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**2012 POST-ELECTION ANALYSIS**

A NARROWLY DIVIDED ELECTORATE HAS SPOKEN

# HOW WILL THE PRESIDENT AND THE CONGRESS RESPOND?

**NOVEMBER 7, 2012**

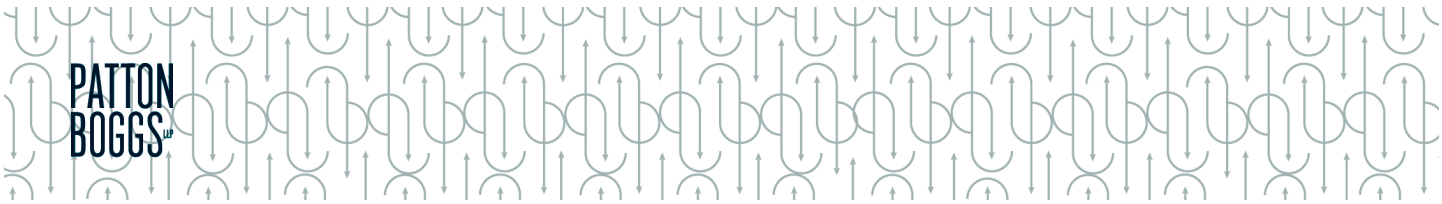
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**“[C]ONSIDERING THAT GREAT INNOVATIONS SHOULD NOT BE  
FORCED ON SLENDER MAJORITIES . . . .”**

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—Letter from President Thomas Jefferson to General Thaddeus Kosciusko  
(May 2, 1808)



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## INTRODUCTION

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With President Barack Obama having been reelected and the Senate and the House having stayed in Democratic and Republican hands, respectively, attention now will turn to the lame duck session that will formally get underway the week of November 12 but won't likely get down to business until the week of November 26. Based on past experience, we expect to hear sleigh bells before the 112<sup>th</sup> Congress leaves town. Since so much that will happen next year will be driven by what happens in the next two months, we principally focus this introduction on the challenges facing the President and the Congress in the lame duck session.

To put matters in perspective: Unless current law is amended, all of the Bush tax cuts will expire at the end of the year, as will various other temporary tax provisions (*e.g.*, AMT relief for middle class Americans, extension of estate tax relief, and a variety of tax credits that are enjoyed by individuals, as well as the R&D tax credit and a host of other tax credits relied upon by the business community, some of which need to be extended retroactively to the beginning of 2012). Congress and the Administration also must decide how to protect physicians serving Medicare patients from sustaining steep cuts in reimbursement rates and whether to extend enhanced unemployment insurance for the long-term unemployed. In addition, decisions need to be made whether to extend, replace, or allow to lapse the two percentage point payroll tax cut for all working Americans. Finally, \$109 billion in across-the-board spending cuts ("sequestration") mandated by the Budget Control Act of 2011 will begin to kick in on January 2. Half of the automatic spending cuts will hit the Pentagon, while the other half will reduce spending by the rest of the government, with most agencies facing funding cuts of 8.2%. In popular parlance, the United States will fall off a fiscal cliff with potentially no safety net in place unless the President and the Congress agree to amend current law.

Recognizing the dangers to the economy, the Administration reportedly is analyzing the extent to which it could use existing authority to buy additional time to reach an agreement with Congress early next year, such as by freezing the amount of money taken out of payroll checks by not updating tax withholding tables to reflect expiration of the Bush tax cuts on December 31. The Administration also could seek to delay to later in the year automatic spending cuts that otherwise would begin on January 2. We do not expect the Administration to make its plans public any time soon, not least because identifying an escape hatch early could create the very outcome it hopes to avoid. And, in any event, it doesn't have to come to this.

A great deal was accomplished in the lame duck session of 2010, in large part because Democrats and Republicans agreed to compromise. Both sides recognized that the economy needed a boost and that, by working together, they could resolve issues that until then had eluded resolution. In that environment, the President agreed to extend all the Bush tax cuts, as well as to extend other expiring or expired tax provisions, such as AMT relief. He also succeeded in pushing a major arms control treaty through the Senate. We expect a comparable effort this time as well, though the details on the tax policy side will likely be subject to intense negotiations, particularly on whether to limit extension of the Bush tax cuts to a particular income threshold.

To date, Congress has been unable and unwilling to agree to do anything, in part because of intransigence by both parties over whether to impose an income limit on an extension of the Bush tax cuts and in part because the “cost” of extending current law has been well beyond what Congress has been willing to “pay.” As one example, a two-year extension of an AMT patch for middle-class families plus routine extension of expired and expiring tax provisions would cost \$205 billion. In addition, delaying sequestration for an additional year would require \$109 billion in new revenues or cuts to non-targeted programs (unless, of course, Congress punted by forcing nine years of cuts into eight, increasing the pain in future years).

Over the last year, there has been bipartisan agreement that the fiscal cliff must be avoided and that a comprehensive overhaul of our tax code is necessary. Nonetheless, the parties have fundamentally disagreed about how to approach these issues, with President Obama and Congressional Democrats arguing for significant tax increases as a means of deficit reduction and Governor Romney and Congressional Republicans rejecting the idea that any direct tax increases are necessary, preferring that any new revenue come from assumed economic growth once tax reform is enacted.

The result has been a continued legislative stalemate, with a heavy dose of political posturing by both sides. But even close elections can be clarifying. A narrowly divided electorate now having spoken, we expect discussions to begin anew with some urgency in the lame duck session. Given major philosophical differences on tax policy issues between the parties, it remains to be seen whether these discussions will lead to an agreement to avert the fiscal cliff while, at the same time, clearing the way for comprehensive tax reform. In our view, it is likely both will occur in the lame duck session (or shortly thereafter), beginning with agreement on a Bush tax cut extension coupled with a broad framework for a tax reform agreement, with the hard work of tax reform to span across 2013. Although there are a range of possible outcomes in the lame duck session and beyond, one thing is certain: in stark contrast to the last year, over the next few months we will finally see the parties undertake a serious discussion about tax policy.

In the lame duck session, for example, Congress might agree to legislation that would extend all (or most) expired and expiring tax breaks for six months to a year, tied to fundamental tax reform generating some agreed-upon amount in the hundreds of billions of dollars (or more) in overall deficit reduction over the next decade, with the threat of greater deficit reduction if the 113<sup>th</sup> Congress were to fail to act by then. Democrats will likely raise eliminating or modifying some tax measures, including those aimed at the oil and gas industry, to help offset the cost of forestalling the spending sequester or to make a “down payment” on future deficit reduction. Such an agreement also could mandate some further level of deficit reduction by seeking to compel the 113<sup>th</sup> Congress to reform entitlement programs such as Medicare and Medicaid next year.

Forcing hard decisions as a means of achieving deficit reduction of course is what the Budget Control Act of 2011 was supposed to accomplish by establishing the “Super Committee” and creating the threat of sequestration next year if Congress failed to agree to legislation reducing the deficit by at least \$1.2 trillion over a decade. And it is precisely that failure that has the nation confronting the fiscal cliff. Many Senators and Representatives recognize the irony that the best way to prevent going over the fiscal cliff this year is to cut a deal that merely creates a bigger cliff that would arrive in another six or twelve months. But doing so would at least keep us at the precipice.

With the elections behind them, the President and the 112<sup>th</sup> Congress have an opportunity to succeed where they have failed before. Assuming Congress is willing to support legislation putting off the day of reckoning for an additional six months to a year, we expect the President to ask for an increase in the debt ceiling as part of the final negotiations. (As a result of increased tax receipts, the Treasury Department now anticipates that the debt ceiling will not be reached until early in the first quarter, with action to address the problem probably necessary by late February or early March.) Whether the President can secure congressional support for an increase by the end of the year will be a matter to be negotiated and ultimately will depend on the magnitude of whatever deal is reached. The President will not want to ask Congress to increase the debt ceiling early next year in a situation in which House Republicans would be in a very strong position to extract additional concessions without having to give up something meaningful. For them, the trade off in the lame duck session might be a one-year extension of the Bush tax cuts, including for married couples making more than \$250,000, tied to an agreement to pursue fundamental tax and entitlement reform next year. Even that might be a stretch. Given the election results, Congressional Republicans may have to accept an income limitation for any Bush tax cut extension, if not at \$250,000 then at \$500,000 or \$1,000,000.

What else beyond addressing the fiscal cliff can we expect Congress to accomplish during the lame duck session? Unfortunately, not much. Majority Leader Harry Reid (D-NV) intends to bring some

form of cybersecurity legislation to the Senate floor, but we have our doubts that a bill can get through two houses and to the President by the end of the year. The leadership of the Armed Services Committees will endeavor to move a defense authorization bill that would not be subject to contentious amendments on the floor. Beyond that, a backlog of noncontroversial bills has been building for a long time, but most if not all of them will have to move in the Senate by Unanimous Consent.

When it adjourned for the elections, the 112<sup>th</sup> Congress had approved only 196 bills that were enacted into law, well below the output of the 104<sup>th</sup> Congress, which produced legislation resulting in 333 public laws. Along with many others, we will be pressing to get things done in an environment we hope will be more hospitable to legislating than the first 22 months of the 112<sup>th</sup> Congress.

In our State of the Union Analysis this past January, we pointed out that “[t]he first session of the 112<sup>th</sup> Congress is likely to be remembered as one of the least productive in decades.” When the President signed the National Defense Authorization Act for FY 2012 on New Year’s Eve, it became Public Law No. 112-81. Having fallen seven short of the 88 bills enacted in 1995, the first session of the 112<sup>th</sup> Congress produced the fewest number of public laws since Congress formally began keeping track in 1947. With a flurry of signatures on January 3, however, the President helped this Congress eke out of last place with a total of 90 bills signed into law in the first session. Having barely picked up the pace since then, the 112<sup>th</sup> Congress is now on track to be the least productive ever as measured by bills enacted into law. Congressional Republicans would argue that the slow pace of legislation is the natural and desired result of divided government. But the public’s record low approval rates for this Congress no doubt reflect the perception that partisan activity has prevented necessary legislation from becoming law.

