

WASHINGTON WEEKLY

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Demography Rules

President Bush deserves credit for jump-starting the conversation over how best to change national policy to accommodate the pending first wave of baby boomer retirements, which will affect public and private decisions as no demographic event has done before it. The facts that Bush has not risked providing a detailed roadmap and that many of his early ideas have not gained much traction indicate that consensus building will take time. Three developments support this notion.

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Speaker Dennis Hastert (R-IL)
are the most recent voices to
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First, the administration's early marketing strategy for catalyzing quick action by couching the challenge as a "crisis" has been rejected by important policymakers and a majority of Americans. Federal Reserve Chairman Alan Greenspan and Speaker Dennis Hastert (R-IL) are the most recent voices to advocate a methodical, rather than hurried, pace. In less than a quarter, expectations in markets and on Capitol Hill have trended away from urgent action.

Second, many politicians of both parties now are embracing a more comprehensive approach when contemplating policy changes that will affect the country over a protracted period. House Ways and Means Committee Chairman Bill Thomas (R-CA) was the first GOP leader to publicly force this issue. His position has been advocated by several observers for many years, and it is gaining favor among politicians who would just as soon avoid making tough choices and by others who believe that too much is at stake to artificially speed the process.

Also in This Issue

Capital Calls

Congress sends the President a class-action reform bill, while Greenspan stirs the debates over deficits and housing GSEs.

Polling Place

Americans give even marks to Congress's job, even as the President's numbers take a tumble. Support for new resources of domestic oil is strong.

Health Care: The D.C. Pulse

A new FDA commissioner-nominee is an experienced hand at the agency.

Geopolitical Risks

We view events in Lebanon last week as horrific, regrettable proof of slow, uneven change in the Middle East.

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AND IMPORTANT DISCLOSURES.**

