



Good Morning. This is the Market Digest for Wednesday, August 30, 2006, with analysis of the financial markets and comments on **Prudential Financial Inc., Royal Dutch Shell plc, Constellation Energy Group Inc., DTE Energy Co. and Southern Co.**

IN THIS ISSUE:

- Value Stock: Prudential Financial Inc. has agreed to pay \$600 million in fines and compensation to settle various investigations into improper market timing of mutual fund trading.
- Value Stock: We are maintaining our 2006 earnings estimate on Royal Dutch Shell plc of \$7.35, but lowering our 2007 forecast by \$0.25 to \$7.50.
- UtilityScope: We are reiterating our BUY rating on Constellation Energy Group Inc. with a 12-month target price of \$70.
- UtilityScope: We are maintaining our BUY rating on DTE Energy Co. with a 12-month target price of \$49.
- UtilityScope: We are reiterating our BUY rating on Southern Co. with a 12-month target price of \$41.

MARKET REVIEW:

An afternoon recovery left the major indices in positive territory Tuesday despite an early downdraft created by much-lower-than-projected consumer sentiment data. According to the minutes of the latest FOMC meeting, the Fed considers further rate hikes possible, but most Fed members expect inflation pressures to ease over the next few months. Therefore, the committee decided to wait for more data before taking any further action. This release restored some of the market's confidence that any further hikes would not be anytime soon. This, along with a continued easing in oil prices to below \$70 per barrel, helped boost equities in late trading. Oil fell for the second day in a row, closing down \$0.90 at \$69.71 per barrel. The DJIA closed up 17.93 at 11,369.94; the S&P 500 gained 2.50 points to close at 1,304.28; and the Nasdaq composite finished regular trading higher by 11.60 at 2,172.30. Today, the market will get preliminary data for second-quarter GDP and the chain deflator, as well as the release of the latest crude inventories. (Kevin Calabrese)

PRUDENTIAL FINANCIAL INC. (NYSE: PRU, \$73.75) BUY

- Prudential Financial Inc. has agreed to pay \$600 million in fines and compensation to settle various investigations into improper market timing of mutual fund trading.
- The fines should not have a meaningful negative impact on earnings, but we do think the settlement, by ending uncertainty, could boost the stock price modestly in the near term.
- We are maintaining our BUY rating on Prudential with a 12-month target price of \$85.
- We are maintaining our 2006 EPS estimate of \$5.80, as well as our 2007 forecast of \$6.60. Our long-term growth rate estimate is 13%.
- We rate Prudential's financial strength as High.
- Prudential is trading at 11.2-times our 2007 EPS estimate and at 1.7-times estimated year-end book value.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on Prudential Financial Inc. (NYSE: PRU) with a 12-month target price of \$85. Our continued enthusiasm for the stock reflects positive fundamentals in the company's major business units, continuing aggressive share buybacks, the expectation of significant earnings contributions from the retail brokerage

operation, and strength in asset management operations. Our greatest concern is that retirement services earnings in 2006 are likely to be flat or grow only a little because of increased spending on sales and marketing. The recent settlement of investigations into market timing of mutual fund trading at Prudential ends a major source of uncertainty about future earnings, so we view the agreement as a modest positive.

RECENT DEVELOPMENTS

On August 28, Prudential announced that it had settled with the SEC, Nasdaq, the New York Stock Exchange, the attorneys general for Massachusetts and New York and other state authorities regarding their investigations into improper market timing of mutual fund trading on behalf of select clients. The company admitted to wrongdoing and will pay \$600 million, but it avoids criminal prosecution. Prudential will pay fines of \$330 million, as well as \$270 million for a fund to compensate parties harmed by the market timing during 1999-2003. Since the inception of the case in 2003, the company has accrued approximately \$390 million in related charges. Separately, the company has reserved approximately \$600 million for other legal issues related to the brokerage operation.

Going forward, we estimate that the financial advisory business will produce quarterly pretax operating earnings of \$30-\$50 million, depending on how well the domestic stock market performs. This forecast includes estimated quarterly legal costs of approximately \$30 million for ongoing issues, including arbitration cases – though we believe the worst of the company's legal troubles are behind it.

We are not changing our 2006 or 2007 earnings estimate as a result of this settlement, because we had already anticipated a charge of this magnitude. The 2006 consensus estimate could rise as a result of the settlement, but we do not expect the 2007 consensus to change significantly.

EARNINGS & GROWTH ANALYSIS

We are maintaining our 2006 EPS estimate of \$5.80, as well as our 2007 estimate of \$6.60. In 2005, Prudential posted operating earnings of \$4.83, up 34% year-over-year. Prior to the announcement of the settlement, the consensus estimates were \$5.76 for 2006 and \$6.54 for 2007. Management's guidance for 2006 operating earnings is \$5.50-\$5.70. Our five-year growth rate forecast for operating earnings remains 13%.

In the insurance division, which includes individual life, individual annuities and group insurance, we forecast earnings growth of 10% in 2006, versus an increase of 24% in 2005. We estimate a 10% improvement in individual life and annuity earnings, versus a 23% increase in 2005. We anticipate 3% earnings growth for group insurance, versus a 29% jump in 2005.