What else can we expect in the next few months? With the President having won re-election, we anticipate that many major rules will soon be published in final form, which will likely trigger a political reaction on Capitol Hill as Republicans invoke the Congressional Review Act in an effort to block them from becoming law. The EPA, for example, has many major rules on track to become final later this year or early next year. In addition, dozens of rules required under the Dodd-Frank Act are in the works. Finally, the President’s re-election puts his Administration in a commanding position to finalize numerous rules that solidify the regulatory framework for implementing the Affordable Care Act. Republican efforts to invoke the Congressional Review Act later this year and next year are unlikely to succeed in the Democratic-controlled Senate. Even if one or more do, a certain Presidential veto virtually ensures forthcoming rules will stand unless struck down by the courts.

In its next term, the Administration is likely to face high Cabinet turnover, beginning early in 2013, not least because so many senior officials have been in position so long. (Turnover to date has been historically low for the post-World War II era.) In addition to moving forward with his regulatory agenda, the President may be able to effectuate long-lasting policy changes through Supreme Court and lower-court appointments as well. Four Supreme Court Justices, for example, are in their mid to late 70s and could opt to retire prior to the end of the President's second term.

On Capitol Hill, there will be a great deal of turnover, in particular among Republicans currently serving in committee leadership positions. This will provide the Administration with an opportunity to forge some new relationships in the 113<sup>th</sup> Congress. In the Senate, Republican caucus rules limit time served as a Ranking Member to six years (and time served as a Chairman to an additional six years). While most current Ranking Members have time left to serve as chairmen, many of them are completing their sixth year as the Ranking Member, which will lead to a significant reshuffling of the decks for the 113<sup>th</sup> Congress.

As a result of House Republican Caucus term limit rules, we expect to see as well a great deal of turnover among Republicans chairing House committees. In fact, of the Members who are completing six years of service, House Budget Committee Chairman Paul Ryan might be the only Member to secure a waiver to serve an additional two-year term.

Except for changes triggered by retirements, all Senate Democratic Chairmen will maintain their gavels in the new Congress since they are not subject to term limit rules. Only the Budget Committee, the Energy and Natural Resources Committee, the Homeland Security and Governmental Affairs Committee, and the Veterans' Affairs Committee will likely have new leaders. Among House Democrats, there will be a similar level of continuity, with little turnover among Members serving as Ranking Members.

With the balance of this analysis, we offer our thoughts on major policy areas that will drive the agenda in Washington for the next two years and thus how potential developments might affect you. Given the still narrow margin enjoyed by Senate Democrats, not much will get through the Senate unless each party commits to putting aside partisan differences to get something done on the deficit, fundamental tax reform, and a host of other pressing national issues. Under Republican control, the House leadership will be in a strong position to move whatever their membership supports. But bills written with only the interests of one party in mind stand virtually no chance of moving in the Senate, as House Republicans have seen over and over again in the 112<sup>th</sup> Congress.



Ironically, the voters have elected a 113<sup>th</sup> Congress that may be even more partisan than the 112<sup>th</sup> Congress, at least on paper. Both chambers will have a substantial number of new Members, in part because of redistricting and because so many Senators and House Members have thrown in the towel over their dismay that so little gets done anymore. (The House, for example, had 62 Districts in which an incumbent was not on the ballot.) By casting their votes, we have a sense the public wants the 113<sup>th</sup> Congress to get something done, to address the big issues that confront the country, and to do so working together.

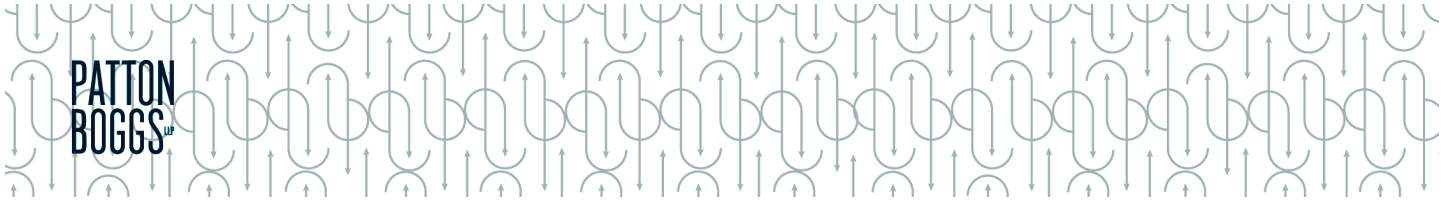
Now that the voters have spoken, will the 113<sup>th</sup> Congress keep in mind Thomas Jefferson's advice and make more of an effort to cross ideological divides, compromise, and solve the major policy challenges that confront our nation? As Jefferson recognized, major policy changes demand broad support to be successful. Addressing the deficit, for example, is too important and too big an issue for one party to hope to dictate the outcome to the other. We thus remain optimistic that the President and the Congress will work together in the lame duck session and establish the framework by which they can continue to work together next year.

In the pages that follow, we sketch out our sense of what is in store in the areas of agriculture policy, budget and sequestration, defense and national security, education, energy and environmental policy, financial services, food and drug policy, foreign investment in the United States, government contracts, health care, homeland security, Native American affairs, tax policy, technology and telecommunications policy, trade policy, and transportation and infrastructure policy.

Among the big issues likely to be addressed by the President and the 113<sup>th</sup> Congress is one we think worth mentioning here: immigration reform. There is broad support in the business community for Congress to finally address the issue. Leaders of the high-tech community, for example, have been calling on Congress for years to adopt legislation that would help them attract skilled engineers and software programmers, especially those who have graduated with advanced degrees from American universities and then are forced to return to their home countries. Moreover, the demographics of the voting population is changing so dramatically that neither party can risk failing to address the issue before the next Presidential election. In an interview with the *Des Moines Register* last month, the President signaled that he wants to take up the issue once the deficit has been addressed. He made the case for reform on both substantive and political grounds, saying in part: "I am fairly confident that [Republicans] are going to have a deep interest in getting that done." As part of this effort, we expect there to be a renewed focus on the DREAM Act, which removes certain barriers to access for undocumented children who wish to attend college. Senator Marco Rubio (R-FL), who has expressed great interest in crafting a compromise, may lead the Republican effort, possibly joined by two incoming Republican Senators from Southwest border states—Ted Cruz of Texas and Jeff

Flake of Arizona. As in addressing the deficit and fundamental tax reform, both parties will need to compromise to get something meaningful done. A policy change of this magnitude simply cannot be forced on a slender majority.

As a firm with deep public policy roots, we are proud of our ability to help clients exercise the right enshrined in the U.S. Constitution of petitioning their government. We have been at it since 1965, when Jim Patton encouraged a young White House aide named Tom Boggs to help him build a different kind of law firm, one that understood that all three branches of government could provide solutions to challenging problems. They had a vision for helping clients achieve success by combining political know-how, legislative and regulatory experience, and substantive knowledge of the law. For our paying and pro bono clients alike, we look forward to helping them achieve their legislative objectives as President Obama engages with the 113<sup>th</sup> Congress.



## AGRICULTURE POLICY

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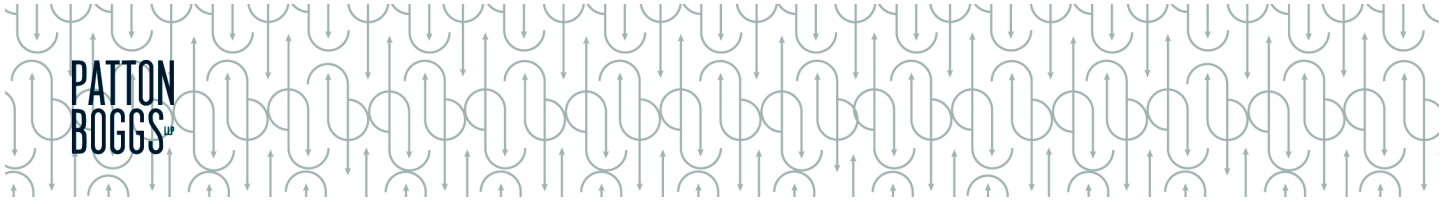
### *Major Issues*

Over the past four years, President Obama and Secretary of Agriculture Tom Vilsack have engaged in a multi-faceted approach to support agriculture and nutrition programs. President Obama established the President's National Export Initiative with the goals of opening new markets for U.S. agricultural products and services, and increasing agricultural exports. As a carryover from his first-term, President Obama will continue to support U.S. negotiations with 11 other countries under the Trans-Pacific Partnership.

This year, both President Obama and Secretary Vilsack unsuccessfully urged Congress to pass a five-year Farm Bill, with the President having endorsed the Senate-passed bill. In its FY 2013 Budget, the Administration proposed cutting farm program spending by about \$30 billion--with much of the cost-savings resulting from the elimination of direct payments and reductions in crop insurance subsidies. In response to the devastating drought that hit the Midwest, the Administration implemented a plan to provide relief to farmers and ranchers by making modifications to the Conservation Reserve Program, Environmental Quality Incentives Program, Wetlands Reserve Program, and Federal Crop Insurance Program.

The Obama Administration also invested in major reforms focused on combating childhood obesity, including through First Lady Michelle Obama's *Let's Move!* campaign. In December 2010, Congress passed the Healthy, Hunger-Free Kids Act, which for the first time in over 30 years allowed the Department of Agriculture (USDA) to make significant reforms to federal school meal and child nutrition programs.

**Farm Bill.** Despite the Senate passing its version of the Farm Bill in June and the House Agriculture Committee reporting out its bill favorably in July, the 2008 Farm Bill expired on September 30, 2012. The House Agriculture Committee bill would cut \$35 billion in spending over ten years, while the Senate-passed bill would cut \$23 billion over ten years. As it remains unlikely Congress will pass a five-year reauthorization in the lame duck session, we expect Congress will pass a one-year extension and punt the reauthorization to the 113<sup>th</sup> Congress.