Capital Calls

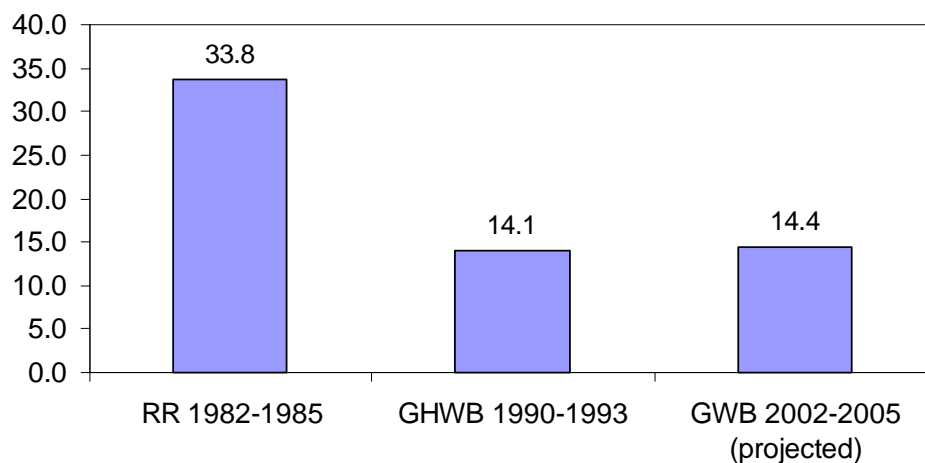
ISSUE	RECENT DEVELOPMENTS	OUR CALL	EFFECT
Bankruptcy Reform	<ul style="list-style-type: none"> Senate Judiciary Committee passed bill by 12-5, providing momentum Legislation is queued up for Senate floor action after the Presidents' Day break 	<ul style="list-style-type: none"> Call: 60% for passage in 2005 Timing: 1Q05 for Senate action Catalyst: Senate floor consideration Risks: Schumer anti-abortion protester amendment 	<ul style="list-style-type: none"> Volatility: Moderate Impact: Positive for financial services, especially credit cards, automotive finance, and retail
GSEs	<ul style="list-style-type: none"> House Financial Services Chairman Oxley (R-OH) said, "every issue has its time—it is time for GSE reform" Fed Chairman Greenspan provided details on his position on limiting portfolio growth 	<ul style="list-style-type: none"> Call: Senate passage of regulatory reform bill Timing: 1H05 Catalyst: Legislative hearings Risks: Senate, House, or administration overreaching beyond thrust of Shelby's bill, causing a slower process and possibly hurting consensus reform effort 	<ul style="list-style-type: none"> Volatility: Moderate Impact: Negligible once markets adjust to high likelihood of change, including receivership, which all federal financial regulators possess
Tort Reform	<ul style="list-style-type: none"> House passage of class-action reform bill Senate Judiciary Chairman Specter (R-PA) diagnosed with Hodgkin's disease Senators Feinstein (D-CA) and Cornyn (R-TX) seeking to find consensus on two asbestos bills 	<ul style="list-style-type: none"> Call: Class action signed by Bush; asbestos probability approximately 25% Timing: 1H05 Catalyst: Specter introducing asbestos bill Risks: An unlikely last-minute hiccup in the House; quick stakeholder consensus for asbestos bill passage would surprise 	<ul style="list-style-type: none"> Volatility: Moderate Impact: Lack of a federal fix maintains irrational system and legal exposure for affected companies
Energy Utilities	<ul style="list-style-type: none"> Senate EPW markup postponed, committee deadlocked Inhofe offered to add approximately \$700M for coal-gasification technology in bid for Democratic support; additional offers could generate volatility 	<ul style="list-style-type: none"> Call: Passage Unlikely Timing: 1Q legislative debate Catalyst: Potential Senate EPW markup; March 15 EPA HG rule and March 31 CAIR rule deadlines Risks: CO2 included in a compromise bill 	<ul style="list-style-type: none"> Volatility: Low Impact: Positive for utilities if Clear Skies passes, negative if regulating CO2 is included to forge compromise
Health Care Drug Reimportation	<ul style="list-style-type: none"> Senate HELP holds two hearings, Chairman Enzi (R-WY) appears reluctant to support Bush budget includes 5% reduction in inspections of foreign manufacturing plants 	<ul style="list-style-type: none"> Call: 55% likelihood of passage in this Congress Timing: Quicker action in Senate, likely prolonged in House Catalyst: Senate HELP markup Risks: Leadership allows bill to move forward 	<ul style="list-style-type: none"> Volatility: Moderate Impact: Negative for pharma, depends on scope of proposal; positive for RFID technology developers
Social Security	<ul style="list-style-type: none"> President signals openness to increasing taxable wage base to attempt to jumpstart effort; GOP leaders oppose Bill introduced to place CDs into the mix should individual accounts move 	<ul style="list-style-type: none"> Call: Privatization remains an uphill climb with solid Democratic opposition given the Senate's 60-vote hurdle Timing: No action likely until 4Q05 at earliest Catalyst: A crack in Democratic solidity if President's pressure is effective or, alternatively, Republican retreat if public remains skeptical Risks: Deadlock as positions harden 	<ul style="list-style-type: none"> Volatility: Low Impact: Fiscal scenarios range from sharp short-term deterioration to start of long-term structural improvement Sector impacts depend on design
Deficit Reduction	<ul style="list-style-type: none"> Hill budget leaders begin discussing reconciliation, fast-track procedures to cut entitlement spending; talk creates less pushback than it did in previous years, with one vocal exception of agriculture subsidies 	<ul style="list-style-type: none"> Call: Modest entitlement cutting package is possible, begins at low probability, facing crowded calendar Timing: Early March Catalyst: New GOP Senate vote cushion makes budget passage easier, sparking aggressive reach Risks: Social Security debate fills calendar 	<ul style="list-style-type: none"> Volatility: Moderate Impact: Medicaid reductions have negative impact on drug retailers and hospitals

Source: Lehman Brothers

This collection of IOUs is the second-fastest four-year rate of debt accumulation in nearly half a century.

Third, the President's budget and fiscal policies are compelling a measured approach. Net federal debt for which taxpayers are ultimately responsible has grown more than 14% as a share of GDP over the four years during which Bush's policies were the primary influence. This collection of IOUs is the second-fastest four-year rate of debt accumulation in nearly half a century, exceeded in modern times only by former President Reagan. Notably, Bush's debt has come during a historically low-rate environment and on the backs of the largest surplus in the post-World Wars era. The growth rate almost matches that of his father, the 41st President.

