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**February 24, 2006**

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## Belated Notes from a Conference Call

	2/23/06	% Change	
		Year-to-date	12 months
Dow Industrials	11,069	3	3
Philadelphia Electric Index	434	2	13

## Constellation Energy (NYSE-CEG-\$58-Hold)

### Introduction

It's getting difficult to create insight, much less timely insight, to earnings releases. Often it's a case of information overload. Take Constellation Energy, for example. It's year-end call was held on January 31, 2006, covered two hours (8:00-10:00AM), included 133 slides and a one-hour Q&A. All this from a company that in December announced that it agreed to be acquired by FPL Group (FPL-NYSE-\$42-Not Rated). Other calls scheduled that day were CINergy (CIN-NYSE-Hold), TECO Energy (TE-NYSE-Hold), NISource (NI-NYSE-Not Rated), Entergy (ETR-NYSE-Not Rated), and Hawaiian Electric Industries (HE-NYSE-Not Rated).

Constellation Energy as expected reaffirmed its December earnings forecasts. Reported earnings of \$3.62 a share in 2005 were up 16% from \$3.12 a share and \$0.02 a share above the high end of guidance of \$3.35 - \$3.60 a share. Management guidance is \$3.65 - \$3.95 a share (up 5% based on mid-point) for 2006 and stand-alone \$4.75 - \$5.00 a share (plus 28%) for 2007. Management also indicated that 2008 profits should rise 10% to 15%. According to the "earnings walk," higher prices, not organic growth, will account for the above-average performances in both 2007 and 2008. Consensus estimates (Bloomberg Financial Services) support management at \$3.89 and \$4.90 a share, respectively, for 2006 and 2007. Our May 2005 report (CEG-\$54) estimated earnings at \$4.00 a share for 2006 and \$4.68 a share for 2007. We will revise our estimates after we review soon to be released SEC statements.

From a stock price standpoint the merger with FPL Group is on schedule to close in the late third or fourth quarter. FPL Group shareholders will receive one share of the combined new company, named Constellation Energy (eliminating the regional emphasis of the FPL label), for each FPL share, while CEG holders receive 1.444 shares. CEG shares currently trade at \$58.95 a share, roughly a 3% discount to the conversion price (FPL-\$41.96). Dividends at the combined company will be paid at the FPL level (currently \$1.50 a share), raising the equivalent CEG dividend from \$1.51 a share to \$2.16 a share (43%).

### Stand-Alone Earnings Profile

The "earnings walk" presentation indicates that growth in competitive businesses is slowing and that the primary growth engine is higher prices following expiration of the rate freeze at Baltimore Gas & Electric (BGE). Higher prices, net of reductions on Competition Transition Credits (CTC), are expected to contribute \$0.79 a share to 2007 profits and another \$0.70 a share plus in 2008 as hedged positions at lower prices roll off. Earnings stemming from rising prices are real as are synfuel credits, but neither is indicative of product growth. Normalized all-in earnings, excluding price changes, are estimated at \$3.92 a share in 2006 and \$4.10 a share in 2007 (Table 1).

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See pages 5 and 6 of report for Analyst's Certification and important disclosures.

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Table 1  
Earnings Walk  
2007-5  
Earnings Changes

Column	(1)	(2)	(3)	(4)	(5)
	Guidance 2007	\$-Chg.	Guidance 2006	\$-Chg.	Reported 2005
Earnings	4.86		3.80		3.62
Organic Growth					
Wholesale Competitive				0.43	
New Energy				0.08	
Total Competitive		0.10		0.51	
BGE		(0.08)		(0.08)	
Total Organic Growth		0.02		0.43	
Cumulative Earnings		3.82		4.05	
% Change		1%		12%	
Productivity Inflation Other		0.30		(0.13)	
Operational Earnings		4.10		3.92	
% Change		8%		8%	
Price Increases net CTC		0.76		(0.12)	
Earnings Guidance		4.86		3.80	
% Change		28%		5%	

Source: Slide Presentation January 31, 2006

## Wholesale

Management response to the question concerning the slowdown of growth in the competitive business in 2007 was to stress the conservative assumptions behind its forecast. Maybe, but the changing profile of the wholesale and retail businesses could have also played a role. Risk appears to be rising, growth in power is slowing and gas and coal businesses will account for a larger portion of earnings. Table 2 compares 2005 actual results (column 2) with the budgeted forecast of early 2005 (column 3) and the variance (column 4). Power, natural gas and coal were pretty much on budget. Portfolio Management and Trading around those products increased to \$204 million, more than doubling the \$96 million estimate. Management, according to the presentation, took advantage of marketing opportunities in the second half (more than doubling VAR) and also offset the negative impact of out of the money power contracts. (Kudos)

