

CONSTELLATION ENERGY GROUP INC  
Form 10-Q  
August 08, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For The Quarterly Period Ended **June 30, 2007**

Commission  
File Number  
**1-12869**  
**1-1910**

Exact name of registrant as specified in its charter

**CONSTELLATION ENERGY GROUP, INC.  
BALTIMORE GAS AND ELECTRIC COMPANY**

IRS Employer  
Identification No.  
**52-1964611**  
**52-0280210**

**MARYLAND**

(State of Incorporation of both registrants)

**750 E. PRATT STREET, BALTIMORE, MARYLAND 21202**

(Address of principal executive offices) (Zip Code)

**410-783-2800**

(Registrants telephone number, including area code)

**NOT APPLICABLE**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrants (1) have filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) have been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether Constellation Energy Group, Inc. is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether Baltimore Gas and Electric Company is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether Constellation Energy Group, Inc. is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No

Indicate by check mark whether Baltimore Gas and Electric Company is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No

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**Common Stock, without par value 180,493,614 shares outstanding of  
Constellation Energy Group, Inc. on July 31, 2007.**

Baltimore Gas and Electric Company meets the conditions set forth in General Instruction H(1)(a) and (b) of Form 10-Q and is therefore filing this form in the reduced disclosure format.

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## PART 1 FINANCIAL INFORMATION

## Item 1 Financial Statements

## Constellation Energy Group, Inc. and Subsidiaries

|   | Three Months Ended<br>June 30,          |            | Six Months Ended<br>June 30, |            |
|---|---|------------|------------------------------|------------|
|   | 2007                                    | 2006       | 2007                         | 2006       |
|   | (In millions, except per share amounts) |            |                              |            |
| <b>Revenues</b>   |   |            |                              |            |
| Nonregulated revenues   | \$ 4,116.8                              | \$ 3,738.3 | \$ 8,255.0                   | \$ 7,675.2 |
| Regulated electric revenues   | 544.3                                   | 498.7      | 1,059.1                      | 1,002.7    |
| Regulated gas revenues  | 159.1                                   | 141.8      | 561.6                        | 560.1      |
| Total revenues  | 4,820.2                                 | 4,378.8    | 9,875.7                      | 9,238.0    |
| <b>Expenses</b>   |   |            |                              |            |
| Fuel and purchased energy expenses  | 3,829.1                                 | 3,396.2    | 7,790.2                      | 7,319.3    |
| Operating expenses  | 580.4                                   | 575.7      | 1,149.1                      | 1,083.4    |
| Impairment losses and other costs   | 20.2                                    |            | 20.2                         |            |
| Workforce reduction costs   | 2.3                                     |            | 2.3                          | 2.2        |
| Merger-related costs  |   | 7.1        |                              | 9.0        |
| Depreciation, depletion, and amortization   | 142.8                                   | 133.3      | 275.2                        | 263.5      |
| Accretion of asset retirement obligations   | 18.2                                    | 16.7       | 35.9                         | 33.2       |
| Taxes other than income taxes   | 72.8                                    | 71.5       | 146.0                        | 145.1      |
| Total expenses  | 4,665.8                                 | 4,200.5    | 9,418.9                      | 8,855.7    |
| <b>Income from Operations</b>   | 154.4                                   | 178.3      | 456.8                        | 382.3      |
| <b>Gains on Sale of CEP LLC Equity</b>  | 12.9                                    |            | 12.9                         |            |
| <b>Other Income</b>   | 45.2                                    | 14.3       | 87.6                         | 29.1       |
| <b>Fixed Charges</b>  |   |            |                              |            |
| Interest expense  | 71.1                                    | 79.3       | 151.4                        | 156.3      |
| Interest capitalized and allowance for borrowed funds used during construction                            | (4.5 )                                  | (3.8 )     | (8.4 )                       | (6.5 )     |
| BGE preference stock dividends  | 3.3                                     | 3.3        | 6.6                          | 6.6        |
| Total fixed charges   | 69.9                                    | 78.8       | 149.6                        | 156.4      |
| <b>Income from Continuing Operations Before Income Taxes</b>  | 142.6                                   | 113.8      | 407.7                        | 255.0      |
| <b>Income Tax Expense</b>   | 26.3                                    | 39.8       | 94.1                         | 79.4       |
| <b>Income from Continuing Operations</b>  | 116.3                                   | 74.0       | 313.6                        | 175.6      |
| Income (loss) from discontinued operations, net of income taxes of \$9.7, \$0.8, and \$16.7, respectively |   | 19.1       | (1.6 )                       | 31.4       |
| <b>Net Income</b>   | \$ 116.3                                | \$ 93.1    | \$ 312.0                     | \$ 207.0   |
| <b>Earnings Applicable to Common Stock</b>  | \$ 116.3                                | \$ 93.1    | \$ 312.0                     | \$ 207.0   |
| <b>Average Shares of Common Stock Outstanding Basic</b>   | 180.3                                   | 179.1      | 180.5                        | 178.8      |
| <b>Average Shares of Common Stock Outstanding Diluted</b>   | 182.7                                   | 180.7      | 182.8                        | 180.6      |
| <b>Earnings Per Common Share from Continuing Operations Basic</b>   | \$ 0.65                                 | \$ 0.41    | \$ 1.74                      | \$ 0.98    |
| Income (loss) from discontinued operations  |   | 0.11       | (0.01 )                      | 0.18       |
| <b>Earnings Per Common Share Basic</b>  | \$ 0.65                                 | \$ 0.52    | \$ 1.73                      | \$ 1.16    |
| <b>Earnings Per Common Share from Continuing Operations Diluted</b>                                       | \$ 0.64                                 | \$ 0.41    | \$ 1.72                      | \$ 0.97    |
| Income (loss) from discontinued operations  |   | 0.11       | (0.01 )                      | 0.18       |
| <b>Earnings Per Common Share Diluted</b>  | \$ 0.64                                 | \$ 0.52    | \$ 1.71                      | \$ 1.15    |
| <b>Dividends Declared Per Common Share</b>  | \$ 0.435                                | \$ 0.3775  | \$ 0.87                      | \$ 0.755   |

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |            |
|--|--------------------------------|----------|------------------------------|------------|
|  | 2007                           | 2006     | 2007                         | 2006       |
|  | (In millions)                  |          |                              |            |
| <b>Net Income</b>  | \$ 116.3                       | \$ 93.1  | \$ 312.0                     | \$ 207.0   |
| Other comprehensive (loss) income (OCI)  |                                |          |                              |            |
| Hedging instruments:   |                                |          |                              |            |
| Reclassification of net loss on hedging instruments from OCI to net income, net of taxes | 158.9                          | 133.1    | 558.3                        | 214.1      |
| Net unrealized loss on hedging instruments, net of taxes                                 | (448.7 )                       | (294.0 ) | (138.4 )                     | (1,049.0 ) |
| Available-for-sale securities:   |                                |          |                              |            |
| Reclassification of net gain on sales of securities from OCI to net income, net of taxes | (1.9 )                         |          | (2.8 )                       | (0.3 )     |

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|   |                    |                   |                 |                    |
|---|--------------------|-------------------|-----------------|--------------------|
| Net unrealized gain (loss) on securities, net of taxes  | 33.2               | (8.5 )            | 13.7            | 3.3                |
| <b>Defined benefit obligations:</b>   |                    |                   |                 |                    |
| Amortization of net actuarial loss, prior service cost, and transition obligation included in net periodic benefit cost, net of taxes | 6.2                |                   | 12.5            |                    |
| Net unrealized gain on foreign currency, net of taxes   | 2.8                | 1.1               | 3.1             | 1.1                |
| <b>Comprehensive (Loss) Income</b>  | <b>\$ (133.2 )</b> | <b>\$ (75.2 )</b> | <b>\$ 758.4</b> | <b>\$ (623.8 )</b> |

*See Notes to Consolidated Financial Statements.*

*Certain prior-period amounts have been reclassified to conform with the current period's presentation.*

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## Constellation Energy Group, Inc. and Subsidiaries

June 30,  
2007\*  
  
December 31,  
2006  
(In millions)

| <b>Assets</b>  | June 30,<br>2007*  | December 31,<br>2006 |
|--|--------------------|----------------------|
| <b>Current Assets</b>  |                    |                      |
| Cash and cash equivalents  | \$ 1,968.0         | \$ 2,289.1           |
| Accounts receivable (net of allowance for uncollectibles of \$48.3 and \$48.9, respectively) | 3,411.5            | 3,248.3              |
| Fuel stocks  | 449.2              | 599.5                |
| Materials and supplies   | 208.2              | 200.2                |
| Mark-to-market energy assets   | 953.5              | 1,294.8              |
| Risk management assets   | 189.9              | 261.7                |
| Unamortized energy contract assets   | 62.3               | 35.2                 |
| Deferred income taxes  | 261.8              | 674.3                |
| Other  | 483.5              | 497.0                |
| Total current assets   | 7,987.9            | 9,100.1              |
| <b>Investments and Other Assets</b>  |                    |                      |
| Nuclear decommissioning trust funds  | 1,330.9            | 1,240.1              |
| Other investments  | 389.6              | 308.6                |
| Regulatory assets (net)  | 627.0              | 389.0                |
| Goodwill   | 157.7              | 157.6                |
| Mark-to-market energy assets   | 755.8              | 623.4                |
| Risk management assets   | 439.1              | 325.7                |
| Unamortized energy contract assets   | 185.5              | 123.6                |
| Other  | 317.5              | 311.4                |
| Total investments and other assets   | 4,203.1            | 3,479.4              |
| <b>Property, Plant and Equipment</b>   |                    |                      |
| Nonregulated property, plant and equipment   | 7,924.2            | 7,587.6              |
| Regulated property, plant and equipment  | 5,893.4            | 5,752.9              |
| Nuclear fuel (net of amortization)   | 329.2              | 339.9                |
| Accumulated depreciation   | (4,620.2 )         | (4,458.3 )           |
| Net property, plant and equipment  | 9,526.6            | 9,222.1              |
| <b>Total Assets</b>  | <b>\$ 21,717.6</b> | <b>\$ 21,801.6</b>   |

\* Unaudited

See Notes to Consolidated Financial Statements.

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Constellation Energy Group, Inc. and Subsidiaries

|  | June 30,<br>2007*  | December 31,<br>2006 |
|--|--------------------|----------------------|
|  | (In millions)      |                      |
| <b>Liabilities and Equity</b>  |                    |                      |
| <b>Current Liabilities</b>   |                    |                      |
| Current portion of long-term debt  | \$ 303.4           | \$ 878.8             |
| Accounts payable and accrued liabilities   | 2,278.1            | 2,137.2              |
| Customer deposits and collateral   | 494.7              | 347.2                |
| Mark-to-market energy liabilities  | 728.6              | 1,071.7              |
| Risk management liabilities  | 815.7              | 1,340.0              |
| Unamortized energy contract liabilities  | 456.7              | 378.3                |
| Accrued expenses and other   | 629.6              | 969.5                |
| Total current liabilities  | 5,706.8            | 7,122.7              |
| <b>Deferred Credits and Other Liabilities</b>  |                    |                      |
| Deferred income taxes  | 1,359.8            | 1,435.8              |
| Asset retirement obligations   | 1,007.8            | 974.8                |
| Mark-to-market energy liabilities  | 448.2              | 392.4                |
| Risk management liabilities  | 711.7              | 707.3                |
| Unamortized energy contract liabilities  | 1,408.5            | 958.0                |
| Defined benefit obligations  | 834.3              | 928.3                |
| Deferred investment tax credits  | 53.8               | 57.2                 |
| Other  | 148.2              | 109.0                |
| Total deferred credits and other liabilities   | 5,972.3            | 5,562.8              |
| <b>Long-term Debt</b>  |                    |                      |
| Long-term debt of Constellation Energy   | 2,433.7            | 3,042.9              |
| Long-term debt of nonregulated businesses  | 325.3              | 347.4                |
| Rate stabilization bonds of BGE  | 623.2              |                      |
| First refunding mortgage bonds of BGE  | 123.1              | 244.5                |
| Other long-term debt of BGE  | 1,214.5            | 1,214.5              |
| 6.20% deferrable interest subordinated debentures due October 15, 2043 to BGE wholly owned BGE Capital Trust II relating to trust preferred securities | 257.7              | 257.7                |
| Unamortized discount and premium   | (5.3 )             | (5.9 )               |
| Current portion of long-term debt  | (303.4 )           | (878.8 )             |
| Total long-term debt   | 4,668.8            | 4,222.3              |
| <b>Minority Interests</b>  |                    |                      |
| BGE Preference Stock Not Subject to Mandatory Redemption   | 190.0              | 190.0                |
| <b>Common Shareholders' Equity</b>   |                    |                      |
| Common stock   | 2,723.0            | 2,738.6              |
| Retained earnings  | 3,593.2            | 3,474.3              |
| Accumulated other comprehensive loss   | (1,157.2 )         | (1,603.6 )           |
| Total common shareholders' equity  | 5,159.0            | 4,609.3              |
| <b>Commitments, Guarantees, and Contingencies (see Notes)</b>  |                    |                      |
| <b>Total Liabilities and Equity</b>  | <b>\$ 21,717.6</b> | <b>\$ 21,801.6</b>   |

\* Unaudited

See Notes to Consolidated Financial Statements.

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Constellation Energy Group, Inc. and Subsidiaries

| Six Months Ended June 30,  | 2007              | 2006            |
|--|-------------------|-----------------|
|  |                   | (In millions)   |
| <b>Cash Flows From Operating Activities</b>  |                   |                 |
| Net income   | \$ 312.0          | \$ 207.0        |
| Adjustments to reconcile to net cash provided by (used in) operating activities                      |                   |                 |
| Gain on sales of discontinued operations   |                   | (0.9 )          |
| Depreciation, depletion, and amortization  | 239.5             | 287.5           |
| Accretion of asset retirement obligations  | 35.9              | 33.2            |
| Deferred income taxes  | 60.2              | (26.9 )         |
| Investment tax credit adjustments  | (3.4 )            | (3.5 )          |
| Deferred fuel costs  | (260.5 )          | 17.8            |
| Defined benefit obligation expense   | 73.1              | 64.7            |
| Defined benefit obligation payments  | (146.5 )          | (69.7 )         |
| Workforce reduction costs  | 2.3               | 2.2             |
| Impairment losses and other costs  | 20.2              |                 |
| Gains on sale of CEP LLC equity  | (12.9 )           |                 |
| Equity in earnings of affiliates less than dividends received  | 33.4              | 16.1            |
| Proceeds from derivative power sales contracts classified as financing activities under SFAS No. 149 | (3.8 )            | (44.1 )         |
| Changes in   |                   |                 |
| Accounts receivable  | 10.8              | 38.2            |
| Mark-to-market energy assets and liabilities   | 0.4               | (181.7 )        |
| Risk management assets and liabilities   | 16.8              | 1.3             |
| Materials, supplies, and fuel stocks   | 72.7              | (188.2 )        |
| Other current assets   | 11.4              | 11.6            |
| Accounts payable and accrued liabilities   | 133.3             | (303.0 )        |
| Other current liabilities  | (179.3 )          | (286.8 )        |
| Other  | (5.5 )            | 5.9             |
| Net cash provided by (used in) operating activities  | 410.1             | (419.3 )        |
| <b>Cash Flows From Investing Activities</b>  |                   |                 |
| Investments in property, plant and equipment   | (564.1 )          | (414.4 )        |
| Acquisitions, net of cash acquired   | (250.6 )          | (126.2 )        |
| Investments in nuclear decommissioning trust fund securities   | (352.7 )          | (236.2 )        |
| Proceeds from nuclear decommissioning trust fund securities  | 343.9             | 227.4           |
| Sales of investments and other assets  | 4.7               | 43.1            |
| Contract and portfolio acquisitions  | (474.2 )          | (2.3 )          |
| Other  | (0.6 )            | 8.3             |
| Net cash used in investing activities  | (1,293.6 )        | (500.3 )        |
| <b>Cash Flows From Financing Activities</b>  |                   |                 |
| Net issuance of short-term borrowings  |                   | 154.3           |
| Proceeds from issuance of  |                   |                 |
| Common stock   | 39.2              | 40.8            |
| Long-term debt   | 643.2             | 122.0           |
| Repayment of long-term debt  | (731.7 )          | (123.0 )        |
| Common stock dividends paid  | (147.6 )          | (127.7 )        |
| Reacquisition of common stock  | (114.4 )          |                 |
| Proceeds from contract and portfolio acquisitions  | 847.8             | 221.3           |
| Proceeds from derivative power sales contracts classified as financing activities under SFAS No. 149 | 3.8               | 44.1            |
| Other  | 22.1              | 2.9             |
| Net cash provided by financing activities  | 562.4             | 334.7           |
| <b>Net Decrease in Cash and Cash Equivalents</b>   | <b>(321.1 )</b>   | <b>(584.9 )</b> |
| <b>Cash and Cash Equivalents at Beginning of Period</b>  | <b>2,289.1</b>    | <b>813.0</b>    |
| <b>Cash and Cash Equivalents at End of Period</b>  | <b>\$ 1,968.0</b> | <b>\$ 228.1</b> |

See Notes to Consolidated Financial Statements.



