

WASHINGTON WEEKLY

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Leadership Stakes in Iraq

Not much is going well in Iraq these days. Altering this situation will require a new approach.

Not much is going well in Iraq these days. Violence has slowly escalated in the central and southern parts of the country to levels unseen since Saddam Hussein was overthrown. August was the deadliest month for the U.S. military. There have been more kidnappings (20) and hostages killed (7) in August and September than in any other two-month period, even though 10 days remain in this month.¹ Despite election-driven positive statements from the Bush administration, every expert, including most within the administration, believe that events are slipping to the negative end of any range of likely outcomes. Altering this situation will require a new approach that will not come until after the U.S. elections this November.

In the United States, a careful analysis of what has happened and what is reasonably possible in Iraq is inextricably clouded by politics. Desperate to regain traction lost since midsummer, Senator John Kerry (D-MA) is sharpening his attacks on President Bush's rationale for and execution of the war. The President, brimming in confidence from public opinion polls that strongly imply his reelection, continually harangues Kerry about those statements but does not tell voters how a second Bush term would adjust.

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It is clear that meaningful discourse over what should and what could come next is not realistic until after the presidential elections. One hopes that after November 2, elected policymakers in Washington can come together to reassess objectives in Iraq and the means of achieving those goals. The greatest risk to this path is that the electoral outcome only deepens commitment to a politically convenient, but nonetheless dangerous, mantra that the future of Iraq is mainly the responsibility of Iraqis. This responsibility very likely will be shared by a wider group of authorities than were in charge of planning the war or managing affairs there in the past six quarters.

Also in This Issue

Cap Calls

Highway bill received positive attention last week; the export tax bill did not, although leaders say they will try again this week.

Health Care: The D.C. Pulse

Generic biologics and oxygen therapy costs made headlines last week. An FDA seizure of drug shipments from Canada is likely to keep reimportation in the news.

Geopolitical Risks

Current trends in Iraq worry experts inside and outside the Bush administration.

¹ "Hostage taking in Iraq," Reuters (September 16, 2004).

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AND IMPORTANT DISCLOSURES.**

