Stuart J. Sweet, President **January 9, 2007**

HANDICAPPING PELOSI'S "100 HOURS" LEGISLATIVE AGENDA

This week, the Democratic Congress gets down to business, with the national spotlight beaming on Speaker Nancy Pelosi (D-CA). During the campaign, Pelosi promised that if the voters threw out the Republicans and installed a Democratic House majority, the House would pass her "Six for '06" proposals within "100 hours" of Democrats taking power. It is now Pelosi's turn to deliver. There is a high likelihood the House will do her bidding, although the term "100 hours" has been redefined to the first 100 hours the House is in session.

In sync with this promise, House Majority Leader Steny Hoyer (D-MD) has sent the following floor schedule to House Members.

House Floor Action	Legislation	Likely Outcome
Jan. 9 Debate H.R. 1	Implement the 9/11 Commission recommendations	Most remaining provisions enacted into law
Jan. 10 debate H.R. 2	Raise the minimum wage from $5.15/hr to $7.25/hr	**Expected to become law**
Jan. 11 Debate H.R. 3	Funding for embryonic stem cell research	Presidential veto, sustained by House
Jan. 12 Debate H.R. 4	Require HHS to negotiate for lower Medicare drug costs	Unlikely to become law
Jan. 17 Debate H.R. 5	Cut college student loan interest rates in half	**Narrowly focused bill has 60% chance of becoming law**
Jan 18 (in development)	Repeal oil industry tax breaks and renegotiate flawed offshore drilling leases	**Expected to become law**

<u>Nancy's In the Spotlight, But Harry's the One to Watch</u>

Passage by the House is not the same thing as passage in the Senate and signed into law by President Bush. The real power to decide the final shape of these bills, as well as almost all others, and their ultimate outcomes will rest primarily with Senate Majority Leader Harry Reid (D-NV) and George Bush. The reasons for this are the Senate filibuster and, to a lesser degree, presidential veto math.

Under Senate rules, almost all legislation is subject to a potential filibuster threat. It takes sixty votes to defeat one. Harry Reid has the smallest majority possible, 50 to 49, assuming that Independent Democrat Joe Lieberman votes with him. The 100th Senator, Tim Johnson (D-SD), is expected to remain hospitalized for much of the 110th Congress. As Majority Leader, Reid can decide which bills are put before the Senate and use his influence to get all Democrats to back him. However, it will prove very difficult to get the remaining 10 Senate Republican votes on any major bill to defeat a filibuster unless President Bush is satisfied that Reid has made enough concessions that a proposed compromise is worthy of becoming law with his signature. Never has a Majority Leader had to rely so much on the kindness of political strangers.

On those few occasions where Reid can get 10 Republicans to vote for legislation that Bush dislikes, Bush can use his veto. It takes 67 Senate votes to override one. With Senator Johnson (D-SD) incapacitated, at least 17 Senate Republicans must abandon Bush for Reid to prevail in a veto override. If getting 10 Senate GOP defections is tough, just imagine how hard it will be to get 17 Republicans to bolt. It will be an unusual day when Bush cannot count on 67 percent or more of Senate Republicans to back him up in a public veto override showdown. On those occasions where 17 GOP Senators do abandon him, the House is unlike to be his savior, with one possible exception being an override on federally funded embryonic stem cell research. That is because Bush must hold on to 73 percent of House Republicans in a veto override fight to prevail. If he cannot hold only 67 percent of GOP Senators, then the task of holding onto 73 percent House Republicans is even more daunting.

Speaker Pelosi can push bills through the House, almost at will, by writing bills that attract 218 votes from her 233 member party caucus. However, Senate filibuster rules and veto override math make it clear whether they become law will be decided by whether Harry Reid and George Bush reach compromises on amended versions of them. If they do not, then they will die.

CAN's advice to investors wanting to outperform by managing federal political risk better than the competition over the next two years: Watch what Harry Reid and President Bush say and do and pay less attention to Nancy Pelosi.

<u>You Can't Always Get What You Want – So Try To Get What You Need</u>

With the approval of Majority Leader Reid, Senate Democrats have declared their support for all of Pelosi' "Six for '06" legislative objectives, but they have not provided specific details on any of their companion proposals. The reticence of Senate Democrats to speak ahead of holding back channel discussions with the White House is understandable.

Here is an overview on the state of play of the five "Six for'06" Pelosi bills that should matter to investors.