We project that investment earnings growth will be driven by gains in the asset management segment and the international insurance and investment segment. In asset management, we expect earnings to rise 30% this year, compared to 74% last year. For the retirement line, we forecast flat earnings after a 49% jump in 2005. We anticipate profits of \$45 million in the financial advisory segment, following 2005's loss of \$255 million. And for the international insurance and investment segment, we project earnings growth of 14%, versus a 42% increase in 2005.

We anticipate further share repurchases in 2006, for a weighted average diluted share count of 494 million, down from 521 million in 2005. In the first half of 2006, the company bought back 16.42 million shares at a cost of \$1.2 billion.

FINANCIAL STRENGTH

We rate the financial strength of Prudential as High. Moody's rates Prudential's long-term debt A3 and its short-term debt as P-2, while Standard & Poor's rates the same issues as A- and A-2, respectively. A.M. Best rates the company's long-term debt A-.

As for the company's claims-paying ability, Moody's assigns a mark of Aa3 to the rated subsidiaries, while Standard and Poor's has AA- ratings on all subsidiaries. A.M. Best has an A+ rating on the rated subsidiaries. These ratings have been stable for some time.

Prudential assets totaled \$361.9 billion at the end of the second quarter, with the investment portfolio at \$164 billion. Approximately \$6.3 billion, or 5.8%, of the \$108 billion fixed-income portfolio is rated below investment grade. Net unrealized pretax gains in the bond portfolio total \$216 million. Deferred policy-acquisition costs were on

the books at \$9.2 billion. The commercial loan portfolio of \$18 billion appears to be very seasoned and diversified. On the liability side, short- and long-term debt totaled \$17 billion at the close of the second quarter, versus stockholders' equity of \$20.4 billion. The debt/capital ratio is a very conservative 17.6%, versus 17.2% at the end of 2005. Management views 20% as a reasonable ceiling.

The company estimates that it has approximately \$2.3 billion of excess capital, including unused credit lines. However, under a broader definition of excess capital that could be used for an acquisition, the figure would jump to about \$10 billion in a number of scenarios, according to the company. Management expects share repurchases to continue at approximately \$625 million per quarter for the foreseeable future.

MANAGEMENT & RISKS

The most critical issues facing the company include normal economic and interest-rate risks; the potential for weaker economic activity in Japan or Korea; a large acquisition that might be viewed negatively by investors; SEC or NASD changes to rules dealing with the sale of retirement products such as annuities; and competition. We also note that the Japanese life insurance market is becoming more competitive, which will have an influence on Prudential's Japanese life operations. Finally, Prudential has exposure to a potential bird flu pandemic, which could affect the company's life insurance, annuity and financial advisory operations both in the United States and in Asian markets. At present, we do not see any significant short- or intermediate-term risks to the company's major product lines or business model.

COMPANY DESCRIPTION

Prudential Financial Inc. provides a wide range of financial services. Its focus is individual life insurance and investment products for consumers and institutions. Prudential completed its demutualization and IPO in December 2001. The company enjoys leading positions in a number of markets, including retirement services and individual life insurance, and it is expanding its life insurance and asset management activities in Asia. The company has \$670 billion of assets under management.

INDUSTRY

Prudential operates in a number of financial markets, including individual life and annuities, group insurance, retirement, asset management and retail brokerage. Important issues for participants in the life insurance industry include managing spreads on annuity and variable life products; developing new products, particularly in the annuity markets; coping with regulatory pressures, especially in international markets; and achieving asset growth at profitable margins in businesses such as retirement services and asset management.

VALUATION

Prudential, which went public in 2000, does not have an extended trading history for valuation purposes. PRU shares are trading at 11.2-times our 2007 EPS estimate, or about 83% of the projected P/E for the S&P 500. This compares to a peer average of 12.3. Prudential is trading at 1.7-times estimated year-end book value, versus the peer average ratio of 1.6. Our 12-month target price for PRU is \$85, which implies a P/E of 12.8-times our 2007 estimate.

The stock is up 1% year-to-date, following increases of 33% in 2005 and 32% in both 2004 and 2003.

On August 29, BUY-rated PRU closed at \$73.75, up \$0.03. (David Anthony, 8/29/06)

ROYAL DUTCH SHELL PLC (NYSE: RDS.A, \$70.19) HOLD

- We are maintaining our 2006 earnings estimate on Royal Dutch Shell plc of \$7.35, but lowering our 2007 forecast by \$0.25 to \$7.50.
- Second-quarter earnings were \$2.05 per diluted ADR, up 10% sequentially and 49% year-over-year.
- We are maintaining our HOLD rating on the ADRs of Royal Dutch Shell.
- We are lowering our financial strength rating to Medium-High, our second-best rating.

