SHIELDS & COMPANY
MEMBER NEW YORK STOCK EXCHANGE

140 BROADWAY NEW YORK, NY 10005

RAYMOND E. MOORE, CFA
(212) 320-3065 **Trading (212) 320-3001** **September 27, 2007**

ray.moore@shieldsandco.com
Prior Report: January 26, 2007

Rating: Hold

Constellation Energy
CEG – NYSE – $87

Sum of the Parts Earnings per Share Valuations

Constellation Energy	9/27						
Price	87						
52-week range	98-60				Price	Yr.-end	12 Mos.
Book value (6/30/07)	28.58	306%	p/b	Performance	9/26	% Chg.	%Chg.
Earnings - ongoing				Constellation Energy	87	27	46
2005 actual	2.89	30.3	p/e	Phila. 22 Elec. Index	543	10	17
2006 actual	3.61	24.2		Dow Industrials	13,891	11	19
2007 Consensus	4.57	19.1		Shares-millions	181		
2008 Consensus	5.57	15.7		Equity Value - $Bil.	16		
2008 Shields	6.00	14.6		Analyst Coverage	11	82%	Buys
Dividend	1.74	2.0	Yield				

Summary & Recommendation

Constellation Energy has been a huge success story with the share price up over 280% since October 2001. Its current price of $87 a share represents a 27% year-to-date increase and a 46% gain for the trailing 12-months versus gains of 10% and 17%, respectively, for the Philadelphia Electric Index and the 11% and 19%, respectively, posted by the Dow Industrials. Despite the run up, the stock remains a favorite of the investment community. According to Bloomberg Financial Service, the company has 9 buy recommendations, one with a price target $108 a share.

Management believes the stock price undervalued and has suggested the Merchant Group be valued based on EBITDA multiples of companies with similar risk characteristics and, for the utility, comparable price/earnings multiples. That exercise produces a value range of $104 to $156 a share with a $130 a share midpoint. This study takes the same companies and arrays them by 2007 and 2008 consensus price/earnings multiples, and applies those multiples to earnings components in the Merchant Group. We then interpolate market value and earnings on a bottom up (sum of the parts) and top down (market price less implied value) basis.

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See page 6 of report for Analyst's Certification, pages 6-7 for Important Disclosures and page 7 for Other Disclosures and Disclaimers

Because management only presents earnings components within the Merchant Group by EBITDA, we developed earnings per share ranges for the Customer Serving (wholesale and retail) and Risk Management and Investing (RMI) from profit parameters cited by Tom Brooks at the company's January 31, 2007 investor meeting. Our interpolation indicates that the $87 price assumes 2008 earnings in the range of $5.50-$6.20 a share, versus guidelines of $5.25-$5.75 a share.

We rate the shares Hold.

Upward revisions in earnings estimates would be in keeping with management practice of under promising and over delivering. Also, the company's principle growth vehicle is Fleet Generation, a commodity-like business benefiting from rising prices on relatively stable volumes. In up cycles, earnings tend to exceed expectations with estimated price/earnings multiples understated. Conversely, in down cycles multiples are generally high, reflecting less than expected earnings or, as in Fleet Generation 2006 numbers, sharply higher earnings prospects.

The $1.74 a share indicated annual dividend, raised 15% at the October 2006 declaration, represents a modest 31% payout of 2008 earnings and provides a 2.0% yield. We expect the Board to declare another 15% increase next month to a $2.00 a share indicated rate.

Market Performance - Street Recommendations - Holders

Constellation Energy (CEG) share price increased 27% year-to-date and 46% for the trailing 12-months, far outpacing both the Dow Industrials and the Philadelphia 22 Electric Stock Index. According to Bloomberg Financial Service, CEG has 11 active recommendations - 9 buys: Lehman Bros.; Matrix USA, Citigroup, Credit Suisse, Jefferies, Banc of America, Deutsche Bank, HSBC. Market perform/neutral ratings are maintained at BMO Capital and JP Morgan. Constellation Energy's largest holders are Barclays (12.5 million shares), Fidelity (12.7 million), AXA (7.7 million), State Street Corp. (5.8 million), Vanguard (5.6 million), and Janus (5.2 million).