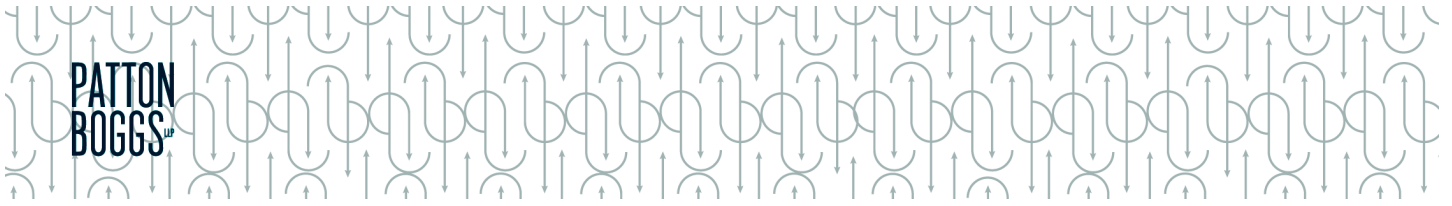
- **Commodity Programs.** Both the Senate-passed bill and the House Agriculture Committee bill would eliminate direct payments, the existing counter-cyclical price program, and the Average Crop Revenue Election (ACRE) program. The bills also would create a new dairy margin insurance program and a new supply management program. Speaker John Boehner (R-OH) has expressed his concern with the supply control aspects of the program, which suggests proposed reforms to the dairy program may get serious consideration (at least in the House.)

The House Agriculture Committee bill would establish a Price Loss Coverage program (a target price-based risk management option for commodities) and a separate STAX program for cotton for which Senators from southern states have voiced their support.

The Senate-passed bill would establish a new shallow loss program to provide aid to farmers when prices drop or crops fail; however, more than a dozen southern Senators, including Mary Landrieu (D-LA) and Saxby Chambliss (R-GA), believe rice, peanuts, and cotton are not protected adequately under the bill's crop insurance program.

Chairwoman Debbie Stabenow (D-MI) and Ranking Member Pat Roberts (R-KS) were able to round up the requisite number of votes to pass the Farm Bill without the support of the southern Senators. But in light of the effective deadlock over the Farm Bill this year, the southern Senators may have an advantage in seeking desired changes to the program in the 113<sup>th</sup> Congress to ensure what they see as the proper protections survive the conferencing of the two bills.

- **Supplemental Nutrition Assistance Program (SNAP).** The House Agriculture Committee Farm Bill would cut \$16 billion from SNAP (formerly known as the Food Stamp Program), which is nearly four times the amount of SNAP cuts included in the Senate-passed bill (\$4 billion in cuts). The degree of reductions to SNAP remains a contentious, partisan issue and is one of the primary reasons why the Republican leadership failed to secure the requisite number of votes to pass a Farm Bill in the House. If Congress passes a one-year extension during the lame duck session, we expect House Republicans to continue to push next year for sizable cuts to SNAP to which Senate Democrats will push back, particularly when the Farm Bill is brought to Conference.

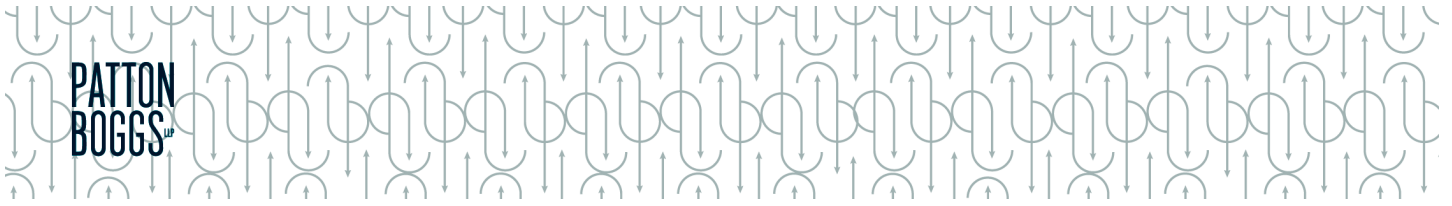


**Implementation of the Healthy, Hunger-Free Kids Act of 2010.** In the 113<sup>th</sup> Congress, House Republicans can be expected to continue their efforts to halt implementation of the *Healthy, Hunger-Free Kids Act* by proposing the repeal of its provisions. We expect legislation to be introduced granting states flexibility in determining what meals should be provided to students or what foods can be offered outside of the school meal programs (competitive foods). In September, House Republicans introduced a bill to repeal new nutrition standards under the National School Lunch and Breakfast programs, and Senate Agriculture Committee Ranking Member Roberts requested from USDA further information and data from the implementation of the rules. Most recently, Representative John Kline (R-MN), Chairman of the House Education and the Workforce Committee, accused USDA of pursuing a “one-size-fits-all” policy. Despite Republican opposition, USDA will likely move forward with implementing the Act by issuing a proposed rule on competitive foods by January 2013.

**Renewable Fuel Standard (RFS).** Many stakeholders in the agriculture sector continue to point to ethanol as the cause of record-high export prices, domestic food price inflation, and commodity prices, especially with corn prices reaching historic highs in August at a little over \$8 a bushel. Deficit reduction will continue to be a motivating factor for reevaluating federal support for ethanol production; however, we do not expect to see any substantial changes in ethanol subsidies beyond what is expected in the Farm Bill (the Senate-passed bill does not repeal or eliminate USDA programs critical to ethanol production and maintains existing research and loan guarantee programs that support ethanol production; the House Agriculture Committee’s Farm Bill eliminates funding for the establishment of ethanol blender pumps), especially with the expiration of the ethanol tax credit and import tariffs.

In September, the Environmental Protection Agency (EPA) solicited comments on two petitions from Governors Beverly Perdue (D-NC) and Mike Beebe (D-AR), requesting EPA waive the RFS for 2013. On this issue, Secretary Vilsack has continuously voiced strong support for preserving the current RFS program. We expect EPA to deny the waiver request before the end of the year.

**Trans-Pacific Partnership.** The ongoing Trans-Pacific Partnership (TPP) negotiations have the potential to affect U.S. agriculture policy and will continue to have the full backing of President Obama (for more on this, please see the chapter on Trade Policy). This is especially true given the recent additions of Canada and Mexico, who will join the rest of the TPP nations—Australia, Brunei



Darussalam, Chile, Malaysia, New Zealand, Peru, Singapore, Vietnam, and the United States—for the first time in the next round of negotiations in New Zealand this December.

Through the TPP, the U.S. will address with Canada, Mexico, Australia, and other countries important issues involving major agricultural commodities such as sugar and dairy. For example, Australia has grown increasingly frustrated with the U.S.'s refusal to revisit opening the U.S. sugar market, which uses strict quotas to restrict imports. Additionally, TPP negotiations will continue to cover market access and sanitary and phytosanitary standards (SPS).

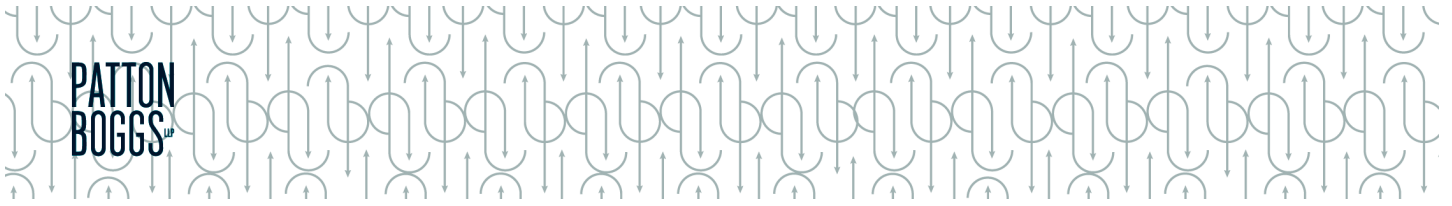
**Commodity Futures Trade Commission.** In 2013, the CFTC will continue its efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). To date, the CFTC has proposed 39 rules, though implementation is still months away for many of them.

Among the issues the CFTC will address are the position limits rulemaking, which was recently struck down by a Federal District Court. The CFTC is also expected to finalize rules related to the operation of swap execution facilities, provide guidance on the international application of the new swap regulatory regime, continue its work in designating swaps subject to mandatory clearing and trade execution, register and regulate swap dealers and major swap participants, and implement the reporting requirements for swap transaction data.

In response to the collapse of MF Global and Peregrine, the CFTC can be expected to take on new rulemakings with the goal of bolstering customer protection requirements. The CFTC will also scrutinize high frequency trading, with a concept paper expected to be released in the near future.

#### *Forecast for the 113<sup>th</sup> Congress*

Should Congress pass a one-year extension of the 2008 Farm Bill during the lame duck session, then we expect Congress to pass a five-year Farm Bill before the end of the first session of the 113<sup>th</sup> Congress. If Congress fails to pass a five-year Farm Bill before March 2013, the final legislation will likely include updated spending estimates that take into account this year's high price of corn and other commodities, as well as higher price projections over the next few years. This scenario would favor the approach taken under the House Committee bill as opposed to the Senate's as the higher market prices would most likely increase the cost of subsidizing farmers under the Senate-passed



bill, but lower costs under the House Agriculture Committee Farm Bill. In addition to commodity programs, SNAP funding will remain a high-stakes issue between both chambers and parties, as Republicans will view the counter-cyclical nutrition program as the primary source for cost savings. It is likely that the House Agriculture Committee will markup its version of the Farm Bill by late February or early March.

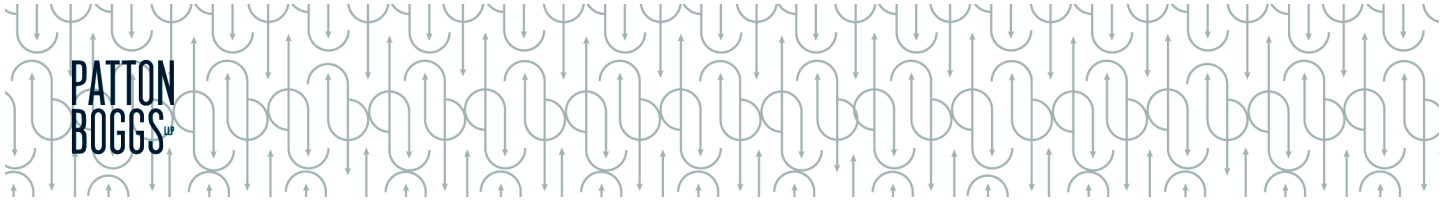
As for CFTC-related issues, Chairwoman Stabenow is likely to continue pursuing various technical amendments to Title VII of the Dodd-Frank Act related to derivatives regulation. In contrast, House Republicans will continue to push for the repeal of certain Dodd-Frank Act provisions and engage in aggressive oversight of the CFTC rulemaking process.

