benefit obligation	\$ 11,050	\$ 9,462	\$ 654	\$ 608
FirstEnergy fair value of plan assets	8,395	6,984	458	408
FirstEnergy funded status	<u>(2,655)</u>	<u>(2,478)</u>	<u>(196)</u>	<u>(200)</u>
FirstEnergy accumulated benefit obligation	10,439	8,951	—	—
FirstEnergy net periodic costs (credits) ⁽¹⁾	703	287	(20)	(156)
PE's share of net liability ⁽²⁾	(7)	25	10	7
PE's share of net periodic costs (credits) ⁽¹⁾	(25)	11	1	(4)

⁽¹⁾ Includes annual pension and OPEB mark-to-market adjustment.

⁽²⁾ Excludes \$2 million of affiliated non-current liabilities and \$11 million of affiliated non-current assets as of December 31, 2019 and 2018, respectively, related to pension and OPEB mark-to-market costs allocated to PE.

	Pension		OPEB	
	2019	2018	2019	2018
Assumptions Used to Determine Benefit Obligations				
(as of December 31)				
Discount rate	3.34%	4.44%	3.18%	4.30%
Rate of compensation increase	4.10%	4.10%	N/A	N/A
Cash balance weighted average interest crediting rate	2.57%	3.34%	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	4.5%	4.5%
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				
Weighted-average discount rate	4.44%	3.75%	4.30%	3.50%
Expected long-term return on plan assets	7.50%	7.50%	7.50%	7.50%
Rate of compensation increase	4.10%	4.20%	N/A	N/A

*Excludes impact of pension and OPEB mark-to-market adjustment.

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 trusts. The long-term rate of return is developed considering the portfolio's asset allocation strategy.

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

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.

INCOME TAXES:	For the Years Ended December 31,	
	2019	2018
	<i>(In millions)</i>	
Currently payable (receivable)		
Federal	\$ (8)	\$ 3
State	—	1
	<u>(8)</u>	<u>4</u>
Deferred, net-		
Federal	17	5
State	6	4
	<u>23</u>	<u>9</u>
Total income taxes	<u>\$ 15</u>	<u>\$ 13</u>

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, 2019 and 2018:

<i>(In millions)</i>	For the Years Ended December 31,	
	2019	2018
Book income before income taxes	\$ 75	\$ 65
Federal income tax expense at statutory rate	\$ 16	\$ 14
Increases (reductions) in taxes resulting from-		
State income tax, net of federal income tax benefit	4	4
Excess deferred tax amortization due to the Tax Act	(5)	(4)
Other, net	—	(1)
Total income taxes	<u>\$ 15</u>	<u>\$ 13</u>
Effective income tax rate	<u>20.0%</u>	<u>20.0%</u>

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

PE's effective tax rate on pre-tax income for 2019 and 2018 was 20.0% for both periods.

Accumulated deferred income taxes as of December 31, 2019 and 2018 were as follows:

<i>(In millions)</i>	As of December 31,	
	2019	2018
Property basis differences	\$ 222	\$ 213
Regulatory asset/liability	34	20
Purchase accounting adjustments	(9)	(10)
Pension and OPEB	(1)	(4)
Other	(4)	(7)
Net deferred income tax liabilities	<u>\$ 242</u>	<u>\$ 212</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, 2019, PE's loss carryforwards consisted of \$16 million (\$3 million, net of tax) of Federal NOL carryforwards that will begin to expire in 2032.

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, 2019 and 2018, 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 2019 and 2018, 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. In June 2019, the IRS completed its examination of FirstEnergy's 2017 federal income tax return and issued a Full Acceptance Letter with no changes or adjustments to PE's taxable income. Tax year 2018 is 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 2016-2018.

General Taxes

Details of general taxes for the years ended 2019 and 2018 are shown below:

<i>(In millions)</i>	2019	2018
Kilowatt-hour excise	\$ 15	\$ 14
State gross receipts	4	6
Real and personal property	19	18
Business and occupation	4	5
Social security and unemployment	5	4
Total general taxes	<u>\$ 47</u>	<u>\$ 47</u>

6. LEASES

PE primarily leases vehicles as well as building space 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.

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

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, 2019, 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 \$201 million and \$195 million for the year ended December 31, 2019 and 2018, respectively.