*Certain prior-period amounts have been reclassified to conform with the current period's presentation.*

*Baltimore Gas and Electric Company and Subsidiaries*

|   | <i>Three Months Ended<br/>June 30,</i> |                | <i>Six Months Ended<br/>June 30,</i> |                |
|---|--|----------------|--------------------------------------|----------------|
|   | <i>2007</i>                            | <i>2006</i>    | <i>2007</i>                          | <i>2006</i>    |
|   | <i>(In millions)</i>                   |                |                                      |                |
| <b>Revenues</b>                                       |  |                |                                      |                |
| Electric revenues                                     | \$ 544.3                               | \$ 498.7       | \$ 1,059.1                           | \$ 1,002.7     |
| Gas revenues  | 162.8                                  | 143.6          | 570.1                                | 563.8          |
| Total revenues  | 707.1                                  | 642.3          | 1,629.2                              | 1,566.5        |
| <b>Expenses</b>                                       |  |                |                                      |                |
| Operating expenses                                    |  |                |                                      |                |
| Electricity purchased for resale                      | 320.9                                  | 279.8          | 595.1                                | 542.7          |
| Gas purchased for resale                              | 102.9                                  | 83.8           | 387.0                                | 382.2          |
| Operations and maintenance                            | 131.3                                  | 120.3          | 254.4                                | 240.3          |
| Merger-related costs                                  |  | 1.9            |                                      | 2.5            |
| Depreciation and amortization                         | 58.5                                   | 57.2           | 117.4                                | 114.9          |
| Taxes other than income taxes                         | 43.0                                   | 40.8           | 88.8                                 | 84.3           |
| Total expenses  | 656.6                                  | 583.8          | 1,442.7                              | 1,366.9        |
| <b>Income from Operations</b>                         | <b>50.5</b>                            | <b>58.5</b>    | <b>186.5</b>                         | <b>199.6</b>   |
| <b>Other Income</b>                                   | <b>5.4</b>                             | <b>0.9</b>     | <b>10.0</b>                          | <b>1.0</b>     |
| <b>Fixed Charges</b>                                  |  |                |                                      |                |
| Interest expense                                      | 29.1                                   | 24.3           | 57.1                                 | 48.5           |
| Allowance for borrowed funds used during construction | (0.7 )                                 | (0.5 )         | (1.1 )                               | (0.9 )         |
| Total fixed charges                                   | 28.4                                   | 23.8           | 56.0                                 | 47.6           |
| <b>Income Before Income Taxes</b>                     | <b>27.5</b>                            | <b>35.6</b>    | <b>140.5</b>                         | <b>153.0</b>   |
| <b>Income Taxes</b>                                   | <b>10.6</b>                            | <b>13.9</b>    | <b>54.3</b>                          | <b>59.6</b>    |
| <b>Net Income</b>                                     | <b>16.9</b>                            | <b>21.7</b>    | <b>86.2</b>                          | <b>93.4</b>    |
| <b>Preference Stock Dividends</b>                     | <b>3.3</b>                             | <b>3.3</b>     | <b>6.6</b>                           | <b>6.6</b>     |
| <b>Earnings Applicable to Common Stock</b>            | <b>\$ 13.6</b>                         | <b>\$ 18.4</b> | <b>\$ 79.6</b>                       | <b>\$ 86.8</b> |

*See Notes to Consolidated Financial Statements.*

*Baltimore Gas and Electric Company and Subsidiaries*

|  | <i>June 30,<br/>2007*</i> | <i>December 31,<br/>2006</i> |
|--|---------------------------|------------------------------|
|  | <i>(In millions)</i>      |                              |
| <b>Assets</b>  |                           |                              |
| <b>Current Assets</b>  |                           |                              |
| Cash and cash equivalents  | \$ 634.7                  | \$ 10.9                      |
| Accounts receivable (net of allowance for uncollectibles of \$16.1 and \$16.1, respectively) | 410.0                     | 344.7                        |
| Investment in cash pool, affiliated company  |                           | 60.6                         |
| Accounts receivable, affiliated companies  | 2.2                       | 2.5                          |
| Fuel stocks  | 77.6                      | 110.9                        |
| Materials and supplies   | 45.6                      | 40.2                         |
| Prepaid taxes other than income taxes  | 0.3                       | 48.0                         |
| Regulatory assets, net   | 61.4                      | 62.5                         |
| Other  | 18.8                      | 35.2                         |
| Total current assets   | 1,250.6                   | 715.5                        |
| <b>Investments and Other Assets</b>  |                           |                              |
| Regulatory assets (net)  | 627.0                     | 389.0                        |
| Receivable, affiliated company   | 166.0                     | 150.5                        |
| Other  | 139.5                     | 127.5                        |
| Total investments and other assets   | 932.5                     | 667.0                        |
| <b>Utility Plant</b>   |                           |                              |
| Plant in service   |                           |                              |
| Electric   | 4,138.4                   | 4,060.2                      |
| Gas  | 1,165.1                   | 1,148.3                      |
| Common   | 444.1                     | 444.6                        |
| Total plant in service   | 5,747.6                   | 5,653.1                      |
| Accumulated depreciation   | (2,042.6 )                | (1,994.7 )                   |
| Net plant in service   | 3,705.0                   | 3,658.4                      |
| Construction work in progress  | 143.4                     | 97.1                         |
| Plant held for future use  | 2.4                       | 2.7                          |
| Net utility plant  | 3,850.8                   | 3,758.2                      |
| <b>Total Assets</b>  | <b>\$ 6,033.9</b>         | <b>\$ 5,140.7</b>            |

\* Unaudited

See Notes to Consolidated Financial Statements.

## Baltimore Gas and Electric Company and Subsidiaries

|  | June 30,<br>2007 * |   | December 31,<br>2006 |
|--|--------------------|---|----------------------|
|  | (In millions)      |   |                      |
| <b>Liabilities and Equity</b>  |                    |   |                      |
| <b>Current Liabilities</b>   |                    |   |                      |
| Current portion of long-term debt  | \$ 287.9           |   | \$ 258.3             |
| Accounts payable and accrued liabilities   | 159.4              |   | 187.3                |
| Accounts payable and accrued liabilities, affiliated companies   | 155.0              |   | 163.4                |
| Borrowing from cash pool, affiliated company   | 270.8              |   |                      |
| Customer deposits  | 72.1               |   | 71.4                 |
| Deferred income taxes  | 38.2               |   | 47.4                 |
| Accrued expenses and other   | 102.1              |   | 98.3                 |
| Total current liabilities  | 1,085.5            |   | 826.1                |
| <b>Deferred Credits and Other Liabilities</b>  |                    |   |                      |
| Deferred income taxes  | 778.3              |   | 697.7                |
| Payable, affiliated company  | 248.7              |   | 250.7                |
| Deferred investment tax credits  | 12.7               |   | 13.5                 |
| Other  | 18.5               |   | 14.0                 |
| Total deferred credits and other liabilities   | 1,058.2            |   | 975.9                |
| <b>Long-term Debt</b>  |                    |   |                      |
| Rate stabilization bonds   | 623.2              |   |                      |
| First refunding mortgage bonds   | 123.1              |   | 244.5                |
| Other long-term debt   | 1,214.5            |   | 1,214.5              |
| 6.20% deferrable interest subordinated debentures due October 15, 2043 to wholly owned BGE Capital Trust II relating to trust preferred securities | 257.7              |   | 257.7                |
| Long-term debt of nonregulated businesses  | 25.0               |   | 25.0                 |
| Unamortized discount and premium   | (2.7)              | ) | (2.9)                |
| Current portion of long-term debt  | (287.9)            | ) | (258.3)              |
| Total long-term debt   | 1,952.9            |   | 1,480.5              |
| <b>Minority Interest</b>   | 16.7               |   | 16.7                 |
| <b>Preference Stock Not Subject to Mandatory Redemption</b>  | 190.0              |   | 190.0                |
| <b>Common Shareholder s Equity</b>   |                    |   |                      |
| Common stock   | 912.2              |   | 912.2                |
| Retained earnings  | 817.7              |   | 738.6                |
| Accumulated other comprehensive income   | 0.7                |   | 0.7                  |
| Total common shareholder s equity  | 1,730.6            |   | 1,651.5              |
| <b>Commitments, Guarantees, and Contingencies (see Notes)</b>  |                    |   |                      |
| <b>Total Liabilities and Equity</b>  | \$ 6,033.9         |   | \$ 5,140.7           |

\* Unaudited

See Notes to Consolidated Financial Statements.

*Baltimore Gas and Electric Company and Subsidiaries*

| <b>Six Months Ended June 30,</b>   | <b>2007</b>          | <b>2006</b>    |
|--|----------------------|----------------|
|  | <i>(In millions)</i> |                |
| <b>Cash Flows From Operating Activities</b>  |                      |                |
| Net income   | \$ 86.2              | \$ 93.4        |
| Adjustments to reconcile to net cash (used in) provided by operating activities                              |                      |                |
| Depreciation and amortization  | 123.7                | 121.9          |
| Deferred income taxes  | 87.3                 | (15.5 )        |
| Investment tax credit adjustments  | (0.8 )               | (0.8 )         |
| Deferred fuel costs  | (260.5 )             | 17.8           |
| Defined benefit plan expenses  | 20.3                 | 22.6           |
| Allowance for equity funds used during construction  | (2.1 )               | (1.6 )         |
| Changes in   |                      |                |
| Accounts receivable  | (65.3 )              | 161.4          |
| Accounts receivable, affiliated companies  | 0.3                  | 0.1            |
| Materials, supplies, and fuel stocks   | 27.9                 | 25.3           |
| Other current assets   | 64.1                 | 46.3           |
| Accounts payable and accrued liabilities   | (27.9 )              | (83.9 )        |
| Accounts payable and accrued liabilities, affiliated companies   | (8.5 )               | 60.2           |
| Other current liabilities  | (29.5 )              | 52.4           |
| Long-term receivables and payables, affiliated companies   | (37.8 )              | (37.2 )        |
| Other  | (1.6 )               | 5.2            |
| Net cash (used in) provided by operating activities  | (24.2 )              | 467.6          |
| <b>Cash Flows From Investing Activities</b>  |                      |                |
| Utility construction expenditures (excluding equity portion of allowance for funds used during construction) | (175.5 )             | (147.5 )       |
| Change in cash pool at parent  | 331.4                | (241.7 )       |
| Other  | (3.1 )               | 10.3           |
| Net cash provided by (used in) investing activities  | 152.8                | (378.9 )       |
| <b>Cash Flows From Financing Activities</b>  |                      |                |
| Proceeds from issuance of long-term debt   | 623.2                |                |
| Repayment of long-term debt  | (121.4 )             | (25.0 )        |
| Preference stock dividends paid  | (6.6 )               | (6.6 )         |
| Distribution to parent   |                      | (59.8 )        |
| Net cash provided by (used in) financing activities  | 495.2                | (91.4 )        |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b>  | <b>623.8</b>         | <b>(2.7 )</b>  |
| <b>Cash and Cash Equivalents at Beginning of Period</b>  | <b>10.9</b>          | <b>15.1</b>    |
| <b>Cash and Cash Equivalents at End of Period</b>  | <b>\$ 634.7</b>      | <b>\$ 12.4</b> |

*See Notes to Consolidated Financial Statements.*

*Certain prior-period amounts have been reclassified to conform with the current period's presentation.*



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Various factors can have a significant impact on our results for interim periods. This means that the results for this quarter are not necessarily indicative of future quarters or full year results given the seasonality of our business.

Our interim financial statements on the previous pages reflect all adjustments that management believes are necessary for the fair statement of the results of operations for the interim periods presented. These adjustments are of a normal recurring nature.

### Basis of Presentation

This Quarterly Report on Form 10-Q is a combined report of Constellation Energy Group, Inc. (Constellation Energy) and Baltimore Gas and Electric Company (BGE). References in this report to we and our are to Constellation Energy and its subsidiaries, collectively. References in this report to the regulated business(es) are to BGE.

### Variable Interest Entities

We have a significant interest in the following variable interest entities (VIE) for which we are not the primary beneficiary:

| VIE                                  | Nature of Involvement                        | Date of Involvement |
|--------------------------------------|--|---------------------|
| Power projects                       | Equity investment and guarantees             | Prior to 2003       |
| Power contract monetization entities | Power sale agreements, loans, and guarantees | March 2005          |
| Oil and gas fields                   | Equity investment                            | May 2006            |
| Retail power supply                  | Power sale agreement                         | September 2006      |

We discuss the nature of our involvement with the power contract monetization VIEs in detail in *Note 4* to our 2006 Annual Report on Form 10-K.

The following is summary information available as of June 30, 2007 about the VIEs in which we have a significant interest, but are not the primary beneficiary:

|                              | Power Contract Monetization VIEs | All Other VIEs<br>(In millions) | Total      |
|------------------------------|----------------------------------|---------------------------------|------------|
| Total assets                 | \$ 742.8                         | \$ 356.5                        | \$ 1,099.3 |
| Total liabilities            | 589.2                            | 151.6                           | 740.8      |
| Our ownership interest       |                                  | 49.4                            | 49.4       |
| Other ownership interests    | 153.6                            | 155.5                           | 309.1      |
| Our maximum exposure to loss | 62.6                             | 97.9                            | 160.5      |

The maximum exposure to loss represents the loss that we would incur in the unlikely event that our interests in all of these entities were to become worthless and we were required to fund the full amount of all guarantees associated with these entities. Our maximum exposure to loss as of June 30, 2007 consists of the following:

- ◆ outstanding receivables, loans and letters of credit totaling \$98.5 million,
- ◆ the carrying amount of our investment totaling \$49.3 million, and
- ◆ debt and performance guarantees totaling \$12.7 million.

We assess the risk of a loss equal to our maximum exposure to be remote.

*RSB BondCo LLC*

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In 2007, BGE formed RSB BondCo LLC (BondCo), a special purpose bankruptcy-remote limited liability company. In June 2007, BondCo purchased rate stabilization property from BGE, including the right to assess, collect, and receive non-bypassable rate stabilization charges payable by all residential electric customers of BGE. These charges are being assessed in order to recover previously incurred power purchase costs that BGE deferred pursuant to Senate Bill 1. We discuss Senate Bill 1 in more detail in our 2006 Annual Report on Form 10-K.

