

**Constellation Energy
Analyst Meeting
Derivative and Fair Value Accounting Summary
August 27, 2008**

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Introduction

This paper is designed primarily to summarize the impacts of the accounting requirements for derivatives on financial reporting for energy companies in order to help translate the impacts of those requirements within a complex industry. The accounting for derivatives and related fair value is governed by a large body of literature reflecting the diverse variety of commercial contracts that exist and the numerous environments in which they are deployed, and it would be difficult to summarize all of the relevant accounting requirements accurately and completely in a brief paper.

Because this paper is designed to assist in promoting a broad understanding of some of the more significant impacts of the accounting rules for derivatives, by necessity it cannot and does not cover every possible application of derivatives accounting. The actual standards governing the accounting for derivatives and fair value are highly detailed and specific, and this paper only highlights certain aspects of these matters. While it is important for accounting professionals to understand and apply all relevant aspects of these rules, this paper is not designed primarily for accountants.

Therefore, because this paper summarizes selected highlights of these accounting requirements, it is intended for general information only. For additional information about the accounting requirements summarized in this document, refer to our periodic reports filed with the Securities and Exchange Commission, review the governing accounting literature, and consult your professional accounting advisor.

The focus of this document is directed toward typical energy industry activities and some of the more significant accounting and financial reporting effects of the derivative accounting requirements within this industry. The structure of the paper is as follows: First, it describes certain key aspects of the accounting standards governing derivatives and fair value; second, it addresses selected impacts from the application of these rules in the energy industry; and third, it highlights certain aspects of the Constellation's derivatives accounting.

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Section I – Understanding the Accounting Principles for Derivatives

Accounting standards governing derivatives and fair value

The Financial Accounting Standards Board (FASB) has promulgated specific accounting and disclosure requirements related to derivatives and fair value. While these standards are quite detailed, key provisions of their most basic requirements may be summarized as follows:

- FASB Statement 133, including its amendments and interpretations
 - Defines derivatives – broad definition encompasses many physical commodity contracts
 - Requires mark-to-market (MTM) accounting as default accounting treatment
 - Allows exceptions only if relevant requirements are met
- FASB Statement 157
 - Defines “fair value” as used for accounting and financial reporting
 - Defines a fair value “hierarchy” based on how fair value is determined
 - Level 1 – quoted prices for an identical asset or liability
 - Level 2 – quoted prices for similar assets or liabilities
 - Level 3 – management estimates in the absence of quoted prices
 - Requires specific disclosures segregated by Level in the hierarchy that must be presented on a gross basis rather than an economic or credit risk basis

Key concepts underlying derivative accounting requirements

The derivative accounting requirements are based upon certain key concepts as discussed more fully in the text of Statement 133.

- Broad definition of “derivative” – any contract with:
 - A quantity and price or rate for the underlying commodity or financial instrument
 - Little or no initial cash investment
 - Settles in cash or a commodity that is fungible
 - Power and gas are generally considered fungible
- Derivatives should be recorded in financial statements at fair value
 - Fair value represents economic assets and liabilities
 - Required to estimate fair value, even if illiquid or unobservable
- Statement 133 indicates that changes in fair value of derivatives should be MTM through earnings
 - Represents economic gain or loss to entity
 - Accounting earnings reflect economic gains/losses, not timing of settlement
- Statement 133 indicates that exceptions to MTM should be limited
 - Fair value is considered to be most conceptually supportable measurement basis
 - Certain exceptions permitted for practical reasons if specific requirements are satisfied

Typical derivative and non-derivative contracts

It was noted above that a variety of contracts may meet the accounting definition of a derivative. The following are typical examples of some of the types of contracts used in the energy industry that meet the definition of a derivative, as well as examples of certain types of contracts that are not derivatives.

- Derivatives
 - Any exchange-traded futures or option contract
 - Most bilateral forward, swap, or option contracts
 - Many structured contracts with specified quantities

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- Non-derivatives
 - Full-requirements contracts (power or gas)
 - Quantity is specified as a percentage of a customer's actual needs or a plant's actual output, but no fixed or determinable amount included in contract
 - Physical commodity contracts in illiquid markets
 - Serving customers under regulated tariffs with no contract
- The focus of this document is commodity contracts, not financial contracts

Three primary accounting treatments for derivatives

Statement 133 provides three fundamental accounting treatments for which derivatives are potentially eligible under Generally Accepted Accounting Principles (GAAP). The specific accounting treatment that is applied depends upon a number of factors, including whether the terms of the contract meet all of the underlying requirements for a particular accounting treatment.