Management Earnings Forecasts - EBITDA Valuation Methodology

Management hasn't changed the earnings forecast it released in January 2007: $4.30-$4.65 a share range in 2007 (street consensus $4.57 a share), $5.25-$5.75 a share for 2008 (street consensus $5.57 a share), and 10%-plus in 2009. Although price performance has been strong, management (like most management) believes its shares undervalued. One obstacle to fair valuation is the absence of an "industry" group having similar business characteristics. By 2008, the Merchant Group will account for 89% of midpoint earnings or $4.87 a share. Merchant businesses in turn consist of Fleet Generation (estimated EBITDA of un-hedged generation - $1,922 million in 2007), Competitive Customer Serving retail and commercial distribution (EBIDTA of $402 million in 2007) and Risk Management and Investing (RMI - EBITDA of $342 million in 2007).

At its January 31, 2007 analysts meeting, E. Follin Smith, then Executive Vice President and Chief Financial Officer, suggested comparing multiples of income before interest, income taxes, depreciation and amortization (EBITDA) to companies having similar business risks. Fleet generation could be compared to merchant generators, Customer Serving to specialty insurers, RMI to merchant banks. For the utility, she suggested using price/earnings multiple ranges of 13-17times.

At Constellation Energy's "Analysts Day" presentation in August, John Collins, new Chief Financial Officer, reaffirmed Smith's approach but increased EBIDTA multiples for Fleet from 7-10 times un-hedged generation less the net present value of hedges to 8-12 times and the regulated price/earnings multiple range from 13-17 times to 14-16 times.

Management methodology has Constellation Energy's value in a range of $104 a share (+ 20%) to $156 a share (+ 79%), with a $130 a share (+ 49%) midpoint.

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Table 1
Management Valuation
Sum of the Parts

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Forecast 2007 EBITDA $-Mil.	Multiple Range	Market Low $-Mil.	Market High $-Mil.	Market Avg.	Market Low PS	Market High PS	Market Avg. PS
Un-hedged Generation Fleet	1,922	8-12	15,376	23,064	19,220			
Less								
NPV Hedges (net of tax)			2,200	2,200				
Merchant Debt			791	791				
Net Market			12,385	20,073	16,229	69	111	90
Competitive Supply	402	7-9	2,814	3,618	3,216	16	20	18
Risk Management & Inv.	342	5-7	1,710	2,394	2,052	9	13	11
Total Merchant			16,909	26,085	21,497	94	145	119
Utility	130	14-16	1,820	2,080	1,950	10	12	11
Consolidated			18,729	28,165	23,447	104	156	130

Earnings per Share Valuation

The problem with EBITDA is that it often has no relationship to profits or losses. Case in point, Fleet generation lost money in 2006, yet it's the largest component of Constellation Energy's EBITDA and the highest recommended multiple ranges. But it's also true that Fleet generation will be the largest contributor to CEG earnings growth. Since the sample companies are publicly traded, why not compare businesses according to traditional price/earnings multiples? The obvious reason is that management doesn't detail the earnings components of the Merchant Group, except by EBITDA.

In the company's January 2007 presentation, Tom Brooks, Vice Chairman, issued for the first time profit parameters for the Customer Serving and RMI businesses. Admittedly, profits fall within wide ranges, but are sufficient to develop a "back of the envelope" range of estimates. Fleet results are total Merchant earnings less the combined profits of Customer Serving and RMI.

Customer Serving: According to Brooks, Customer Serving (competitive wholesale and retail) 2006 common equity totaled $600-$800 million and earned a return in the range of 26% to 34%. The arithmetic works out to a range of $0.86 a share ($156 million) to $1.50 a share ($272 million). For 2007, Brooks forecasted an 18% increase in EBITDA to $402 million and he also indicated the return on common would exceed 2006. Our estimates of $1.09 a share ($196 million) to $1.80 a share ($324 million) are based on returns of 28% to 36% and an equity component of $700-$900 million. Our 2008 earnings range of $1.24 a share ($224 million) to $1.80 a share ($324 million) maintains the return range at 28%-36% on a common equity of $800-$900 million.

RMI: According to Brooks, RMI earned a return of 30% to 37% on a common equity investment of $900-$1,100 million in 2006, indicating profits of anywhere from $1.50 a share ($270 million) to $2.25 a share ($407 million). For 2007, he forecasted a 38% decline in EBITDA to $342 million, down from an exceptional $553 million in 2006. Our earnings range of $1.05 a share ($190 million) to $1.52 a share ($275 million) incorporates a decline in return on common to 19%-25% and an equity component ranging from $1,000-$1,100 million. Earnings for 2008 of $1.22 a share ($220 million) to $1.66 a share ($300 million) maintain the return on common in a 20% to 25% area on an equity component of $1,100 to $1,200 million.