Boosting the Minimum Wage: This proposal has the greatest likelihood of becoming law, possibly by February. With polls showing almost 80 percent approval for raising the minimum wage, President Bush already has announced his willingness to sign an increase into law. Therefore, Senator Reid and Bush already are in agreement that the federal minimum wage should be raised from $5.15 per hour to $7.25 per hour, over two years. The increase may be one of the first bills Bush signs in 2007. Senate Republicans will fall in behind Bush, but are likely to demand that restaurants, which are the businesses most adversely affected by raising the minimum wage, be protected by having their federal taxes lowered to mitigate the impact. Coming out of a Senate Democratic caucus last Friday, Senator Reid said, “If it takes adding small-business tax cuts to have a minimum wage increase, then we’ll do that.” Last Congress, the GOP proposed that restaurants write off new construction over 15 years, instead of the current 39 years, as the offset. If this pattern is repeated, then one vulnerable group of companies, amusement parks, may not be protected. They employ many minimum wage workers but only a fraction of their capital equipment may qualify for offsetting tax breaks. CAN recommends that investors steer clear of Cedar Fair’s (**FUN**) and Six Flags (**SIX**) roller coasters for this reason. It also will nick performance of Universal Studios, Anheuser-Busch, and Disney which have amusement park divisions.

Boosting Federal Embryonic Stem Cell Research Funding: The only bill President Bush has vetoed was one that increased federal funding for embryonic stem cell research. With 290 votes needed to override him in the House, his veto of H.R. 810 was sustained on July 19, 2006, 235 to 193, 55 votes short. Unless Bush is presented with a bill more to his liking, he likely will veto another bill soon and have it sustained by the House – this time with only 25 votes to spare. Senate Majority Leader Reid has said nothing about a compromise so far and has tentatively scheduled a Senate floor vote on expanded funding embryonic stem cell for February or March, making another veto likely. There is a slim chance Reid will surprise Washington and entice President Bush by adding to the bill a cloning ban, federal funding for embryo adoption, stronger informed consent language, or greater federal regulatory oversight of embryonic research. Speculators might consider taking a flyer on **(STEM)** now with expectations of a compromise almost non-existent. More likely, speculators will be rewarded in March 2008 when it becomes clear that both the Republican and Democratic presidential candidates support embryonic stem cell funding. At that point, higher funding will be “locked in.” The House, Senate, and the 44th president will all back such funding.

Mandating HHS Negotiations over Medicare Drug Pricing: Democratic critics of the new Medicare Part D drug benefit believe that taxpayers can save money if the federal government were to use its bargaining power to force drug companies to sell their wares to Medicare at more reasonable prices. The idea has drawn a Bush veto threat. Reality is overpowering theory, however. Insurance companies offering federally-subsidized Part D plans have been fierce negotiators and pressed drug companies to make concessions, driving down insurance company costs sharply per enrolled senior. They are passing on these savings to the taxpayers by lowering their bids to Medicare for covering seniors’ outpatient drug costs. Just this week, Medicare predicted that the ten-year Part D program costs will come in 30 percent below previously estimated, with 80 percent of the difference due to lower insurance company bid submissions. There are only two ways to “save money” now. The first option would create a highly restrictive Part D formulary, selecting a single drug for every theraputic class out of several possible choices, based on lowest price. The second would remove drugs with unique theraputic value from Part D because of cost. With 80 percent of seniors happy with the drug plan according to the Kaiser Family Foundation, either idea will ignite a firestorm of protest from seniors. Expect Senator Reid to save face by offering Bush a weakened proposal, perhaps mandating that the Department of Health and Human Services negotiate with drug companies to lower Part D costs in some circumstances. However, there will be no enforcement if Bush agrees to make a watered down bill law, and the Department “fails” to secure more price discounts.

Cut college student loan interest rates in half: Lenders participating in the federally guaranteed loan program charge college students 6.8 percent but collect more interest revenue from the government when lender funding costs are high. If all college student borrowers using the program were to pay 3.4 percent interest instead, with the federal government paying lenders another 3.4 percent or more, it would cost the government $6 billion annually. This is more than House Democrats can comfortably pay for, given their commitment to "pay-as-you go" budgeting. As a result, Speaker Pelosi and House Democrats have decided to scale this commitment way back. The 3.4 percent rate would apply only to new loans made to needy undergraduate students. Furthermore, the reduced interest rate would be phased-in over five years. Pelosi has not specified how House Democrats would pay for this vastly weaker proposal which carries only a $1 billion annual cost. Possible ideas include demanding that lenders absorb a larger share of student loan default expenses or boosting lender origination fees. Reid supports lowering student loan interest rates but has provided no specifics. However, student lenders took several legislative hits last Congress, and Bush's appetite to cut their profits again so soon is probably not very high. Reid and Bush might agree to limited new lender concessions but major pain is unlikely. Sallie Mae's (**SLM**) stock price probably factors in more danger than actually exists.