BGE has determined that BondCo is a variable interest entity for which it is also the primary beneficiary. As a result, BGE consolidated BondCo. We discuss the consolidation method of accounting in more detail in *Note 1* of our 2006 Annual Report on Form 10-K.

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### Discontinued Operations

In the fourth quarter of 2006, we completed the sale of six natural gas-fired plants. We recognized an after-tax loss of \$1.6 million as a component of *Income (loss) from discontinued operations* for the six months ended June 30, 2007 due to post-closing working capital adjustments. We discuss the details of the sale in *Note 2* of our 2006 Annual Report on Form 10-K.

### Impairment Losses and Other Costs

In connection with the termination of the merger agreement with FPL Group, Inc., we acquired certain rights relating to a wind development project in Western Maryland. In the second quarter of 2007, we elected not to make the additional investment that was required at that time to retain our rights in the project; therefore, we recorded a charge of \$20.2 million pre-tax to write-off our investment in these development rights.

### Workforce Reduction Costs

We incurred costs related to workforce reduction efforts initiated in 2006. We discuss these costs in more detail in *Note 2* of our 2006 Annual Report on Form 10-K.

The following table summarizes the status of the 2006 involuntary severance liability for Nine Mile Point and Calvert Cliffs at June 30, 2007:

|  | <i>(In millions)</i> |
|--|----------------------|
| Initial severance liability balance                        | \$ 19.6              |
| Amounts recorded as pension and postretirement liabilities | (7.3 )               |
| Net cash severance liability                               | 12.3                 |
| Cash severance payments                                    | (8.6 )               |
| Other  |                      |
| Severance liability balance at June 30, 2007               | \$ 3.7               |

In June 2007, we approved an additional restructuring of the workforce at our Nine Mile Point nuclear facility. We recognized costs of \$2.3 million pre-tax during the quarter ended June 30, 2007 related to the elimination of 23 positions associated with this restructuring.

### Earnings Per Share

Basic earnings per common share (EPS) is computed by dividing earnings applicable to common stock by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution of common stock equivalent shares that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

Our dilutive common stock equivalent shares consist of stock options and other stock-based compensation awards. The following table presents stock options that were not dilutive and were excluded from the computation of diluted EPS in each period, as well as the dilutive common stock equivalent shares:

|   | 2007 | Quarter Ended<br>June 30,<br>2006 | 2007<br><i>(In millions)</i> | Six Months<br>Ended June 30,<br>2006 |
|---|------|-----------------------------------|------------------------------|--------------------------------------|
| Non-dilutive stock options              |      | 2.2                               |                              | 2.0                                  |
| Dilutive common stock equivalent shares | 2.4  | 1.6                               | 2.3                          | 1.8                                  |

### Accretion of Asset Retirement Obligations

We discuss our asset retirement obligations in more detail in *Note 1* of our 2006 Annual Report on Form 10-K. The change in our *Asset retirement obligations liability* during 2007 was as follows:

|                              | <i>(In millions)</i> |
|------------------------------|----------------------|
| Liability at January 1, 2007 | \$ 974.8             |
| Accretion expense            | 35.9                 |

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|   |            |
|---|------------|
| Liabilities incurred                    |            |
| Liabilities settled                     |            |
| Revisions to expected future cash flows |            |
| Other                                   | (2.9 )     |
| Liability at June 30, 2007              | \$ 1,007.8 |

Other represents Constellation Energy Partners LLC's (CEP) asset retirement obligation that is no longer included in our Consolidated Balance Sheets. We discuss the deconsolidation of CEP on the next page.

In 2007, we are performing site specific studies for all three of our nuclear facilities. We expect to complete these studies and adjust our nuclear decommissioning asset retirement obligations in the third quarter of 2007.

### Constellation Energy Partners LLC

In April 2007, CEP acquired 100% ownership of certain coalbed methane properties located in the Cherokee Basin in Kansas and Oklahoma. In anticipation of closing this acquisition and the related equity issuance, at March 31, 2007 we evaluated the probability of forecasted sales of natural gas from CEP's properties that previously had been hedged by our merchant energy business. As a result of the anticipated deconsolidation of CEP resulting from this equity issuance, which we discuss on the next page, we determined that the hedged forecasted sales were probable of not occurring. Therefore, we reclassified \$21.8 million pre-tax in previously deferred cash-flow hedge losses from

Accumulated other comprehensive loss to earnings during the first quarter of 2007.

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As a result of the April 2007 equity issuance by CEP, our ownership percentage in CEP fell below 50 percent. Therefore, during the second quarter of 2007, we deconsolidated CEP and began accounting for our investment using the equity method under Accounting Principles Board Opinion (APB) No. 18, *The Equity Method of Accounting for Investments in Common Stock*. We discuss the equity method of accounting in more detail in Note 1 of our 2006 Annual Report on Form 10-K.

The details of the April 2007 CEP equity issuance and subsequent equity sales, as well as the gains recognized by or expected to be recognized by us, are summarized below:

|                           | Units<br>Issued                         | Price/<br>Unit | Proceeds<br>to CEP | Approximate<br>pre-tax<br>gain |
|---------------------------|---|----------------|--------------------|--------------------------------|
|                           | <i>(In millions, except price/unit)</i> |                |                    |                                |
| <b>April 2007 Sale</b>    |   |                |                    |                                |
| Common units              | 2.2                                     | \$ 26.12       | \$ 58              | \$ 12.5                        |
| Class E units 1           | 0.1                                     | 25.84          | 2                  | 0.4                            |
| <b>July 2007 Sale</b>     |   |                |                    |                                |
| Common units              | 2.7                                     | 35.25          | 94                 | 20.6                           |
| Class F units 2           | 3.4                                     | 34.43          | 116                | 13-18                          |
| <b>Pending sale</b>       |   |                |                    |                                |
| Common units <sup>3</sup> | 2.5                                     | 42.50          | 105                | 14-20                          |

1 The gain on Class E units was recognized upon conversion to common units in the quarter ended June 30, 2007.

2 The Class F units are expected to be converted to common units within 90 days after the closing of the July 2007 sale of common units. We expect to record the pre-tax gain upon conversion.

3 The sale of common units and recognition of gain is contingent upon CEP issuing these common units.

### Acquisitions

#### *Working Interests in Gas Producing Fields*

In the first quarter of 2007, we acquired working interests of 41% and 55% in two gas and oil producing properties in Oklahoma for \$212.0 million in cash, subject to closing adjustments. We purchased leases, producing wells, inventory, and related equipment. We have included the results of operations from these properties in our merchant energy business segment since the date of acquisition.

Our preliminary purchase price is allocated to the net assets acquired as follows:

*At March 23, 2007*

|                               | <i>(In millions)</i> |
|-------------------------------|----------------------|
| Property, Plant and Equipment |                      |
| Inventory                     | \$ 0.2               |
| Unproved property             | 7.3                  |
| Proved property               | 204.5                |
| Net Assets Acquired           | \$ 212.0             |

The purchase price is subject to closing adjustments, which could impact our purchase price allocation.

We believe that the pro-forma impact of the acquisition of these working interests would not have been material to our results of operations for the three months ended March 31, 2007 and for the quarter and six month periods ended June 30, 2006.

#### *Contract and Portfolio Acquisitions*

In June 2007, our wholesale marketing, risk management, and trading operation closed a transaction for the purchase of a portfolio of power-related contracts in the southeast region of the United States. Under this transaction, we assumed several full-requirements fixed-price power sales agreements with peak demand totaling more than 3,000 megawatts, and several long-term tolling agreements. The power sales and

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tolling agreements terminate at various dates through 2015. In addition, we also assumed various power and natural gas hedges.

The market price was different than the contract prices at closing. As a result, each contract was evaluated to determine whether the fair value of the contract price was above- or below-market at the time of closing. We recorded the fair value of each contract as an asset if the fair value was above-market (in-the-money) and as a liability if the contract was below-market (out-of-the-money).

The table below summarizes the transaction and the net cash received at closing:

|                                       | <i>(In millions)</i> |
|---------------------------------------|----------------------|
| Contracts out-of-the-money at closing | \$ 820.8             |
| Contracts in-the-money at closing     | (474.2 )             |
| Net cash received at closing          | \$ 346.6             |

We recorded this transaction in our financial statements as follows:

|   | <b>Balance Sheet</b>  | <b>Cash Flows</b>      |
|---|---|------------------------|
| Acquisition of out-of-the-money contracts | Unamortized energy contract liabilities and risk management liabilities   | Financing cash inflow  |
| Acquisition of in-the-money contracts     | Unamortized energy contract assets, mark-to-market energy assets, risk management assets, and accounts receivable | Investing cash outflow |

We recorded the acquisition of contracts out-of-the-money at closing as a financing cash inflow because it does not represent a cash inflow from current period operating activities. For those acquired contracts that are derivatives, we record the ongoing cash flows related to the contract with the counterparties as financing cash inflows in accordance with SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. We record all other ongoing cash flows from the sale or purchase of power under contracts assumed in this transaction as operating cash flows.

#### *Cornerstone Energy*

In July 2007, our retail competitive supply operation acquired 100% ownership of Cornerstone Energy, Inc. for approximately \$100 million. Cornerstone Energy, Inc. provides natural gas supply and related services to more than 1,400 commercial, industrial and institutional customers across the central United States. It also provides natural gas and related services to more than 8,500 small commercial businesses. Cornerstone Energy, Inc. is expected to add 100 billion cubic feet of natural gas to our annual volumes served.

#### **Shipping Joint Venture**

In December 2006, we formed a shipping joint venture in which we have a 50% ownership interest. The joint venture will own and operate six freight ships. In July 2007, we made an initial cash contribution of approximately \$37 million to the joint venture. We expect our total cash contribution will be approximately \$60 million in 2007. The joint venture will be accounted for using the equity method of accounting under APB No. 18. We discuss the equity method of accounting in more detail in *Note 1* of our 2006 Annual Report on Form 10-K.

#### **Electricite de France Joint Venture**

In July 2007, we announced a joint venture, UniStar Nuclear Energy, LLC (UniStar) with an affiliate of Electricite de France, SA (EDF). We have a 50% ownership interest in this joint venture to develop, own, and operate new nuclear projects in the United States and Canada. This joint venture will be accounted for using the equity method of accounting under APB No. 18. The agreement with EDF includes a phased-in investment of \$625 million by EDF in UniStar. Initially, EDF will invest \$350 million in UniStar, and we will contribute the new nuclear line of businesses we have developed over the past two years and the right to develop possible new nuclear projects at our existing nuclear plant locations. Upon reaching certain licensing milestones, EDF will contribute up to an additional \$275 million in UniStar.

In connection with this joint venture, we entered into an investor agreement with EDF under which EDF may purchase in the open market up to a total of 9.9% of our outstanding common stock during the next five years, with a limit of 5% ownership during the first twelve months of the agreement. EDF has agreed to vote any shares of our common stock owned by it in the manner recommended by our Board of Directors and to not take any actions that seek control of Constellation Energy during the next five years.

#### **Information by Operating Segment**

Our reportable operating segments are Merchant Energy, Regulated Electric, and Regulated Gas:

◆ Our merchant energy business is nonregulated and includes:

full requirements load-serving sales of energy and capacity to utilities, cooperatives, and commercial, industrial, and governmental customers,

structured transactions and risk management services for various customers (including hedging of output from generating facilities and fuel costs),

deployment of risk capital through portfolio management and trading activities,

gas retail energy products and services to commercial, industrial, and governmental customers,

fossil, nuclear, and interests in hydroelectric generating facilities and qualifying facilities, fuel processing facilities, and power projects in the United States,

upstream (exploration and production) and downstream (transportation and storage) natural gas operations,

coal sourcing and logistics services for the variable or fixed supply needs of global customers, and

generation operations and maintenance and new nuclear development consulting services.

- ◆ Our regulated electric business purchases, transmits, distributes, and sells electricity in Central Maryland.
- ◆ Our regulated gas business purchases, transports, and sells natural gas in Central Maryland.

Our remaining nonregulated businesses:

- ◆ design, construct, and operate heating, cooling, and cogeneration facilities for commercial, industrial, and municipal customers throughout North America, and
- ◆ provide home improvements, service electric and gas appliances, service heating, air conditioning, plumbing, electrical, and indoor air quality systems, and provide natural gas marketing to residential customers in Central Maryland.

In addition, we own several investments that we do not consider to be core operations. These include financial investments and real estate projects.

Our Merchant Energy, Regulated Electric, and Regulated Gas reportable segments are strategic businesses based principally upon regulations, products, and services that require different technology and marketing strategies. We evaluate the performance of these segments based on net income. We account for intersegment revenues using market prices. A summary of information by operating segment is shown on the next page.

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|                                     | Merchant<br>Energy<br>Business | Reportable Segments<br>Regulated<br>Electric<br>Business | Regulated<br>Gas<br>Business | Other<br>Nonregulated<br>Businesses | Eliminations | Consolidated |
|-------------------------------------|--------------------------------|--|------------------------------|-------------------------------------|--------------|--------------|
|                                     | (In millions)                  |  |                              |                                     |              |              |
| <i>For the three months ended</i>   |                                |  |                              |                                     |              |              |
| <i>June 30,</i>                     |                                |  |                              |                                     |              |              |
| <b>2007</b>                         |                                |  |                              |                                     |              |              |
| Unaffiliated revenues               | \$ 4,072.0                     | \$ 544.3   | \$ 159.1                     | \$ 44.8                             | \$           | \$ 4,820.2   |
| Intersegment revenues               | 267.7                          |  | 3.7                          |                                     | (271.4 )     |              |
| Total revenues                      | 4,339.7                        | 544.3  | 162.8                        | 44.8                                | (271.4 )     | 4,820.2      |
| Net income (loss)                   | 102.2                          | 19.4   | (5.7 )                       | 0.4                                 |              | 116.3        |
| <b>2006</b>                         |                                |  |                              |                                     |              |              |
| Unaffiliated revenues               | \$ 3,675.4                     | \$ 498.7   | \$ 141.8                     | \$ 62.9                             | \$           | \$ 4,378.8   |
| Intersegment revenues               | 232.5                          |  | 1.8                          |                                     | (234.3 )     |              |
| Total revenues                      | 3,907.9                        | 498.7  | 143.6                        | 62.9                                | (234.3 )     | 4,378.8      |
| Income from discontinued operations | 19.1                           |  |                              |                                     |              | 19.1         |
| Net income (loss)                   | 71.7                           | 19.9   | (1.4 )                       | 2.9                                 |              | 93.1         |
| <i>For the six months ended</i>     |                                |  |                              |                                     |              |              |
| <i>June 30,</i>                     |                                |  |                              |                                     |              |              |
| <b>2007</b>                         |                                |  |                              |                                     |              |              |
| Unaffiliated revenues               | \$ 8,135.5                     | \$ 1,059.1   | \$ 561.6                     | \$ 119.5                            | \$           | \$ 9,875.7   |
| Intersegment revenues               | 590.6                          |  | 8.5                          |                                     | (599.1 )     |              |
| Total revenues                      | 8,726.1                        | 1,059.1  | 570.1                        | 119.5                               | (599.1 )     | 9,875.7      |
| Loss from discontinued operations   | (1.6 )                         |  |                              |                                     |              | (1.6 )       |
| Net income                          | 222.2                          | 51.6   | 28.0                         | 10.2                                |              | 312.0        |
| <b>2006</b>                         |                                |  |                              |                                     |              |              |
| Unaffiliated revenues               | \$ 7,551.5                     | \$ 1,002.7   | \$ 560.1                     | \$ 123.7                            | \$           | \$ 9,238.0   |
| Intersegment revenues               | 439.7                          |  | 3.7                          | 0.1                                 | (443.5 )     |              |
| Total revenues                      | 7,991.2                        | 1,002.7  | 563.8                        | 123.8                               | (443.5 )     | 9,238.0      |
| Income from discontinued operations | 30.5                           |  |                              | 0.9                                 |              | 31.4         |
| Net income                          | 115.3                          | 53.5   | 33.6                         | 4.6                                 |              | 207.0        |

*Certain prior year amounts have been reclassified to conform with the current year's presentation. The reclassifications primarily relate to operations that have been classified as discontinued operations in the current year.*



**Pension and Postretirement Benefits**

We show the components of net periodic pension benefit cost in the following table:

|  | 2007          |        | Quarter Ended<br>June 30,<br>2006 |        | 2007 |        | Six Months<br>Ended<br>June 30,<br>2006 |        |
|--|---------------|--------|-----------------------------------|--------|------|--------|---|--------|
|  | (In millions) |        |                                   |        |      |        |   |        |
| <b>Components of net periodic pension benefit cost</b> |               |        |                                   |        |      |        |   |        |
| Service cost   | \$            | 12.2   | \$                                | 12.9   | \$   | 24.7   | \$                                      | 24.6   |
| Interest cost  |               | 22.9   |                                   | 24.0   |      | 47.3   |   | 44.5   |
| Expected return on plan assets                         |               | (24.7) |                                   | (26.2) |      | (51.3) |   | (48.5) |
| Recognized net actuarial loss                          |               | 8.4    |                                   | 10.2   |      | 16.4   |   | 18.8   |
| Amortization of prior service cost                     |               | 1.3    |                                   | 1.5    |      | 2.6    |   | 2.8    |
| Amount capitalized as construction cost                |               | (2.9)  |                                   | (3.8)  |      | (5.9)  |   | (6.7)  |
| Net periodic pension benefit cost <sup>1</sup>         | \$            | 17.2   | \$                                | 18.6   | \$   | 33.8   | \$                                      | 35.5   |

<sup>1</sup> BGE's portion of our net periodic pension benefit cost, excluding amounts capitalized, was \$5.1 million for the quarter ended June 30, 2007 and \$6.8 million for the quarter ended June 30, 2006. BGE's portion of our net periodic pension benefit cost, excluding amounts capitalized, was \$10.3 million for the six months ended June 30, 2007 and \$12.4 million for the six months ended June 30, 2006.