Capital Calls

ISSUE	RECENT DEVELOPMENTS	OUR CALL	EFFECT
Transportation TEA-21 Reauthorization	<ul style="list-style-type: none"> High-level meetings held, with discussions of an "equity bonus" proposal to remain at \$299B Senate Environment and Public Works Chairman James Inhofe (R-OK) has angered Senate Democrats 	<ul style="list-style-type: none"> Call: Ultimately a one- to two-year extension Timing: 4Q04 Catalyst: Agreement with Senate Democrats Risks: President pushes for and receives agreement on his six-year \$299B request 	<ul style="list-style-type: none"> Volatility: Low Impact: Positive for highway and transit sector, energy, and aggregate concrete
Tort Reform Asbestos	<ul style="list-style-type: none"> Senate Minority Leader Tom Daschle's (D-SD) 9/15/04 letter agreeing to \$140B fund points to several areas of disagreement Disagreements have shifted from the size of the fund to existing cases, smokers, and other areas 	<ul style="list-style-type: none"> Call: Legislation is unlikely to be enacted Catalyst: Agreement on existing cases, smokers, and size of fund 	<ul style="list-style-type: none"> Volatility: Low Impact: Lack of a federal fix maintains irrational system and legal exposure for affected companies
Health Care Drug Reimportation	<ul style="list-style-type: none"> The FDA seized 450 drug shipments from CanadaRx, the Internet pharmacy servicing the program sponsored by a seniors group in MN and WI Bipartisan battleground state governors urge Senator Senate Majority Leader Bill Frist (R-TN) to schedule reimportation vote 	<ul style="list-style-type: none"> Call: Congress unlikely to pass legislation, though continued noise is expected Timing: Through elections Catalyst: Task Force report Risks: Senate surprise amendment; pressure forces HELP markup 	<ul style="list-style-type: none"> Volatility: Low Impact: Negative for pharma and distributors; precedent set for D.C. intervention on pricing issue is far worse than actual economic impact of any bill
Financial Services GSEs	<ul style="list-style-type: none"> Rep. Barney Frank (D-MA) suggested GSE reform bill include a percentage of earnings set aside by Fannie Mae and Freddie Mac for affordable housing programs Treasury Under Secretary Brian Roseboro said reform bill "remains a priority" and new GSE agency should have divisions for Fannie/Freddie and Federal Home Loan Banks HUD Assistant Secretary John Weicher said new affordable housing goals for Fannie/Freddie will take effect 1/1/05 Freddie Mac Chairman/CEO Richard Syron remarked that he is "optimistic" about reaching agreement on a reform bill and wants "to get it off the table" 	<ul style="list-style-type: none"> Call: Oversight shift to single GSE regulator unlikely in 2004 Catalyst: OFHEO raises concern about findings in Fannie Mae accounting review; HUD/Congress find GSE noncompliant with affordable housing goals; Treasury broadens role in debt issuance Risks: Regulatory powers, especially receivership process, capital requirements, approval of new business, and affordable housing mandates remain contentious issues 	<ul style="list-style-type: none"> Volatility: Low Impact: Political risk continues, particularly on regulatory front, with rulemaking on corporate governance, affordable housing goals, and possibly, liquidating conservator ship
Fiscal Policy FSC/ETI Repeal	<ul style="list-style-type: none"> Issue could be one reason for a postelection session Conferees have yet to be appointed A lame-duck session would increase likelihood of passage if progress is made in the next two weeks 	<ul style="list-style-type: none"> Call: Congress unlikely to enact legislation that satisfies U.S. exporters, U.S. multinationals, and the European Union Timing: 4Q04 Catalyst: Conference agreement Risks: Congress enacts legislation, but fails to satisfy WTO rules 	<ul style="list-style-type: none"> Volatility: Low Impact: Sectors most heavily targeted by sanctions, which began March 1, are precious stones and jewelry; machinery and mechanical appliances; wood and paper articles; leather articles; and toys, games, and sports equipment

Source: Lehman Brothers

Iraq, Phase II

What is oddly comforting about that last point is the wealth of sources not involved in the campaign saying change must come. In the current issue of *Foreign Policy*, Javier Solana, secretary-general of the Council of the European Union, suggests concrete steps to strengthening chances that the absence of Saddam does not guarantee the presence of country-destructing violence.²

The theme of his article is that "the enduring lesson of the war in Iraq is the importance of linking force and legitimacy." We know of no one who believes that force will not be required to settle Iraq. The same is true for battling transnational terrorism. However, **because these are missions with global implications, more input regarding strategy is needed from important players around the world to ensure that the force used serves a consensus, legitimate purpose.**

Francis Fukuyama, author and futurist, recently wrote an editorial that so plainly presents the facts that they can easily be digested free of political overtones.³ He chides Kerry for facile political statements and rejects much of Bush's campaign myopia. Fukuyama points to the well-known lack of postwar planning now manifesting itself in southwest Asia that has "created a new Afghanistan inside Iraq."

Even more disturbing is the latest report on Iraq reconstruction from the think tank chosen by the White House to help manage the process. **The Center for Strategic and International Studies confirms that negligible reconstruction expenditures have left many Iraqis without hope that the U.S.-led invasion will soon lead to a healthy economy.**⁴ Almost one year after Congress appropriated \$18.4 billion to this effort, less than \$1.0 billion has been spent. This is primarily due to the serious lack of security in many areas in dire need of reconstruction.

Two facts that result from the war are pressing decisionmakers to develop and implement a "plan B" lest the situation continues its destructive spiral. Success here is too complicated for the United States alone to handle.