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Fleet: Consolidated Merchant Group earned $2.74 a share ($495 million) in 2006. Earnings guidelines are $3.60 a share ($650 million) to $3.85 a share ($694 million) in 2007 and $4.67 a share ($843 million) to $5.07 a share ($915 million) in 2008. Fleet Generation using Brooks' parameters either earned $0.38 a share ($69 million) or lost $1.02 a share ($184 million) in 2006. Our interpolations of Brooks' guidelines indicate Fleet will earn $0.53 a share ($96 million) to $1.46 a share ($264 million) in 2007 and $1.61 a share ($291 million) to $2.21 a share ($299 million) in 2008. Since guidelines were issued in early 2007, increases in prices bid for capacity in the MAAC and PJM power pools and increases in energy prices overall suggest Fleet Generation earnings forecasts are conservative.

Comparable Companies: The following table lists the 16 companies used by management in its EBITDA valuation methodology. The array includes year-to-date and trailing 12-months market performance, 2007 and 2008 consensus earnings estimates and price/earnings multiples. Also shown are shares outstanding and total equity market values. Based on 2008 earnings, the group with the highest price/earnings multiple is in Merchant generation at 18.2, followed by Utilities – 15.5, Specialty Insurers -15.0, and Merchant Banks - 9.3.

Table 2
Management - Comparable Companies

Column		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
			Price		EPS		P/E		Shs	Mkt Val
Company		9/27	%-ytd	%-1Yr.	2007	2008	2007	2008	Mil.	$-Bil
Fleet										
Mirant	mir	41	31	53	2.42	2.69	17.1	15.3	256	11
Nrg	nrg	42	50	84	2.08	2.26	20.2	18.6	240	10
RRI	rri	26	83	110	0.33	1.05	79.2	24.8	343	9
Group		36	48	76	1.61	2.00	22.7	18.2	280	10
Specialty Ins.										
Berkley Corp	ber	29	(15)	(18)	3.67	3.77	8.0	7.8	187	6
James River	jrvr	32	(2)	8	2.53	2.76	12.6	11.5	15	0
Kingsway Fin.	kfs	18	(12)	(19)	1.85	2.25	9.9	8.2	56	1
RLI Corp	rli	57	1	11	4.75	4.22	12.0	13.5	24	1
White Mtn. Ins.	wtm	525	(9)	5	21.00	31.00	25.0	16.9	11	6
Group		132	(9)	4	6.76	8.80	19.6	15.0	59	3
Merchant Bks.										
Bear Stearns	bsc	123	(24)	(12)	10.95	12.66	11.2	9.7	116	14
Goldman Sachs	gs	216	8	28	24.00	22.84	9.0	9.5	406	88
Lehman Bros	leh	61	(22)	(16)	7.46	7.69	8.2	8.0	531	33
Group		133	(9)	5	14.14	14.40	9.4	9.3	351	47
Utilities										
Duke	duk	19	(2)	6	1.17	1.25	16.2	15.2	1,260	24
Energen	egn	58	23	36	4.07	3.86	14.1	14.9	72	4
Nstar	nst	35	1	2	2.10	2.24	16.6	15.5	107	4
PG&E	pcg	48	1	13	2.78	3.01	17.3	16.0	353	17
Southern Co	so	37	0	6	2.19	2.30	16.9	16.1	756	28
Group		39	6	14	2.46	2.53	15.9	15.5	510	20

Source: Bloomberg Financial Service

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Earnings & Market Profile 2006: Table 3 takes earnings contributions for 2006 based on Brooks' parameters (columns 1-3), the current average 2007 price/earnings ratios (column 5) of comparable companies and, in columns 6-8, the implied market values. We did not impute a negative value for losses at Generation since investors were well aware of the pending earnings improvements following expiration of the below-market sales contract with BGE and the roll-off of below-market hedges. If current 2007 price/earnings multiples (which also represent 2008 prospects) are applied to Customer Serving and RMI, implied values for Fleet based on 2006 results were $24-$5 a share, with a $15 a share midpoint.

Table 3
Earnings per Share
Sum of the Parts Valuation
2006 Earnings per Share Applied to 2007 P/Es

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	% Total	2006				Value		
EPS Range	Avg.	Low	High	Avg.	P/e 2007	Low	High	Avg.
Utility	24%	0.87	0.87	0.87	15.9	14	14	14
Total Merchant	76%	2.74	2.74	2.74				
Generation	-8%	0.38	(1.02)	(0.30)		24	5	15
Customer Serving	33%	0.86	1.50	1.18	19.6	17	29	23
RMI	51%	1.50	2.25	1.86	9.4	14	21	17
Merchant	76%	2.74	2.74	2.74		55	56	56
Consolidated		3.61	3.61	3.61		69	69	69

Market Value Based on 2008 Earnings Profile: Table 4 breaks out our estimated 2008 earnings per share components based on management's guideline of $5.25 to $5.75 a share (columns 2-4). Column 5 lists the current average 2008 price/earnings multiple of comparable companies listed in Table 2. Implied market value ranges for each business segment are in columns 6-8.