We show the components of net periodic postretirement benefit cost in the following table:

|   | 2007          |       | Quarter<br>Ended<br>June 30,<br>2006 |       | 2007 |       | Six Months<br>Ended<br>June 30,<br>2006 |       |
|---|---------------|-------|--------------------------------------|-------|------|-------|---|-------|
|   | (In millions) |       |                                      |       |      |       |   |       |
| <b>Components of net periodic postretirement benefit cost</b> |               |       |                                      |       |      |       |   |       |
| Service cost  | \$            | 1.8   | \$                                   | 2.1   | \$   | 3.5   | \$                                      | 4.2   |
| Interest cost   |               | 7.1   |                                      | 6.6   |      | 13.3  |   | 12.8  |
| Amortization of transition obligation                         |               | 0.7   |                                      | 0.6   |      | 1.2   |   | 1.1   |
| Recognized net actuarial loss                                 |               | 0.8   |                                      | 1.6   |      | 2.2   |   | 3.6   |
| Amortization of prior service cost                            |               | (1.1) |                                      | (1.0) |      | (1.9) |   | (1.9) |
| Amount capitalized as construction cost                       |               | (2.2) |                                      | (2.3) |      | (4.3) |   | (4.3) |
| Net periodic postretirement benefit cost <sup>1</sup>         | \$            | 7.1   | \$                                   | 7.6   | \$   | 14.0  | \$                                      | 15.5  |

<sup>1</sup> BGE's portion of our net periodic postretirement benefit cost, excluding amounts capitalized, was \$4.2 million for the quarter ended June 30, 2007 and \$4.4 million for the quarter ended June 30, 2006. BGE's portion of our net periodic postretirement benefit costs, excluding amounts capitalized, was \$8.2 million for the six months ended June 30, 2007 and \$8.7 million for the six months ended June 30, 2006.

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Our non-qualified pension plans and our postretirement benefit programs are not funded; however, we have trust assets securing certain executive pension benefits. We estimate that we will incur approximately \$4 million in pension benefit payments for our non-qualified pension plans and approximately \$30 million for retiree health and life insurance benefit payments during 2007. We contributed \$125.0 million to our qualified pension plans in March 2007.

### Financing Activities

Constellation Energy had committed bank lines of credit under facilities totaling \$4.55 billion at June 30, 2007 for short-term financial needs. We discuss these facilities in more detail in *Note 8* of our 2006 Annual Report on Form 10-K. At June 30, 2007, these facilities can issue letters of credit up to approximately \$4.05 billion. Letters of credit issued under all of our facilities totaled \$1.5 billion at June 30, 2007.

In July 2007, we entered into a new five-year credit facility totaling \$3.85 billion. This new facility amended and restated three facilities totaling \$3.35 billion a \$1.5 billion facility that would have expired in March 2010, a \$1.1 billion facility that would have expired in November 2010, and a \$750 million facility that would have expired in November 2010. In connection with entering into the new five-year credit facility, we terminated a \$1.0 billion facility that would have expired in October 2007. As of August 1, 2007, we had committed bank lines of credit under facilities totaling \$4.05 billion for short-term financial needs. These facilities can issue letters of credit up to approximately \$4.05 billion.

In June 2007, BondCo, a subsidiary of BGE, issued an aggregate principal amount of \$623.2 million of rate stabilization bonds to recover deferred power purchase costs. We discuss BondCo in more detail on page 11. Below are the details of the rate stabilization bonds:

| Principal | Interest Rate | Scheduled<br>Maturity Date |
|-----------|---------------|----------------------------|
| \$284.0   | 5.47 %        | October 2012               |
| 220.0     | 5.72          | April 2016                 |
| 119.2     | 5.82          | April 2017                 |

The bonds are secured primarily by a usage-based, non-bypassable charge payable by all of BGE's residential electric customers over the next ten years. The charges will be adjusted semi-annually to ensure that the aggregate charges collected are sufficient to pay principal and interest on the bonds as well as certain on-going costs of administering and servicing the bonds. BondCo cannot use the charges collected to satisfy any other obligations. BondCo's assets are not assets of any affiliate and are not available to pay creditors of any affiliate of BondCo. If BondCo is unable to make principal and interest payments on the bonds, neither Constellation Energy nor BGE are required to make the payments on behalf of BondCo.

In connection with the equity issuance by CEP discussed beginning on page 12, we deconsolidated CEP and began accounting for our investment using the equity method of accounting under APB No. 18. As a result, the \$32.0 million of borrowings outstanding under the CEP credit facility at the time of deconsolidation are no longer included in our Consolidated Balance Sheets.

Under our shareholder investment plans we issued \$39.2 million of common stock during the six months ended June 30, 2007. In addition, during the first six months of 2007, we purchased \$114.4 million of our common stock in the open market. These common shares are held by us in order to satisfy employee stock-based compensation obligations.

### Income Taxes

Total income taxes are different from the amount that would be computed by applying the statutory Federal income tax rate of 35% to book income before income taxes as follows:

|   | Quarter Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|---|---------------------------|----------|------------------------------|----------|
|   | 2007                      | 2006     | 2007                         | 2006     |
|   | <i>(In millions)</i>      |          |                              |          |
| Income before income taxes (excluding BGE preference stock dividends) | \$ 145.9                  | \$ 117.1 | \$ 414.3                     | \$ 261.6 |
| Statutory federal income tax rate                                     | 35 %                      | 35 %     | 35 %                         | 35 %     |
| Income taxes computed at statutory federal rate                       | 51.1                      | 41.0     | 145.0                        | 91.5     |
| (Decreases) increases in income taxes due to:                         |                           |          |                              |          |
| Synthetic fuel tax credits flowed through to income                   | (42.9)                    | (37.9)   | (82.6)                       | (72.2)   |
| Synthetic fuel tax credit phase-out                                   | 12.4                      | 25.8     | 23.9                         | 41.6     |
| Phase-out true up from prior periods                                  |                           | 3.7      | (7.9)                        | 3.7      |

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|  |                |   |         |   |                |   |         |
|--|----------------|---|---------|---|----------------|---|---------|
| State income taxes, net of federal tax benefit | <b>5.8</b>     |   | 6.2     |   | <b>17.6</b>    |   | 13.6    |
| Other  | <b>(0.1)</b>   | ) | 1.0     |   | <b>(1.9)</b>   | ) | 1.2     |
| Total income taxes                             | <b>\$ 26.3</b> |   | \$ 39.8 |   | <b>\$ 94.1</b> |   | \$ 79.4 |
| Effective tax rate                             | <b>18.0</b>    | % | 33.9    | % | <b>22.7</b>    | % | 30.3    |

*Certain prior year amounts have been reclassified to conform with the current year's presentation.*

Synthetic fuel tax credits are net of our expectation of a 29% phase-out in 2007 based on forward market prices and volatilities at June 30, 2007. In the first quarter of 2007, we recorded \$7.9 million of additional tax credits related to 2006 to reflect the impact of the final oil reference price and inflation factor published by the Internal Revenue Service (IRS) in 2007.

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Based on forward market prices and volatilities as of July 27, 2007, we currently estimate a 44% tax credit phase-out in 2007. The expected amount of synthetic fuel tax credits phased-out may change materially from period to period as a result of continued changes in oil prices.

We discuss the adoption of the Financial Accounting Standards Board's (FASB) Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, beginning on page 22.

### Commitments, Guarantees, and Contingencies

We have made substantial commitments in connection with our merchant energy, regulated electric and gas, and other nonregulated businesses. These commitments relate to:

- ◆ purchase of electric generating capacity and energy,
- ◆ procurement and delivery of fuels,
- ◆ the capacity and transmission and transportation rights for the physical delivery of energy to meet our obligations to our customers, and
- ◆ long-term service agreements, capital for construction programs, and other.

Our merchant energy business enters into various long-term contracts for the procurement and delivery of fuels to supply our generating plant requirements. In most cases, our contracts contain provisions for price escalations, minimum purchase levels, and other financial commitments. These contracts expire in various years between 2007 and 2020. In addition, our merchant energy business enters into long-term contracts for the capacity and transmission rights for the delivery of energy to meet our physical obligations to our customers. These contracts expire in various years between 2007 and 2019.

Our merchant energy business also has committed to long-term service agreements and other purchase commitments for our plants.

Our regulated electric business enters into various long-term contracts for the procurement of electricity. These contracts expire between 2007 and 2009. Our regulated gas business has gas transportation and storage contracts that expire between 2007 and 2028. As discussed in *Note 1* of our 2006 Annual Report on Form 10-K, the costs under these contracts are fully recoverable by our regulated businesses.

Our other nonregulated businesses have committed to gas purchases, as well as to contribute additional capital for construction programs and joint ventures in which they have an interest.

We have also committed to long-term service agreements and other obligations related to our information technology systems.

At June 30, 2007, the total amount of commitments was \$7,994.6 million. These commitments are primarily related to our merchant energy business.

### Long-Term Power Sales Contracts

We enter into long-term power sales contracts in connection with our load-serving activities. We also enter into long-term power sales contracts associated with certain of our power plants. Our load-serving power sales contracts extend for terms through 2019 and provide for the sale of energy to electricity distribution utilities and certain retail customers. Our power sales contracts associated with power plants we own extend for terms into 2014 and provide for the sale of all or a portion of the actual output of certain of our power plants. All long-term contracts were executed at pricing that approximated market rates, including profit margin, at the time of execution.

### Guarantees

Our guarantees do not represent incremental Constellation Energy obligations; rather they primarily represent parental guarantees of subsidiary obligations. The following table summarizes the maximum exposure based on the stated limit of our outstanding guarantees:

At June 30, 2007

Stated Limit  
(In millions)

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|                                |    |          |
|--------------------------------|----|----------|
| Competitive supply guarantees  | \$ | 11,683.0 |
| Nuclear guarantees             |    | 783.6    |
| BGE guarantees                 |    | 263.3    |
| Other non-regulated guarantees |    | 79.0     |
| Power project guarantees       |    | 19.2     |
| Total guarantees               | \$ | 12,828.1 |

At June 30, 2007, Constellation Energy had a total of \$12,828.1 million in guarantees outstanding related to loans, credit facilities, and contractual performance of certain of its subsidiaries as described below.

◆ Constellation Energy guaranteed \$11,683.0 million on behalf of our subsidiaries for competitive supply activities. These guarantees are put into place in order to allow our subsidiaries the flexibility needed to conduct business with counterparties without having to post other forms of collateral. While the face amount of these guarantees is \$11,683.0 million, our calculated fair value of obligations for commercial transactions covered by these guarantees was \$3,493.2 million at June 30, 2007. The \$3,493.2 million represents the total amount Constellation Energy could be required to fund based on market prices as of June 30, 2007, if the subsidiaries do not honor contractual commitments covered by these guarantees. For those guarantees related to our mark-to-market energy or risk management liabilities, the fair value of the obligation is recorded in our Consolidated Balance Sheets.

- ◆ Constellation Energy guaranteed \$783.6 million primarily on behalf of our nuclear generating facilities for nuclear insurance and credit support to ensure these plants have funds to meet expenses and obligations to safely operate and maintain the plants.
- ◆ BGE guaranteed the Trust Preferred Securities of \$250.0 million of BGE Trust II.
- ◆ BGE guaranteed two-thirds of certain debt of Safe Harbor Water Power Corporation, an unconsolidated investment. At June 30, 2007, Safe Harbor Water Power Corporation had outstanding debt of \$20.0 million. The maximum amount of BGE's guarantee is \$13.3 million.
- ◆ Constellation Energy guaranteed \$67.6 million on behalf of our other nonregulated businesses primarily for loans and performance bonds of which \$25.0 million was recorded in our Consolidated Balance Sheets at June 30, 2007.
- ◆ Our other nonregulated business guaranteed \$11.4 million primarily for performance bonds.
- ◆ Our merchant energy business guaranteed \$19.2 million for loans and other performance guarantees related to certain power projects in which we have an investment.

We believe it is unlikely that we would be required to perform or incur any losses associated with guarantees of our subsidiaries' obligations.

#### **Contingencies**

##### *Revenue Sufficiency Guarantee Costs*

During 2006, the Federal Energy Regulatory Commission (FERC) issued orders finding that the Midwest Independent System Operator (MISO) violated its tariff by incorrectly allocating revenue sufficiency guarantee (RSG) charges among market participants. As a result of FERC orders, MISO proposed a revised methodology for the allocation of RSG charges in its December 2006 compliance filing with the FERC with a proposed effective date of April 1, 2007.

In March 2007, FERC rejected the RSG allocation methodology proposed by MISO in its December 2006 compliance filing and ordered MISO to reallocate RSG costs based on its existing tariff back to the date of FERC's original order (April 2006). Based on this FERC order, we recorded an immaterial liability in our Consolidated Balance Sheets based on our estimate of the amount of re-allocated RSGs we believe is probable. Our liability is subject to change based upon MISO's calculation of the actual RSG adjustment. In addition, the order may be appealed, and we cannot predict the ultimate timing or outcome of any appeal.

##### *Environmental Matters*

###### *Solid and Hazardous Waste*

The Environmental Protection Agency (EPA) and several state agencies have notified us that we are considered a potentially responsible party with respect to the clean-up of certain environmentally contaminated sites. We cannot estimate the final clean-up costs for all of these sites, but the current estimated costs for, and current status of, each site is described in more detail below.

