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Stuart J. Sweet, President

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UNFINISHED BUSINESS AFTER THE GOP COLLAPSE

With two House races left to be decided, the rock slide that engulfed 29 House and 6 Senate Republican candidates Tuesday night may not have claimed its final victims. The good news for the House GOP is that the bad news could have been worse. They could have lost 42 seats instead of 29; House Republican candidates squeaked by in another 13 races. Life for congressional GOP survivors will be painful. It does not matter that George Bush's careless use of political nitroglycerin triggered the disaster. Regardless of the cause, the American people have stripped them of much of their power – which for many, who just three days ago were called “Mr. Chairman,” is a form of political death.

President Bush did not escape, either. Half of the White House lies buried, and he will spend his remaining time in office digging out – a task he will not complete before turning 1600 Pennsylvania Avenue over to the next occupant in two years. As penance for political manslaughter, George W. will spend his remaining time in office suffering through painfully low approval numbers and watching the policy initiative pass to the new Democratic masters of Capitol Hill. Later, he will become little more than a bystander when Republicans choose their new leader, their president nominee, in the spring of 2008. It is likely to be Bush critic, Senator John McCain (R-AZ).

Bush's political punishment will be severe because Republicans lost the Senate as well as the House. If the GOP had held on to the upper chamber, then Speaker Pelosi's legislative initiatives would have little chance of reaching his desk. However, neither Speaker Denny Hastert (R-IL) nor Senate Majority Leader Bill Frist (R-TN) are there to protect him anymore, and the pent up legislative energy of congressional Democrats who have been out of power for twelve years will be felt in the fullness of time.

In an irony worthy of an ancient Greek playwright, George Bush became president in 2000 because Ralph Nader split the liberal vote in Florida. Starting November 2006, Bush's political woes multiply because Democrats took over the Senate, 51-49. The agent of Bush's heightened misfortune is the invisible Libertarian candidate from Montana, Stan Jones, who siphoned off three percent of the vote from Conrad Burns (R-MT), just barely making Jon Tester (D-MT) the 51st Democratic Senator. To paraphrase the Greek poets, those whom the gods elevate, they later humiliate.

Roasting The Lame Duck at Thanksgiving

The 109th Congress is not yet over, and investors should keep a close eye on Washington even though the election excitement has ended. When Congress reconvenes next week to complete action on ten appropriations bills, investors should pay close attention to the Gulf of Mexico. Before the lame duck Congress finishes in December, the odds favor that Congress will

give final approval to a bill making an area the size of Maryland open to oil and gas drilling. Congress also may approve the U.S.-India nuclear accord, and hurt Medicare providers. It appears that legislation to reform the regulatory apparatus for Fannie Mae and Freddie Mac will not become law, however.

Deepwater Oil and Gas Drilling in the Gulf of Mexico

After a year of exhaustive bi-partisan negotiations, the Senate approved S. 3711 on August 1, 2006, the Gulf of Mexico Energy Security Act. The bill makes available two large deep water in the Gulf of Mexico tracks known as "Lease Sale 181" and "181 South." The parcels begin approximately 150 miles south of the Alabama/Florida border and form two misshapen rectangles on top of each other that extend southward almost to the tip of Florida, but also stay 150 miles west of the State.

If it becomes law, the Senate passed proposal will break a 25 year federal prohibition on oil and gas drilling in the eastern Gulf of Mexico and represent a break with the past. Currently, 85 percent of America's territorial waters legally can not be drilled for oil or gas.

In June 2006, when the House GOP was confident its majority was safe, the House passed H.R. 4761, which would open up federal offshore water acreage throughout the Gulf and also off the Atlantic Coast, provided nearby states agreed. They are incented to do so, by receiving a generous portion of formerly federal-only royalty revenue.

Last summer, the Chairman of the House Resources Committee, Richard Pombo (R-CA), was dismissive of the Senate proposal, promising he would force the Senate to make the final bill that went to Bush for his signature more industry friendly. Meanwhile, the Senate authors of S. 3711, led by Energy Chairman Pete Domenici (R-NM), warned Pombo that a successful filibuster awaited any bill that expanded drilling beyond what the Senate had laboriously produced. Pombo did not seem to care, and created the impression he might walk away rather than limit the oil and gas industry's gains to just the amount provided by the Senate. Tuesday night, however, Pombo lost – the only GOP Chairman, and the only Californian, to do so.

While Pombo packs up his memorabilia, Senate Majority Leader in waiting, Harry Reid (D-NV), reiterates his support for passing S. 3711. So has President Bush. Given that S. 3711 will become law if the House GOP passes the Senate bill, as is, and sends it an eager Bush who wants to sign it, investors should consider taking the risk that Reid, Bush, and industry lobbyists will prevail. It looks like oil and gas drilling will take place in "Lease Sale 181" and 181 South.