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 for the year ended December 31, 2019, were as follows:

<i>(In millions)</i>	
Operating lease costs ⁽¹⁾	\$ 2
Finance lease costs:	
Amortization of right-of-use assets	1
Interest on lease liabilities	—
Total finance lease cost	1
Total lease cost	\$ 3

⁽¹⁾ Includes \$1 million of short-term lease costs.

Supplemental balance sheet information related to leases was as follows:

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

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

Lease terms and discount rates were as follows:

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

⁽¹⁾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.

Supplemental cash flow information related to leases was as follows:

<i>(In millions)</i>		For the Year Ended December 31, 2019
<i>Cash paid for amounts included in the measurement of lease liabilities</i>		
Operating cash flows from operating leases	\$	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
Finance leases		1

Maturities of lease liabilities as of December 31, 2019, were as follows:

<i>(In millions)</i>	Operating Leases	Finance Leases	Total
2020	\$ 2	\$ —	\$ 2
2021	2	1	3
2022	2	—	2
2023	2	—	2
2024	2	—	2
Thereafter	4	—	4
<i>Total lease payments</i>	14	1	15
Less imputed interest	(1)	—	(1)
<i>Total net present value</i>	\$ 13	\$ 1	\$ 14

As of December 31, 2019, additional operating leases agreements, primarily for vehicles, that have not yet commenced are \$2 million. These leases are expected to commence within the next 18 months with lease terms of 5 to 10 years.

ASC 840, "Leases" Disclosures

PE's estimated future minimum lease payments for capital and operating leases as of December 31, 2018, as reported in the 2018 financial statements under ASC 840, with initial or remaining lease terms in excess of one year are as follows:

<i>(In millions)</i>	2019	2020	2021	2022	2023	Thereafter	Total	Less: amount representing interest and fees	Present value of net minimum capital lease payments
Capital leases	\$ 1	\$ 1	\$ —	\$ —	\$ —	\$ —	\$ 2	\$ 1	\$ 1
Operating leases	\$ 2	\$ 2	\$ 1	\$ 1	\$ 2	\$ 5	\$ 13	N/A	N/A

Operating lease expense under ASC 840 "Leases" for the year ended December 31, 2018 was \$1 million.

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

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 included in PE's consolidated financial statements consist of PE Environmental Funding Company. 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. As of December 31, 2019 and 2018, \$81 million and \$87 million of environmental control bonds were outstanding, respectively.

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 \$116 million and \$108 million during the years ended December 31, 2019 and 2018, 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 value of long-term debt, which excludes finance lease obligations and net unamortized debt issuance costs:

<i>(In millions)</i>	December 31, 2019		December 31, 2018	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Long-term debt	\$ 583	\$ 667	\$ 590	\$ 545

The fair values of long-term debt and other long-term obligations 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, 2019 and December 31, 2018.

9. CAPITALIZATION

COMMON STOCK

PE is authorized to issue 26,000,000 shares of common stock, \$0.01 par value, as of December 31, 2019. As of December 31, 2019 and 2018, 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, 2019. As of December 31, 2019 and 2018, there were no preferred shares outstanding.

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

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, 2019 and 2018:

<i>(Dollar amounts in millions)</i>	As of December 31, 2019		As of December 31,	
	Maturity Date	Interest Rate	2019	2018
FMBs	2044 - 2046	3.890% - 4.470%	\$ 500	\$ 500
Secured notes - fixed rate	2026 - 2031	5.127% - 5.523%	81	87
Finance lease obligations			1	1
Unamortized fair value adjustments			2	3
Unamortized debt issuance costs			(3)	(4)
Currently payable long-term debt			(7)	(6)
Total long-term debt and other long-term obligations			<u>\$ 574</u>	<u>\$ 581</u>

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, 2019.

Year	PE
	<i>(In millions)</i>
2020	\$ 6
2021	6
2022	7
2023	7
2024	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, 2019 and 2018, \$83 million and \$87 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, 2019, PE was in compliance with all debt covenant default provisions.

10. SHORT-TERM BORROWINGS AND BANK LINES OF CREDIT

PE had \$26 million of outstanding short-term borrowings as of December 31, 2019 and no outstanding short-term borrowings as of December 31, 2018.

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

Revolving Credit Facilities

FE and the Utilities, including PE, participate in a five-year syndicated revolving credit facility providing for aggregate commitments of \$2.5 billion (Facility), which are available through December 6, 2022. Under the 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.

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, 2019. 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 2019 was 2.27% 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 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 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.

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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 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.