In terms of the Renewable Fuel Standard, we expect House committees to start holding hearings on this issue given Members' concerns with high commodity prices, how the mandate regulates the market, and the problems refiners are confronting to comply with EPA regulations. We also expect the Senate to address the ethanol mandate, particularly in the Energy and Natural Resources Committee most likely chaired by Senator Ron Wyden (D-OR). Most likely, the House will move first on this issue.

#### *Anticipated Agency and Committee Developments*

**Secretary of Agriculture.** To move forward President Obama's agriculture agenda for his second term, Secretary Vilsack is likely to continue serving in this role. Should Secretary Vilsack decide to step down, the two front-runners are reported to be former Democratic Senator and former Chair of the Senate Agriculture Committee, Blanche Lincoln (D-AR), and Senator Kent Conrad (D-ND), who is retiring from the Senate. Both are well respected in the Senate, and Senator Conrad is known for expertise in issues related to the budget and his leadership in bi-partisan efforts to pass previous Farm Bills.

**CFTC.** The term for Chairman Gary Gensler expired in April 2012, and the term for Commissioner Bart Chilton will expire in April 2013. With Obama winning re-election, he will either nominate new Commissioners and designate a new Chair or re-nominate the two incumbents, with one selected as Chair. Regardless, the nominations will be the subject of major debate in the Senate as the nominees will have a significant impact on the direction of the implementation of the Dodd-Frank Act.



**House Agriculture Committee.** Representative Frank Lucas (R-OK) and Collin Peterson (D-MN) will continue to serve as Chairman and Ranking Member, respectively.

**Senate Agriculture Committee.** With Democrats retaining control of the Senate, Senator Debbie Stabenow remains Chairwoman and Senator Pat Roberts will continue as the Ranking Member.

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*Contact Information*

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## **BUDGET AND SEQUESTRATION**

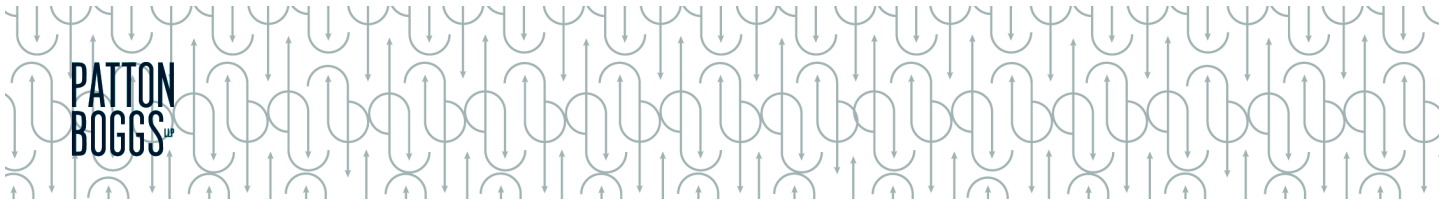
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*Major Issues*

The federal budget and the health of the nation’s economy will shape the 113<sup>th</sup> Congress and the second term of President Obama. Unless Congress and the White House are able to agree on a comprehensive plan for deficit reduction in the lame duck session, the 113<sup>th</sup> Congress will begin with the nation’s economy falling off of a fiscal cliff and potentially into another recession.

To prevent the U.S. Treasury from going into default, the Budget Control Act of 2011 was enacted to raise the nation’s debt limit by \$2.1 trillion (implemented in three installments over the course of six months). The Budget Control Act also mandated deficit reduction measures to offset the debt ceiling increase. The initial increase of \$900 billion in borrowing authority was fully offset through discretionary spending caps for FY 2013 through FY 2021 specifically identified in the Budget Control Act. To offset the final debt ceiling installment, the bill authorized a Joint Select Committee on Deficit Reduction (the “Super Committee”) to craft a plan to reduce the deficit by \$1.2 to \$1.5 trillion. In the event the Super Committee and/or Congress failed to approve such a deficit reduction package, the law mandated automatic spending cuts to defense and domestic non-exempt discretionary, mandatory, and entitlement programs totaling \$1.2 trillion over ten years to go into effect on January 2, 2013.

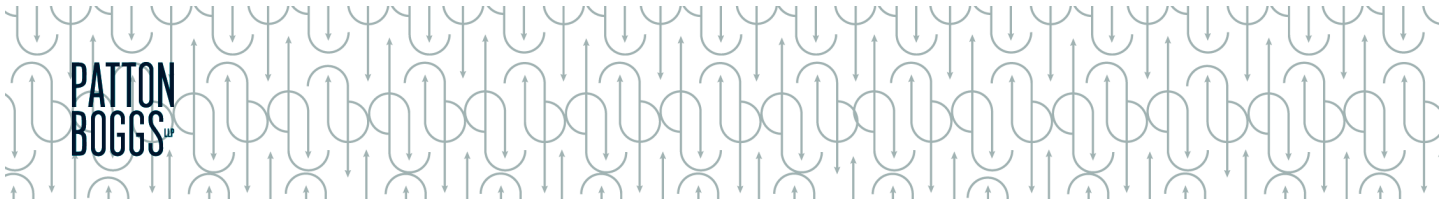




The sequestration process would involve across-the-board cuts evenly divided between security and non-security functions. (While there are other agencies and accounts included in the security category, the sequestration is generally referenced in terms of defense and non-defense, or domestic, spending.) Over nine fiscal years (FY 2013 – FY 2021), \$1.2 trillion in sequestration cuts would amount to a \$984 billion reduction in federal spending, with the remaining \$216 billion coming from savings of interest payments. For FY 2013, non-exempt federal agencies and programs would be reduced by \$109 billion: discretionary domestic (non-defense) programs by 8.2 percent; mandatory/direct domestic (non-defense) programs by 7.6 percent; discretionary defense programs by 9.4 percent; and mandatory/direct defense programs by 10 percent. Overall, the sequestration process would cut spending across over 1,200 non-exempt federal accounts—\$54.67 billion from defense programs; \$38 billion from domestic discretionary programs; \$11 billion from Medicare (no beneficiary cuts); and \$5 billion from other mandatory spending programs.

While Democrats and Republicans agree that sequestration must be avoided, partisan brinkmanship on how to achieve deficit reduction—whether through additional tax revenue, spending cuts, or a combination of both—was heightened leading up to the election and has thus far prevented a comprehensive agreement, thereby potentially setting the stage for intense lame duck negotiations. During the third Presidential debate, President Obama stated that sequestration “will not happen;” the President’s advisors clarified that he was merely expressing the opinion of many that some type of agreement can and must be reached to prevent the automatic spending cuts. Congressional Republicans may use the President’s statement to extract concessions, such as maintaining defense spending and preserving the Bush tax cuts for all taxpayers.

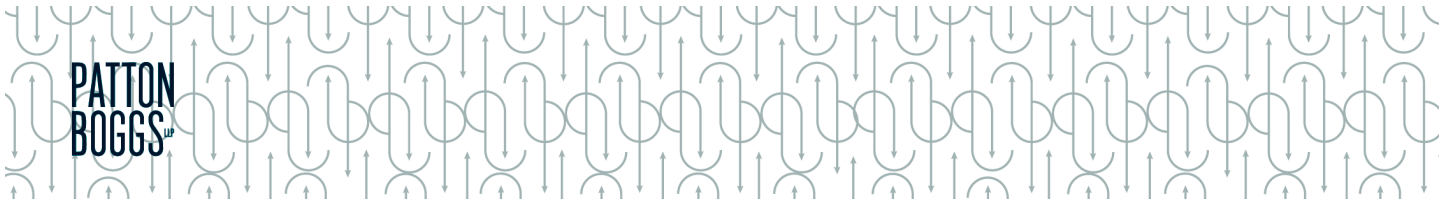
In the run up to the election, lawmakers from both parties had been working behind the scenes to develop strategies that would at least delay the fiscal crisis and provide the new Congress time to develop a comprehensive plan. Among them is a bipartisan group of eight Senators who have been working on a framework for a deficit reduction plan comprised of spending cuts, tax reform, and changes to entitlement programs that is reportedly modeled after the \$4 trillion proposal the National Commission on Fiscal Responsibility and Reform, chaired by former Senator Alan Simpson and President Bill Clinton’s White House chief of staff Erskine Bowles, set forth in 2010. The “Gang of Eight” is comprised of Senators Mark Warner (D-VA); Richard Durbin (D-IL); Kent Conrad (D-ND); Michael Bennet (D-CO); Saxby Chambliss (R-GA); Tom Coburn (R-OK); Michael Crapo (R-ID); and Mike Johanns (R-NE).



In order to reach agreement on such a plan, however, Republicans and Democrats must be willing to work together and compromise. Leading up to the election, President Obama reiterated his threat to veto any proposal that does not increase tax rates on the wealthy (which he generally defines as individuals earning over \$200,000/married couples earning over \$250,000, although some prominent Democrats have advocated for a higher threshold of \$500,000 or \$1 million). Despite his re-election, the election was too close to be considered a mandate. As we noted in our Introduction, we expect a concerted push to get something done but the lame duck session might not provide enough time for the ultimate dealmakers—President Obama and the congressional leadership—to negotiate and secure adequate rank-and-file congressional support to pass a comprehensive deal that resolves all the major issues, including increasing the debt ceiling.

In order to defer sequestration and avoid another downgrade of the U.S. debt rating that occurred as a result of the protracted and contentious debate in last year's debt ceiling negotiation, Congress will likely pursue one of several options to defer sequestration until next year. Several Republican and Democratic lawmakers have floated short-term proposals in which a \$20 billion to \$75 billion deficit reduction "down payment" is used to delay the process for three to six months, or even a year. Another possibility is that the \$984 billion in spending cuts is postponed and subsequently implemented into a shorter window, *i.e.*, over eight fiscal years instead of nine. Some conservatives in both chambers are hesitant to delay sequestration because its forced spending reductions were the only concessions they received in raising the debt ceiling in 2011.

For the eighteenth consecutive year, Congress was unable to complete the appropriations process in regular order and prior to the start of the federal fiscal year on October 1. Hence, a Continuing Resolution (CR) was enacted which funds the federal government through March 27, 2013. Despite lingering friction over top-line discretionary numbers (the House adopted a \$1.028 trillion spending limit while the Senate utilized the cap of \$1.047 trillion established in the Budget Control Act), Republicans agreed to use the \$1.047 trillion discretionary spending cap in the CR (an increase of 0.6 percent over FY 2012 spending). As the damage assessments from Hurricane Sandy continue to rise, Congress may need to take up a supplemental appropriations package during the lame duck to provide emergency disaster relief funding to several federal agencies.