ANALYSIS

INVESTMENT THESIS

MARKET DIGEST

We are maintaining our HOLD rating on Royal Dutch Shell plc (NYSE: RDS.A). As we see it, the company has made progress in overcoming current challenges, but still has a long way to go. A company the size of Royal Dutch Shell takes a long time to turn in the right direction. The relative paucity of Shell's reserves may not impact its financial performance in the near to intermediate term, but it will make it increasingly difficult for the company to compete over the long run. While Shell is acting aggressively to address this issue, its plan makes it more dependent than peers on continued high oil prices and thus raises risks for investors.

RECENT DEVELOPMENTS

Shell's second-quarter results improved both sequentially and year-over-year on higher realized global oil and gas prices, though lower volumes and higher costs partly offset this benefit. Revenue net of sales and excise taxes was \$83 billion, up 9% sequentially and 1% year-over-year. Earnings from operations were \$6.7 billion, or \$2.05 per diluted share. This figure excludes Shell's \$500 million legal reserve for the potential settlement of class action litigation related to the overstatement of its hydrocarbon reserves, and a \$147 million benefit related to the mark-to-market revaluation of certain U.K. gas contracts. Net income was up 10% sequentially and 43% year-over-year. Upstream earnings were \$4.0 billion, up 7% sequentially and 46% year-over-year. Downstream earnings were \$2.1 billion, up 55% sequentially and 2% year-over-year. Compared to first-quarter earnings, second-quarter results were aided by stronger refining margins, particularly in the U.S., and increased trading profits. This improvement was partially offset by the negative contribution from lower retail marketing margins and lower refinery utilization, primarily in Europe.

Upstream production was 3,253 thousand barrels of oil equivalent (mboe/d). This compares to 3,746 mboe/d in the prior quarter and 3,526 mboe/d in the second quarter of 2005. Excluding the effect of security concerns in Nigeria, damage from last year's Gulf of Mexico hurricanes, and lower oil prices on production sharing contracts, production was unchanged from the year-ago quarter. Production out of the Gulf has been coming back on line over the last few quarters, though it is not yet back to pre-hurricane levels.

The realized price of crude was \$63.95 per barrel, up 11% sequentially and 33% year-over-year. The realized price of natural gas was \$4.82 per mcf. This was down 15% from the prior quarter, but up 10% from 2Q05.

Refining volume was 3,789 mb/d compared to 3,862 mb/d in the first quarter and 3,981 mb/d in the second quarter of 2005.

EARNINGS & GROWTH ANALYSIS

We are maintaining our 2006 earnings estimate of \$7.35 and lowering our 2007 forecast by \$0.25 to \$7.50. Although we have increased our crude oil price estimate for this year and next, Shell's problems in Nigeria continue, limiting production. However, stronger-than-anticipated refining margins should help offset the lower production.

Shell relies more heavily on natural gas than its peers. For the second quarter, natural gas represented 42% of production. Currently, natural gas trades at a significant discount to oil, a discount we believe will narrow. We expect average daily production in 2006 to be slightly above that of the second quarter. The company's goal is to bring production to near 4,000 mboe/d by 2009 and over 4,500 mboe/d by 2014. That's an annualized growth rate of about 3%, which seems achievable. But given the civil unrest in Nigeria and other regions where oil is abundant, many things have to go right for Shell to meet this target.

Shell has been an active acquirer of late, and we believe that it will continue to make acquisitions as it seeks to overcome its relatively meager proved reserves. The company recently purchased BlackRock Ventures, a Canadian oil sands producer, for \$2.2 billion.

Unlike its peers, Shell is more focused on unconventional sources of hydrocarbons. Approximately 5% of current production is from oil sands or gas-to-liquid technology. The company expects this figure to increase to 10%-15% of production by 2014. In the second quarter, Canadian oil sands accounted for nearly 1.5% of Shell's total production. We expect these operations to be a major source of growth. Shell made its final investment decision related to the Pearl gas-to-liquids project in Qatar, which should enable it to develop offshore natural gas from Qatar's North Field and convert it into clean liquid fuels and base oils.

The 2006 capital budget is \$19 billion, and should increase to about \$21 billion in 2007. The company spent some \$7.1 billion on capital projects in the second quarter, including the BlackRock Ventures acquisition. The budgeted amount is likely to grow due to oilfield service inflation, and is also higher than its peers on a relative basis. We believe that Shell's aggressive capex budget makes sense since the company has lower proved reserves than peers and needs to obtain new sources of oil and natural gas.

FINANCIAL STRENGTH & DIVIDEND

We are lowering our financial strength rating for Royal Dutch Shell from High to Medium-High, our second-best rating. S&P rates the company's long-term debt as AA. The company's total debt/capitalization ratio, including its off-balance sheet liabilities in the form of operating lease obligations, is 29%. Shell's aggressive capital spending program will also use significant capital. On a trailing four-quarter basis, earnings before interest and taxes (EBIT) cover interest by well over 100-times.

Shell pays a quarterly dividend in euros and then converts it into dollars. The dividend paid in the second quarter was \$0.6305 per ADR, which includes an 8% increase in the euro-denominated dividend. The dividend to be paid in the third quarter will be \$0.6308 per ADR, representing a 9% year-over-year increase. Depending on exchange rates, the annualized rate is about \$2.40-\$2.60 per ADR. At the midpoint of \$2.50, this would represent a current yield of about 3.6%, which is strong compared to peers. Our dividend estimates are \$2.50 for 2006 and \$2.60 for 2007. The company repurchased \$5 billion in stock in 2005. In the second quarter, \$2.5 billion was spent on share buybacks. Obviously, fluctuations in the dollar/euro exchange rate will have a significant impact on what is actually paid.