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 August 21, 2019, MP and PE filed with the WVPSC their annual ENEC case requesting a decrease in ENEC rates of \$6.1 million beginning January 1, 2020, representing a 0.4% decrease in rates versus those in effect on August 21, 2019. On October 11, 2019, MP and PE filed a supplement requesting approval of the termination of the 50 MW PPA with Morgantown Energy Associates, a NUG entity. A settlement between MP, PE, and the majority of the intervenors fully resolving the ENEC case, which maintains 2019 ENEC rates into 2020, and supports the termination of the Morgantown Energy Associates PPA, was filed with the WVPSC on October 18, 2019. An order was issued on December 20, 2019, approving the ENEC settlement and termination of the PPA with Morgantown Energy Associates.

On August 21, 2019, MP and PE filed with the WVPSC for a reconciliation of their VMS and a periodic review of its vegetation management program requesting an increase in VMS rates of \$7.6 million beginning January 1, 2020. The increase is due to moving from a 5-year maintenance cycle to a 4-year cycle and performing more operation and maintenance work and less capital work on the rights of way. The increase is a 0.5% increase in rates versus those in effect on August 21, 2019. All the parties reached a settlement in the case, and the WVPSC issued its order approving the settlement without change on December 20, 2019.

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. PE's transmission facilities 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 agreement that did not specify an allowed capital structure or ROE.

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 erect barriers to entry into markets. PE has been authorized by FERC to sell wholesale power in interstate commerce at market-based rates and has a market-based rate tariff on file with FERC, although major wholesale purchases remain subject to regulation by the relevant state commissions. In addition, pursuant to a full requirements power purchase agreement on with FERC, PE receives capacity, energy and ancillary service from MP to serve PE's West Virginia load.

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 ERO 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.

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

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 864). Order 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. Alternatively, formula rate utilities can demonstrate to FERC that their formula rate template already achieves these outcomes. Utilities with transmission stated rates are required to address these new requirements as part of their next transmission rate case. To assist with implementation of the proposed rule, FERC also issued on November 15, 2018, a policy statement providing accounting and ratemaking guidance for treatment of ADIT for all FERC-jurisdictional public utilities. The policy statement also addresses the accounting and ratemaking treatment of ADIT following the sale or retirement of an asset after December 31, 2017. PE will address the requirements as part of their next transmission rate case.

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 October 16, 2018, FERC issued an order in which it proposed a revised ROE methodology. FERC proposed that, for complaint proceedings alleging that an existing ROE is not just and reasonable, FERC will rely on three financial models - discounted cash flow, capital-asset pricing, and expected earnings - to establish a composite zone of reasonableness to identify a range of just and reasonable ROEs. FERC then will utilize the transmission utility's risk relative to other utilities within that zone of reasonableness to assign the transmission utility to one of three quartiles within the zone. FERC would take no further action (i.e., dismiss the complaint) if the existing ROE falls within the identified quartile. However, if the replacement ROE falls outside the quartile, FERC would deem the existing ROE presumptively unjust and unreasonable and would determine the replacement ROE. FERC would add a fourth financial model risk premium to the analysis to calculate a ROE based on the average point of central tendency for each of the four financial models. On March 21, 2019, FERC established NOIs to collect industry and stakeholder comments on the revised ROE methodology that is described in the October 16, 2018 decision, and also whether to make changes to FERC's existing policies and practices for awarding transmission rates incentives. On November 21, 2019, FERC announced in a complaint proceeding involving MISO utilities that FERC would rely on the discounted cash flow and capital-asset pricing models as the basis for establishing ROE. It is not clear at this time whether FERC's November ruling will be applied more broadly. Any changes to FERC's transmission rate ROE and incentive policies would be applied on a prospective basis. FirstEnergy currently is participating through various trade groups in the FERC dockets where the ROE methodology is being reviewed.

12. COMMITMENTS AND CONTINGENCIES

ENVIRONMENTAL MATTERS

Various federal, state and local authorities regulate PE with regard to air and water quality 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

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 or 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.

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

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 pools, and other transactions.

The primary affiliated company transactions for PE during the years ended December 31, 2019 and 2018 are as follows:

	For the Years Ended December 31,	
	2019	2018
	<i>(In millions)</i>	
Revenues	\$ 2	\$ 2
Expenses:		
Purchased power from affiliates	275	305
Support services	54	53
Miscellaneous Income	1	2

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, including FES and FENOC, 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 providing power to certain facilities. See Note 6, "Leases" for additional information on the agreement with MP.