Sum of the parts valuations indicate a range of $79-$82 a share, $8-$5 a share (10%-7%) below the current $87 a share price. If we assume the differences accurately reflect market expectation of increased earnings at Fleet (capitalized at 18.2 times), the 2008 earnings range will be raised $0.27-$0.44 a share to $5.52-$6.19 a share. This type of revision is in keeping with management's history of exceeding forecasts.

Table 4
Earnings per Share
Sum of the Parts Valuation
2008 Earnings per Share Applied to 2008 P/Es

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	% Total	2008				Value		
	Avg.	Low	High	Avg.	P/E 2008	Low	High	Avg.
EPS Range		5.25	5.75	5.50				
Utility	11%	0.58	0.68	0.63	15.5	9	11	10
Total Merchant	89%	4.67	5.07	4.87				
Generation	39%	2.21	1.61	1.92	18.2	40	29	35
Customer Serving	31%	1.24	1.80	1.51	15.0	19	27	23
RMI	30%	1.22	1.66	1.44	9.3	11	15	13
Merchant	100%	4.67	5.07	4.87		70	72	71
Consolidated		5.25	5.75	5.50		79	82	81

Analyst's Certification

I Raymond E. Moore certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. Other Constellation Energy reports issued by me are: 2/24/06 ($58) - Hold; 1/9/06 ($58) - Hold; 9/13/05 ($60) – Hold; 5/12/05 ($54) – Hold; 1/26/07 ($71) – Hold.

Important Disclosures

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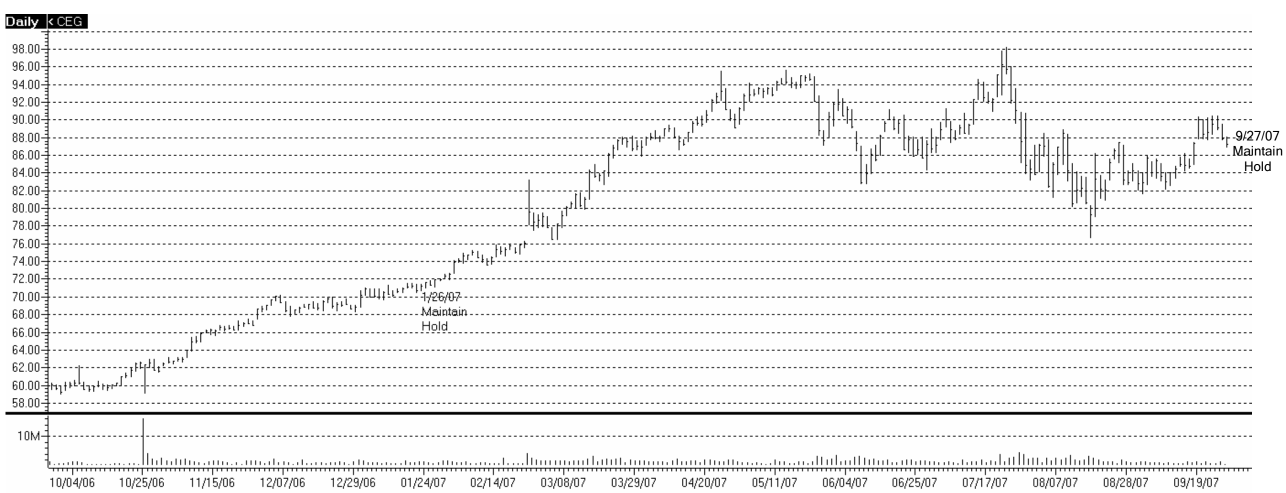
Buy Total return is expected to exceed significantly the average total return of the analyst's industry coverage universe over the next 12 months.
Market Perform & Hold Total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.
Sell Total return is expected to significantly under perform (15% plus) the total return of the industry coverage universe over the next 12 months.

Analyst's Ratings Distribution

		% Investment Banking
Buy	20%	0%
Hold	80%	0%
Sell	0%	0%

The principal risks to the achievement of our price targets include general market trends, disappointing earnings and lower energy prices and adverse regulatory developments

Our target prices are based on projected earnings for the following calendar year, and an assumed price/earnings ratio in line with the company's historical valuation or those of other companies with similar businesses and prospects.



Important Disclosures, continued

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