MANAGEMENT & RISKS

In our opinion, the company is on the road to recovery. We believe the unification of Royal Dutch and Shell into one company was a necessary step. Once that is complete, the task will be to drive the "Enterprise First Culture" (to use the term used by Group Chairman Jeroen van der Veer) down to the middle and lower levels of management. Creating a more responsive entrepreneurial culture in a company the size of Royal Dutch Shell is a monumental task and will take a long time.

Royal Dutch Shell faces a number of risks, including the possibility that volatile oil prices and refining margins may destabilize earnings.

In addition, the company operates in regions of the world where official corruption is endemic, heightening its exposure to unethical business practices. The company's operations may also be disrupted by political instability, as has recently been the case in Nigeria.

Shell often incurs higher costs than peers to find and produce new oil. For example, it may cost up to \$40 per barrel in capital and production costs to extract oil from Canada's tar sands. Moreover, as one of the world's largest energy companies, Shell will have a tough time finding enough new reserves to replace depleted ones.

Finally, like other major oil companies, Shell is exposed to significant environmental risks.

COMPANY DESCRIPTION

Royal Dutch Shell is the world's second-largest international petroleum enterprise and one of five "super majors." It operates in all phases of the industry, including production, transportation, refining and marketing, as well as petrochemicals. The company is headquartered in Amsterdam.

INDUSTRY

Our full-year 2006 estimate for the average price of West Texas Intermediate (WTI) crude oil is \$66 per barrel, with a trading range of \$58-\$84. Oil currently trades at about \$73. In 2007, we think WTI will average about \$67 per barrel. Crude oil averaged \$56.40 in 2005.

Our estimates are based on five factors. First, oil consumption continues to rise, driven by a still-expanding global economy. Modest demand growth of 1% annually in the period 2000-2003 rose to nearly 2.5% in 2004 and then jumped to almost 3% in 2005. In 2006 and on through 2008, we think prospects are good for annual growth in worldwide oil requirements to stay above the 1.9%-2.0% level. Second, traders are reacting to the fact that OPEC now has little spare capacity. As recently as three years ago, Saudi Arabia's spare production capacity was just over 2.6

million barrels per day; today it is less than 800,000 barrels per day. Third, even though U.S. inventory stocks of crude oil have risen almost 20% over the last 12 months (from 285 million barrels to over 340 million barrels), the growing challenge of reserve replacement for oil companies is driving prices higher. Throughout the 1990s, the international integrated oil group posted growth in proved reserves of about 6%-7% per year. Over the last three years, growth in proved reserves for the group has fallen to an average of just under 3%. Fourth, geopolitics continues to be of concern, with threats to the world's oil supply in such places as West Africa, Iran and Venezuela.

Our estimate for the average price of natural gas at the Henry Hub in 2006 is \$7.50 per thousand cubic feet (mcf). We project a trading range of \$5.25-\$11.00. Natural gas currently trades at about \$6.50 per mcf. In 2007, we think natural gas prices will average \$9.25 per mcf. In 2005, the average price was \$8.80.

VALUATION

RDS shares are trading at 9.5-times our 2006 earnings estimate and at 9.3-times our 2007 forecast. The stock is trading near the top of its 52-week range of \$57.79-\$72.38. Our valuation model is multistage, including peer analysis; relative valuation metrics; and discounted cash flow modeling. In terms of historical multiples, the company's trailing P/E of 8.6 is near the bottom of its five-year range of 7.4-25.0. On a price/cash flow basis, RDS.A is trading closer to the high end of its five-year range (3.4-8.4, with a current reading of 7.4). The shares are trading around the middle of their five-year price/sales range (0.4-0.9, with a current 0.7). (All ratios were calculated on a trailing four-quarter basis.) Shell pays a relatively generous dividend, increasing the shares' total return potential. Compared to other integrated oil companies, Shell is relatively inexpensive.

When compared to its peers, Shell's proven reserves are low, its reliance on natural gas is relatively high, and its gross and operating margins are also low. The company also has not fully recovered from the overhang caused by its overstatement of reserves and other management-related issues. Based on our discounted cash flow model and historical price metrics, the shares have room for appreciation. However, we also believe that the stock carries significant risks. As a result, we would like to see a decline in the share price, or more certainty about the success of the company's development projects before considering an upgrade.

On August 29, HOLD-rated RDS.A closed at \$70.19, down \$0.31. (Philip Weiss, CFA, CPA 8/29/06)

CONSTELLATION ENERGY GROUP INC. (NYSE: CEG, \$59.90) BUY

- We are reiterating our BUY rating on Constellation Energy Group Inc. with a 12-month target price of \$70.
- Our EPS estimates are \$3.95 for 2006 and \$4.80 for 2007.
- The company's annual dividend is \$1.51 per share, and our 2007 dividend estimate is \$1.61.
- We think this Maryland-based electric utility company continues to have above-average prospects for EPS and cash flow growth over the intermediate term.
- The company's non-regulated merchant energy subsidiary is growing market share and now counts 71 of the Fortune 100 as electricity customers.
- Our financial strength rating for the company is Medium-High, and our long-term EPS growth rate forecast is 8%.