The three primary derivative accounting treatments are as follows:

- Mark to market accounting
 - Default treatment if no other treatment elected
 - Derivative recorded at fair value in balance sheet
 - Changes in fair value recorded in earnings as they occur
- Hedge accounting (primarily cash flow hedges¹)
 - Requires affirmative election and satisfaction of specific criteria
 - Derivative recorded at fair value in balance sheet
 - Changes in fair value
 - Recorded in accumulated other comprehensive income (AOCI) component of shareholders' equity if the derivative is effective in offsetting the hedged risk
 - Recorded in earnings for portion that is ineffective in offsetting the hedged risk
 - At settlement, AOCI amounts reclassified to earnings to correspond with timing of settlement of hedged transaction
- Normal purchase/normal sale
 - Requires affirmative election and satisfaction of specific criteria
 - Accounted for as if the contract was not a derivative
 - Changes in fair value not recorded
 - Gross settlement recorded in earnings when it occurs
 - Identical treatment to accrual accounting

¹ Predominant use of hedge accounting by Constellation is cash flow hedges of forecasted transactions; limited use of fair value hedges. Therefore, the remainder of this paper focuses on of cash flow hedge accounting.

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Derivative accounting treatment, regardless of which of the three alternatives is applied, has no effect on timing or amount of cash flows.

- Cash flows from economics always occur at settlement, regardless of accounting treatment
 - Mark to market accounting recognizes earnings impact prior to settlement
 - Settlement affects cash, not earnings
 - Hedge accounting recognizes earnings primarily at settlement
 - Ineffectiveness recognized in earnings as it occurs prior to settlement
 - Normal purchase/normal sale
 - Earnings and cash recognized simultaneously at settlement
- Cash flows from collateral occur based on timing and conditions specified in underlying contracts, which may differ from timing of settlement of contracts

Key derivative and fair value implications that impact financial reporting

Summarizing the principles governing the requirements of Statement 133 and the accounting treatments that apply to contracts within its scope, several key implications for financial reporting should be noted:

- Derivative accounting is not optional
 - Contracts meeting the definition of a derivative are subject to Statement 133
 - Contracts not meeting the definition cannot be accounted for at fair value
- Broad definition of derivatives captures a significant portion of our business activity
 - Incorporates most fixed quantity energy contracts, even if intended for own use or for physical receipt from/delivery to others
- Exceptions to MTM accounting for derivatives exist but have significant limitations
 - Use of exceptions may not always be permitted
 - Contracts may not qualify for exceptions
 - “Normal purchase/normal sale”
 - Benefit – allows exemption from derivative rules and results in accrual accounting
 - Limitations
 - Only available for a physically delivering contract
 - Intent to deliver not sufficient – must always settle full quantity physically
 - Cannot settle financially
 - Operations of power pools to optimize physical flows may cause contracts not to be considered physical for accounting purposes
 - Only available for fixed quantity contracts (other than power) and power contracts meeting specific criteria
 - Limited use by Constellation due to these constraints

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- Hedge accounting (primarily cash flow hedges of forecasted transactions)
 - Benefit – if hedges are effective in offsetting hedged risk, change in fair value of the hedge recorded in equity (AOCI) until hedged transaction affects earnings, with limited exceptions
 - Matches economics of hedges and hedged risk
 - Limitations
 - High threshold for effectiveness of hedge in offsetting changes in fair value of hedged risk
 - *De facto* threshold of $\geq 80\%$ correlation effectively limits application
 - If correlation less than 80%, must use MTM
 - Volatility in balance sheet and equity as fair values change even though underlying transaction margin may be fully locked in
 - Volatility in income statement prior to settlement due to ineffectiveness
 - Does not reflect offsetting changes in fair value of the hedged transaction (which is not being marked to market) in earnings until settlement
 - Used by Constellation as permitted in order to better match results of our hedging activities with hedged risks

The principles and requirements of FASB Statement 133 drive the accounting and financial reporting effects of derivatives for all companies in general and energy companies specifically.

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Section II – Derivatives Accounting for Energy Companies

The following section describes two fundamental approaches to derivatives accounting that are applicable to energy companies, highlighting the major implications of each. This discussion is supplemented by several examples of typical energy industry transactions that illustrate the associated accounting.