Revisit flawed offshore drilling leases and repeal 2004 and 2005 oil industry tax breaks: First, Democrats want to open negotiations on lease agreements made nearly a decade ago. In 1995, the Republican Congress and the Clinton Administration wanted to encourage deep water oil and gas exploration of the Gulf of Mexico. With oil prices around $24 per barrel, little Gulf deep water drilling was taking place because many companies viewed such drilling as expensive and risky. The GOP Congress and the Clinton Administration decided the inducement should be forbearance on federal royalty payments unless oil prices rose above $36 per barrel and the flow of oil or gas from a given deep water lease also proved significant. In 1998 and 1999, Clinton officials inside the Interior Department were careless, and inadvertently left out the royalty payment trigger provisions on 1,023 deep water leases. While the oversight was corrected on subsequent leases, the blunder so far has cost the Treasury $2 billion. Over the next 20 years, the total cost could rise to $10 billion. Democrats want to force the oil and gas companies to pay royalties retroactively. Republicans want royalty provisions to apply prospectively, reclaiming $8 billion, not the full $10 billion. Both want to make an offer the companies can not refuse: Pay up or be shut out of all future federal lease auctions. The differences between Senator Reid and the Administration are bridgeable.

Second, at a time of high oil prices, Senator Reid and President Bush join with House Democrats to argue that the oil and gas industry does not need targeted tax breaks. Both want to repeal a provision of the 2005 Energy Bill that allows oil field investments to be expensed, instead of capitalized and depreciated. On April 27, 2006, Senator Reid used this quote from President Bush while introducing S. 2672: "Record oil prices mean that Congress has to understand that these energy companies don't need unnecessary tax breaks like the write-offs of certain geological and geophysical expenditures, or the use of taxpayers' money to subsidize energy companies' research into deep water drilling. I'm looking forward to Congress to take about $2 billion of these tax breaks out of the budget over a 10-year period of time." Finally, in 2004, Congress passed H.R. 4520, the American Jobs Creation Act of 2004, which sought to hold harmless domestic manufacturers from a WTO ruling that compelled Congress to repeal export tax credit laws. Congress complied, but it also passed a law that phased in a reduction in the manufacturers' corporate income tax rate from 35 percent to 31.85 percent by 2009. Although oil and gas companies were almost unaffected by the WTO ruling because little domestically produced U.S. oil and gas is exported, their lobbyists succeeded in having them defined as "manufacturers" eligible for the reduced tax rate. House Democrats want to restore the 35 percent corporate tax rate for the domestic production of oil and gas. In after-tax terms, repeal would harm domestic oil and gas producers the most and the major oil companies the least. Reid and Bush have not addressed this tax issue yet. Therefore, the outcome is uncertain. Investors should underweight independent domestic producers until the uncertainty ends.

<u>The New Congress Opens in Noisy Fanfare, But its Rhetoric will (Mostly) Fade to Echoes</u>

Shareholders of publicly held companies have little to fear from the "100 Hours" because either the Senate or Present Bush, and maybe both, will water most of them down.

- The minimum wage increase bill will hurt amusement park operators and drive up labor costs negligibly for other public companies.
- Investors in the few public stem cells ventures can expect a White House veto.
- The market has probably already discounted the impact of asking student lenders to make concessions to boost college student loan interest subsidies.
- Drug negotiation mandates will only pass with loopholes that neuter enforcement.
- The industry to watch is oil and gas. Democratic House leaders are making the final revisions to their industry-specific tax increase bill later this week. Independent domestic producers appear most at risk.

For further analysis or information, contact Capitol Analysts Network, Inc. at:
2000 P Street, N.W.
Suite 615
Washington, D.C. 20036
Phone: 202-223-4014
Fax: 202-223-4243
Email: capnet@xecu.net
website: www.capitolanalysts.com