Partisan and Familial Similarities: The Three Periods of Fastest U.S. Debt Accumulation, 1945–2005 (percentage)



Source: Congressional Budget Office

We continue to argue that \$500 billion deficits this year and next, assuming FY05 and FY06 war supplementals of around \$80 billion each year, will complicate borrowing \$2 trillion without concrete deficit-reduction proposals. Add to this weight Bush's recent veto threat of attempts to reduce costs of the not-yet-implemented Medicare prescription drug benefit, and it becomes easier to understand the bicameral, bipartisan pushback to creating more debt for another entitlement program.

Under all scenarios that assume current policies, outlays for Medicare and Medicaid (primarily Medicare) will increasingly encroach on all other categories.

The table on page 4 shows intermediate- and longer-term projections of spending as a share of the overall domestic economy. This work by the CBO is illustrative and obviously less reliable the further out in time one projects. Our reason for showing these data is to stress spending trends. Under all scenarios that assume current policies, outlays for Medicare and Medicaid (primarily Medicare) will increasingly encroach on all other categories. Demography implies these results, but it is interesting to read the baseline projections, as policymakers and their staffs have the same data.

Autopilot Policy: Alternative Long-Term Paths for Primary Spending
(percentage of GDP), 2010, 2030, and 2050

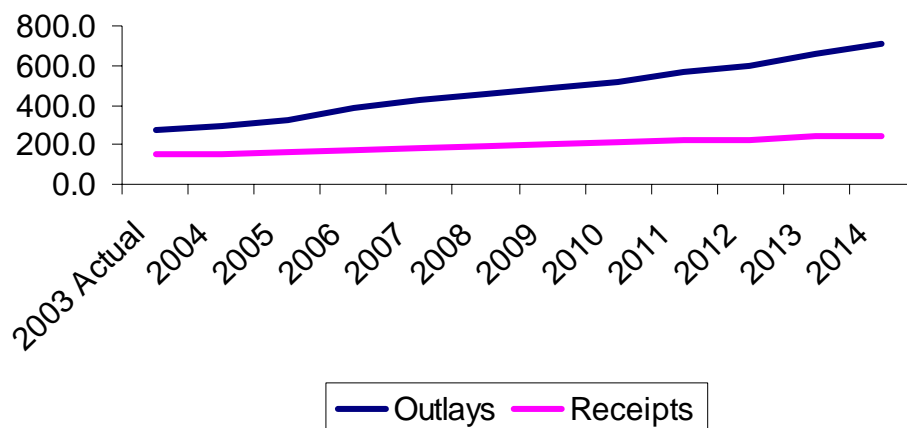
	2010	2030	2050
High Spending Path			
Defense	3.7	2.8	2.0
Social Security	4.2	5.9	6.3
Medicare and Medicaid	5.3	11.5	21.3
Other	4.9	4.3	3.4
Total	18.1	24.5	33.0
Intermediate Spending Path			
Defense	3.1	2	1.4
Social Security	4.2	5.9	6.2
Medicare and Medicaid	4.8	8.4	11.5
Other	4.9	4.5	4.2
Total	17.0	20.8	23.3
Low Spending Path			
Defense	3.1	2.0	1.4
Social Security	4.2	5.9	6.1
Medicare and Medicaid	4.4	5.7	6.4
Other	4.8	3.5	2.5
Total	16.5	17.1	16.6

Source: Congressional Budget Office

We anticipate legislative action in the near future to constrain costs, irrespective of veto threats.

The President's position on the drug benefit will come under pressure. The program was created under questionable fiscal pretenses, it has not yet come on line, and a vast majority of elderly still do not understand the program and the many who do understand it oppose it. For all these reasons and the larger fiscal imbalances, we expect legislative action in the near future to constrain costs, regardless of veto threats. As the accompanying chart shows, near-term jumps in Medicare spending rates come as the drug benefit is scheduled to begin (2006) and again as the first wave of boomers is expected to retire (2013). The primary reason we believe that remedial action is likely is that the current \$100 billion-plus program deficit only worsens under current policy.