Two fundamental approaches for reporting effects of derivatives

- Use MTM accounting for all derivatives
 - Typical application
 - Trading activities
 - Economic hedges that do not qualify for hedge or accrual accounting
 - Financial instruments
 - Benefits
 - Simplicity – single treatment for all derivatives
 - Most transparent for trading activities
 - Limitations
 - Potential for significant volatility in GAAP earnings even when economic margin is fully hedged
 - Greater potential for timing differences between recognition of earnings from MTM transactions and the related accrual activities
 - Greater divergence between GAAP earnings and cash flows
- Use accrual (normal purchase/normal sale) or hedge accounting for derivatives transactions undertaken as part of physical energy business activities to extent permitted
 - Typical application
 - Derivatives under which physical commodities will be delivered
 - Derivatives used to hedge risks related to operations subject to accrual accounting, including physical assets, manufacturing operations, or services
 - Benefits
 - Reduced potential for timing differences between earnings recognition of derivative contracts and related accrual transactions
 - Better aligns GAAP earnings with cash flow
 - Limitations
 - Not all derivatives qualify for normal purchase/normal sale (accrual) or hedge accounting treatment
 - Multiple business activities (physical delivery, trading) conducted by same entity may require using a combination of MTM, hedge, and accrual accounting, even when economics of the transactions may be similar
- Constellation generally elects the second alternative as more relevant and transparent for our physical energy generation/procurement and delivery businesses

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Implications of energy business model and derivatives accounting

- Combination of a physical generation/procurement and delivery business hedged with derivatives
 - Broad definition of derivatives results in many physical delivery contracts being derivatives that may not be eligible for accrual or hedge accounting
 - Transactions may involve one portion that is eligible for accrual or hedge accounting (for example, generation of power) but for which the other portion (for example, derivative contract to sell that power) may not qualify for the same accounting treatment
- Creates “mixed-attribute” accounting for non-trading activities
 - Accrual accounting required for some activities
 - Mark-to-market accounting required for other (related) activities
- When two components of the same activity receive different accounting treatments, mismatches arise in the timing of recognizing revenues and expenses
 - Examples illustrated below
- Activities that have to be accounted for at fair value produce volatility in balance sheet amounts of assets and liabilities that are recorded at fair value, income statement earnings, and other comprehensive income
 - Volatility may be representative of changes in economic value of derivatives but may not reflect business intent or contractually hedged margins
 - The required fair value presentation for some derivatives does not reflect potentially offsetting changes in value of related nonderivatives that cannot be MTM
 - Doesn't incorporate changes in value of fixed assets (for example, power plants used to serve physical delivery sales contracts) and non-derivative contracts, neither of which are eligible to be marked to market
 - As a result, the volatility reported in the financial statements exceeds volatility of underlying margins
- Business activities or transactions that are economically similar may require different accounting treatments in the financial statements

Sample Transactions Illustrating Mixed-Attribute Accounting

Generation Activities

- Power plant operations – fuel procurement
 - Purchase of fuel at spot prices or under full-requirements contracts
 - Accrual accounting
 - Fuel cost expensed when consumed
 - Hedges of fuel cost with derivatives
 - Elect hedge accounting
 - Derivative fair value recorded on balance sheet as asset or liability
 - Changes in fair value split between AOCI in equity (if the hedge is effective) and earnings (for any ineffectiveness in the hedge)
 - Settlement of effective portion of hedge gain or loss adjusts cost of fuel when consumed
 - Same economics as accrual but with financial statement volatility
 - Derivative assets/liabilities and AOCI fluctuate as market prices for fuel change, even though hedged fuel purchase occurs at contract price

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- Power plant operations – power sales
 - Sale of power at spot prices or under full-requirements contracts
 - Accrual accounting
 - Revenue recognized when power generated and delivered
 - Hedges of power sales price with derivatives
 - Elect hedge accounting
 - Derivative fair value recorded on balance sheet as asset or liability
 - Changes in fair value split between AOCI component of equity (if the hedge is effective) and earnings (for any ineffectiveness in the hedge)
 - Settlement of effective portion of hedge gain or loss adjusts revenue when power generated and delivered
 - Same economics as accrual but with financial statement volatility
 - Derivative assets/liabilities and AOCI fluctuate as market prices for power change, even though hedged power sale occurs at contract price

Customer Supply Activities

- Sales to end use customers – power or gas
 - Power and gas delivered to utilities and/or end-use customers at spot prices or under full-requirements contracts
 - Accrual accounting
 - Revenue from sales recognized when power delivered
 - Costs to purchase power/gas recognized when power/gas received
 - Hedges of power or gas purchases to serve customers with derivatives
 - Elect hedge accounting
 - Derivative fair value recorded on balance sheet as asset or liability
 - Changes in fair value split between AOCI component of equity (if the hedge is effective) and earnings (for any ineffectiveness in the hedge)
 - Settlement of effective portion of hedge gain or loss adjusts cost of power/gas purchase when received
 - Same economics as accrual but with financial statement volatility
 - Derivative assets/liabilities and AOCI fluctuate as market prices for power or gas change, even though hedged power or gas purchase occurs at contract price