As Table 2 shows, growth in power gross margins is estimated to slow to 8% to \$355 million in 2006. Natural gas (downstream and upstream) and coal (domestic and international), from almost nothing in 2004, are expected to grow sharply. Natural gas is budgeted to increase to \$159 million in 2006, up from \$40 million. Coal gross margins are expected to rise to \$66 million versus \$24 million in 2005. Coal and gas businesses are less structured than power and present trading and asset sale opportunities. Management indicated that a portion of the \$67 million (\$18 million in 2005) of origination in the upstream gas will stem from asset sales (harvesting is management's phrase). We believe organic growth and profits from asset sales, if separated, provide a more accurate measure of growth. It's the rate of organic that's in question.

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Table 2  
Wholesale Competitive Gross Margin  
Estimated 2006, Actual 2005, Budget 2005 and 2004 Actual

Column	(1)	(2)	(3)	(4)	(5)	(6)
Wholesale Competitive		Slide 58 1/28/05			Slide 58 1/28/05	
Gross Margin	2006Est \$-Mil	2005Act. \$-Mil	2005 budget \$-Mil	Variance \$-Mil	2004 Act. \$-Mil	2005 Actual %
Power	355	330	332	(2)	278	19
Natural Gas	159	40	25	15	7	471
Coal	66	24	36	(12)	9	167
Portfolio Mgmt & Trading	173	204	96	108	93	119
Total	753	598	489	109	387	55

### New Energy

Retail business was launched in September 2002. It was initially designed to exploit opportunities created by deregulation, a movement that has pretty much come to an abrupt halt. New Energy markets nationally, but primarily in deregulated regions of the Northeast, Mid-Atlantic, Mid-West, Texas and California. New Energy customers include 70 of the Fortune 100, and by definition are sophisticated consumers seeking the lowest prices possible.

In early 2005, management forecasted a decline in gross margins of 25% in 2005 from \$4.45 a Mwh to \$3.35 a Mwh. Based on its guidelines, (report issued in May 2005), we estimated operating earnings (before financing costs) of \$0.38 a share (\$67 million). The actual decline in gross margin was 42% to \$2.56 Mwh and although the company softened the impact on earnings by reducing SGA by 19% to \$2.05 Mwh, our estimate of operating earnings fell to \$0.22 a share (\$39 million). Management attributes the electric decline to weakness in Texas. According to the data on slide 53, had margins in Texas kept pace with New Energy's other regions, pretax operating earnings would have increased 6% to \$91 million.

Table 3 interpolates New Energy's income statements before capital allocation for the 2004 to 2008 period. Revenues and expenses are derived from slides and guidelines issued during the company presentations on January 31, 2006. We excluded gross receipts taxes of \$39 million and \$57 million in 2005 and 2006 from revenues. Proceeds from bankruptcy settlements, consulting fees and contract amortization are shown below the line.

Total electric and gas revenues declined 8% in 2005 to \$215 million while EBIT dropped 45% to \$53 million. Electric EBIT declined 62% to \$33 million, despite a 45% increase in volumes. By contrast gas EBIT gained 72% to \$24 million on an 8% volume increase.

In slide 62 of its recent-year conference call, management budgeted a 13% improvement in gross electric margin for 2006 (\$2.90 Mwh versus \$2.56 Mwh), a 7% reduction in SGA (\$1.90 a Mwh vs. \$2.05 Mwh) and a 15% increase in sales to 73.8 millions Mwh. That combination would raise electric EBIT by 125% to \$74 million in 2006. Gas volumes are expected to rise 13%, but margin contraction would reduce gas EBIT by 15% to \$20 million. Consolidated earnings (pre-financing costs) could rise 62% to \$0.35 a share (\$64 million).

In columns 7 and 8 we pretty much adhered to management guidelines. Consolidated operating earnings would rise 20% in 2007 to \$0.42 a share (\$76 million) and slow to 10% in 2008 to \$0.46 a share (\$83 million).

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Management doesn't separate all-in costs that could be significant if sector results were brought to the bottom line. In a separate conference call held by TXU Corporation (NYSE-\$51-Rated Hold), management indicated that its long-term net margin goal for its retail business is 5%, a percentage that it compares to companies in the UK. If we apply a 5% margin to New Energy, its earnings per share would total \$0.06 a share (\$11 million) in 2005, \$0.07 a share (\$13 million) in 2006, \$0.09 a share (\$16 million) in 2007 and \$0.10 a share (\$18 million) in 2008.