There may be purer plays, but it appears that Transocean (**RIG**), GlobalSanteFe (**GSF**), Diamond Offshore Drilling (**DO**), and Noble (**NE**) should welcome these developments as owners of the nation's largest deep water drilling fleets. Another possible winner may be Enterprise Products (**EPD**) along with other owners of oil and gas pipelines near the eastern Gulf of Mexico and also companies that assist drillers and pipeline owners working in the Gulf.

A Warning to Medicare Providers: Congress Has Not Gone Home Yet

Before Congress recessed for the elections, both Republican and Democratic leaders promised to help doctors avoid taking five percent cuts on the Medicare patients they treat. Medicare pays doctors based on a peculiar funding formula tied to changes in nominal GDP. They have liked it when the formula has generated generous increases. Now, the formula is generating pay reduction signals, and they want Congress to hold them harmless. The cost would be \$13 billion over five years.

When Congress has needed funds to fix a Medicare underfunding problem in the past, often it has cut compensation to Medicare providers who are doing better than federal cost accountants say they have to do. If this is the approach taken in the lame duck session to “fix the doctors’ problem,” then shareholders of skilled nursing homes, home health care, durable medical equipment, and hospitals, look out. CAN recommends under weighting Medicare providers until it is clear who will pay to make the doctors whole.

The GSE’s: Fannie and Freddie Enjoy Election Night

It was the Clinton Administration that gave the green light to the GSE’s when they sought massively to expand their balance sheets. Prior to Treasury Secretary Robert Rubin’s tenure, the GSE’s made money the way people expected them to do so. They purchased mortgages originated by savings institutions, bundled them into mortgage-back securities for sale to institutional investors, and made money two ways, by charging mark-ups for the bundles and for charging fees for guaranteeing the timely payment of all interest and principal providing credit enhancement.

They still do these things. However, thanks to the Clinton Administration the housing GSE’s now make even more money simply by buying and holding mortgages, earning a spread on \$1.4 trillion in mortgages by funding their holdings with dirt cheap debt because their bond holders believe such instruments carry the implied guarantee of the U.S. government. Congressional Democrats overwhelmingly seem to favor letting Fannie and Freddie earn these spreads, or even to let them grow back to their pre-scandal sizes, while the Bush Administration wants them cut down to \$200 billion or so.

The markets assume that a weakened White House is less likely to make good on its threat to rein in the GSE’s portfolios by Treasury regulation or that a compromise legislative solution driven by Senate Republicans that also would reduce “portfolio lending” is likely to become law. Shares of Fannie and Freddie have risen accordingly.

It appears likely that no GSE reform legislation will pass during the lame duck session. The Senate Democrats’ leader on banking issues, Senator Paul Sarbanes (D-MD), is showing no interest in moving a bill now. In the three weeks that the lame duck will be in session, any determined Senator probably could kill GSE reform legislation. Sarbanes certainly can. It looks like he will.

A Passage to India

Both India and the United States are watching the rise of China with concern. Strategic ties between the two countries are improving rapidly. Before ties can blossom fully, however, the U.S. must first amend the Atomic Energy Act. The Act bans the export of nuclear material to nations that have not signed the Nuclear Non-Proliferation Treaty of 1970. India never signed the Treaty and, worse, succeeded in developing nuclear weapons. The Administration believes the best way to advance American security interests is to guarantee the Indians a secure source of nuclear fuel to be used solely in India's civilian nuclear energy program. This cannot be done unless the Atomic Energy Act is amended.

The House approved such amendments in July, as has the Senate Foreign Relations Committee. Democratic Senator Majority Leader-in-waiting, Harry Reid, agrees with Senate Republican leaders and the White House that the amendments should become law during the lame duck session.

Tentative plans have been made to bring the matter to the Senate floor *next* Wednesday or Thursday. It will be a test of Reid's skill and power as leader to see if he can persuade Senator Barbara Boxer (D-CA) and Senator Russ Feingold (D-WI) to let the amendments pass. If either filibusters, then the outcome is placed in doubt due to the limited time left before final adjournment. The odds favors that Reid will prevail before final adjournment in mid-December. Therefore, speculators may wish to purchase Indian ADRs, hoping to benefit if the Sensex rallies on news that the U.S.-India relationship will move forward.

Opening Business in 2007: The 100 Hour Pledge

Speaker-in-waiting Nancy Pelosi (D-CA) has already published the agenda she plans to undertake immediately upon seizing the House gavel: increase the minimum wage; give the government authority to negotiate drug prices for Medicare Part D; mandate and fund the port security recommendations of the 9/11 Commission; expand federal funding for stem cell research; cut student loan rates; and repeal "Big Oil" tax breaks. This list is a measure of how much the legislative environment will change because of the election. The House GOP opposes all six ideas, but all six will clear the House easily in early January.

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
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