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Structured Energy Products

- Gas transportation – contractual purchase of gas transportation capacity
 - Accrual accounting required for gas transportation contract
 - Gas transportation contract not a derivative
 - Costs to use recorded in earnings over contract period
 - Hedges of value of transportation contract capture price differences between injection and withdrawal points
 - Derivative contracts hedge price of gas at injection point and withdrawal point
 - Economic hedges of the value underlying the transportation contract
 - MTM accounting required for derivative contracts
 - Contracts do not meet all criteria for hedge accounting
 - Economics of pipeline capacity recognized in earnings over contract term while economics of contracts recognized as market prices change, not at settlement

Applying derivatives accounting in the energy industry poses unique challenges flowing from the combination of the industry's inherent physical commodity operations and the use of derivative contracts to manage the risks of those operations.

Recording derivative fair values in the financial statements can result in timing differences between reported GAAP earnings and cash flows as well as volatility in both balance sheet and income statement amounts.

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Section III – Derivatives Accounting at Constellation

As a diverse energy company, many contracts that are integral to our normal business activities meet the accounting definition of a derivative. Therefore, derivatives accounting is one of our critical accounting policies. This section summarizes how we report and disclose the effects of derivatives throughout our financial statements, notes, and management's discussion and analysis. It provides tables that summarize these impacts as presented in our 2007 Annual Report on Form 10-K as well as our Form 10-Q report for the second quarter of 2008.

Derivatives accounting is a critical accounting policy for Constellation

- Applying derivatives accounting requires us to determine
 - Whether contracts meet the definition of a derivative
 - Whether we qualify for exceptions to MTM accounting
 - The fair value of derivatives daily and at the end of each reporting period
- Derivatives are material to our financial position and results of operations
 - Balance sheet
 - Significant assets and liabilities
 - Significant component of AOCI portion of equity
 - Income statement
 - Significant components of revenue and expense
 - Cash flow statement
 - Significant cash flow impacts
 - Significant disclosures – MD&A and footnotes

How derivatives are reported in our financial statements

- We account for derivatives using a combination of normal purchase/normal sale (accrual) treatment, hedge accounting, and MTM accounting depending upon the nature of the business activity, the terms of individual contracts, and the accounting treatment for which each contract qualifies
- We use the normal purchase/normal sale exception and hedge accounting for physical purchase and delivery activities to the extent permitted
 - Derivatives which qualify for the normal purchase/normal sale exception are not recorded on balance sheet or income statement until settlement
 - Accrual accounting similar to non-derivatives
 - Energy sales recorded as nonregulated revenue
 - Energy purchases recorded as fuel and purchased energy
 - Derivatives for which we have elected and qualify for hedge accounting are recorded at fair value on the balance sheet over the term of the contract
 - Changes in fair value split between AOCI component of equity (if the hedge is effective) and earnings (for any ineffectiveness in the hedge)
 - At settlement, AOCI amounts reclassified to earnings to correspond with timing of settlement of hedged transaction
 - All other derivatives receive MTM accounting and are recorded at fair value on the balance sheet with changes in fair value recorded in earnings as they occur

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Balance Sheet					
Item	Financial Statement Location	Components	Comments	10-Q Page	10-K Page
Derivative assets and liabilities			<ul style="list-style-type: none"> • Both MTM and hedge • Normal purchase/normal sale excluded – accrual accounting 		
Exchange traded	Accounts Receivable	<ul style="list-style-type: none"> • Initial margin posted (receivable) • Fair value of positions (unrealized gain or loss) • Offsetting variation margin (reflects unrealized losses) 	<ul style="list-style-type: none"> • Presented as accounts receivable because margin account with broker always in net receivable position 	4	72
All other	Derivative assets/liabilities	<ul style="list-style-type: none"> • Unrealized (open) positions • Cash collateral received or paid <ul style="list-style-type: none"> • Obligation to return collateral reduces assets • Right to reclaim collateral reduces liabilities 	<ul style="list-style-type: none"> • Valued using established procedures consistent with Statement 157 requirements • Assets represent credit exposure from third parties • Liabilities represent third parties' credit exposure to us • Netting prescribed by FASB requirements 	4-5	72-73
	Current Noncurrent	<ul style="list-style-type: none"> • Settling within one year • Settling after one year 	<ul style="list-style-type: none"> • Required classification 	4-5	72-73