Table 3  
New Energy  
Operating Earnings Income Statement  
Estimates 2004-2008; Source January 2006 slide presentation

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Operating	2004Est.	% Change	2005Est.	% Change	2006Est.	2007Est.	2008Est.
Electricity (millions MWh)	44.3	45	64.2	15	73.8	92.0	103.0
Gas (millions dth)	279	8	300	13	340	408	490
Revenue MWH	4.45	(42)	2.56	13	2.90	2.90	2.90
Revenue Dth	0.13	31	0.17	(12)	0.15	0.14	0.13
SGA Electric	2.52	(19)	2.05	(7)	1.90	1.90	1.90
SGA Gas	0.08	13	0.09	0	0.09	0.09	0.09
SGA Margin Electric	1.93	(74)	0.51	96	1.00	1.00	1.00
SGA Margin Gas	0.05	60	0.08	(25)	0.06	0.05	0.04
Income Statement \$-millions							
Electric	197	(17)	164	30	214	267	299
Gas	36	41	51	(0)	51	57	64
Operating Gross Margin	233	(8)	215	23	265	324	362
SGA Electric	112	18	132	7	140	175	196
SGA Gas	22	21	27	13	31	37	44
Total SGA Direct	134	18	159	8	171	212	240
EBIT Electric	85	(62)	33	125	74	92	103
EBIT Gas	14	72	24	(15)	20	20	20
Total EBIT Direct	99	(43)	57	66	94	112	123
Depreciation & Amortization	4		4		4	4	4
Pre Tax Operating Income	95	(45)	53	71	90	108	119
Tax Rate	35%	0	35%	0	35%	35%	35%
Taxes	33	(45)	18	71	32	38	42
Operating Income	62	(45)	34		59	70	77
Consulting (net of taxes)	9	(1)	9	0	9	9	9
Bankruptcy Settlement (net)	12	(91)	1				
Contract Amortization	(15)	(67)	(5)		(4)	(3)	(3)
Earnings	68	(42)	39	62	64	76	83
Average Shares	173	4	180	0	180	180	180
EPS Operating	0.39	(44)	0.22	62	0.35	0.42	0.46
Margin \$@5%	12		11		13	16	18
Per Share	0.07		0.06		0.07	0.09	0.10

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**Range of Formal Recommendations 15 total 1-buy-13-holds-1 sell**

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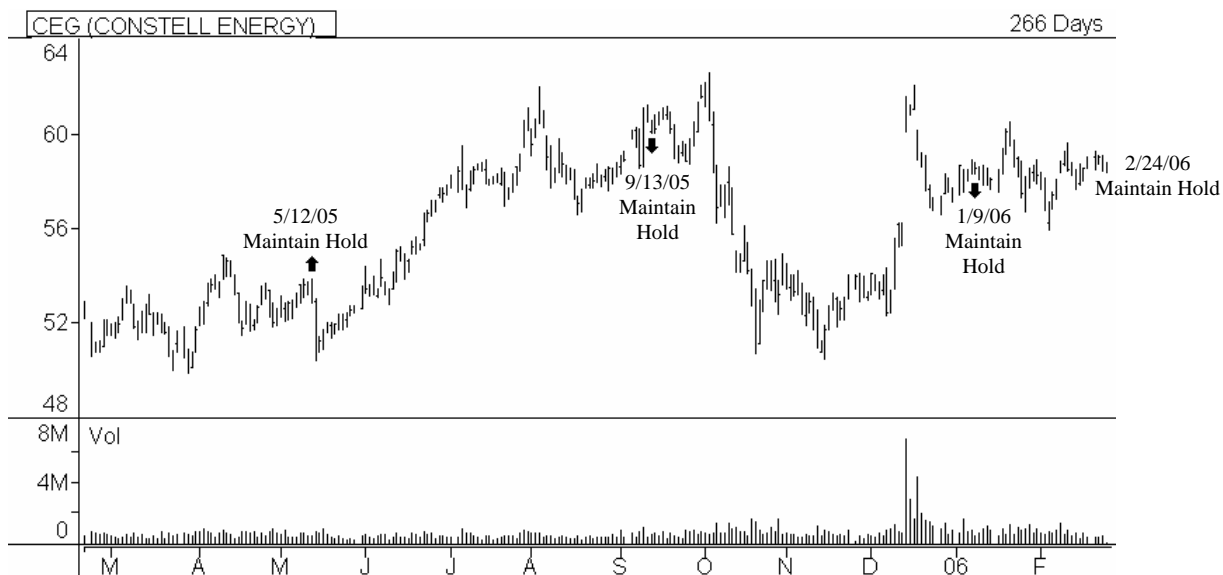
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