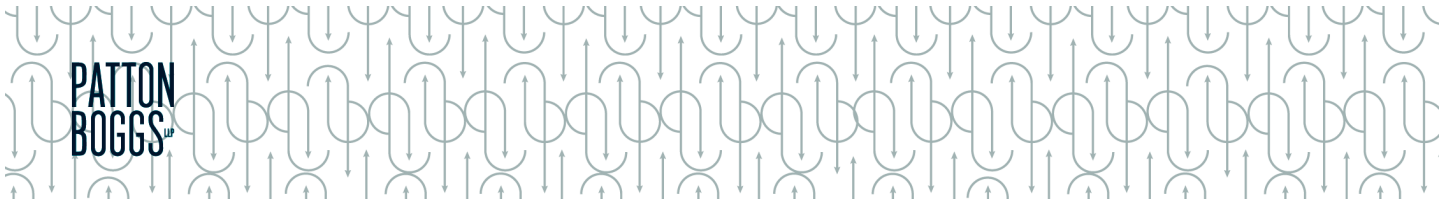


### *Forecast for the 113<sup>th</sup> Congress*

In the weeks leading up to his re-election, President Obama expressed confidence in reaching a comprehensive and balanced deficit reduction agreement within the first six months of his second term. But it will be difficult to achieve any agreement without bipartisan compromise. If the bipartisan Senate “Gang of Eight” puts forward a proposal, this may be a factor in the negotiations. That said, prior “Gang” proposals have not had a history of success. Bills recently passed along party lines in the House and Senate are likely indicative of initial party positions. In July, after defeating a wholesale extension of the Bush-era tax cuts for one year, the Senate on a nearly straight party-line vote symbolically approved a bill to support the middle class by limiting the extension to those individuals earning less than \$250,000. In September, the House also by a nearly straight party-line vote approved a measure to replace sequestration with only spending reductions and no revenue increases. While it will be difficult to achieve any agreement without bipartisan compromise, continued Democratic control of the Senate could yet lead to compromise and agreement.

Within the first three months of next year Congress also must resolve the FY 2013 federal budget. There are two probable scenarios for the resolution of the final six months of the federal FY 2013 budget. First, an omnibus bill could be drafted in order to provide Members the opportunity to propose policy and funding changes. Second, an extension of the CR could be enacted in order to allow Members to focus on the broader deficit reduction package. It is important to note that no matter how the FY 2013 process is resolved, sequestration—or whatever deficit reduction measures are put into place—will certainly have an impact and decrease spending in FY 2013 and beyond.

We anticipate that Congress will endeavor to return to normal order for the FY 2014 budget process and attempt to approve individual spending bills prior to the start of the federal fiscal year on October 1. The earmark moratorium implemented for the FY 2011, FY 2012, and FY 2013 appropriations cycles likely will be renewed, albeit with some potential changes to the definition of an earmark. While there are Members who view earmarks positively (*e.g.*, as a means to bring federal funding back to their districts/states and regain some control over the allocation of federal funds), there also remains strong opposition, even with the transparency measures and limitations put into place prior to the ban. Moreover, President Obama has repeatedly threatened to veto any bill that comes across his desk with earmarks. However, some Republican Members who strongly supported the ban have since raised questions upon realizing the ban included authorized transportation and water projects, limited tax benefits, and limited tariff benefits. Additionally, Members of both parties



are becoming increasingly aware of their decision to take away their “power of the purse,” leaving spending allocation decisions solely in the hands of the Administration. As such, there likely will be efforts to rework the earmark process. While a wholesale return of earmarks is not likely, a new definition is expected to be less comprehensive than what the current ban covers.

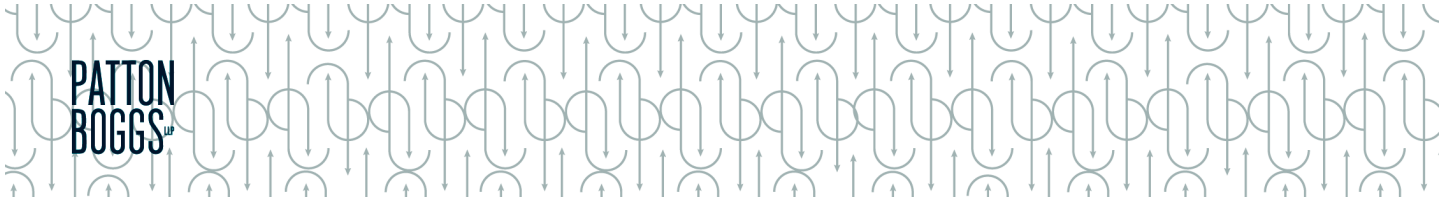
### *Anticipated Committee Developments*

**Senate Committees.** We expect Senator Daniel Inouye (D-HI) will retain his position as Chairman of the Senate Appropriations Committee. Senator Thad Cochran (R-MS) is term-limited as Ranking Member due to the Republican rule limiting service as Ranking Member of a full committee to six years. Unless Senator Cochran receives a waiver from leadership to retain his position, Senator Richard Shelby (R-AL) will likely assume the role of Ranking Member. Two Democrats and one Republican currently serving on the committee are leaving the Senate at the end of the year.

Senate Budget Committee Chairman Kent Conrad (D-ND) is retiring at the end of this Congress and Senator Patty Murray (D-WA) is next in seniority to chair the committee. To do so, she will have to relinquish her position as Chairman of the Veteran Affairs Committee. She will make this decision in the coming weeks. Senator Jeff Sessions (R-AL) will likely remain as Ranking Member.

**House Committees.** House Appropriations Committee Chairman Hal Rogers (R-KY) will likely retain his position in the 113<sup>th</sup> Congress. Ranking Member Norm Dicks (D-WA) is retiring. Representative Marcy Kaptur (D-OH) is next in seniority to serve as Ranking Member, but she will face a spirited challenge from Representative Nita Lowey (D-NY). Four Republicans and four Democrats currently serving on the committee will not return to the committee next year. Representative Tim Ryan (D-OH) has expressed an interest in reclaiming the committee seat he lost when Republicans took control of the House in 2011. With years of Continuing Resolutions replacing regular order in passing appropriations bills, the earmark ban, and a fiscal environment of spending reductions, serving on the House Appropriations Committee may not be quite the coveted spot it was in the past.

House Budget Committee Chairman Paul Ryan (R-WI) will also require—and will likely be granted—a term-limit waiver to retain his chairmanship. In the event he is not granted a waiver, Representative Scott Garrett (R-NJ) will likely replace him as chair, although Mr. Garrett could face challenges from Representatives John Campbell (R-CA) and Tom Price (R-GA). Representative



Chris Van Hollen (D-MD) will likely continue as Ranking Member. Only one Republican and one Democrat currently serving on the committee will not return to Congress next year; Representative Tim Ryan (D-OH) announced he would resign from the Budget Committee if he returns to the Appropriations Committee.

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#### *Contact Information*

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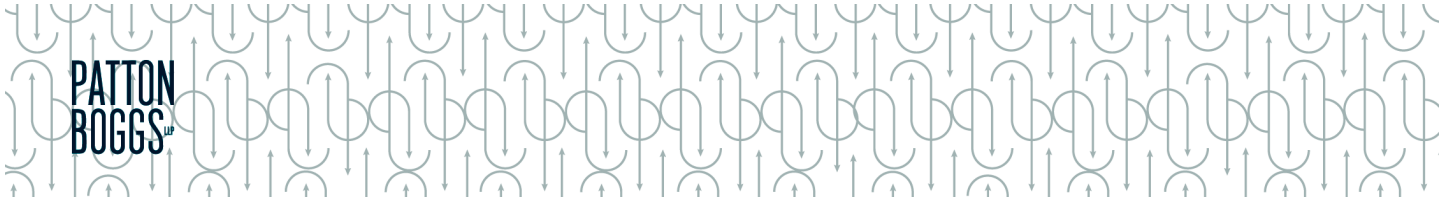
## **DEFENSE AND FOREIGN POLICY**

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### *Defense Issues*

**Budget and Sequestration Decisions.** As noted in our introduction, the President and Congress face major decisions in addressing the looming fiscal cliff, the sequestration portion of which will have a particularly significant impact on defense spending. While President Obama already has signaled he is prepared to compromise over the automatic defense cuts, Congressional Republicans have not yet indicated any willingness to strike a deal that includes revenue increases and assumes continuation of the Administration's domestic spending priorities. The threat of looming defense reductions under sequester and automatic tax increases when the Bush tax cuts expire was intended to spur Republican movement on those issues, even as most analysts already had predicted that the Administration and Congress would find a way to avoid the automatic cuts.

Now, following President Obama's public commitment during the last debate with Governor Romney to avoid sequester, Congressional Republicans have less incentive to negotiate on the Administration's non-defense priorities. That is especially the case given that House Republicans can claim a mandate of their own, having staved off Democratic efforts to reclaim the House. Most Senate and House Democratic negotiators also have been anxious to prevent the across-the-board defense reductions from taking hold, even as they realize the inherent challenges in reaching a more comprehensive long term deficit reduction plan that addresses entitlements, discretionary spending and revenue from taxes. Accordingly, a lame duck deal to postpone most of the larger budgetary



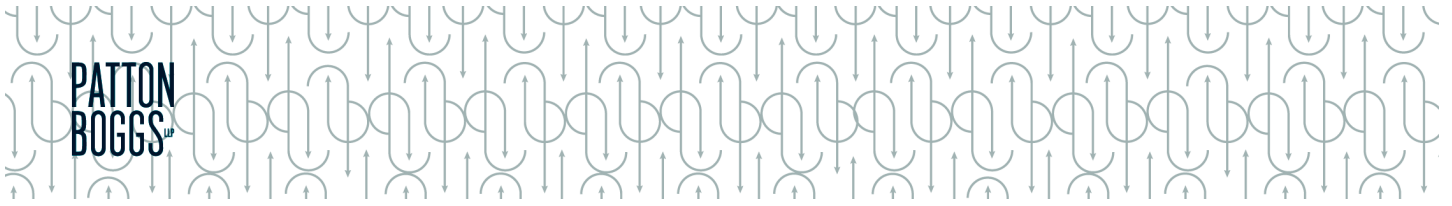
decisions, including staving off the bulk of the approximately \$55 billion in the first year of defense cuts, will remain a priority for Members particularly concerned about maintaining a strong defense industrial base.