Statement of Comprehensive Income					
Item	Financial Statement Location	Components	Comments	10-Q Page	10-K Page
Effective portion of changes in cash flow hedge fair value	AOCI	<p>Two primary components (all activity required to be presented net of income tax impact):</p> <ul style="list-style-type: none"> • Effective portion of MTM (unrealized) changes in cash flow hedge fair values • Reclassification of hedge results to earnings 	<ul style="list-style-type: none"> • Gains = increases in AOCI • Losses = decreases in AOCI • • Reclassification occurs when the hedged transaction affects earnings • In essence, matches the realization of the hedge with the realization of the hedged transaction in earnings • Gains reclassified = decreases in AOCI/increases in earnings • Losses reclassified = increases in AOCI/decreases in earnings 	3	75

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Income statement					
Item	Financial Statement Location	Components	Comments	10-Q Page	10-K Page
MTM gains and losses • Trading activities	• Nonregulated revenues	• Net trading gains/losses	Always recorded in earnings in the period in which fair value changes	3	71
• Nontrading activities – purchase and sales contract	• Nonregulated revenues	• MTM gains/losses	Always recorded in earnings in the period in which fair value changes	3	71
Hedge gains and losses	AOCI	• Effective portion of unrealized change in fair value	• Effective change in FV of hedges deferred in equity until hedged transaction affects earnings	3	75
	Nonregulated revenues or purchased fuel and energy	• Ineffective portion of unrealized change in fair value	• Ineffective change in FV of hedges recognized in earnings immediately in the period in which fair value changes	3	71
	Nonregulated revenues or purchased fuel and energy	• Reclassification of realized hedge gains/losses from AOCI when hedged transaction affects earnings	• Hedges of forecasted sales recorded in nonregulated revenues • Hedges of forecasted purchases recorded in purchased fuel and energy	3	71, 75

Cash flow statement					
Item	Financial Statement Location	Components	Comments	10-Q Page	10-K Page
Cash flows from operations	Net income	Derivatives gains and losses included in net income	Both unrealized and realized	6	74
	Noncash adjustments to net income • Changes in derivative assets and liabilities	Unrealized portion removed in determining cash flow from operations	Removes noncash portion of derivatives gains and losses (i.e., unrealized amounts) included in net income. Results in reporting only realized gains and losses in computation of cash flows from operations	6	74
	Change in accounts receivable	Change in margin account • Initial margin • Variation margin	Includes change in cash from collateral on exchange-traded derivatives	6	74
	Changes in other current assets and liabilities	Change in obligation to return cash collateral or right to reclaim cash collateral	Includes change in cash from collateral on all non-exchange-traded derivatives	6	74
Investing cash flows	Portfolio acquisitions	At time of acquisition, cash paid for fair value of in-the-money acquired derivatives		6	74
Financing cash flows	Portfolio acquisitions	At time of acquisition, cash received for fair value of out-of-the-money acquired derivatives		6	74
		All subsequent cash flows on acquired contracts containing a significant financing aspect	Treatment required by Statement 133	6	74

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How derivatives are disclosed in our notes to financial statements and MD&A

Notes to Financial Statements					
Item	Footnote Location *	Components	Comments	10-Q Page	10-K Page
Revenue accounting policy	Note 1	<ul style="list-style-type: none"> • Accrual accounting for nonderivatives • Mark-to-market accounting when required for derivatives • Financial statement presentation of derivative assets and liabilities 	<ul style="list-style-type: none"> • Components of mark-to-market gains and losses • Valuation adjustments required to determine fair value 	N/A**	83-84
Derivatives and hedging accounting policy	Note 1	<ul style="list-style-type: none"> • Overall discussion of commodity price risk management and contracts • Hedging objectives 		N/A**	85-86
Hedging activities financial data	Note 13	<ul style="list-style-type: none"> • Effects of cash flow hedging <ul style="list-style-type: none"> • Effective portion of unrealized hedge gains/losses in AOCI at year-end • Amounts expected to be reclassified to earnings during subsequent 12 months as hedged transaction affects earnings • Losses recorded in earnings on hedges that ceased to qualify for hedge accounting • Hedge ineffectiveness recorded in earnings 		21	122-123
SFAS No. 157	Accounting standards adopted	<ul style="list-style-type: none"> • Summary of Statement 157 	<ul style="list-style-type: none"> • New disclosure beginning in 2008 upon required adoption of Statement 157 	22	N/A
		<ul style="list-style-type: none"> • Summary of fair value amounts in our balance sheet 		23	N/A
		<ul style="list-style-type: none"> • Details of fair value amounts by fair value hierarchy level 	<ul style="list-style-type: none"> • Assets and liabilities required to be disclosed on a gross basis • Gross amounts do not reflect credit netting benefits from master netting agreements or collateral • Netting and collateral included to reconcile table to balance sheet totals 	23	N/A
		<ul style="list-style-type: none"> • Explanations of fair value levels and how we determine fair value 		24	N/A
		<ul style="list-style-type: none"> • Reconciliation of changes in Level 3 (modeled) amounts 	Disclosure required by Statement 157	25	N/A
* Footnote numbers correspond to 10-K. In the 10-Q, notes are a single section and are not numbered					
** Accounting policies presented in the 10-K are not repeated quarterly in the 10-Q					