- The resistance is a mixture of foreign jihadists and Iraqi nationalists upset over the way in which the war and occupation have been handled. U.S. intelligence officials believe that the vast majority of resisters are Iraqis. Elections scheduled for, but unlikely to be held, in January will not sit well with many in Iraqis unless citizens believe that this is a sovereign exercise devoid of U.S. influence.
- Reports by people at the very minimum not politically hostile toward President Bush have reaffirmed impediments to success. First, an administration task force has concluded that Saddam Hussein did not possess weapons of mass destruction last year (although signs indicate aspirations of such). Second, an internal U.S. intelligence community assessment found that conditions in the near term are not conducive to constructing a government that can lead a nation of citizens willing to work toward economic, cultural, and social health.

² "Rules with Teeth," Javier Solana, *Foreign Policy* (September/October 2004).

³ "The Next President Will Need to Rethink Iraq," *Financial Times* (September 13, 2004).

⁴ *Progress or Peril?: Measuring Iraq's Reconstruction*, Frederick Barton and Bathsheba Crocker, Center for Strategic and International Studies (September 2004).

The more critical market-relevant issue concerning Iraq is whether current conditions can be managed to reduce probabilities that the war ultimately increased rather than reduced geopolitical risks. Congress, the United Nations, and the European Union are very likely to assume stronger roles in determining what comes next in Iraq. In the meantime, politics will regrettably but understandably dominate the discussion in America. As the following graph shows, even if expedient news comes soon about reducing U.S. forces in Iraq, the already-strained National Guard and Reserve forces likely will be their replacements.