Following an agreement on sequestration, the Administration and House and Senate Armed Services and Appropriations Committees must turn their attention back to broader questions of the defense budget for the remainder of FY 2013 and the FY 2014 appropriations cycles. The Continuing Resolution, funding government operations including defense, expires on March 27, 2013 and must either be replaced by appropriations acts or a further Continuing Resolution. The eventual outcome for the FY 2013 defense appropriations bill will be the President's budget numbers as reflected in the Senate mark-ups, not the increase contained in the bill passed by the Republican-controlled House.

While the Administration has already built in reductions to defense of \$487 billion over the next ten years (which was agreed to in the Budget Control Act of 2011), most defense experts predict additional reductions beyond that amount even without sequester. These additional reductions in defense spending will be part of the agreement needed to reduce the deficit over the longer term. Personnel reductions beyond the 100,000 already planned are likely. The pressure on the procurement and research and development budgets will be intense. The drawdowns in Iraq and Afghanistan will have the most immediate effect on those companies providing the supplies and manpower needed to support those contingency operations. However, the major aerospace and defense companies can certainly expect a slowdown in the acquisition of new weapons systems and reductions in the number of previously planned systems.

#### *Anticipated Agency and Committee Developments*

**Secretary of Defense.** Most defense experts predict that Secretary Panetta will step down, following a highly respected career in Washington as House Budget Committee Chairman, President Clinton's budget director and Chief of Staff, and President Obama's CIA Director and Defense Secretary. Most defense analysts tend to view Secretary Panetta's legacy as one of generally effective management of the Pentagon bureaucracy and ardent advocacy on budget, Afghanistan, and Iraq matters, but as more of a transitional figure than an influence on larger defense policy and force structure issues. In comparison, Michelle Flournoy, the former Under Secretary of Defense for Policy, whom most Pentagon watchers consider to be the leading candidate to succeed Secretary



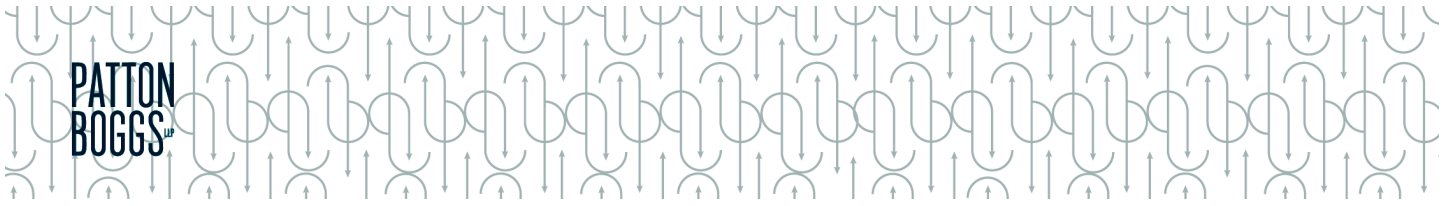
Panetta, likely would play a more aggressive role in tackling those larger structural issues in the near term. Flournoy advised the Obama campaign on national security issues, and she also served in the Clinton Administration Defense Department and in the think tank community. Other leading candidates to be Secretary of Defense include Senate Armed Services Committee Member Jack Reed (D-RI), Deputy Secretary of Defense Ash Carter, and former Clinton Secretary of the Navy Richard Danzig.

**Senate Armed Services Committee (SASC).** Senator Carl Levin (D-MI) is expected to remain as SASC Chairman. Senator Levin will continue his opposition to sequestration while remaining open to targeted defense cuts as part of a balanced approach to a grand bargain on tax revenues and domestic spending issues. A longtime supporter of nonproliferation efforts and a leading advocate of the Obama Administration’s “reset” in U.S.-Russian relations, Senator Levin also will attempt to help revive Russian interest in the Nunn-Lugar Cooperative Threat Reduction program. The Democratic SASC Caucus will experience some turnover in its ranks, as Committee Members Joe Lieberman (D-CT), Daniel Akaka (D-HI), Ben Nelson (D-NE), and Jim Webb (D-VA) all are retiring at the end of this year.

Senator Jim Inhofe (R-OK) is the favorite to serve as the SASC’s next Ranking Member, replacing Senator John McCain (R-AZ), who is term-limited in that position. Senator Inhofe will push the Administration hard on missile defense issues, but Senator Inhofe and his staff have forged some bipartisan cooperation on other SASC matters. The defeat of Senator Scott Brown (R-MA) creates a vacancy among the SASC’s Republican membership.

**Senate Appropriations Committee.** The committee is likely to remain in the hands of seasoned defense experts who will be heavily engaged in the budget and spending decisions discussed above. Senator Daniel Inouye (D-HI) is likely to retain his position as the Chairman of both the full Senate Appropriations Committee and its Defense Subcommittee. Senator Thad Cochran (R-MS) is term-limited as Ranking Member of the full committee, but he may well stay on as Ranking Member of the Defense Subcommittee. Senator Richard Shelby (R-AL), a member of the Defense Subcommittee, is likely to replace him as Ranking Member of the full committee. Senator Herb Kohl (D-WI) and Senator Kay Bailey Hutchison (R-TX) will leave the Defense Subcommittee.

**House Armed Services Committee.** After losing numerous senior HASC members to retirement or electoral defeat in the elections of 2006, 2008, and 2010, the committee will have greater



continuity from the 112<sup>th</sup> Congress to the 113<sup>th</sup> Congress. Representatives Todd Platts (R-PA) and Silvestre Reyes (D-TX) retired from the House. HASC Seapower Subcommittee Chairman Todd Akin (R-MO) lost a Senate race, Representative Martin Heinrich (D-NM) has been elected to the Senate and may vie for a SASC seat there, and a handful of other HASC members were defeated for reelection, including Tactical Air and Land Forces Subcommittee Chairman Roscoe Bartlett (R-MD), Representative Bobby Schilling (R-IL), Representative Larry Kissell (D-NC), and, pending a final count, likely Representative Allen West (R-FL). Unfortunately, the bipartisan cooperation that marked the committee's work in prior years is in relative decline, as the number of relatively new HASC members are often either unaccustomed or unwilling to work across party lines on a regular basis. Representative Buck McKeon (R-CA) will remain as HASC Chairman, and Representative Adam Smith (D-WA) will continue to serve as Ranking Member. Chairman McKeon will continue his public campaign against sequestration and other potential defense budget cuts while remaining skeptical of any future Libya-like deployments of U.S. combat power for humanitarian purposes. For instance, Chairman McKeon is deeply wary of further involvement by the Administration in the Syrian conflict. Ranking Member Smith will continue to spar with the Chairman on budget issues, as the Washington Representative calls for a balanced approach that can include targeted defense and non-defense cuts, along with revenue increases.

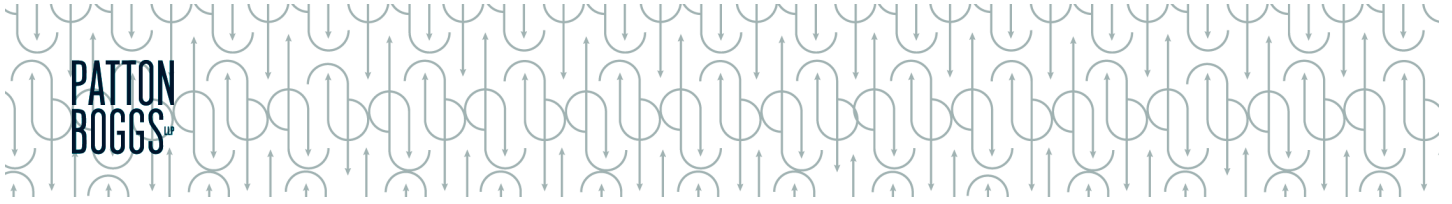
#### *Other National Security Issues*

**Afghanistan and Pakistan.** The Obama Administration will stand by its decision to withdraw U.S. combat troops from Afghanistan by 2014. Many Congressional Republicans will continue to oppose this timeline, as well as to the announcement of *any* concrete withdrawal timeline. However, public weariness with the war, along with the intermittent progress in the training of Afghan military and police units and the incremental if incomplete progress against Taliban forces, likely will override those objections and cement the U.S. withdrawal schedule.

The U.S. military withdrawal from Afghanistan may be the only upcoming development that can check the deterioration in U.S.-Pakistan relations. However, Washington will continue to be clear with Pakistan's civilian and military leadership that it will refuse to take off the table future drone strikes and other potential operations involving Al Qaeda-affiliated targets in Pakistani territory.

**Iran.** In addressing arguably the most pressing foreign policy issue of the President's second term, the Obama Administration will continue its focus on enforcing and selectively expanding



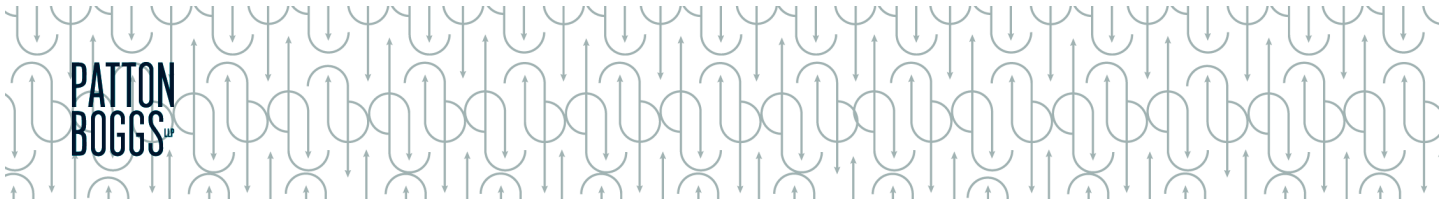


multilateral (and corresponding unilateral) sanctions in order to intensify the pressure against the Iranian Government as it pursues its nuclear enrichment program. The Administration has been frankly surprised by the degree of international cooperation it has received from European and Asian Governments over the past four years, and it will seek to build on that momentum.