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Management's Discussion and Analysis (MD&A)					
Item	MD&A Location	Components	Comments	10-Q Page	10-K Page
Critical accounting policies	Accounting for Derivatives	<ul style="list-style-type: none"> • Similar to Note 1 • Factors affecting accounting treatment 	<ul style="list-style-type: none"> • Accounting for derivatives is one of our critical accounting policies 	30	36-38
Results of operations	Merchant energy business	<ul style="list-style-type: none"> • Summary of impact 		29-30	42
		<ul style="list-style-type: none"> • Mark to market results 	<ul style="list-style-type: none"> • Overview and major components <ul style="list-style-type: none"> • Origination gains • Unrealized MTM gains/losses • Realized gains/losses 	34	46-47
		<ul style="list-style-type: none"> • Summary of changes in derivative assets/liabilities 	<ul style="list-style-type: none"> • Basis for reconciliation discussed below 	35	47-48
		<ul style="list-style-type: none"> • Reconciliation of net MTM derivative asset • Represents bilateral derivatives recorded in separate derivative asset/liability line items on balance sheet • Changes in fair value recorded in earnings 	<ul style="list-style-type: none"> Rollforward of net change in derivatives asset/ liability • Agrees to components of MTM results <ul style="list-style-type: none"> • Beginning and ending balances exclude exchange traded derivatives recorded in accounts receivable • Earnings impact of exchange traded derivatives is a reconciling item • Cash transactions to buy/sell derivatives portfolios 	35-36	48
		<ul style="list-style-type: none"> • Composition of net MTM derivative asset by year and pricing source 	<ul style="list-style-type: none"> • In 10-Q, reflects fair value hierarchy implemented by Statement 157 	36-37	48-49

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Highlights of 2Q 2008 Derivatives Impacts

A number of factors impacted our second quarter 2008 Form 10-Q and the derivatives amounts and disclosures it included. The table below summarizes selected highlights from this document.

Selected Highlights of Second Quarter 2008 Derivatives Impacts				
Item	Location	Components	Comments	10-Q Page
Summary	Commodity Prices	<ul style="list-style-type: none"> • Commodity price volatility • Financial statement impacts • Capital requirements impacts 	<ul style="list-style-type: none"> • Overview of significant factors during the period as context for MD&A 	28
Mark to market gains	Mark to market	<ul style="list-style-type: none"> • Significant MTM gains – discussed on pages 34-35 • Long positions • Price increases produced gains • Approximately half of MTM gains were realized during the quarter 		34-35
Gains on hedges	AOCI	<ul style="list-style-type: none"> • Significant net unrealized gain on hedges 		3
Increase in derivatives assets and liabilities	Derivatives assets and liabilities	<ul style="list-style-type: none"> • Reflects commodity price increases primarily • Balance sheet fair value represents NPV of difference between contract price and market price • When prices increase, NPV (positive or negative) increases 	<ul style="list-style-type: none"> • See Appendix for examples of how and why price volatility affects fair value 	35
Increases in gross derivative asset/liability disclosures	SFAS No. 157	<ul style="list-style-type: none"> • Gross derivative assets and liabilities reflect increased fair value of each individual contract before credit and collateral netting • Illiquidity in markets contributes to higher amounts in Level 3 • Increased fair values increase credit exposure and collateral requirements 	<ul style="list-style-type: none"> • See Appendix for examples of how and why price volatility affects fair value 	23
Increased exposure to lower grade counterparties	Wholesale credit risk	<ul style="list-style-type: none"> • Primarily coal counterparties • Coal prices increased dramatically • Fair value of coal purchase hedges (primary fuel for generation) as percentage of total credit risk increased as a result 		48

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Appendix
Effect of Price Changes on Derivatives Assets and Liabilities
August 27, 2008

Changes in commodity prices can have a significant impact on the reported amounts of derivative assets and liabilities presented in the financial statements and footnote disclosures, as discussed earlier in this paper. The information in this Appendix is provided to illustrate the potential effects of these changes, assuming no changes in other factors such as the size of underlying positions or settlement of derivatives.