ANALYSIS

INVESTMENT THESIS

We are reiterating our BUY rating on Constellation Energy Group Inc. (NYSE: CEG) with a 12-month target price of \$70. We think this Maryland-based electric utility holding company, with its strong platform of higher-return, non-regulated operations, continues to have strong prospects for above-average appreciation.

The company has well-managed regulated electric and gas distribution operations in Maryland (Baltimore Gas & Electric), growing merchant energy operations, a strong balance sheet, a solid focus on cost controls and has shed a number of unprofitable non-core and non-utility subsidiaries over the last five years. We expect kilowatt-hour sales growth at Constellation Energy of 1.8%-1.9% this year and next. Other positives are the company's highly efficient and well-operated nuclear generating units, the nationwide reach of the company's non-regulated sales of

electricity, and the stock's attractive valuation metrics.

Constellation Energy's strategy is to become a key regional energy provider. We expect the company to invest its growing cash flow in energy-related assets that have the potential for higher long-term returns. On the other hand, in the absence of attractive acquisition candidates, the company is likely to repurchase shares or pay down long-term debt.

Electric operations in the Constellation's core Baltimore Gas & Electric (BGE) business have improved in recent years as the company has lowered operating expenses and improved refueling performance at its well-managed and highly efficient Calvert Cliffs nuclear generating facility. The company has a growing service territory and balanced regulation, and its non-regulated merchant energy operations have not been tainted by any "Enron-style" management or accounting issues.

EARNINGS & GROWTH ANALYSIS

As discussed in our previous note, a significant rise in operating and maintenance expenses led operating earnings to drop to \$0.56 per share in 2Q06 from \$0.59 per share in 2Q05. Operating earnings exclude the impact of special items, synfuel earnings and certain economic hedges that do not qualify for hedge accounting. On a GAAP basis, the company earned \$0.52 per share, compared to \$0.68 per share in 2Q05. The cost factor involving fuel and purchased energy rose 31% to \$3.4 billion, and total expenses rose 29% to \$4.21 billion.

Despite the disappointing second quarter, we think management's strategies to grow the company are working quite well. Constellation Energy's core competencies in managing energy delivery systems, marketing and selling both natural gas and electricity, growing electric generating assets on the company's unregulated side, and successfully responding to customers in dense urban and suburban environments give the company an edge over the competition in its targeted markets, in our view. We think the CEG stock is an excellent opportunity for shareholders to realize continuing strong growth over the next several years. In accordance with recent company guidance, and based on results achieved in 2005 and so far this year, we estimate the company will earn \$3.95 per share in 2006 and \$4.80 per share in 2007. Our long-term EPS growth rate forecast is 8%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Constellation Energy is Medium-High, the second-highest rating on our five-point scale. In view of a healthy generating reserve margin at Baltimore Gas & Electric and the likelihood of BGE showing moderate growth in kilowatt-hour sales during the next several years, the company will not have to make any major additions to its base load generating capacity until late in the decade, in our estimation. The company is sound financially; its Calvert Cliffs nuclear units are among the highest rated in the industry; earnings are of high quality; and management, while increasingly relying on the diversified subsidiaries for consolidated earnings growth, continues to emphasize the core utility business. We estimate that 2006 cash flow will come in at around \$6.75 per share, more than enough to cover capital expenditures and dividend payments without having to rely significantly on external capital markets.

The company has again reaffirmed its commitment to growing the common dividend. We expect that with prudent external financing for future energy asset acquisitions and a continuation of moderate customer growth in the electric and gas distribution service territory, Constellation could earn 10.9%-11.4% on common equity, and perhaps a bit more from its interests in the non-regulated merchant energy operation.

The company's annual dividend is \$1.51 per share. Our estimate for 2007 is \$1.61 per share. Although CEG shares are not likely to advance much above our 12-month target price of \$70 in the near term, we believe that the yield of about 2.6%, though relatively low, is enough to give the share price a meaningful underpinning.

MANAGEMENT & RISKS

Management is committed to electric service expansion strategies initiated over the past several years and believes significant growth opportunities exist in the company's non-regulated Constellation Enterprises operation. And the company's purchases of quality assets from distressed energy merchants over the last four years should lead to meaningful growth opportunities. We are impressed with management's formation of a national energy risk

management business, which serves commercial and industrial customers. This operation already fits in nicely with the company's large wholesale generation operations. We think the company's platform for growth is solid, and are confident in management's ability to provide shareholders with increased value over the long-term.