Can't Touch This?: Medicare Fiscal Balance, 2003—O15E (\$ billions)



Source: Congressional Budget Office

We continue to believe that before the end of Bush's second term, Washington will cut projected entitlement spending and raise revenues to address imbalances. The three presidents before him did, including two Republicans. Chairman Thomas; his counterpart, Senate Finance Committee Chairman Chuck Grassley (R-IA); and even members of the President's tax reform panel are openly discussing fiscal tightening involving both sides of the ledger.

History and recent fiscal results make it hard to imagine achieving these deficit reduction goals solely by constraining spending.

Greenspan last week discussed improving net national savings and deficit-neutral policies going forward. History and recent fiscal results make it difficult to imagine achieving these deficit-reduction goals solely by constraining spending, especially because the President reacted vehemently to suggestions about restraining growth in the fastest-growing spending program.

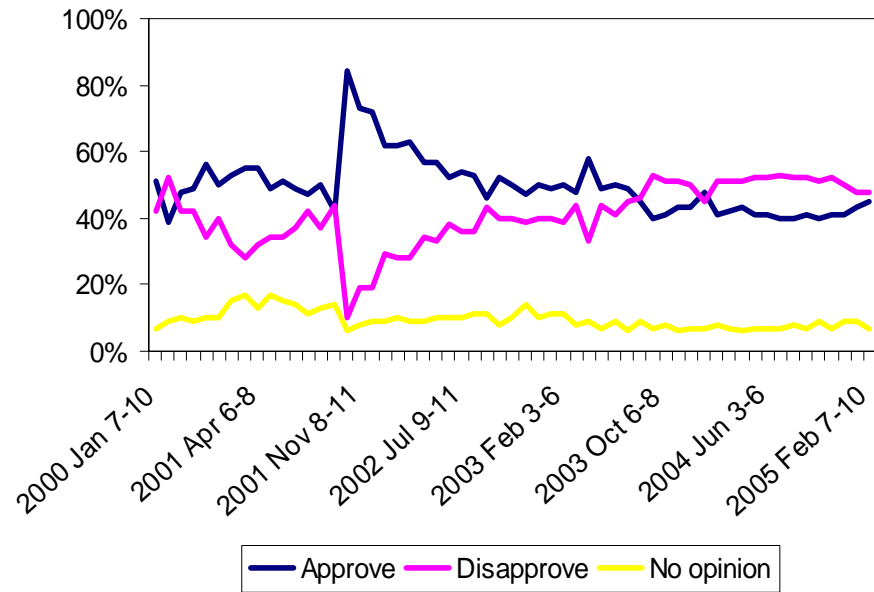
Concerns about growing macroeconomic imbalances are forcing a wider debate than President Bush originally wanted.

That is not to say that a balanced approach to deficits will come easily. Last week, President Bush intimated that he would consider raising the Social Security earnings cap to bring fresh money into the system. The day after, however, Hastert challenged that idea by labeling it a tax increase. It is clear that consensus will be slow to form on how to best address deficits, entitlement spending, and flagging revenues. Our sense is that Washington ultimately will enact changes to national retirement policy, including Social Security, that will affect savings decisions for decades. Concerns about growing macroeconomic imbalances are forcing a wider debate than President Bush originally wanted.

The Polling Place

Monthly Congressional Approval Rating

Do you approve or disapprove of the way Congress is handling its job?