Commodity price changes have had a significant impact on derivative fair value measurements

- Derivative assets and liabilities (presented at fair value) may increase substantially
 - Derivative assets and liabilities reflect fair value of contracts with different parties
 - Fair value essentially reflects the present value of the difference between contract price and market price
 - Fair value increases as prices exceed contract price
 - In the money contracts are assets; out of the money contracts are liabilities
- Derivative gross balances before credit netting often will be substantially greater
 - Statement 157 requires footnote disclosure of gross assets and liabilities
 - These amounts increase by greater orders of magnitude because they are presented without regard to credit and collateral netting
 - The effect of netting to reconcile to the balance sheet will increase commensurately, reflecting the substantial risk-reduction benefits of maximizing credit netting with counterparties
- A portion of the derivative balance changes in the company's second quarter Form 10-Q due to price changes are consistent with impact of significant commodity price movements reflecting market conditions
 - Seasonal price changes
 - Global supply and demand factors

Illustrations

Assumptions

Changes in commodity market prices can have a significant effect on our financial statements and disclosures as illustrated below. For purposes of the illustration, assume a derivative portfolio that consists of three contracts with market prices at the end of each quarter as indicated. All contracts are assumed to settle within one year and therefore are classified as current assets or liabilities.

<u>Contract</u>	<u>Buy/ Sell</u>	<u>Quantity</u>	<u>Contract Price</u>	<u>3/31/XX</u>		<u>6/30/XX</u>	
				<u>Market Price</u>	<u>Fair Value</u>	<u>Market Price</u>	<u>Fair Value</u>
1	Buy	1,000	\$ 50.00	\$ 52.50	\$ 2,500	\$ 95.00	\$ 45,000
2	Buy	2,000	53.00	52.50	(1,000)	95.00	84,000
3	Sell	(3,000)	55.00	52.50	7,500	95.00	(120,000)
Net Position		<u>-</u>			<u>\$ 9,000</u>		<u>\$ 9,000</u>
Margin on settlement							
Revenue		\$ 165,000					
Cost		(156,000)					
Margin		<u>\$ 9,000</u>			<u>\$ 9,000</u>		<u>\$ 9,000</u>

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Key points to note regarding the foregoing assumed transactions that will form the basis for subsequent illustrations:

- The net economic position is flat, fully balanced, and is unaffected by price changes. As a result, the margin on settlement is locked in.
 - The economic position is fully balanced because quantities purchased equal quantities sold
 - The \$9,000 margin is locked in as a result of purchases being equal to sales
 - If market prices increase, gains on the purchase contracts will be exactly offset by losses on the sales contracts
 - If market prices decrease, losses on the purchase contracts will be exactly offset by gains on the sales contracts
- The assumed market price changes for purposes of determining fair value at the end of each period are representative of the order of magnitude of recent price changes.

The balance sheet impacts of the price changes between the two periods are illustrated first, followed by illustrations of the SFAS 157 footnote disclosure impacts.

Balance Sheet Impacts

Illustration 1 – Assuming Credit Netting

The derivatives illustrated above would be presented in the balance sheet as follows, assuming that Contracts 1 and 3 were executed with the same counterparty and the existence of a master netting agreement with that party. The increases in the gross balances are indicative of the conditions that occurred during the second quarter of 2008 that contributed to the increase in derivative assets and liabilities at June 30, 2008 as compared to March 31, 2008.

	<u>3/31/XX</u>	<u>6/30/XX</u>
Derivative Net Asset (Contracts 1 & 3)	\$ 10,000	\$ -
Derivative Asset (Contract 2)	-	84,000
Total Derivative Asset	<u>\$ 10,000</u>	<u>\$ 84,000</u>
Derivative Liability (Contract 2)	\$ (1,000)	\$ -
Derivative Net Liability (Contracts 1 & 3)	-	(75,000)
Total Derivative Liability	<u>\$ (1,000)</u>	<u>\$ (75,000)</u>
Net Derivative Asset	<u>\$ 9,000</u>	<u>\$ 9,000</u>

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Effect of Price Changes on Derivatives Assets and Liabilities
August 27, 2008

Illustration 2 – Assuming No Credit Netting

This example uses the same facts as Illustration 1 with one exception – the three contracts are assumed to be executed with different counterparties. Under this scenario, the derivatives illustrated above would be presented in the balance sheet as follows. As of 6/30, the gross balances are larger than in Illustration 1, highlighting that when buy and sell transactions are executed with different parties (for example, fuel hedges from gas marketers and power hedges with power traders), significant price changes can increase gross derivative assets and liabilities substantially with no change in the underlying economic position (net derivative asset is identical to Illustration 1). This also highlights the beneficial reduction in credit risk from maximizing credit netting under master agreements.