###### *68th Street Dump*

In 1999, the EPA proposed to add the 68th Street Dump in Baltimore, Maryland to the Superfund National Priorities List, which is its list of sites targeted for clean-up and enforcement, and sent a general notice letter to BGE and 19 other parties identifying them as potentially liable parties at the site. In March 2004, we and other potentially responsible parties formed the 68th Street Coalition and entered into consent order negotiations with the EPA to investigate clean-up options for the site under the Superfund Alternative Sites Program. In May 2006, a settlement among the EPA and 19 of the potentially responsible parties, including BGE, with respect to investigation of the site became effective. The settlement requires the potentially responsible parties, over the course of several years, to identify contamination at the site and recommend clean-up options. BGE is fully indemnified by a wholly-owned subsidiary of Constellation Energy for costs related to this settlement, as well as any clean-up costs. The clean-up costs will not be known until the investigation is closer to completion. However, those costs could have a material effect on our financial results.

Spring Gardens

In December 1996, BGE signed a consent order with the Maryland Department of the Environment that requires it to implement remedial action plans for contamination at and around the Spring Gardens site, located in Baltimore, Maryland. The Spring Gardens site was once used to manufacture gas from coal and oil. Based on remedial action plans and cost modeling performed in late 2006, BGE estimates its probable clean-up costs will total \$43 million. BGE has recorded these costs as a liability in its Consolidated Balance Sheets and has deferred these costs, net of accumulated amortization and amounts it recovered from insurance companies, as a regulatory asset. Based on the results of studies at this site, it is reasonably possible that additional costs could exceed the amount BGE has recognized by approximately \$3 million. Through June 30, 2007, BGE has spent approximately \$40 million for remediation at this site.

BGE also has investigated other small sites where gas was manufactured in the past. We do not expect the clean-up costs of the remaining smaller sites to have a material effect on our financial results.

Air Quality

In late July 2005, we received two Notices of Violation (NOVs) from the Placer County Air Pollution Control District, Placer County California (District) alleging that the Rio Bravo Rocklin facility located in Lincoln, California had violated certain District air emission regulations. We have a combined 50% ownership interest in the partnership which owns the Rio Bravo Rocklin facility. The NOVs allege a total of 38 violations between January 2003 and March 2005 of either the facility's air permit or federal, state, and county air emission standards related to nitrogen oxide, carbon monoxide, and particulate emissions, as well as violations of certain monitoring and reporting requirements during that time period. The maximum civil penalties for the alleged violations range from \$10,000 to \$40,000 per violation. Management of the Rio Bravo Rocklin facility is currently discussing the allegations in the NOVs with District representatives. It is not possible to determine the actual liability, if any, of the partnership that owns the Rio Bravo Rocklin facility.

In May 2007, a subsidiary of Constellation Energy entered into a consent decree with the Maryland Department of the Environment to resolve alleged violations of air quality opacity standards at three fossil fuel plants in Maryland. The consent decree requires the subsidiary to pay a \$100,000 penalty, provide \$100,000 to a supplemental environmental project, and install technology to control emissions from those plants.

Litigation

In the normal course of business, we are involved in various legal proceedings. We discuss the significant matters below.

*City of Tacoma v. AEP, et al.*, *The City of Tacoma*, on June 7, 2004, in the U.S. District Court, Western District of Washington, filed a complaint against over 60 companies, including Constellation Energy Commodities Group, Inc. (CCG). The complaint alleges that the defendants engaged in manipulation of electricity markets resulting in prices for power in the western power markets that were substantially above what market prices would have been in the absence of the alleged unlawful contracts, combinations and conspiracy in violation of Section 1 of the Sherman Act. The complaint further alleges that the total amount of damages is unknown, but is estimated to exceed \$175 million. On February 11, 2005, the Court granted the defendants' motion to dismiss the action based on the Court's lack of jurisdiction over the claims in question. The plaintiff appealed the dismissal of the action to the Ninth Circuit Court of Appeals, but subsequently agreed to a dismissal with prejudice, which the Ninth Circuit Court ordered on March 20, 2007.

Challenges to the Illinois Auction

In March 2007, the Illinois Attorney General filed a complaint at FERC against the wholesale suppliers, including our wholesale marketing, risk management and trading operation, that were successful bidders in the recent Illinois auction. The complaint alleges that the rates resulting from the auction are not just and reasonable and requests that FERC commence a proceeding to determine if the rates are just and reasonable and to investigate evidence of price manipulation. In July 2007, the Illinois legislature approved comprehensive legislation to address several energy issues in the state, including dismissal of all claims against wholesale suppliers by the Attorney General, both in the state of Illinois and before the FERC. This legislation is now before the Governor of Illinois, awaiting his signature.

In addition, two class action complaints have been filed in Illinois state court against these wholesale suppliers alleging that they engaged in deceptive practices, including colluding in setting prices and actual price fixing. The complaints seek unspecified damages in an amount to be proven at trial. These complaints subsequently were moved to federal court.

We believe we have meritorious defenses to these claims challenging the Illinois auction and our conduct in the auction and intend to defend against them vigorously. However, we cannot predict the timing, or outcome, of these proceedings, or their possible effect on our financial results.

Mercury

Since September 2002, BGE, Constellation Energy, and several other defendants have been involved in numerous actions filed in the Circuit Court for Baltimore City, Maryland alleging mercury poisoning from several sources, including coal plants formerly owned by BGE. The plants are now owned by a subsidiary of Constellation Energy. In addition to BGE and Constellation Energy, approximately 11 other defendants, consisting of pharmaceutical companies, manufacturers of vaccines, and manufacturers of Thimerosal have been sued. Approximately 70 cases, involving claims related to approximately 132 children, have been filed to date, with each claimant seeking \$20 million in compensatory damages, plus punitive damages, from us.



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In rulings applicable to all but four of the cases, involving claims related to approximately 45 children, the Circuit Court for Baltimore City dismissed with prejudice all claims against BGE and Constellation Energy. Plaintiffs may attempt to pursue appeals of the rulings in favor of BGE and Constellation Energy once the cases are finally concluded as to all defendants. We believe that we have meritorious defenses and intend to defend the remaining actions vigorously. However, we cannot predict the timing, or outcome, of these cases, or their possible effect on our, or BGE's, financial results.

### *Asbestos*

Since 1993, BGE and certain Constellation Energy subsidiaries have been involved in several actions concerning asbestos. The actions are based upon the theory of premises liability, alleging that BGE and Constellation Energy knew of and exposed individuals to an asbestos hazard. BGE and Constellation Energy, and numerous other parties are defendants in these cases.

Approximately 535 individuals who were never employees of BGE or Constellation Energy have pending claims each seeking several million dollars in compensatory and punitive damages. Cross-claims and third-party claims brought by other defendants may also be filed against BGE and Constellation Energy in these actions. To date, most asbestos claims against us have been dismissed or resolved without any payment and a small minority have been resolved for amounts that were not material to our financial results. The remaining claims are currently pending in state courts in Maryland and Pennsylvania.

BGE and Constellation Energy do not know the specific facts necessary to estimate their potential liability for these claims. The specific facts we do not know include:

- ◆ the identity of the facilities at which the plaintiffs allegedly worked as contractors,
- ◆ the names of the plaintiffs' employers,
- ◆ the dates on which and the places where the exposure allegedly occurred, and
- ◆ the facts and circumstances relating to the alleged exposure.

Until the relevant facts are determined, we are unable to estimate what our, or BGE's, liability might be. Although insurance and hold harmless agreements from contractors who employed the plaintiffs may cover a portion of any awards in the actions, the potential effect on our, or BGE's, financial results could be material.

#### *Insurance*

We discuss our nuclear and non-nuclear insurance programs in *Note 12* of our 2006 Annual Report on Form 10-K.

#### **SFAS No. 133 Hedging Activities**

We are exposed to market risk, including changes in interest rates and the impact of market fluctuations in the price and transportation costs of electricity, natural gas, and other commodities. We discuss our market risk in more detail in our 2006 Annual Report on Form 10-K.

#### **Commodity Prices**

Our merchant energy business uses a variety of derivative and non-derivative instruments to manage the commodity price risk of our competitive supply activities and our electric generation facilities, including power sales, fuel and energy purchases, gas purchased for resale, emission credits, weather risk, freight, and the market risk of outages. In order to manage these risks, we may enter into fixed-price derivative or non-derivative contracts to hedge the variability in future cash flows from forecasted sales of energy and purchases of fuel and energy. The objectives for entering into such hedges include:

- ◆ fixing the price for a portion of anticipated future electricity sales at a level that provides an acceptable return on our electric generation operations,
- ◆ fixing the price of a portion of anticipated fuel purchases for the operation of our power plants,
- ◆ fixing the price for a portion of anticipated energy purchases to supply our load-serving customers, and
- ◆ fixing the price for a portion of anticipated sales of natural gas to customers.

The portion of forecasted transactions hedged may vary based upon management's assessment of market, weather, operational, and other factors.

Our merchant energy business designated certain fixed-price forward contracts as cash-flow hedges of forecasted sales of energy and forecasted purchases of fuel and energy for the years 2007 through 2015 under Statement of Financial Accounting Standard (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended*. Our merchant energy business had net unrealized pre-tax losses on these cash-flow hedges recorded in Accumulated other comprehensive loss of \$1,547.8 million at June 30, 2007 and \$2,227.1 million at December 31, 2006.

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We expect to reclassify \$864.0 million of net pre-tax losses on cash-flow hedges from Accumulated other comprehensive loss into earnings during the next twelve months based on market prices at June 30, 2007. However, the actual amount reclassified into earnings could vary from the amounts recorded at June 30, 2007, due to future changes in market prices. Additionally, for cash-flow hedges settled by physical delivery of the underlying commodity, Reclassification of net losses on hedging instruments from OCI to net income represents the fair value of those derivatives, which is realized through gross settlement at the contract price.

During the six months ended June 30, 2007, we de-designated contracts previously designated as cash-flow hedges for which the forecasted transactions originally hedged are probable of not occurring and as a result we recognized a pre-tax loss of \$21.6 million. We discuss the transaction that accounts for substantially all of this amount in more detail in the *Constellation Energy Partners LLC* section beginning on page 12. During the six months ended June 30, 2006, we de-designated contracts previously designated as cash-flow hedges and as a result we recognized a pre-tax loss of \$10.5 million.

Our merchant energy business also enters into natural gas storage contracts under which the gas in storage qualifies for fair value hedge accounting treatment under SFAS No. 133.

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We record changes in fair value of hedges related to our retail competitive supply operations as a component of Fuel and purchased energy expenses in our Consolidated Statements of Income. We record changes in fair value of hedges related to our wholesale competitive supply operations as a component of Nonregulated revenues in our Consolidated Statements of Income.

We recorded in earnings the following pre-tax gains (losses) related to hedge ineffectiveness:

|                   | Quarter Ended<br>June 30, |         | Six Months Ended<br>June 30, |        |
|-------------------|---------------------------|---------|------------------------------|--------|
|                   | 2007                      | 2006    | 2007                         | 2006   |
|                   | <i>(In millions)</i>      |         |                              |        |
| Cash-flow hedges  | \$ (13.8 )                | \$ 10.8 | \$ (30.3 )                   | \$ 5.6 |
| Fair value hedges | 3.3                       | 2.6     | 1.1                          | 1.6    |
| Total             | \$ (10.5 )                | \$ 13.4 | \$ (29.2 )                   | \$ 7.2 |

The ineffectiveness amounts in the table above exclude \$16.4 million of pre-tax losses that we recognized as a result of market price changes for the quarter and six months ended June 30, 2007. These losses represent the change in fair value of derivatives that did not qualify for cash-flow hedge accounting due to reduced price correlation between the hedge and the risk being hedged, but remain designated as hedges prospectively. Corresponding amounts for the prior year were immaterial.

### Interest Rates

We use interest rate swaps to manage our interest rate exposures associated with new debt issuances, to manage our exposure to fluctuations in interest rates on variable rate debt, and to optimize the mix of fixed and floating-rate debt. The swaps used to manage our exposure prior to the issuance of new debt are designated as cash-flow hedges under SFAS No. 133, with the effective portion of gains and losses, net of associated deferred income tax effects, recorded in Accumulated other comprehensive loss in anticipation of planned financing transactions. We reclassify gains and losses on the hedges from Accumulated other comprehensive loss into Interest expense in our Consolidated Statements of Income during the periods in which the interest payments being hedged occur.

The swaps used to optimize the mix of fixed and floating-rate debt are designated as fair value hedges under SFAS No. 133. We record any gains or losses on swaps that qualify for fair value hedge accounting treatment, as well as changes in the fair value of the debt being hedged, in Interest expense, and we record any changes in fair value of the swaps and the debt in Risk management assets and liabilities and Long-term debt in our Consolidated Balance Sheets. In addition, we record the difference between interest on hedged fixed-rate debt and floating-rate swaps in Interest expense in the periods that the swaps settle.

Accumulated other comprehensive loss includes net unrealized pre-tax gains on interest rate cash-flow hedges terminated upon debt issuance totaling \$11.9 million at June 30, 2007 and \$12.5 million at December 31, 2006. We expect to reclassify \$0.1 million of pre-tax net losses on these cash-flow hedges from Accumulated other comprehensive loss into Interest expense during the next twelve months. We had no hedge ineffectiveness on these swaps.

In order to optimize the mix of fixed and floating-rate debt, we entered into interest rate swaps qualifying as fair value hedges relating to \$450.0 million of our fixed-rate debt maturing in 2012 and 2015, and converted this notional amount of debt to floating-rate. The fair value of these hedges was an unrealized loss of \$16.3 million at June 30, 2007 and was recorded as an increase in our Risk management liabilities and a decrease in our Long-term debt. The fair value of these hedges was an unrealized loss of \$7.1 million at December 31, 2006 and was recorded as an increase in our Risk management liabilities and a decrease in our Long-term debt. We had no hedge ineffectiveness on these interest rate swaps.

### Accounting Standards Issued

#### SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*. SFAS No. 159 provides the option to report at fair value certain financial instruments that are not currently required or permitted to be measured at fair value. This option would be applied on an instrument by instrument basis. If elected, unrealized gains and losses on the affected financial instruments would be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective beginning January 1, 2008. We are currently assessing the provisions of SFAS No. 159; however, while the application of the fair value accounting would be optional, the impact of fair value accounting, if elected, could be material to our, or BGE's, financial results.

**FSP FIN 39-1**

In April 2007, the FASB issued Staff Position (FSP) FIN 39-1, *Amendment of FASB Interpretation No. 39*. FSP FIN 39-1 permits an entity to report all derivatives recorded at fair value with any associated fair value cash collateral, which are with the same counterparty under a master netting arrangement, together in the balance sheet. Our wholesale competitive supply operation reports derivative amounts under master netting arrangements net in accordance with FIN 39, *Offsetting of Amounts Related to Certain Contracts*; however, we report fair value cash collateral separately from our derivative amounts. Under the provisions of this FSP, we must either report all derivatives recorded at fair value net with the associated fair value cash

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collateral or report all derivative amounts gross. The effects of FSP FIN 39-1 must be applied by adjusting all financial statements presented beginning January 1, 2008. We are currently evaluating the impact of this FSP; however, this FSP could have a material impact on our financial results.

### Accounting Standards Adopted

#### FIN 48

In July 2006, the FASB issued FIN 48. FIN 48 provides guidance for the recognition and measurement of an entity's uncertain tax positions. These are defined as positions taken in a previously filed tax return or positions expected to be taken in future tax returns and which result in, among other things, a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected ability to realize deferred tax assets. Under FIN 48, we are required to recognize the financial statement effects of tax positions if they meet a more-likely-than-not threshold. In evaluating items relative to this threshold, we must assess whether each tax position will be sustained based solely on its technical merits assuming examination by a taxing authority.