Constellation's regulated electric and gas distribution operations will always be subject to the possibility of warmer-than-normal temperatures during the winter heating season or cooler-than-normal conditions during the summer air conditioning season. And while utility regulation in Maryland is generally fair and balanced, there is always the possibility that the state regulatory commission will lower the company's allowed return on common equity. Finally, in the case of the company's more risk-oriented, non-regulated electric generating operations, our consolidated earnings estimates for the company over the next two years could come under pressure if the nation's economy were to take a turn for the worse.

With regard to the company's core Baltimore Gas & Electric business, the attitudes and policies of any state regulatory commission have a significant impact on the utility's operating, financial and investment prospects. Over the last several years, Argus Research has viewed the regulatory climate in Maryland as above-average. Maryland rate orders, in our opinion, reflect a reasonable balance between the shareholders and the ratepayers. Positive aspects of Maryland regulation include interim rate awards, relatively prompt rate orders, and full consideration of updated test periods.

COMPANY DESCRIPTION

Constellation Energy is the nation's largest competitive supplier of electricity to large commercial and industrial customers and the nation's largest wholesale power seller. The company also manages fuels and energy services on behalf of energy intensive industries and utilities. It owns a diversified fleet of more than 100 generating units located throughout the United States, totaling approximately 12,000 megawatts of generating capacity. The company delivers electricity and natural gas through Baltimore Gas and Electric Co., its regulated utility in Central Maryland.

INDUSTRY

The last few years have been relatively uneventful for the electric utility sector compared to 2002 and 2003, when utilities were hurt by the Enron debacle, the California energy crisis and the near-financial collapse of the non-regulated, merchant energy trading segment. In 2004, utility managers began moving away from risky, high-growth endeavors and returned to the basics – the core businesses of providing electricity and natural gas in the most efficient manner possible. As a result, balance sheets in the industry are now generally healthier, and debt/capital ratios and companies' ability to service interest costs continue to improve.

VALUATION

Investors looking for a common stock with minimal risk should take note of Constellation Energy. The CEG shares, in our opinion, are an attractive investment for investors who want the security of regularly expanding dividend payments as well as the potential for moderate capital appreciation.

CEG stock is trading at 12.5-times our 2007 EPS estimate, a sizeable discount to the average multiple of its peer group of electric utility holding companies with growing non-regulated electric generating operations. We believe that the stock should trade at a premium to peers given the company's earnings growth prospects and strong financial position. Another plus is the company's fast-growing and well-operated non-regulated power division. Our 12-month target price for CEG is \$70 per share. This target, along with the dividend yield of 2.6%, suggests a potential 12-month total return of around 19%.

On August 29, BUY-rated CEG closed at \$59.90, up \$0.53. (Gary F. Hovis, 08/29/06)

DTE ENERGY CO. (NYSE: DTE, \$41.80) BUY

- We are maintaining our BUY rating on DTE Energy Co. with a 12-month target price of \$49.
- Our EPS estimates for DTE Energy are \$3.80 for 2006 and \$3.90 for 2007.
- DTE is conducting a performance review, which will likely lead to a restructuring of some operations.

- We think the company's dividend payout will remain at \$2.06 per share in 2007.
- Our financial strength rating for DTE Energy is Medium-High, and our long-term EPS growth rate estimate is 4%.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on DTE Energy Co. (NYSE: DTE) with a 12-month target price of \$49. At current prices, the shares are trading at 10.8-times our 2007 EPS estimate, well below the current peer group multiple.

DTE Energy continues to execute on its strategy, while also improving its balance sheet and strengthening its credit position. The company has received an electric rate increase of \$374 million and a gas rate increase of \$80.6 million. DTE Energy's core business strategy is also complemented by its well-balanced asset portfolio. As for the long term, we believe the company's electric and gas businesses are well-positioned to grow within the favorable demographics of the company's Michigan service territories.

Moreover, regulated electric and gas utility operations are improving, with kilowatt-hour sales expected to grow by 1.7%-1.8%, in line with industry norms. As for natural gas distribution, we look for throughput revenues to expand about 1.4% in both 2006 and 2007. In addition, depreciation expense is declining, and pension costs are under control. The company's highly efficient generating plants are another strong plus. Other factors expected to aid earnings growth in the near term are a decline in construction spending and an improving financial position, as well as the company's well-managed and highly integrated electric and gas distribution system.

EARNINGS & GROWTH ANALYSIS

As discussed in our previous note, DTE Energy posted an operating loss (excluding one-time items) of \$1 million or \$0.01 per share in 2Q06, compared to operating earnings of \$40 million or \$0.23 per share in 2Q05. The impact of high oil prices on the company's synfuel operations pressured earnings and may continue to do so for the next two or three quarters.

Meanwhile, the company is moving ahead with voluntary separations for approximately 350 employees, which is expected to generate \$50-\$100 million of savings for 2006.

We estimate the company will post EPS of \$3.80 in 2006 and \$3.90 in 2007. Our five-year average annual earnings growth rate estimate is 4%. Key assumptions in our earnings model include kilowatt-hour sales growth of 1.7%-1.8% per year and natural gas demand growth of at least 1.4% annually over the next several years. Economic growth is health in the company's electric and gas service territories. We expect continued solid growth in the company's higher-return, non-regulated power and industrial segment. Our model takes into account the company's strong record of maintaining cost controls. Other factors supporting our EPS estimates are the company's improving financial position, fair and balanced regulation, a well-maintained and efficiently operated electric generating and gas distribution plant, and management's demonstrated ability to execute across the board.