At the same time, the White House will selectively consider imposing unilateral sanctions against third-party actors doing business with the Iranian regime or Iran's oil and gas industry, as Congress has continued to expand the menu of available sanctions options. The Obama Administration generally will continue to follow the lead of its predecessors, the Bush and Clinton Administrations, in avoiding the imposition of sanctions against allies supporting the overall effort. President Obama's recent decision to grant waivers to U.S. allies who had reduced, but not eliminated, their oil imports from Iran caused barely a ripple on Capitol Hill, despite the numerous advocates in Congress for stringent unilateral sanctions against the Iranian regime. Still, the Republican-led House may seek to curtail Presidential waiver authority in the next Congress.

If continued sanctions and diplomatic warnings fail to dissuade Iran from weaponizing its fissile material and possibly outfitting launch vehicles, most experts believe President Obama likely would undertake a preemptive military strike on Iranian nuclear targets. The larger question, though, is how the Administration would respond in the interim to calls from Members of Congress, the Israeli Government, and others to consider an attack at an earlier stage of Iranian preparations. Most analysts believe the White House would continue to resist such calls and would argue strongly against Israel taking unilateral military action. If Israel were to act on its own, the Administration likely would offer modest encouragement in public while expressing displeasure and engaging in diplomatic damage control behind closed doors.

**Syria.** It is doubtful the Obama Administration will intervene militarily in Syria, given its high degree of wariness to this point about the capabilities and intentions of certain parts of the Syrian opposition. However, the clear humanitarian tragedy underway, the opposition's military progress against the Assad regime, and the heightened feelings of insecurity from strong U.S. ally Turkey all combine to suggest that a moderate increase in U.S. support for the opposition is forthcoming. Such support could include lethal military assistance, but the Administration has been reluctant to cross that threshold to this point.



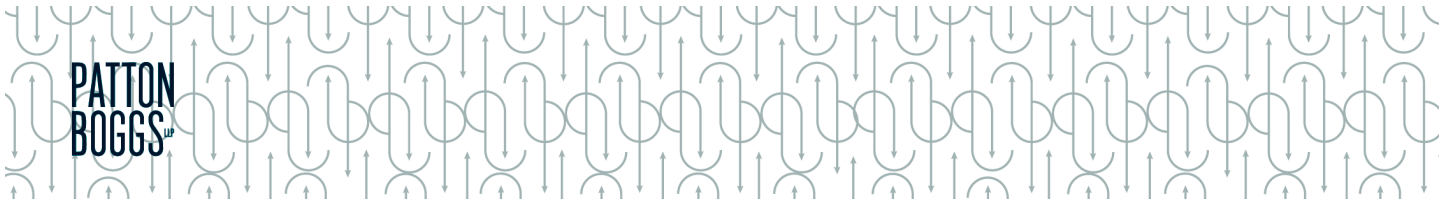
**Response to the Arab Spring.** The Obama Administration also has much work to do in firming up its response to regime change in the Middle East. The new Secretary of State, in particular, not only will engage in continued fence-mending with longtime allies such as Saudi Arabia and Jordan, but he or she also will have to push hard in Congress for foreign assistance to countries such as Egypt and Libya. Some Members of Congress, such as Senator Rand Paul (R-KY), are increasingly working against such assistance. However, to this point, Senate Appropriations Foreign Operations Subcommittee Ranking Member Lindsey Graham (R-SC) and numerous Senate and House Democrats have worked to mitigate cuts to key foreign assistance accounts for the Arab World and elsewhere.

**Export Control Reform.** In 2010, President Obama announced an *Export Control Reform Initiative* to modernize and streamline U.S. export controls on defense and dual-use goods and technologies. Within the Administration, the initiative was championed by, *inter alia*, former Defense Secretary Robert Gates, the only Republican member of the Obama Cabinet at the time. The defense industry widely supports the initiative, arguing that the existing export control regulations are complicated and burdensome and that, especially with respect to military products, U.S. export controls are overly detailed and intrusive.

The Administration has made good progress toward transferring from military to civilian export controls a myriad of less-sensitive products, technologies, and component parts. This effort has generated opposition from Congress, however, which believes it has been largely left out of the process. It has also generated some opposition from some circumspect agencies within the Administration, especially within the Defense Department. Nevertheless, with the re-election of President Obama, we expect to see the Initiative's continued movement toward completion, but the likelihood of passage of the legislation required for full implementation will depend upon the dynamics and receptivity of the 113<sup>th</sup> Congress.

#### *Anticipated Agency and Committee Developments*

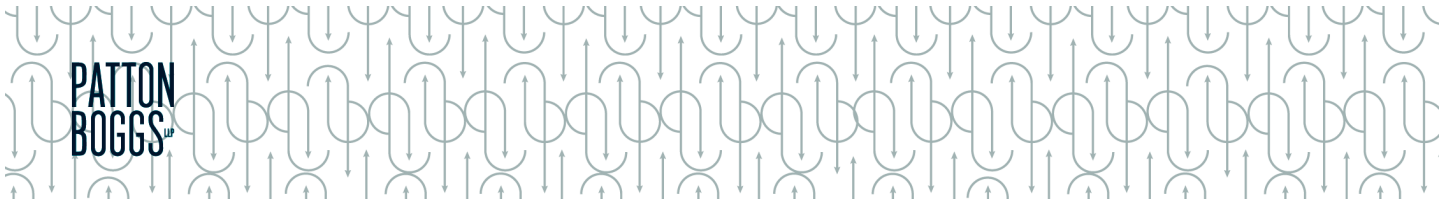
**Secretary of State.** Secretary of State Hillary Clinton will depart as President Obama's second term begins. Secretary Clinton will leave with her formidable political legacy burnished still further by her highly regarded diplomatic tenure at Foggy Bottom. Senate Foreign Relations Committee Chairman John Kerry (D-MA) is a candidate to succeed Secretary Clinton, but might stay in the Senate given the odds that Senator Scott Brown, having just lost his seat to Senator-elect Elizabeth Warren (D-



MA), would likely be favored to win the special election to fill his seat. The Secretary has indicated that she would stay a reasonable time to allow time for the Senate to confirm her successor, which it is likely to do quickly if Senator Kerry were to be nominated. He has served as an ardent and articulate defender of the Obama Administration's foreign policy record and is a longtime foreign policy confidant of Vice President Biden. U.S. Ambassador to the United Nations Susan Rice also will receive strong consideration, as befitting her rapid rise through the Democratic foreign policy establishment. However, she would face a more arduous nomination process. Additional candidates include Senator Richard Lugar (R-IN) and Representative Howard Berman (D-CA), both of whom lost their bids to return to Congress, Lugar in his primary and Berman to fellow Californian Brad Sherman in the general election.

**National Security Adviser.** President Obama might ask Tom Donilon to serve as Secretary of State, but his relatively lower public profile and his longtime advisory roles in Democratic Administrations make it more likely he will remain in place as National Security Adviser. If Donilon does leave the West Wing, Ambassador Rice (who would not be subject to a grueling Senate confirmation for that White House position) and Deputy National Security Advisor Denis McDonough likely would be favorites for the post. Former Deputy Secretary of State and Deputy National Security Adviser Jim Steinberg would bring intellectual heft and political acumen to the position or as a potential nominee as Secretary of State, but reports of a prickly management style may work against him.

**Senate Foreign Relations Committee (SFRC).** If President Obama does not nominate Senator Kerry as Secretary of State, the Senator almost certainly will continue to serve as Chairman. If Senator Kerry does depart, Senator Barbara Boxer (D-CA) would be in line to succeed him as the first woman to hold the position. If she were to opt to stay as Chairman of the Senate Environment and Public Works Committee, the jurisdictional interests of which are important to her home state, Senator Bob Menendez (D-NJ) would likely take over as Chairman. Senator Menendez has long taken an interest in foreign affairs issues, including during his previous tenure in the House. In general, the Senator will serve as a forceful defender of the Administration's policies. However, he is likely to be more aggressive on two of his longstanding key issues: Cuba and Iran. Senator Menendez has been a leading advocate for strict unilateral sanctions on Iran. Coming from a Cuban-American family himself, the Senator strongly opposes any normalization of relations with Cuba for the foreseeable future.

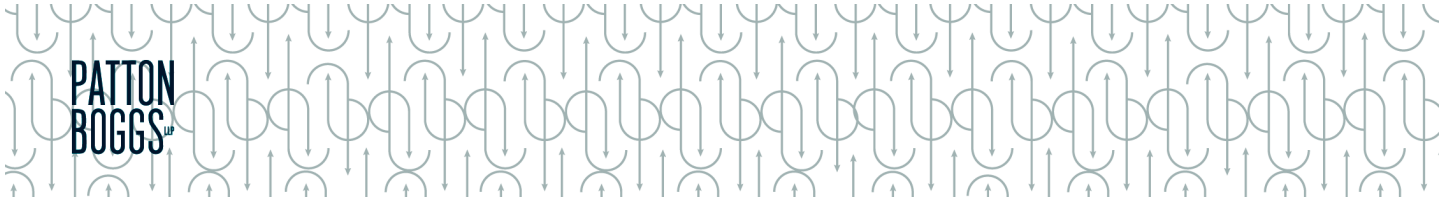


Senator Bob Corker (R-TN) is likely to take over as Ranking Member, as longtime member Senator Richard Lugar (R-IN) retires following his primary defeat earlier this year. A leading skeptic regarding the Libya intervention, Senator Corker likely will continue his criticism of the Administration's approach to War Powers issues. On the other hand, Senator Corker's vote for the "New START" nuclear arms reduction treaty with Russia is just one example of the Senator working with the Administration and SFRC Democrats on other issues. In addition to Senator Lugar, Senator Jim Webb (D-VA) is retiring, meaning another Committee member will have to strive to replace Senator Webb's leadership on East Asian security and diplomatic issues.

**Senate Appropriations Committee.** Senator Patrick Leahy (D-VT) and Senator Lindsey Graham (R-SC) are very likely to continue to serve as Chairman and Ranking Member, respectively, of the Senate Appropriations Committee's Foreign Operations Subcommittee. Senator Leahy will continue to serve as a zealous advocate for human rights causes and well-designed foreign assistance programs. Senator Graham will be a key pivot point for foreign assistance issues, as the Senator will continue to make the case to fellow Republicans that targeted foreign aid is a worthwhile extension of the U.S. national security budget.