For those uncertain tax positions that we have recognized in our financial statements, we establish liabilities to reflect the portion of those positions we cannot conclude are more likely than not to be realized upon ultimate settlement. These are referred to as liabilities for unrecognized tax benefits under FIN 48. We recognize interest and penalties related to unrecognized tax benefits in Income tax expense in our Consolidated Statements of Income.

The adoption of FIN 48 on January 1, 2007, resulted in our recording a \$7.3 million incremental liability for unrecognized tax benefits and a corresponding reduction in Retained earnings in our Consolidated Balance Sheets as a cumulative effect of change in accounting principle. We also reclassified \$49.4 million from existing tax liabilities (primarily deferred income taxes) to the new FIN 48 liability for unrecognized tax benefits. Our resulting total \$56.7 million FIN 48 liability for unrecognized tax benefits included \$12.1 million of accrued interest and penalties.

Additionally, FIN 48 requires disclosure of total unrecognized tax benefits, regardless of whether or not these amounts are reflected in our balance sheet. We have \$59.4 million of unrecognized tax benefits related to outstanding federal and state refund claims for which no tax benefit was previously provided in our financial statements because the claims do not meet the more-likely-than-not threshold. Included in this amount is \$48.3 million of refund claims that have been disallowed by the applicable tax authorities for which we assess the probability of tax benefit recognition to be remote.

The following table summarizes our total unrecognized tax benefits at January 1, 2007. There have been no significant changes to our unrecognized tax benefits during the six months ended June 30, 2007.

At January 1, 2007

|   | <i>(In millions)</i> |
|---|----------------------|
| Total liabilities reflected in our balance sheet for unrecognized tax benefits of \$56.7 million less |                      |
| \$12.1 million of interest and penalties  | \$ 44.6              |
| Other unrecognized tax benefits not reflected in our balance sheet                                    | 59.4                 |
| Total unrecognized tax benefits   | \$ 104.0             |

If the total amount of unrecognized tax benefits of \$104.0 million were ultimately realized, our income tax expense would decrease by approximately \$65 million; however, this includes the \$48.3 million of disallowed refund claims discussed above.

We file income tax returns in the United States and foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2002. The IRS commenced an examination of our U.S. income tax returns for 2002, 2003, and 2004 in the third quarter of 2005. We anticipate that these examinations will be completed by the end of 2007.

Recently, the IRS has proposed certain adjustments to our 2002-2004 deductions for repairs and casualty losses. We do not anticipate the adjustments, if any, would result in a material impact on our financial results. However, we anticipate that it is reasonably possible that an additional payment in the range of \$20 to \$25 million will be made by June 30, 2008, which will reduce our liabilities for unrecognized tax benefits.

The adoption of FIN 48 did not have a material impact on BGE's financial results.

### Related Party Transactions BGE

**Income Statement**

BGE is obligated to provide market-based standard offer service to all of its electric customers for varying periods. Bidding to supply BGE's market-based standard offer service to electric customers will occur from time to time through a competitive bidding process approved by the Maryland PSC.

Our wholesale marketing, risk management, and trading operation supplied a substantial portion of BGE's market-based standard offer service obligation to residential electric customers through May 31, 2007, and will supply a portion of BGE's market-based standard offer service obligations for electric customers from June 1, 2007 through May 31, 2009.

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The cost of BGE's purchased energy from nonregulated subsidiaries of Constellation Energy to meet its standard offer service obligation was as follows:

|                  | 2007                 | Quarter Ended<br>June 30,<br>2006 | 2007     | Six Months Ended<br>June 30,<br>2006 |
|------------------|----------------------|-----------------------------------|----------|--------------------------------------|
|                  | <i>(In millions)</i> |                                   |          |                                      |
| Purchased energy | \$ 254.3             | \$ 220.7                          | \$ 557.0 | \$ 408.3                             |

In addition, Constellation Energy charges BGE for the costs of certain corporate functions. Certain costs are directly assigned to BGE. We allocate other corporate function costs based on a total percentage of expected use by BGE. We believe this method of allocation is reasonable and approximates the cost BGE would have incurred as an unaffiliated entity.

The following table presents the costs Constellation Energy charged to BGE in each period.

|                | 2007                 | Quarter Ended<br>June 30,<br>2006 | 2007    | Six Months Ended<br>June 30,<br>2006 |
|----------------|----------------------|-----------------------------------|---------|--------------------------------------|
|                | <i>(In millions)</i> |                                   |         |                                      |
| Charges to BGE | \$ 35.5              | \$ 30.1                           | \$ 69.8 | \$ 61.7                              |

### Balance Sheet

BGE participates in a cash pool under a Master Demand Note agreement with Constellation Energy. Under this arrangement, participating subsidiaries may invest in or borrow from the pool at market interest rates. Constellation Energy administers the pool and invests excess cash in short-term investments or issues commercial paper to manage consolidated cash requirements. Under this arrangement, BGE had borrowed \$270.8 million at June 30, 2007 and had invested \$60.6 million at December 31, 2006.

BGE's Consolidated Balance Sheets include intercompany amounts related to corporate functions performed at the Constellation Energy holding company, BGE's purchases to meet its standard offer service obligation, BGE's charges to Constellation Energy and its nonregulated affiliates for certain services it provides them, and the participation of BGE's employees in the Constellation Energy defined benefit plans.

We believe our allocation methods are reasonable and approximate the costs that would be charged to unaffiliated entities.





**Item 2. Management's Discussion**

**Management's Discussion and Analysis of Financial Condition and Results of Operations**

## Introduction and Overview

Constellation Energy Group, Inc. (Constellation Energy) is an energy company that conducts its business through various subsidiaries including a merchant energy business and Baltimore Gas and Electric Company (BGE). We describe our operating segments in the Notes to Consolidated Financial Statements on page 14.

This Quarterly Report on Form 10-Q is a combined report of Constellation Energy and BGE. References in this report to we and our are to Constellation Energy and its subsidiaries, collectively. References in this report to the regulated business(es) are to BGE. We discuss our business in more detail in *Item 1 Business* section of our 2006 Annual Report on Form 10-K and we discuss the risks affecting our business in *Item 1A. Risk Factors* section on page 49.

Our 2006 Annual Report on Form 10-K includes a detailed discussion of various items impacting our business, our results of operations, and our financial condition. These include:

- ◆ *Introduction and Overview* section which provides a description of our business segments,
- ◆ *Strategy* section,
- ◆ *Business Environment* section, including how regulation, weather, and other factors affect our business, and
- ◆ *Critical Accounting Policies* section.

Critical accounting policies are the accounting policies that are most important to the portrayal of our financial condition and results of operations and require management's most difficult, subjective, or complex judgment. Our critical accounting policies include derivative accounting, evaluation of assets for impairment and other than temporary decline in value, and asset retirement obligations.

In this discussion and analysis, we explain the general financial condition and the results of operations for Constellation Energy and BGE including:

- ◆ factors which affect our businesses,
- ◆ our earnings and costs in the periods presented,
- ◆ changes in earnings and costs between periods,
- ◆ sources of earnings,
- ◆ impact of these factors on our overall financial condition,
- ◆ expected future expenditures for capital projects, and
- ◆ expected sources of cash for further capital expenditures.

As you read this discussion and analysis, refer to our Consolidated Statements of Income on page 3, which present the results of our operations for the quarters and six months ended June 30, 2007 and 2006. We analyze and explain the differences between periods in the specific line items of the Consolidated Statements of Income.

We have organized our discussion and analysis as follows:

- ◆ We describe changes to our business environment during the year.
- ◆ We highlight significant events that occurred in 2007 that are important to understanding our results of operations and financial condition.

- ◆ We then review our results of operations beginning with an overview of our total company results, followed by a more detailed review of those results by operating segment.
- ◆ We review our financial condition, addressing our sources and uses of cash, capital resources, commitments, and liquidity.
- ◆ We conclude with a discussion of our exposure to various market risks.

#### **Business Environment**

With the evolving regulatory environment surrounding customer choice, increasing competition, and the growth of our merchant energy business, various factors affect our financial results. We discuss these various factors in the *Forward Looking Statements* section on page 50 and in *Item 1A. Risk Factors* section on page 49. We discuss our market risks in the *Market Risk* section beginning on page 45.

In this section, we discuss in more detail events which have impacted our business during 2007.

#### **Regulation by the Maryland PSC**

In April 2007, Senate Bill 400 was enacted, which makes certain modifications to Senate Bill 1. We discuss Senate Bill 1 in more detail in *Item 1. Business Electric Regulatory Matters and Competition* section of our 2006 Annual Report on Form 10-K. Under Senate Bill 400, the Maryland Public Service Commission (Maryland PSC) is required to initiate several studies, including studies relating to stranded costs, the costs and benefits of various options for regulation, and the structure of the electric industry in Maryland. The Maryland PSC is required to submit an interim report by December 1, 2007 and a final report by December 1, 2008. We cannot at this time predict the outcome of these studies or their actual effect on our, or BGE's, financial results, but it could be material.

As required by Senate Bill 1, in May 2007, the Maryland PSC approved a plan allowing residential electric customers the option to defer the transition to market rates from June 1, 2007 to January 1, 2008. Customers participating in the plan will repay the deferred charges beginning April 1, 2008 through December 31, 2009 without interest. Only 4 percent of BGE's residential electric customers opted into this plan, while the remaining

96 percent moved to full market rates effective June 1, 2007. The total amount deferred under this plan is expected to be approximately \$6 million.

The Maryland PSC is expected to hold hearings relating to the relationship between Constellation and BGE and the impact of that relationship on the rates paid by BGE residential electric customers. We cannot at this time predict the outcome of any hearings that may be held or how such outcome may affect our, or BGE's, financial results, but it could be material.

#### **Environmental Matters**

##### *Air Quality*

###### National Ambient Air Quality Standards (NAAQS)

In June 2007, the United States Court of Appeals for the District of Columbia Circuit denied a petition by the Environmental Protection Agency (EPA) to rehear a Court decision finding that the EPA must impose fees on emissions sources that failed to achieve applicable ozone standards retroactive to November 2005. At this time, we cannot predict the EPA's response to the Court's denial for rehearing including whether the EPA will appeal to the U.S. Supreme Court. In addition, the exact method of computing these fees has not been established and will depend in part on state implementation regulations that have not been finalized. Consequently, we are unable to estimate the ultimate financial impact of the fees in light of the uncertainty surrounding the methodology that will be used in calculating the fees. However, any fees that are ultimately assessed could have a material impact on our financial results.

###### New Source Review

In April 2007, the U.S. Supreme Court issued a decision regarding the standard to be used to measure emissions when the EPA's new source review requirements are triggered but did not address when those requirements are triggered. We do not believe the Court's decision will have a material impact on our financial results.

###### Global Climate Change

In April 2007, the U.S. Supreme Court ruled that the EPA has authority to regulate carbon dioxide (CO<sub>2</sub>) emissions from automobiles. Although the decision did not address CO<sub>2</sub> emissions from stationary sources such as power generation facilities, federal legislation or regulation addressing CO<sub>2</sub> emissions from other sources may now be more likely. We cannot predict the nature or timing of any CO<sub>2</sub> legislation or regulation, but any compliance costs we incur could have a material impact on our financial results.

Also in April 2007, Maryland became a full participant in the Northeast Regional Greenhouse Gas Initiative (RGGI). We discuss RGGI in more detail in *Item 1 Business* section of our 2006 Annual Report on Form 10-K.

##### *Water Quality*

###### Water Intake Regulations

In response to a ruling by the United States Court of Appeals for the Second Circuit that the EPA's water intake regulations did not properly implement the Clean Water Act requirements in a number of areas, the EPA suspended the second phase of the regulations for existing facilities pending further rulemaking, and directed permitting authorities to use their best professional judgment to establish controls for cooling water intake structures that reflect the best technology available for minimizing adverse environmental impact. We continue to evaluate our compliance options in light of the court decision and the EPA's order. Until we determine our most viable option, we cannot estimate our compliance costs. However, those costs could be material.

###### Capital Expenditures

As discussed in our 2006 Annual Report on Form 10-K, we expect to incur additional environmental capital expenditures to comply with air quality laws and regulations. Based on updated information from vendors, we expect our estimated environmental capital requirements to be approximately \$200 million in 2007, \$550 million in 2008, \$330 million in 2009 and \$30 million from 2010-2011.

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Our estimates may change further as we implement our compliance plan. As discussed in our 2006 Annual Report on Form 10-K, our estimates of capital expenditures continue to be subject to significant uncertainties.

### **Accounting Standards Issued and Adopted**

We discuss recently issued and adopted accounting standards in the *Accounting Standards Issued* and *Accounting Standards Adopted* sections of the *Notes to Consolidated Financial Statements* beginning on page 21.

### **Events of 2007**

#### **Constellation Energy Partners LLC**

We discuss the issuances of Constellation Energy Partners LLC equity and their impact on our financial results in more detail in the *Notes to Consolidated Financial Statements* beginning on page 12.

#### **Acquisitions**

##### *Working Interests in Gas Producing Fields*

In March 2007, we acquired working interests in gas and oil producing fields. We discuss this acquisition in more detail in the *Notes to Consolidated Financial Statements* on page 13.

##### *Contract and Portfolio Acquisitions*

In June 2007, our wholesale marketing, risk management, and trading operation acquired a portfolio of energy contracts in the southeast region of the United States. We discuss this in more detail in the *Notes to Consolidated Financial Statements* beginning on page 13.

*Cornerstone Energy*

In July 2007, we acquired Cornerstone Energy, Inc. We discuss this acquisition in more detail in the *Notes to Consolidated Financial Statements* on page 14.

**Shipping Joint Venture**

We formed a shipping joint venture in which we have a 50% ownership interest. We discuss this joint venture in more detail in the *Notes to Consolidated Financial Statements* on page 14.

**Rate Stabilization Bonds**

In 2007, BGE formed a special purpose bankruptcy-remote entity to purchase rate stabilization property from BGE and to issue rate stabilization bonds. We discuss this entity and the related financing in more detail in the *Notes to Consolidated Financial Statements* on pages 11 and 16.

**Electricite de France Joint Venture**

In July 2007, we announced a joint venture, UniStar Nuclear Energy, LLC, with an affiliate of Electricite de France. We discuss this joint venture in more detail in the *Notes to Consolidated Financial Statements* on page 14.

**Synthetic Fuel Tax Credits**

As discussed in our 2006 Annual Report on Form 10-K, the Internal Revenue Code provides for a phase-out of synthetic fuel tax credits if average annual wellhead oil prices increase above certain levels. For 2007, we estimate the tax credit reduction would begin if the reference price exceeds approximately \$56 per barrel and would be fully phased out if the reference price exceeds approximately \$70 per barrel.

Based on forward market prices and volatilities and current production levels as of June 30, 2007, we estimate a 29% tax credit phase-out in 2007. We discuss the impact of synthetic fuel tax credits on our total income tax expense and effective tax rate in the *Notes to Consolidated Financial Statements* beginning on page 16.

Based on forward market prices and volatilities and current production levels as of July 27, 2007, we currently estimate a 44% tax credit phase-out in 2007. However, the ultimate amount of tax credits phased-out for 2007, if any, is subject to change based on the actual reference price and production levels for the entire year.





**Results of Operations for the Quarter and Six Months Ended June 30, 2007  
Compared with the Same Periods of 2006**

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In this section, we discuss our earnings and the factors affecting them. We begin with a general overview, then separately discuss earnings for our operating segments. We discuss changes in other income, fixed charges, and income taxes, as necessary, in the aggregate for all segments in the *Consolidated Nonoperating Income and Expenses* section on page 40.