**Not Close to Over: U.S. National Guard and Reserve Mobilizations,
January 2003 to September 2004**



Source: The U.S. Department of Defense

Health Care: The D.C. Pulse

Sector	Recent Developments
Brand-Pharma Generics Biotech Med-Tech	<ul style="list-style-type: none"> Generic Biologics The FDA held a two-day workshop on generic biologics, beginning what is likely to be a long process toward eventual development of these products. Congress has not been actively engaged in this issue and is unlikely to become engaged over the next 12 months, in our view. Moreover, the pharmaceutical industry itself does not appear to have a consistent approach toward generic biologics. Reports indicate that Novartis and Wyeth have urged PhRMA, the drug industry trade group, to avoid attacking the 505(b)2 process in developing a position against generic biologics; 505(b)2s remain the most likely short-term pathway for approvals.
	<ul style="list-style-type: none"> Oxygen Therapy The HHS Office of the Inspector General released a long-awaited and oft-delayed report on Federal Employees Health Benefits Plan (FEHBP) pricing for oxygen therapy, which will form the basis of a cut that CMS will implement for 2005. OIG found that FEHBP's median rates for home oxygen equipment are 10%-20% lower than Medicare's, well within the expected range of results. The trade association representing oxygen therapy companies, AAHomecare, released a study arguing that there is virtually no difference between FEHBP and Medicare pricing. CMS does not have to accept the OIG numbers in whole and could moderate the findings when it issues a final rule for January 1, 2005 implementation.
	<ul style="list-style-type: none"> Choices vs. Cost-Containment: Medicare's Dilemma Medicare announced new drug comparison tools for five key chronic illnesses for seniors to compare drug costs, while a new AHRQ study on chronic illnesses found that more than one-third of patients surveyed discontinued their use of such drugs because of cost concerns without first telling their doctors. This highlights a huge dilemma for CMS as it seeks to develop tools to control costs under the Medicare program—how to increase information but ensure that seniors can and will use it. "I believe there are too many choices, too many options can result in paralysis," said Senator Max Baucus (D-MT), the ranking member on the Senate Finance Committee. The new CMS Web site feature enables seniors to compare drugs by disease category, including cholesterol, blood pressure, allergies, and arthritis. To the extent that CMS can ration choices (if it so desires) and develop more efficient cost-containment tools, chronic illness drug categories are likely to remain under pressure as cost controls continue to mount.
	<ul style="list-style-type: none"> Drug Efficacy When cost-containment and price transparency strategies are wed to drug efficacy studies, drug purchasers will be able to better discriminate between different products. Last week, the Drug Effectiveness Review Project at Oregon State announced that 11 states and two foundations have agreed to review the results of studies of various drug classes to help states and individuals compare efficacy standards. "If pharmaceutical products have similar results, then the manufacturers should compete on price, just like manufacturers in any other market," said former Governor John Kitzhaber (D-OR), the head of the project.
	<ul style="list-style-type: none"> Anti-Depressants An FDA Advisory Committee recommended last week that black-box warnings be placed on antidepressants for children, finally channeling months long negative publicity around the prescriptions. Both the House Oversight and Investigations Subcommittee and the Senate Finance Committee have investigated antidepressants, particularly in light of the controversy over testimony that was not previously presented by the FDA's Dr. Andrew Mosholder. We view this development as a short-term positive to help the industry escape headline pressure and fears over prescribing of these drugs.
	<ul style="list-style-type: none"> Drug Reimportation News and Notes <ul style="list-style-type: none"> ➢ Pfizer executive states he is in favor of drug reimportation ➢ A bipartisan letter from governors of NH and WI calls on Senator Frist to schedule a reimportation vote ➢ The FDA seizes 450 drug shipments from CanadaRx, the Canadian Internet pharmacy servicing the program sponsored by a seniors group in MN
Facilities Managed Care PBMs	<ul style="list-style-type: none"> Health Savings Accounts Continuing the slow rollout this year, the federal government announced that the FEHBP program will offer up to three million participants access to Health Savings Accounts through Aetna, which has expanded its offerings of savings accounts this year. In our view, health savings accounts are likely to continue to expand, particularly if President Bush is reelected and Congressional Republicans are able to build off the 2003 and 2004 progress.
	<ul style="list-style-type: none"> Hospital Group Purchasing A draft bill on addition regulations for hospital supply purchases was circulated at a Senate Judiciary Subcommittee hearing on September 14, as part of what ranking member Herb Kohl (D-WI) said "centers on perhaps the most important work of our subcommittee in the past few years." The bill reportedly would set up an interagency group with the HHS Secretary, attorney general, and FTC to jointly draft regulations for hospital supply purchasers. It is difficult for such a bill to pass in the short period before Congress leaves in October. Instead, industry self-regulation will likely continue in the short term.
Medicare Watch	<ul style="list-style-type: none"> The Kerry Health Plan The American Enterprise Institute (AEI) released a new report alleging that Senator Kerry's health plan would cost upward of \$1.5T (and cover 27.3M individuals), far more than the \$653B estimate produced by Emory economist Kenneth Thorpe, a former Clinton administration official. Meanwhile, both Bush and Kerry escalated domestic policy rhetoric this year, with Kerry guaranteeing that he would legalize drug reimportation and Bush painting Kerry's health care proposals as tantamount to a government takeover of health care.