	<u>3/31/XX</u>	<u>6/30/XX</u>
Derivative Asset (Contract 1)	\$ 2,500	\$ 45,000
Derivative Asset (Contract 2)	-	84,000
Derivative Asset (Contract 3)	7,500	-
Total Derivative Asset	<u>\$ 10,000</u>	<u>\$ 129,000</u>
Derivative Liability (Contract 1)	\$ -	\$ -
Derivative Liability (Contract 2)	(1,000)	-
Derivative Liability (Contract 3)	-	(120,000)
Total Derivative Liability	<u>\$ (1,000)</u>	<u>\$ (120,000)</u>
Net Derivative Asset	<u>\$ 9,000</u>	<u>\$ 9,000</u>

Statement 157 Disclosure Impacts

Illustration 3 – Statement 157 Disclosure Impact

Regardless of whether or not derivatives are eligible for netting in the balance sheet, the footnote disclosures mandated by Statement 157 require gross presentation of all derivative assets separately from all derivative liabilities. The disclosure example below is presented assuming the use of credit netting as presented in Illustration 1 because this fact pattern is representative of Constellation’s credit netting activities. For simplicity, the tables in Illustration 3 do not divide the derivatives into the three levels in the fair value hierarchy under Statement 157. Rather, they simply show the total derivatives balance in total in order to highlight the impact of price changes on these disclosures. In our actual footnote disclosure, this impact is spread across the three levels based upon the appropriate classification of each derivative.

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The disclosures are presented separately in two tables:

- The first table presents the 3/31/XX reporting period
- The second table presents the 6/30/XX reporting period

<u>Period Ended 3/31/XX</u>	<u>Gross</u>	<u>Netting *</u>	<u>Net</u>
Derivative Asset (Contract 1)	\$ 2,500	\$ -	\$ 2,500
Derivative Asset (Contract 2)	-	-	-
Derivative Asset (Contract 3)	7,500	-	7,500
Total Derivative Asset	<u>\$ 10,000</u>	<u>\$ -</u>	<u>\$ 10,000</u>
Derivative Liability (Contract 1)	\$ -	\$ -	\$ -
Derivative Liability (Contract 2)	(1,000)	-	(1,000)
Derivative Liability (Contract 3)	-	-	-
Total Derivative Liability	<u>\$ (1,000)</u>	<u>\$ -</u>	<u>\$ (1,000)</u>
Net Derivative Asset	<u>\$ 9,000</u>	<u>\$ -</u>	<u>\$ 9,000</u>

* There is no netting impact at 3/31 because Contracts 1 and 3 with the same party are both assets.

<u>Period Ended 6/30/XX</u>	<u>Gross</u>	<u>Netting</u>	<u>Net</u>
Derivative Asset (Contract 1)	\$ 45,000	\$ (45,000)	\$ -
Derivative Asset (Contract 2)	84,000	-	84,000
Derivative Asset (Contract 3)	-	-	-
Total Derivative Asset	<u>\$ 129,000</u>	<u>\$ (45,000)</u>	<u>\$ 84,000</u>
Derivative Liability (Contract 1)	\$ -	\$ -	\$ -
Derivative Liability (Contract 2)	-	-	-
Derivative Liability (Contract 3)	(120,000)	45,000	(75,000)
Total Derivative Liability	<u>\$ (120,000)</u>	<u>\$ 45,000</u>	<u>\$ (75,000)</u>
Net Derivative Asset	<u>\$ 9,000</u>	<u>\$ -</u>	<u>\$ 9,000</u>

The foregoing illustration demonstrates that the difference in the magnitude of gross balances at the end of the second period as compared to the first is due to the impact of the substantial price increase between those dates. Because the gross amounts are presented prior to credit netting, the impact of the price increase is substantially greater than its effect on the net balance sheet amounts, consistent with the difference between the first two illustrations. In this regard, note that the net totals of derivative assets and derivative liabilities in the disclosure agree to the balance sheet presentation for Illustration 1, while the corresponding gross totals agree to the balance sheet presentation for Illustration 2.

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