### Overview

### Results

|  | Quarter Ended<br>June 30,       |                 | Six Months Ended<br>June 30, |                  |
|--|---------------------------------|-----------------|------------------------------|------------------|
|  | 2007                            | 2006            | 2007                         | 2006             |
|  | <i>(In millions, after-tax)</i> |                 |                              |                  |
| Merchant energy                            | \$ 102.2                        | \$ 52.6         | \$ 223.8                     | \$ 84.8          |
| Regulated electric                         | 19.4                            | 19.9            | 51.6                         | 53.5             |
| Regulated gas                              | (5.7)                           | (1.4)           | 28.0                         | 33.6             |
| Other nonregulated                         | 0.4                             | 2.9             | 10.2                         | 3.7              |
| Income from Continuing Operations          | 116.3                           | 74.0            | 313.6                        | 175.6            |
| Income (loss) from discontinued operations |                                 | 19.1            | (1.6)                        | 31.4             |
| <b>Net Income</b>                          | <b>\$ 116.3</b>                 | <b>\$ 93.1</b>  | <b>\$ 312.0</b>              | <b>\$ 207.0</b>  |
| <i>Other Items Included in Operations</i>  |                                 |                 |                              |                  |
| Impairment losses and other costs          | \$ (12.2)                       | \$              | \$ (12.2)                    | \$               |
| Non-qualifying hedges                      | 1.4                             |                 | (7.9)                        | (9.7)            |
| Workforce reduction costs                  | (1.5)                           |                 | (1.5)                        | (1.3)            |
| Merger-related costs                       |                                 | (6.0)           |                              | (7.5)            |
| <b>Total Other Items</b>                   | <b>\$ (12.3)</b>                | <b>\$ (6.0)</b> | <b>\$ (21.6)</b>             | <b>\$ (18.5)</b> |

*Certain prior-period amounts have been reclassified to conform with the current period's presentation.*

### Quarter Ended June 30, 2007

Our total net income for the quarter ended June 30, 2007 increased \$23.2 million, or \$0.12 per share, compared to the same period of 2006 mostly because of the following:

- ◆ We had higher earnings of approximately \$34 million after-tax at our merchant energy business due to higher gross margin from the Mid-Atlantic Region. We discuss this increase in gross margin in more detail in the *Mid-Atlantic Region* section beginning on page 31.
- ◆ We had higher earnings of approximately \$24 million after-tax from an increase in other income mostly due to interest income resulting from a higher cash balance primarily from proceeds from the sale of gas-fired plants in December 2006, and lower fixed charges due to the repayment of \$600 million of long-term debt in April 2007.
- ◆ We had higher earnings of \$13.8 million after-tax from our facilities that produce synthetic fuel. We discuss the impact of synthetic fuel tax credits from these facilities in more detail in the *Notes to Consolidated Financial Statements* beginning on page 16.
- ◆ We had higher earnings of \$6.0 million after-tax due to the absence of merger-related costs associated with our cancelled merger with FPL Group.

These increases were partially offset by the following:

- ◆ We had lower earnings from discontinued operations of \$19.1 million after-tax.
- ◆ We had lower earnings due to a \$12.2 million after-tax charge related to a cancelled wind development project. We discuss this charge in more detail in the *Notes to Consolidated Financial Statements* on page 12.

- ◆ We had lower earnings of \$18.3 million after-tax at our retail competitive supply operation. We discuss our retail gross margin in more detail in the *Competitive Supply* section on page 31.
- ◆ We had lower earnings of \$4.8 million after-tax at our regulated businesses due to higher operations and maintenance expenses.

**Six Months Ended June 30, 2007**

Our total net income for the six months ended June 30, 2007 increased \$105.0 million, or \$0.56 per share, compared to the same period of 2006 mostly because of the following:

- ◆ We had higher earnings of approximately \$126 million after-tax at our merchant energy business due to higher gross margin from the Mid-Atlantic Region. We discuss this increase in gross margin in more detail in the *Mid-Atlantic Region* section beginning on page 31.
- ◆ We had higher earnings of approximately \$39 million after-tax from an increase in other income mostly due to interest income resulting from a higher cash balance primarily from proceeds from the sale of gas-fired plants in December 2006, and lower fixed charges due to the repayment of \$600 million of long-term debt in April 2007.
- ◆ We had higher earnings of \$28.7 million after-tax from our facilities that produce synthetic fuel.
- ◆ We had higher earnings of \$7.5 million after-tax, due to the absence of merger-related costs associated with our cancelled merger with FPL Group.

These increases were partially offset by the following:

- ◆ We had lower earnings of approximately \$42 million after-tax due to lower gross margin at our wholesale competitive supply operation. We discuss our mark-to-market and wholesale accrual results in more detail in the *Competitive Supply* section beginning on page 32.
- ◆ We had lower earnings from discontinued operations of \$33.0 million after-tax.

- ◆ We had lower earnings due to a \$12.2 million after-tax charge related to a cancelled wind development project. We discuss this charge in more detail in the *Notes to Consolidated Financial Statements* on page 12.
- ◆ We had lower earnings of \$7.5 million after-tax at our regulated businesses due to higher operations and maintenance expenses.

In the following sections, we discuss our net income by business segment in greater detail.

## **Merchant Energy Business**

### ***Background***

Our merchant energy business is a competitive provider of energy solutions for various customers. We discuss the impact of deregulation on our merchant energy business in *Item 1. Business Competition* section of our 2006 Annual Report on Form 10-K.

Our merchant energy business focuses on delivery of physical, customer-oriented products to producers and consumers, manages the risk and optimizes the value of our owned generation assets, and uses our portfolio management and trading capabilities both to manage risk and to deploy risk capital to generate additional returns. We continue to identify and pursue opportunities which can generate additional returns through portfolio management and trading activities within our business. These opportunities have increased due to the significant growth in scale of our competitive supply operations.

We record merchant energy revenues and expenses in our financial results in different periods depending upon which portion of our business they affect. We discuss our revenue recognition policies in the *Critical Accounting Policies* section and *Note 1* of our 2006 Annual Report on Form 10-K. We summarize our revenue and expense recognition policies as follows:

- ◆ We record revenues as they are earned and fuel and purchased energy costs as they are incurred for contracts and activities subject to accrual accounting, including certain load-serving activities.
- ◆ Prior to the settlement of the forecasted transaction being hedged, we record changes in the fair value of contracts designated as cash-flow hedges in other comprehensive income to the extent that the hedges are effective. We record the effective portion of the changes in fair value of hedges in earnings in the period the settlement of the hedged transaction occurs. We record the ineffective portion of the changes in fair value of hedges, if any, in earnings in the period in which the change occurs.
- ◆ We record changes in the fair value of contracts that are subject to mark-to-market accounting in revenues or fuel and purchased energy expenses in the period in which the change occurs.

Mark-to-market accounting requires us to make estimates and assumptions using judgment in determining the fair value of certain contracts and in recording revenues from those contracts. We discuss the effects of mark-to-market accounting on our results in the *Competitive Supply Mark-to-Market* section beginning on page 32.

Our wholesale marketing, risk management, and trading operation actively transacts in energy and energy-related commodities in order to manage our portfolio of energy purchases and sales to customers through structured transactions. As part of these activities, we trade energy and energy-related commodities and deploy risk capital in the management of our portfolio in order to earn additional returns. These activities are managed through daily value at risk and stop loss limits and liquidity guidelines, and may have a material impact on our financial results. We discuss the impact of our trading activities and value at risk in more detail in the *Competitive Supply Mark-to-Market* section beginning on page 32 and the *Market Risk* section on page 45.



**Results**

|   | Quarter Ended<br>June 30, |                 | Six Months Ended<br>June 30, |                  |
|---|---------------------------|-----------------|------------------------------|------------------|
|   | 2007                      | 2006            | 2007                         | 2006             |
|   | (In millions)             |                 |                              |                  |
| Revenues  | \$ 4,339.7                | \$ 3,907.9      | \$ 8,726.1                   | \$ 7,991.2       |
| Fuel and purchased energy expenses                    | (3,668.3)                 | (3,258.7)       | (7,377.1)                    | (6,806.7)        |
| Operating expenses                                    | (431.7)                   | (416.7)         | (851.9)                      | (779.0)          |
| Impairment losses and other costs                     | (20.2)                    |                 | (20.2)                       |                  |
| Workforce reduction costs                             | (2.3)                     |                 | (2.3)                        | (2.2)            |
| Merger-related costs                                  |                           | (5.0)           |                              | (6.3)            |
| Depreciation, depletion, and amortization             | (67.9)                    | (66.6)          | (130.8)                      | (130.7)          |
| Accretion of asset retirement obligations             | (18.2)                    | (16.7)          | (35.9)                       | (33.2)           |
| Taxes other than income taxes                         | (29.1)                    | (30.1)          | (55.9)                       | (59.6)           |
| Income from Operations                                | \$ 102.0                  | \$ 114.1        | \$ 252.0                     | \$ 173.5         |
| Income from Continuing Operations (after-tax)         | \$ 102.2                  | \$ 52.6         | \$ 223.8                     | \$ 84.8          |
| Income from discontinued operations (after-tax)       |                           | 19.1            | (1.6)                        | 30.5             |
| <b>Net Income</b>                                     | <b>\$ 102.2</b>           | <b>\$ 71.7</b>  | <b>\$ 222.2</b>              | <b>\$ 115.3</b>  |
| <i>Other Items Included in Operations (after-tax)</i> |                           |                 |                              |                  |
| Impairment losses and other costs                     | \$ (12.2)                 | \$              | \$ (12.2)                    | \$               |
| Non-qualifying hedges                                 | 1.4                       |                 | (7.9)                        | (9.7)            |
| Workforce reduction costs                             | (1.5)                     |                 | (1.5)                        | (1.3)            |
| Merger-related costs                                  |                           | (4.2)           |                              | (5.2)            |
| <b>Total Other Items</b>                              | <b>\$ (12.3)</b>          | <b>\$ (4.2)</b> | <b>\$ (21.6)</b>             | <b>\$ (16.2)</b> |

Certain prior-period amounts have been reclassified to conform with the current period's presentation. Above amounts include intercompany transactions eliminated in our Consolidated Financial Statements. The Information by Operating Segment section within the Notes to Consolidated Financial Statements on page 14 provides a reconciliation of operating results by segment to our Consolidated Financial Statements.

**Revenues and Fuel and Purchased Energy Expenses**

Our merchant energy business manages the revenues we realize from the sale of energy to our customers and our costs of procuring fuel and energy. As previously discussed, our merchant energy business uses either accrual or mark-to-market accounting to record our revenues and expenses. Mark-to-market results reflect the net impact of amounts recorded in either revenues or fuel and purchased energy expenses to recognize changes in fair value of derivative contracts subject to mark-to-market accounting during the reporting period.

The difference between revenues and fuel and purchased energy expenses, including all direct expenses, is the gross margin of our merchant energy business, and this measure is a useful tool for assessing the profitability of our merchant energy business. Accordingly, we believe it is appropriate to discuss the operating results of our merchant energy business by analyzing the changes in gross margin between periods. In managing our portfolio, we may terminate, restructure, or acquire contracts. Such transactions are within the normal course of managing our portfolio and may materially impact the timing of our recognition of revenues, fuel and purchased energy expenses, and cash flows.

We analyze our merchant energy gross margin in the following categories because of the risk profile of each category, differences in the revenue sources, and the nature of fuel and purchased energy expenses. With the exception of a portion of our competitive supply activities that we are required to account for using the mark-to-market method of accounting, all of these activities are accounted for on an accrual basis.

◆ **Mid-Atlantic Region** our fossil, nuclear, and hydroelectric generating facilities and load-serving activities in the PJM region. This also includes active portfolio management of the generating assets and other physical and financial contractual arrangements, as well as other PJM competitive supply activities.

◆ **Plants with Power Purchase Agreements** our Nine Mile Point and Ginna nuclear generating facilities.

- ◆ Wholesale Competitive Supply our marketing, risk management, and trading operation that provides energy products and services (including portfolio management and trading activities) primarily to distribution utilities, power generators, and other wholesale customers. We also provide global energy, logistics, and downstream natural gas services.
- ◆ Retail Competitive Supply our operation that provides electric and gas energy products and services to commercial, industrial, and governmental customers.
- ◆ Other our investments in qualifying facilities and domestic power projects and our generation operations and maintenance services.





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We provide a summary of our revenues, fuel and purchased energy expenses, and gross margin as follows:

|  | Quarter Ended June 30, |               | Six Months Ended June 30, |               |
|--|------------------------|---------------|---------------------------|---------------|
|  | 2007                   | 2006          | 2007                      | 2006          |
| <i>(Dollar amounts in millions)</i>        |                        |               |                           |               |
| <b>Revenues:</b>                           |                        |               |                           |               |
| Mid-Atlantic Region                        | \$ 684.3               | \$ 651.6      | \$ 1,232.2                | \$ 1,117.0    |
| Plants with Power Purchase Agreements      | 162.3                  | 150.9         | 313.5                     | 303.3         |
| Competitive Supply                         |                        |               |                           |               |
| Retail                                     | 2,158.7                | 1,845.9       | 4,380.2                   | 3,870.1       |
| Wholesale                                  | 1,330.5                | 1,249.9       | 2,775.7                   | 2,670.4       |
| Other                                      | 3.9                    | 9.6           | 24.5                      | 30.4          |
| Total                                      | \$ 4,339.7             | \$ 3,907.9    | \$ 8,726.1                | \$ 7,991.2    |
| <b>Fuel and purchased energy expenses:</b> |                        |               |                           |               |
| Mid-Atlantic Region                        | \$ (375.6 )            | \$ (398.9 )   | \$ (670.9 )               | \$ (765.0 )   |
| Plants with Power Purchase Agreements      | (19.6 )                | (19.1 )       | (37.6 )                   | (34.8 )       |
| Competitive Supply                         |                        |               |                           |               |
| Retail                                     | (2,085.3 )             | (1,751.8 )    | (4,188.8 )                | (3,702.7 )    |
| Wholesale                                  | (1,187.8 )             | (1,088.9 )    | (2,479.8 )                | (2,304.2 )    |
| Other                                      |                        |               |                           |               |
| Total                                      | \$ (3,668.3 )          | \$ (3,258.7 ) | \$ (7,377.1 )             | \$ (6,806.7 ) |

|                                       |          | % of Total |          | % of Total |            | % of Total |            | % of Total |
|---------------------------------------|----------|------------|----------|------------|------------|------------|------------|------------|
| <b>Gross Margin:</b>                  |          |            |          |            |            |            |            |            |
| Mid-Atlantic Region                   | \$ 308.7 | 46%        | \$ 252.7 | 39%        | \$ 561.3   | 42%        | \$ 352.0   | 30%        |
| Plants with Power Purchase Agreements | 142.7    | 21         | 131.8    | 20         | 275.9      | 20         | 268.5      | 23         |
| Competitive Supply                    |          |            |          |            |            |            |            |            |
| Retail                                | 73.4     | 11         | 94.1     | 14         | 191.4      | 14         | 167.4      | 14         |
| Wholesale                             | 142.7    | 22         | 161.0    | 25         | 295.9      | 22         | 366.2      | 31         |
| Other                                 | 3.9      |            | 9.6      | 2          | 24.5       | 2          | 30.4       | 2          |
| Total                                 | \$ 671.4 | 100%       | \$ 649.2 | 100%       | \$ 1,349.0 | 100%       | \$ 1,184.5 | 100%       |

*Certain prior-period amounts have been reclassified to conform with the current period's presentation*

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Merchant energy gross margin for the quarter ended June 30, 2007 includes the effects of market price changes on derivatives designated as cash-flow and fair value hedges. These market price changes had two primary impacts on the quarter and six months ended June 30, 2007 compared to the same periods in 2006:

- ◆ We experienced a significant increase in the level of ineffectiveness associated with derivatives that qualified for hedge accounting treatment during the quarter.
- ◆ Additionally, we were required to discontinue the application of hedge accounting treatment for certain derivatives due to insufficient price correlation between the hedge and the risk being hedged. As a result, the full change in the fair value of these derivatives has been recorded in earnings for the quarter. While certain of these derivatives are eligible and remain designated for hedge accounting in the future, others may not qualify for prospective designation as hedges due to continued insufficient price correlations.