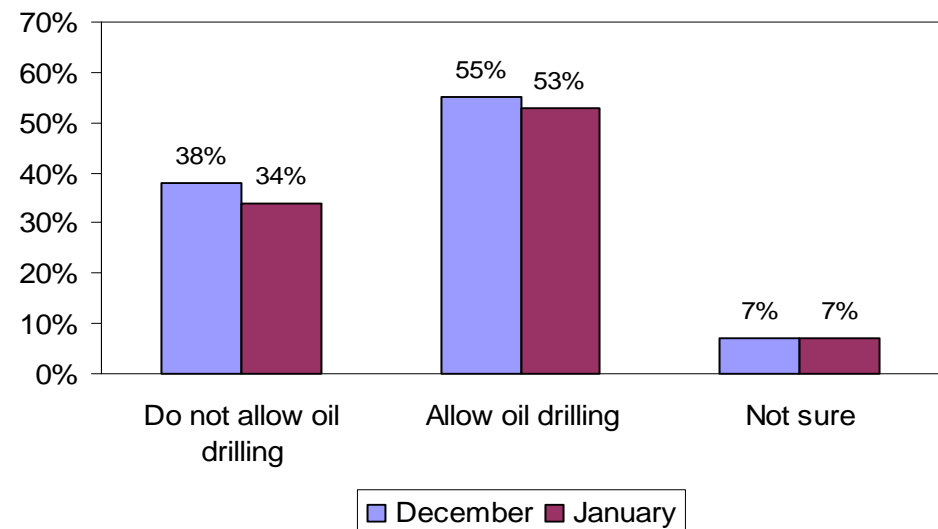
Source: Gallup Poll

Despite that a majority of Americans do not support oil drilling in ANWR, prospects for drilling remain a possibility either

- through an energy bill, although key Republicans sent mixed messages this week, or
- through the budget reconciliation process, thereby avoiding the Senate's 60-vote hurdle that has prevented ANWR's passage in previous attempts by the Bush administration.

Weekly Focus Poll: Energy Policy, ANWR

Should oil drilling be allowed in America's Arctic National Wildlife Refuge?



Source: ZOGBY, December 13-15, 2004, and Bellwether Research, January 13-17, 2005

Health Care: The D.C. Pulse

Sector	Recent Developments
Pharma Generics Biotech Med-Tech	<ul style="list-style-type: none"> Crawford Positive Nomination for Drug Companies We view Acting FDA Commissioner Crawford's nomination for full commissioner as positive for drug companies. We expect Crawford to receive a confirmation, although Senate Democrats (and some Republicans) will likely grill Crawford on perceived failings of the agency, including Plan B contraceptives, antidepressants, flu vaccines, and Vioxx. The nomination confirms our view (also reinforced by HHS Secretary Leavitt) that the White House will push for incremental reforms at the FDA and resist Congressional efforts to further restructure the agency. Next Step: Crawford decides how to react to recommendations of the FDA Advisory Committee meeting Drug Safety One day after the Crawford nomination, HHS Secretary Leavitt announced the creation of an independent Drug Safety Oversight Board within the FDA and the launch of a new "drug watch" Web page. The board will act as a safety clearinghouse, resolve disagreements on drug safety, and oversee development of new drug safety policies. This board will likely help the FDA resist efforts in Congress to more sharply restructure the agency in 2005, despite what we expect to be considerable headlines about drug safety in the next three quarters. Next Step: Senate HELP chairman to hold three hearings in March; Chairman Grassley to introduce bill in next three weeks Drug Reimportation Two hearings last week featured reimportation opponents highlighting concerns about the safety and actual savings that might be achieved by legalizing drug reimportation on any scale. We expect Chairman Enzi to hold additional hearings, although it remains unclear whether bill proponents will be able to force consideration of the Dorgan-Snowe bill in committee. President Bush received criticism for his budget as details became clear that he would slash, by about 5%, inspections of foreign drug manufacturing facilities, a key safety check for drug reimportation. However, the FDA noted that risk-based incentives will allow it to translate fewer inspections into increased efficiency in those inspections. Next Step: Senate HELP Chairman Enzi likely to hold additional hearings, markup uncertain at this stage. FDA Advisory and COX-2 The FDA held three meetings on the safety of COX-2 drugs. We do not expect these drugs to be pulled from the market; labeling changes and stronger warnings remain a higher probability. Headlines on this issue, however, have affected COX-2 prescriptions, which fell 43% from December 2003 to December 2004, according to IMS data. Next Step: Advisory Committee recommendation Drug Price Negotiations on the Way? A vigorous debate erupted last as Senate HELP ranking member Kennedy (D-MA) and House Government Reform ranking member Waxman (D-CA) sent