Finally, the company is actively developing opportunities in such areas as on-site energy, waste coal recovery, and power generating asset management services. These projects fit the company's criteria – they require low capital investment, they are low risk, and they build upon the company's core skills and assets. These businesses should serve as the basis for the future growth of DTE's non-regulated business portfolio.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for DTE Energy is Medium-High, the second-highest notch on our five-point scale. The company's bond ratings are investment grade. At the end of 2003, DTE's long-term debt/equity ratio was a high 61.4%. Taking into account the company's growing cash flow stream, our analysis shows that the debt/equity ratio should decline to a more favorable range of 51%-52% by the end of the year.

We view the company's annual dividend of \$2.06 per share as safe. However, it has held steady at this level for the last 13 years and we do not foresee any increases for another one-and-a-half to two years. In any case, the current dividend yield of 5.0% provides a good underpinning for the current stock price.

MANAGEMENT & RISKS

Management is committed to electric and gas service expansion strategies in its regulated service territories. We think the company's platform for growth is solid, and are confident in management's ability to provide shareholders with increased value over the long term.

The company's regulated utility operations will at times be subject to cooler-than-normal conditions during the summer air conditioning season and, in the case of the gas distribution business, the possibility of warmer-than-normal temperatures during the winter heating season. And while utility regulation in Michigan is generally balanced, it is always possible that regulators could lower the company's allowed return on common equity if they decide that the company is "earning too much" or if, for example, the commission removes a portion of a newly constructed generating plant from the rate base.

With regard to the company's core utility operations, the attitudes and policies of any state regulatory commission strongly affect a utility's operating, financial and investment prospects. Over the last several years, Argus Research has viewed the regulatory climate in Michigan as average in terms of decisions favorable to utilities.

COMPANY DESCRIPTION

DTE Energy is a Detroit-based diversified energy company involved in the development and management of energy-related businesses and services nationwide. Its operating units include Detroit Edison, an electric utility serving 2.2 million customers in Southeastern Michigan; MichCon, a natural gas utility serving 1.3 million customers in Michigan; and other non-utility, energy businesses focused on power and industrial projects, fuel transportation and marketing, and nontraditional gas production.

INDUSTRY

The last few years have been relatively uneventful for the electric utility sector compared to 2002 and 2003, when utilities were hurt by the Enron debacle, the California energy crisis and the near financial collapse of the non-regulated, merchant energy trading segment. In 2004, utility managers began moving away from risky, high-growth endeavors and returned to the basics – the core businesses of providing electricity and natural gas in the most efficient manner possible. As a result, balance sheets in the industry are now generally healthier, and debt/capital ratios and companies' ability to service interest costs continue to improve.

VALUATION

DTE shares are currently trading at just 10.8-times our 2007 EPS estimate, a sizable discount to the peer group average multiple. We believe the shares deserve a multiple at least in line with peer average, based on the company's growing financial strength, limited risk, visible earnings stream, and attractive, integrated structure. Our 12-month target price for DTE is \$49 per share. This target, along with the dividend yield of 5.0%, suggests a potential 12-month total return of more than 20%.

On August 29, BUY-rated DTE closed at \$41.80, up \$0.28. (Gary F. Hovis, 8/29/06)

SOUTHERN CO. (NYSE: SO, \$33.83) BUY

- We are reiterating our BUY rating on Southern Co. with a 12-month target price of \$41.
- We estimate the company will earn \$2.25 per share in 2006 and \$2.40 per share in 2007.
- Southern is adding new customers at an above-average rate, reflecting both growing economic activity and population increases in the company's service areas.
- We like Southern's strong balance sheet, its integrated structure, its earnings visibility, its high return on capital employed, and its status as a fully regulated utility.
- Our financial strength rating for Southern remains High, and our long-term earnings growth rate projection is 5%.

ANALYSIS

INVESTMENT THESIS

We are reiterating our BUY rating on Southern Co. (NYSE: SO) with a 12-month target price of \$41. Southern is adding new customers at an above-average rate, reflecting both growing economic activity and population increases

in the company's Southeast service areas. The company continues to lower operating and maintenance expenses and to improve its earnings visibility. We expect the company to deliver quality and stable results, including an above-average return on capital employed and a relatively low cost of capital. We think revenue will come in above \$13 billion in 2006.

Given Southern Company's growing balance sheet strength and its stable outlook from all three bond rating agencies, we expect annual dividend growth to be above average for several years. In our view, these factors should combine to generate total returns to shareholders of 10%-11% annually over the next three to four years.

EARNINGS & GROWTH ANALYSIS

As discussed in our previous note, the company reported second-quarter operating earnings (excluding investments in synthetic fuels) of \$0.53 per share, up from \$0.49 per share in the prior-year period. Electricity usage increased during the quarter as a result of continued customer growth and above-average temperatures in the Southeast in the early part of the summer. This was partially offset by higher operating and maintenance expenses.