The merchant energy gross margin impact for the quarter ended June 30, 2007 from the effect of market price changes on derivatives designated as cash-flow and fair value hedges is summarized as follows:

|   | <i>(In millions)</i> |
|---|----------------------|
| Ineffectiveness on derivatives that qualified for hedge accounting treatment during the quarter                           | \$ (10.5 )           |
| Effect of reduced price correlation on derivatives that did not qualify for hedge accounting treatment during the quarter |                      |
| Derivatives that remain designated as hedges prospectively  | (16.4 )              |
| Derivatives not eligible for designation as hedges prospectively  | (37.0 )              |
| <b>Total</b>  | <b>\$ (63.9 )</b>    |



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We discuss below the impact of these items on the applicable categories of merchant energy gross margin for the quarter and six months ended June 30, 2007 compared to the same periods of 2006. We discuss our hedging activities in more detail in the *Notes to Consolidated Financials* beginning on page 20.

### Mid-Atlantic Region

|                                    | Quarter Ended<br>June 30, |         |      |         | Six Months Ended<br>June 30, |         |      |         |
|------------------------------------|---------------------------|---------|------|---------|------------------------------|---------|------|---------|
|                                    | 2007                      |         | 2006 |         | 2007                         |         | 2006 |         |
|                                    | <i>(In millions)</i>      |         |      |         |                              |         |      |         |
| Revenues                           | \$                        | 684.3   | \$   | 651.6   | \$                           | 1,232.2 | \$   | 1,117.0 |
| Fuel and purchased energy expenses |                           | (375.6) |      | (398.9) |                              | (670.9) |      | (765.0) |
| Gross margin                       | \$                        | 308.7   | \$   | 252.7   | \$                           | 561.3   | \$   | 352.0   |

The increase in gross margin during the quarter ended June 30, 2007 compared to the same period of 2006 is primarily due to approximately \$106 million in higher margins on new and existing contracts, which included the effect of the expiration of below-market hedges. This increase in gross margin included higher revenues from BGE of approximately \$34 million during the quarter ended June 30, 2007 compared to the same period of 2006. As discussed in our 2006 Annual Report on Form 10-K, our wholesale marketing, risk management, and trading operation served fixed-price standard offer service obligations to BGE from July 1, 2000 until July 1, 2006.

The increase from higher margins on new and existing contracts was partially offset by the following:

- ◆ the unfavorable impact of approximately \$36 million related to losses recognized on cash-flow hedges due to ineffectiveness and certain cash-flow hedges that did not qualify for hedge accounting during the quarter. We discuss this in more detail on page 30, and
- ◆ the absence of competitive transition charge (CTC) revenue of \$14.3 million. In June 2006, all customers completed their CTC obligation.

The increase in gross margin during the six months ended June 30, 2007 compared to the same period of 2006 is primarily due to approximately \$289 million in higher margins on new and existing contracts, which included the effect of the expiration of below-market hedges. This increase in gross margin included higher revenues from BGE of approximately \$149 million during the six months ended June 30, 2007 compared to the same period of 2006. The increase in gross margin was partially offset by the following:

- ◆ the unfavorable impact of approximately \$44 million related to losses recognized on cash-flow hedges due to ineffectiveness and certain cash-flow hedges that did not qualify for hedge accounting during the quarter, and
- ◆ absence of CTC revenue of \$35.5 million.

### Plants with Power Purchase Agreements

|                                    | Quarter Ended<br>June 30, |        |      |        | Six Months Ended<br>June 30, |        |      |        |
|------------------------------------|---------------------------|--------|------|--------|------------------------------|--------|------|--------|
|                                    | 2007                      |        | 2006 |        | 2007                         |        | 2006 |        |
|                                    | <i>(In millions)</i>      |        |      |        |                              |        |      |        |
| Revenues                           | \$                        | 162.3  | \$   | 150.9  | \$                           | 313.5  | \$   | 303.3  |
| Fuel and purchased energy expenses |                           | (19.6) |      | (19.1) |                              | (37.6) |      | (34.8) |
| Gross margin                       | \$                        | 142.7  | \$   | 131.8  | \$                           | 275.9  | \$   | 268.5  |

Gross margin from our Plants with Power Purchase Agreements was slightly higher primarily due to greater output from our Ginna nuclear facility for the quarter and the six months ended June 30, 2007 compared to the same periods of 2006. During the fourth quarter of 2006, we completed a planned outage at Ginna, which included increasing the plant capacity from 498 megawatts to the current 581 megawatts.

### Competitive Supply

## Retail

|                                    | Quarter Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|------------------------------------|---------------------------|------------|------------------------------|------------|
|                                    | 2007                      | 2006       | 2007                         | 2006       |
|                                    | <i>(In millions)</i>      |            |                              |            |
| Accrual revenues                   | \$ 2,154.5                | \$ 1,843.1 | \$ 4,377.3                   | \$ 3,859.9 |
| Fuel and purchased energy expenses | (2,065.5)                 | (1,749.5)  | (4,165.9)                    | (3,683.5)  |
| Retail accrual activities          | 89.0                      | 93.6       | 211.4                        | 176.4      |
| Mark-to-market activities          | (15.6)                    | 0.5        | (20.0)                       | (9.0)      |
| Gross margin                       | \$ 73.4                   | \$ 94.1    | \$ 191.4                     | \$ 167.4   |

The decrease in accrual gross margin from our retail competitive supply activities during the quarter ended June 30, 2007 compared to the same period of 2006 is primarily due to the unfavorable impact of approximately \$12 million related to losses recognized during the quarter ended June 30, 2007 on hedges due to ineffectiveness and certain hedges that did not qualify for hedge accounting. We discuss this in more detail on page 30. This unfavorable impact was mostly offset by approximately \$7 million primarily related to the positive impact of higher volumes served at higher contract rates per megawatt hour and lower costs to serve load in our retail electric operations.

The increase in accrual gross margin from our retail competitive supply activities during the six months ended June 30, 2007 compared to the same period of 2006 is primarily due to the positive impact of higher volumes served at higher contract rates per megawatt hour and lower costs to serve load in our retail electric operations, which was partially offset by approximately \$15 million related to losses recognized during the six months ended June 30, 2007 on hedges due to ineffectiveness and certain hedges that did not qualify for hedge accounting.

Wholesale

|                                    | Quarter Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|------------------------------------|---------------------------|------------|------------------------------|------------|
|                                    | 2007                      | 2006       | 2007                         | 2006       |
|                                    | (In millions)             |            |                              |            |
| Accrual revenues                   | \$ 1,263.7                | \$ 1,144.5 | \$ 2,751.7                   | \$ 2,467.7 |
| Fuel and purchased energy expenses | (1,187.8)                 | (1,088.9)  | (2,479.8)                    | (2,304.2)  |
| Wholesale accrual activities       | 75.9                      | 55.6       | 271.9                        | 163.5      |
| Mark-to-market revenues            | 66.8                      | 105.4      | 24.0                         | 202.7      |
| Gross margin                       | \$ 142.7                  | \$ 161.0   | \$ 295.9                     | \$ 366.2   |

Our wholesale marketing, risk management, and trading operation had higher accrual gross margin during the quarter ended June 30, 2007 compared to the same period of 2006 primarily due to approximately \$49 million from new contracts executed during 2007, higher realized gross margin associated with existing contracts, and the favorable impact of higher energy prices. These increases in gross margin were partially offset by the recognition of approximately \$29 million related to losses recognized on cash-flow hedges due to ineffectiveness and certain cash-flow hedges that did not qualify for hedge accounting during the quarter ended June 30, 2007. We discuss this in more detail on page 30.

Our wholesale marketing, risk management, and trading operation had higher accrual gross margin during the six months ended June 30, 2007 compared to the same period of 2006 primarily due to approximately \$172 million from new contracts executed during 2007, higher realized gross margin associated with existing contracts, and the favorable impact of higher energy prices. These increases in gross margin were partially offset by the recognition of approximately \$30 million related to losses recognized on cash-flow hedges due to ineffectiveness and certain cash-flow hedges that did not qualify for hedge accounting during the quarter ended June 30, 2007 and approximately \$34 million in losses recorded during the quarter ended March 31, 2007 for amounts reclassified from Accumulated other comprehensive loss to earnings related to:

- ◆ as discussed in more detail in the *Notes to Consolidated Financial Statements* on page 12, as a result of the anticipated CEP equity issuance and subsequent deconsolidation, we determined that the hedged forecasted sales were probable of not occurring, which resulted in the reclassification of losses from Accumulated other comprehensive loss into earnings.
- ◆ as discussed in more detail on the next page, we amended certain nonderivative contracts such that the new contracts are accounted for as mark-to-market. This resulted in the recognition of losses from cash-flow hedges previously deferred in Accumulated other comprehensive loss due to the forecasted transaction affecting earnings.

Mark-to-Market

Mark-to-market results include net gains and losses from origination, trading, and risk management activities for which we use the mark-to-market method of accounting. We discuss these activities and the mark-to-market method of accounting in more detail in the *Critical Accounting Policies* section of our 2006 Annual Report on Form 10-K.

As a result of the nature of our operations and the use of mark-to-market accounting for certain activities, mark-to-market earnings will fluctuate. We cannot predict these fluctuations, but the impact on our earnings could be material. We discuss our market risk in more detail in the *Market Risk* section beginning on page 45. The primary factors that cause fluctuations in our mark-to-market results are:

- ◆ the number, size, and profitability of new transactions, including termination or restructuring of existing contracts,
- ◆ the number and size of our open derivative positions, and
- ◆ changes in the level and volatility of forward commodity prices and interest rates.

Mark-to-market results were as follows:

|  | Quarter Ended<br>June 30, | Six Months Ended<br>June 30, |
|--|---------------------------|------------------------------|
|  |                           |                              |

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|   | 2007                 |        | 2006 |         | 2007 |        | 2006 |         |
|---|----------------------|--------|------|---------|------|--------|------|---------|
|   | <i>(In millions)</i> |        |      |         |      |        |      |         |
| <b>Unrealized mark-to-market results</b>          |                      |        |      |         |      |        |      |         |
| Origination gains                                 | \$                   | 1.5    | \$   | 2.7     | \$   | 33.1   | \$   | 6.0     |
| Risk management and trading mark-to-market        |                      |        |      |         |      |        |      |         |
| Unrealized changes in fair value                  |                      | 49.7   |      | 103.2   |      | (29.1) |      | 187.7   |
| Changes in valuation techniques                   |                      |        |      |         |      |        |      |         |
| Reclassification of settled contracts to realized |                      | (18.9) | )    | (104.8) | )    | (61.2) | )    | (228.9) |
| Total risk management and trading mark-to-market  |                      | 30.8   |      | (1.6)   | )    | (90.3) | )    | (41.2)  |
| Total unrealized mark-to-market*                  |                      | 32.3   |      | 1.1     |      | (57.2) | )    | (35.2)  |
| <b>Realized mark-to-market</b>                    |                      | 18.9   |      | 104.8   |      | 61.2   |      | 228.9   |
| Total mark-to-market results                      | \$                   | 51.2   | \$   | 105.9   | \$   | 4.0    | \$   | 193.7   |

\* Total unrealized mark-to-market is the sum of origination gains and total risk management and trading mark-to-market.

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Origination gains arise primarily from contracts that our wholesale marketing, risk management, and trading operation structures to meet the risk management needs of our customers or relate to our trading activities. Transactions that result in origination gains may be unique and provide the potential for individually significant revenues and gains from a single transaction.

Origination gains represent the initial fair value recognized on these transactions. The recognition of origination gains is dependent on sufficient observable market data that validates the initial fair value of the contract. Liquidity and market conditions impact our ability to identify sufficient, objective market-price information to permit recognition of origination gains. As a result, while our strategy and competitive position provide the opportunity to continue to originate such transactions, the level of origination gains we are able to recognize may vary from period to period as a result of the number, size, and market-price transparency of the individual transactions executed in any period.

During the first six months of 2007, our wholesale marketing, risk management, and trading operation amended certain nonderivative power sales contracts such that the new contracts are derivatives subject to mark-to-market accounting under Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended*. Simultaneous with the amending of the nonderivative contracts, we executed at current market prices several new offsetting derivative power purchase contracts subject to mark-to-market accounting. The combination of these transactions resulted in substantially all of the origination gains presented for the first six months of 2007 in the table on the previous page, as well as mitigated our risk exposure under the amended contracts.

The origination gain from these transactions was partially offset by approximately \$12 million of losses in our accrual portfolio due to the reclassification of losses related to cash-flow hedges previously established for the amended nonderivative contracts from Accumulated other comprehensive loss into earnings as discussed in our *Competitive Supply-Wholesale Accrual* section on the previous page. In the absence of these transactions, the origination gain and the losses associated with cash-flow hedges would have been recognized over the remaining term of the contracts, which extended through the first quarter of 2009.

Risk management and trading mark-to-market represents both realized and unrealized gains and losses from changes in the value of our portfolio, including the recognition of gains associated with decreases in the close-out adjustment when we are able to obtain sufficient market price information. In addition, we use derivative contracts subject to mark-to-market accounting to manage our exposure to changes in market prices primarily as a result of our gas transportation and storage activities, while in general the underlying physical transactions related to our gas activities are accounted for on an accrual basis. We discuss the changes in mark-to-market results below. We show the relationship between our mark-to-market results and the change in our net mark-to-market energy asset later in this section.

Total mark-to-market results decreased \$54.7 million during the quarter ended June 30, 2007 compared to the same period of 2006 mostly because of a decrease in unrealized changes in fair value, which resulted from lower gains on open positions being recorded during the second quarter of 2007 compared to the same period of 2006. The decrease in fair value was primarily due to a less favorable price environment during the second quarter of 2007 compared to the same period of 2006.

Total mark-to-market results decreased \$189.7 million during the six months ended June 30, 2007 compared to the same period of 2006 mostly because of a decrease in unrealized changes in fair value, partially offset by the increase in origination gains previously discussed. Unrealized changes in fair value decreased \$216.8 million primarily due to losses on open positions resulting from an unfavorable price environment, which was partially offset by a \$21.1 million favorable impact related to changes in the close-out adjustment during the six months ended June 30, 2007 compared to the same period of 2006.

The close-out adjustments are determined by the change in open positions, new transactions where we did not have observable market price information, and existing transactions where we have now observed sufficient market price information and/or we realized cash flows since the transactions inception. We discuss the close-out adjustment in more detail in the *Critical Accounting Policies* section of our 2006 Annual Report on Form 10-K.

### *Mark-to-Market Energy Assets and Liabilities*

Our mark-to-market energy assets and liabilities are comprised of derivative contracts subject to mark-to-market accounting and consisted of the following:

|                   | June 30,<br>2007     |  | December 31,<br>2006 |
|-------------------|----------------------|--|----------------------|
|                   | <i>(In millions)</i> |  |                      |
| Current Assets    | \$ 953.5             |  | \$ 1,294.8           |
| Noncurrent Assets | 755.8                |  | 623.4                |
| Total Assets      | 1,709.3              |  | 1,918.2              |



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|                        |         |  |  |         |  |
|------------------------|---------|--|--|---------|--|
| Current Liabilities    | 728.6   |  |  | 1,071.7 |  |
| Noncurrent Liabilities | 448.2   |  |  | 392.4   |  |
| Total Liabilities      | 1,176.8 |  |  |         |  |