a letter to President Bush outlining a potential \$190B in savings that could be achieved via Medicare negotiations with drug companies, according to estimates. They suggested authority similar to that of the VA, which we note severely limits the drugs that veterans are able to access. This prompted the administration to release a letter from Chief Actuary Foster to Administrator McClellan in which he estimates that health plans can achieve cost reductions of 15%, moving to 25% over a five-year period. Stem Cells We continue to believe that companies affected by government stem cell research will benefit at the state level (e.g., CA); however, at the federal level, we are unlikely to see federal government expansion of funding, although we expect positive headlines related to stem lines. Despite a bipartisan bill introduced by Senate Judiciary Chairman Specter (R-PA) last week, Conservative Republicans and President Bush remain unlikely to support expansion of research.
Facilities HMOs PBMs Retail	<ul style="list-style-type: none"> Medco a National Part D player An announcement from Medco Health that it would apply to become a nationwide Medicare Part D sponsor has increased the optimism for success of the benefit next year. Lehman Brothers' analyst Larry Marsh estimates a "PDP/PBM market expansion opportunity of \$44B in 2006, expanding to \$59B in 2008, expanding the current PBM-like market 30% in 2006 off the current base and 35% in 2007 off the current base (with full ramp up)." Medicaid Cuts We believe that significant (\$40B-60B) Medicaid cuts will likely be enforced this year if either reconciliation language or a firm cap is included in the budget resolution. We expect significant efforts to stall these cuts, particularly as almost half of the Senate Finance Committee (a bipartisan group) supports an independent commission to review the Medicaid program before cuts are enacted. That commission could be created, but Chairman Grassley has vowed to push forward on the Medicaid cuts regardless. National Governors Association head Warner (D-VA) and other governors met with Senate Finance leaders to discuss potential cuts. Next Step: Early March budget markups
Health Care Trends	<ul style="list-style-type: none"> Bush and Medicare Benefit The clamor against the \$700B to \$1.2T estimates for the Medicare benefit forced President Bush to wield his veto threat. "Any attempt to limit the choices of our seniors and to take away their prescription drug benefits will meet my veto." Senate Majority Leader Frist (R-TN) and House Whip Blunt (R-MO) signaled support for the President's threat. White House Press Secretary McClellan blamed members of the Democratic party who want to "undermine the reforms," disregarding the reality that some of the more vocal criticisms of late have come from Republican members upset with the costs of the bill. Rhetoric to limit the costs of the drug benefit will continue, but we see almost no chance of limiting the drug benefit this year. Greenspan on Medicare Deficits "The Medicare shortfall is several multiples of what we confront with Social Security," Greenspan noted in testimony to the House Financial Services Committee, echoing even more forceful comments from the comptroller general. Despite the acknowledgment of the looming crisis, President Bush has chosen Social Security as the playing field in 2005, and Medicare restructuring or significant cost reductions are unlikely. Next Step: Potentially significant debate about Medicare cuts in 2006