We expect Southern to generate average annual earnings growth of 5% over the next five years. We look for retail kilowatt-hour sales to advance 2.2%-2.3% in 2006, which is above the rate we project for Southern's peers. In addition, the company should benefit from a continuing influx of industrial and commercial customers in its service areas. Ongoing operating efficiencies, cost controls, and low-cost coal and nuclear power production should also help Southern's performance. Southern's regulated utilities provide about 90% of its operating income. The company's competitive wholesale generation business, which continues to add long-term sales contracts to its portfolio, is also aiding earnings. Taken together, we expect these positives to offset the effects of power supply overcapacity in the Southeast.

We think the company's business plan is solid. Assuming continued favorable rate treatment and normal weather conditions in its service territories, we estimate the company will earn \$2.25 per share in 2006 and \$2.40 per share in 2007.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Southern remains High, the top of our five-point scale. The company's debt ratings are investment grade. Over the next three to four years, the company should generate sufficient cash flow to cover approximately 85% of planned construction expenditures. We see little need for significant equity issuances over the intermediate term, as Southern continues its disciplined approach to capital spending and timely rate relief filings.

Southern's annual dividend is \$1.55 per common share, which yields about 4.6%. Given the company's strong financial position, we anticipate dividend payouts of \$1.62 per share in 2007.

MANAGEMENT & RISKS

Management is committed to electric and gas service expansion strategies in the regulated service territories. It will purchase energy assets only after thorough due diligence. We think the company's platform for growth is solid and are confident in management's ability to provide shareholders with increased value over the long term.

Key risks for stocks in our electric utility universe include commodity price fluctuations, the effect of adverse weather on revenue, regulatory risk, and potential environmental and safety liabilities. Additionally, the capital-intensive nature of the utility industry creates ongoing liquidity risk that must be actively managed.

In the case of Southern, we would probably reduce our earnings estimates if the regional economies in Southern's service areas take a turn for the worse.

COMPANY DESCRIPTION

With 4.3 million customers and more than 40,000 megawatts of generating capacity, Atlanta-based Southern Co. is a super-regional energy company in the Southeast and a leading U.S. electricity producer. The company owns electric utilities in four states, a growing competitive generation company, an energy services business, a competitive retail natural gas business, and fiber optics and wireless communications assets. Southern Company brands are known for retail electric prices that are 15% below the national average. Southern Company has more than 500,000

shareholders, making its common stock one of the most widely held in the United States.

INDUSTRY

The last few years have been relatively uneventful for the electric utility sector compared to 2002 and 2003, when utilities were hurt by the Enron debacle, the California energy crisis and the near-financial collapse of the non-regulated, merchant energy trading segment. In 2004, utility managers began moving away from risky, high-growth endeavors and returned to the basics – the core businesses of providing electricity and natural gas in the most efficient manner possible. As a result, balance sheets in the industry are now generally healthier, and debt/capital ratios and companies' ability to service interest costs continue to improve.

VALUATION

SO is trading at 14.1-times our 2007 EPS estimate, a discount to its peers. We believe that Southern's strong finances, its manageable risk profile, its focus on regulated utility operations, its increasingly visible earnings stream and its solid experience with state regulatory commissions justify an above-average P/E multiple. Our 12-month target price is \$41 per share. This target, along with the stock's dividend yield of 4.6%, suggests a potential 12-month total return of about 20%.

On August 29, BUY-rated SO closed at \$33.83, down \$0.15. (Gary F. Hovis, 8/29/06)

Argus Research is an independent investment research provider and is not a member of the NASD or the SIPC. Argus Research is not a registered broker dealer and does not have investment banking operations. The Argus trademark, service mark and logo are the intellectual property of Argus Group Inc. The information contained in this research report is produced and copyrighted by Argus, and any unauthorized use, duplication, redistribution or disclosure is prohibited by law and can result in prosecution. The content of this report may be derived from Argus research reports, notes, or analyses. The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but Argus makes no representation as to their timeliness, accuracy or completeness or for their fitness for any particular purpose. This report is not an offer to sell or a solicitation of an offer to buy any security. The information and material presented in this report are for general information only and do not specifically address individual investment objectives, financial situations or the particular needs of any specific person who may receive this report. Investing in any security or investment strategies discussed may not be suitable for you and it is recommended that you consult an independent investment advisor. Nothing in this report constitutes individual investment, legal or tax advice. Argus may issue or may have issued other reports that are inconsistent with or may reach different conclusions than those represented in this report, and all opinions are reflective of judgments made on the original date of publication. Argus is under no obligation to ensure that other reports are brought to the attention of any recipient of this report. Argus shall accept no liability for any loss arising from the use of this report, nor shall Argus treat all recipients of this report as customers simply by virtue of their receipt of this material. Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance. Argus has provided independent research since 1934. Argus officers, employees, agents and/or affiliates may have positions in stocks discussed in this report. No Argus officers, employees, agents and/or affiliates may serve as officers or directors of covered companies, or may own more than one percent of a covered company's stock.