Source: Lehman Brothers

GPR Weekly

Issue	The Week Just Past	Our Call
Iraq We know that the provision of adequate security up front is requisite to rapid progress on all other fronts. — Ron Schlicher, Deputy Assistant Secretary of State, on the importance of security in Iraq	<ul style="list-style-type: none"> • Attacks: A large-scale bombing in the heart of Baghdad that claimed at least 50 lives and the ongoing battle between insurgents and coalition forces in more distant regions of Iraq highlight the struggles of U.S. and Iraqi troops to bring security to both Iraq as a whole and any one region within the country • National Intelligence Estimate: The highly confidential NIE report presented to President Bush by the National Intelligence Council described the stability of Iraq as tenuous at best; one NIC official described the worst potential scenario as “trend lines that would point to civil war” • Elections: John Danforth, U.S. ambassador to the United Nations, stated, “Let there be no doubt: we are committed to this timetable,” indicating that Iraq will conduct democratic elections on January 31, 2005; in light of the serious security problems facing Iraq, conducting legitimate elections on schedule remains a possibility but is extremely conditional, in our view 	Short-Term Catalyst <ul style="list-style-type: none"> • Factional fighting spreads the thin U.S. troop base throughout the Iraqi countryside and prolongs regional instability Long-Term Call <ul style="list-style-type: none"> • Efforts by the Iraqi government to establish national security before January elections will be hampered by multiregional attacks against U.S. and Iraqi forces and the oil infrastructure
Terrorism As governments fight the enemies of democracy, they must uphold the principles of democracy. — President George W. Bush, on Russia's response to recent Chechen terror attacks	<ul style="list-style-type: none"> • Iran: Although the state of uranium enrichment in Iran has been an ongoing concern to the global community, the IAEA has not been able to provide much, if any, conclusive evidence on the issue; it remains an ongoing risk, as evidenced by Mohamed ElBaradei's statement, “Can we say everything is peaceful? Obviously we aren't at that stage.” • Russia: In response to the recent wave of Chechen-related terror attacks in Russia, President Vladimir Putin recommended that the Kremlin self-appoint governors for each Russian province rather than allow provincial elections; this statement drew a quick response from President Bush, who warned the Russian President not to compromise democracy in fighting terrorism; in our view, Putin's reforms are not likely to be impeded by international responses, an overall negative for Russia • Security: The Transportation Security Administration discovered highly explosive Soviet munitions from Afghanistan on the person of an American medic for DynCorp as he attempted to board a flight from JFK to California; that the medic was able to transport such munitions from the United Arab Emirates into the United States again raises concern about the security of international flights into the States 	Short-Term Catalyst <ul style="list-style-type: none"> • IAEA annual general meetings do not accelerate progress with Iran Long-Term Call <ul style="list-style-type: none"> • U.S. problems with preemptive strategy in Iraq and IAEA lack of power give Iran the opportunity to continue regional assertion through oil and nuclear proliferation politics
Oil Past experience suggests that the impact of hurricanes on oil markets usually dissipates rapidly. — Statement from the Department of Energy	<ul style="list-style-type: none"> • Crude Talk: Geopolitical risks—including OPEC's decision to hike output by 4% and talk of a new elevated price target in December, a series of connected pipeline bombings in northern Iraq, and a letdown from Russian oil giant Yukos—took a backseat to Hurricane Ivan and concerns about Tropical Storm Jeanne, as traders speculating vast damage and prolonged shutdowns of oil refineries and processing facilities in the southern United States kept light sweet crude prices around or above the \$44/bbl level 	Short-Term Catalyst <ul style="list-style-type: none"> • Periodic spikes in attacks against infrastructure cannot be prevented, keeping prices above \$40/bbl Long-Term Call <ul style="list-style-type: none"> • Failure to effectively secure global oil infrastructure from geopolitical risks leaves headline risks on the upside
Other Developments [North Korea] clarified its stand that it can never sit at the table to negotiate its nuclear weapon program unless truth about the secret nuclear experiments in South Korea is fully probed. — Bill Rammell, British foreign office minister on his visit to North Korea	<ul style="list-style-type: none"> • North/South Korea: North Korean officials indicated that they will not participate in either this month's scheduled six-nation talk or any other international discussion on nuclear initiatives until South Korea's nuclear enrichment experiment is fully investigated; although South Korea's clandestine efforts undermine the nonproliferation regime, North Korea still headlines nuclear risk in the East • Pakistan: The lower house of Pakistan's parliament passed a bill designed to control the spread of nuclear and biological weapons inside the country and proposed a 14-year prison sentence for anyone trafficking, possessing, or stockpiling nuclear arms; the bill needs approval of the upper house of parliament but could be a positive step for Pakistan; however, instability and radical cells still make the Pakistani government a risk, in our view 	Short-Term Catalyst <ul style="list-style-type: none"> • North Korea uses South Korea as a scapegoat to deflect negative attention away from its own nuclear situation Long-Term Call <ul style="list-style-type: none"> • North Korea refuses to cooperate with the IAEA and six-nation talks until it is in a position to benefit from such action

Source: Lehman Brothers

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