Source: Lehman Brothers

GPR Weekly

ISSUE	THE WEEK JUST PAST	OUR CALL
Iraq <p>This is the curse of democracy—it's open.</p> <p>— Ibrahim Jaafari, alluding to his opponent Ahmed Chalabi and to the decision on who will be Iraq's new Prime Minister</p>	<ul style="list-style-type: none"> • Elections: Iraq's certified elections returns have been tabulated; with 140 seats, the Shiite alliance will take a slim majority in the 275-seat parliament, while Kurdish parties, secular Shiites, and smaller parties won 75, 40, and 20 seats, respectively; Iraq's interim Vice President Jaafari emerged as the top candidate for the post of prime minister in the new Iraqi government; we believe that the new PM, regardless of who it is, will be evaluated on how he addresses the main potentially divisive issues in the new Iraq: marginalized Sunnis and autonomy-coveting Kurds • Attacks: Episodic battles throughout western Al Anbar province and the central cities of Baquba and Baghdad killed more than 27 people last week, including one American soldier and three Iraqi national guards; in the restive northern region, a failed assassination attempt on Mosul's police lieutenant was followed by twin bombings on oil pipelines in Kirkuk; as attacks persist, coalition forces have been increasingly aided by impromptu militia forces receiving financial and logistical support from the government 	Short-Term Catalyst <ul style="list-style-type: none"> • Pressure for a revamped strategy in Iraq will continue to mount on the Bush administration and Defense Secretary Rumsfeld in particular, in the bloody rundown from elections Long-Term Call <ul style="list-style-type: none"> • More U.S. troops alone fail to accelerate stabilization and rebuilding timetable
Terrorism <p>It may be only a matter of time before al-Qa'eda or other groups attempt to use chemical, biological, radiological or nuclear weapons. We must focus on that.</p> <p>— Porter Goss, director of Central Intelligence</p>	<ul style="list-style-type: none"> • U.S. Intelligence: President Bush nominated John Negroponte, the U.S. ambassador to Iraq, as the first director of national intelligence; Negroponte will report directly to the President; President Bush called on Congress to renew the Patriot Act • CIA: New CIA Director Porter Goss warned Congress last week that al-Qa'eda and other terrorist groups pose an imminent threat of attack, most likely in the form of a low-tech weapon, and that attacks by biological, chemical, or nuclear weapon are always a possibility • Iraq: A newly released videotape from an Islamist terrorist organization displays an Italian journalist as the most recent hostage in the clandestine Iraqi insurgency • Philippines: Militant Islamist group Abu Sayyef claimed responsibility for three bombings last week • Pakistan: It has been reported that insurgents have blown up 26 transmission lines in the conflict-ridden province of Baluchistan in the past 25 days; the frequent insurgent activity has exacerbated the devastating effects of torrential rains, leaving much of Pakistan without power throughout the week 	Short-Term Catalyst <ul style="list-style-type: none"> • The war in Iraq and Israeli-Palestinian tensions will provide ideological basis for terrorist activities in the short term Long-Term Call <ul style="list-style-type: none"> • Terrorist networks will continue to conduct global operations focused on symbolic hard targets, oil facilities, and vulnerable international waterways
Oil <p>What [the Russian government is] doing could be explained rationally only if the goal was to stop economic growth.</p> <p>— Yegor Gaidar, former Russian Prime Minister, on the breakup of Yukos</p>	<ul style="list-style-type: none"> • Crude Talk: Light sweet crude oil on the NYMEX was range bound last week, with March futures ending just above where they started (\$48/bbl); prices spiked briefly on Tuesday morning after a mysterious explosion in Iran, but tracked back in line following signals from one OPEC minister that supply levels and pricing points might not need revision at the group's Mar 11 meeting • Qatar: Some of the world's largest energy companies, such as Exxon Mobil, Royal Dutch/Shell, and Chevron-Texaco, have invested \$20B to build LNG facilities in Qatar, in an attempt to redefine global energy markets • Russia: Russia has barred foreign firms from its natural resource tenders in 2005, citing an attempt to enable Russian firms to develop strategic resources; this adds a new twist to Russia's ongoing consolidation trend 	Short-Term Catalyst <ul style="list-style-type: none"> • OPEC recently maintained output and price levels but is apt to shift paths as excess supply builds in the run up to the group's Mar 11 meeting Long-Term Call <ul style="list-style-type: none"> • Failure to effectively secure global oil infrastructure from geopolitical risks leaves headline risk
Middle East and Lebanon <p>We are ready to help Syria on all grounds to confront threats.</p> <p>— Mohammad Reza Aref, Iranian Vice President</p>	<ul style="list-style-type: none"> • Iran: Iranian TV claimed that an explosion rocked the town of Bushehr, home to a Russian-backed nuclear plant; despite the report's timing in conjunction with complaints of American UAV surveillance over Iranian skies, the two incidents were claimed to be mutually exclusive by Iranian officials • Lebanon: A terrorist group claimed responsibility for the detonation of a car bomb that assassinated former Prime Minister Rafik Hariri, sparking renewed tensions between Lebanon and Syria, which has maintained a military presence in the country nearly 15 years since the end of civil war; we await further developments, but we expect Syrian-Lebanese tensions to mount in the aftermath of the Hariri assassination 	Short-Term Catalysts <ul style="list-style-type: none"> • Lebanese-Syrian tensions over perceptions of the Hariri assassination and Syrian occupation could heighten to the brink of conflict Long-Term Call <ul style="list-style-type: none"> • A Syrian-Iranian partnership that continually rebukes U.S. warnings will eventually become the center of growing regional tensions

Source: Lehman Brothers

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