**House Foreign Affairs Committee (HFAC).** The HFAC Leadership is likely to see significant turnover in the next Congress. Chairman Ileana Ros-Lehtinen (R-FL) would like to continue to serve in the position, but she is term-limited and will not likely receive a waiver to do so. Representative Ed Royce (R-CA) is the favorite to serve as the next Chairman, although Representative Chris Smith (R-NJ) also will receive support. Representative Royce has been particularly active on nonproliferation and Korean Peninsula issues during his HFAC tenure. Representative Smith is a vocal advocate for global human rights causes, as evidenced by his Chairmanship of the Commission on Security and Cooperation in Europe, otherwise known as the Helsinki Commission.

Meanwhile, HFAC Democrats will experience substantial turnover as well. HFAC Ranking Member Howard Berman (D-CA), an admired voice on foreign policy matters, lost his intra-party re-election bid to fellow senior HFAC member Brad Sherman (D-CA). Representative Sherman now likely will make an effort to serve as Ranking Member. However, Representative Eliot Engel (D-NY) and Delegate Eni Faleomavega (D-AS) may contend for the role as well.



**House Appropriations Committee.** Chairwoman Kay Granger (R-TX) may have a new ranking colleague next year at the top of the House Appropriations Committee’s Foreign Operations Subcommittee. Current Ranking Member Nita Lowey (D-NY) is the favorite to ascend to Ranking Member of the full committee. In that case, Representative Adam Schiff (D-CA) and Representative Jim Moran (D-VA), among others, may seek to serve as Subcommittee Ranking Member. Chairwoman Granger will continue to advocate for continued, targeted cuts to the foreign assistance budget, sparring with Democratic House and Senate appropriators and the Administration while balancing calls from some other House Republicans for more drastic reductions.

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*Contact Information*

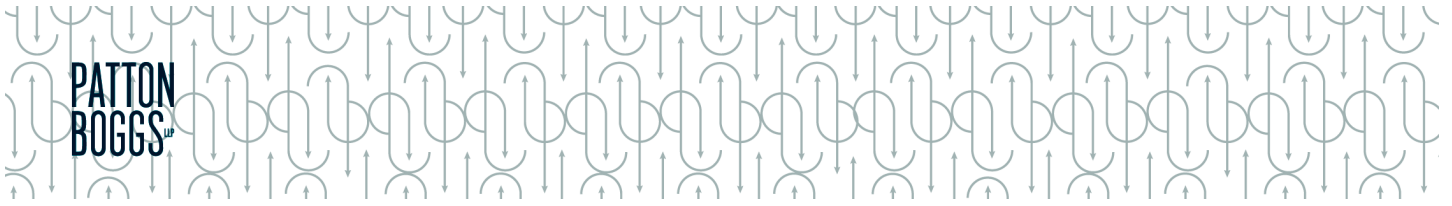
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## **EDUCATION POLICY**

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*Major Issues*

A focus of President Obama’s first Administration, which carried over into his campaign platform, is improving access to and ensuring the affordability of higher education. Additionally, he has sought to make investments in education, particularly in innovation and technology, while also trying to reduce the deficit by consolidating some programs. Elementary education programs such as Race to the Top and Investing in Innovation (i3) were priorities in the first Administration, and he will likely continue and expand upon them to include some higher education elements. For instance, following his State of the Union address this year, President Obama proposed a Race to the Top for College Affordability program (modeled after the original Race to the Top elementary education program) to give states the incentive to restructure financing systems for their public colleges and universities, align entry and exit standards for K-12 education to facilitate on-time completion, and maintain adequate levels of funding for higher education. We expect the Obama Administration to continue urging support for this program with the backing of Senate Democrats.

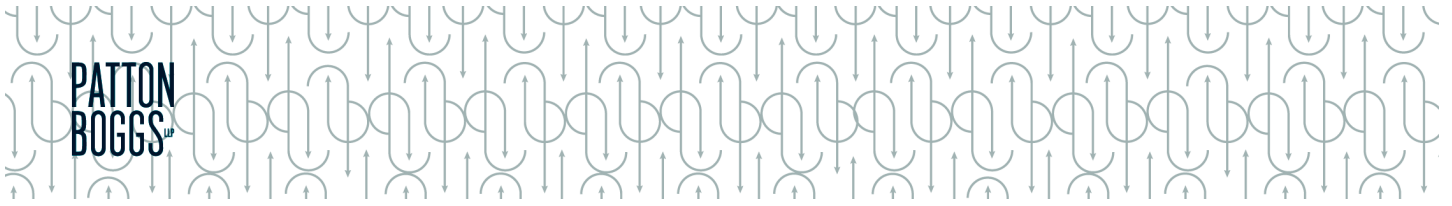


Consumers are increasingly concerned with two macro-trends in education that will affect all higher education policy decisions in the next four years. First, tuition is rising at rates well above inflation even as (a) families find it harder to afford college due to the hard economic conditions and (b) more college graduates are unemployed or underemployed in jobs that do not require a college degree. Second, crushing student debt loads pose long-term structural problems for millions of young Americans that may delay or limit their ability to purchase a home, get married and have children.

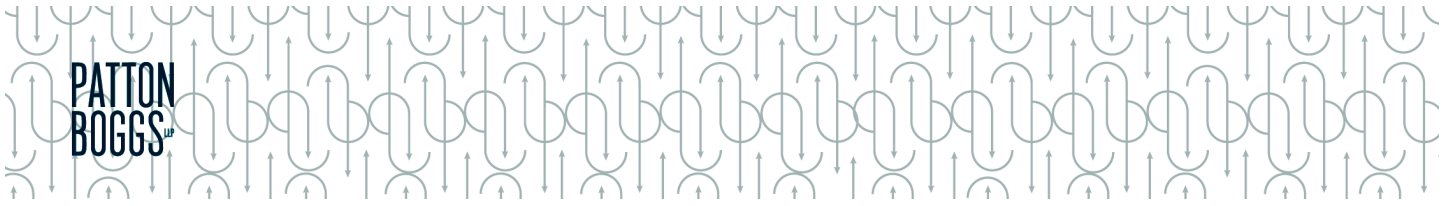
The President also will continue to champion comprehensive reform efforts for No Child Left Behind (NCLB), with his best opportunity to do so within the first two years of the next term. In our view, it is reasonable to believe that a status quo election result in 2012 has created the political conditions needed for a bipartisan rewrite of NCLB in the next Congress. However, should progress in Congress stall, President Obama will again use Executive Orders and waivers to push his preferred solutions for elementary education reform. This might manifest itself most clearly in efforts to provide incentives for state leaders to improve existing achievement gaps, as the Administration reviews waivers already approved for 34 states plus the District of Columbia as they come up for renewal after two years.

Finally, given the challenges faced by individuals looking for jobs in the current environment, President Obama will maintain support for initiatives that support a more-educated and skilled workforce and that would improve job creation, such as the National Network for Manufacturing Innovation and community college training programs. To advance these initiatives, we expect to see budget requests for these programs grow at faster rates than for other education programs.

**College Affordability.** We expect the Obama Administration will confront challenges in receiving full fiscal support for its college affordability initiatives because of two funding challenges that will occur in short order. First, like other agencies, the Department of Education faces potential significant cuts if sequestration occurs. Second is the forecasted shortfall in Pell Grant program funding that is already slated to occur at the end of Fiscal Year 2013. In fact, the Administration may be in the position of defending and protecting the existing funding streams for key programs rather than effectively advocating for expansion of those programs. Additional affordability and access issues to be addressed in the next term include:



- *Pell Grants.* President Obama has committed to expand further Pell Grant eligibility and raise the maximum award amount. Given that additional funding from the 2009 American Recovery and Reinvestment Act to support the Pell Grant program will expire in FY 2013, Congress will face a shortfall of at least \$7.6 billion. Senate Democrats will seek to identify resources to address this funding gap, but they will likely still need to make concessions on reform measures focused on changing the existing funding caps and eligibility requirements. In reforming the eligibility requirements, Republican proposals likely will include lowering the income level at which students qualify for an automatic maximum grant, establishing a maximum income to be eligible for a grant, and coupling job-training requirements with the Pell Grant program.
- *The Student Debt Crisis.* President Obama has pledged to keep interest rates low and to consider a policy forgiving all federal student loan debt after 20 years. We may see some restrictions set within the plan, however, after critics pointed to greater benefits for high-income borrowers over low-income borrowers. Keeping interest rates at these historically low rates may be difficult to do in an environment where Congress is looking for cost savings across the board in the federal budget.
- *Tax Credits.* President Obama will look to expand opportunities to implement new federal tax credits or increase existing credits for students. The debate over these issues will play out as part of the larger debate over extenders in the lame duck session and then again as part of fundamental tax reform.
- *DREAM Act.* While his June Executive Order related to Deferred Action for Childhood Arrivals would grant two-year renewable work authorization to certain undocumented young people, the President is expected to push hard for comprehensive immigration reform early in the next term. (His Executive Order expires after two years.) In particular, we expect there to be a renewed focus on the Development, Relief, and Education for Alien Minors Act, or DREAM Act, which makes college more affordable and removes certain barriers to access for undocumented children who wish to attend college. Despite his criticism of President Obama's action as an overstep, Senator Marco Rubio (R-FL) could emerge as a partner on Capitol Hill in that effort as he worked to pursue legislation similar to the Executive Order this year, possibly joined by two incoming Republican Senators from border States—Ted Cruz of Texas and Jeff Flake of Arizona. While Senator Rubio has called the DREAM Act

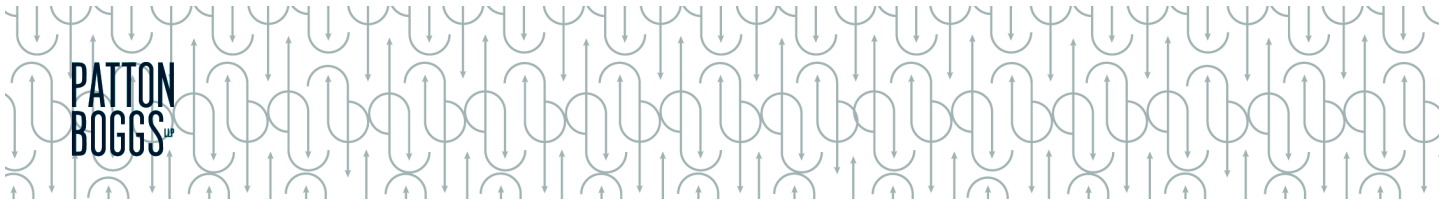


too broad, he believes legal residency should be given to young immigrants who were brought to the United States illegally by their parents. His plan is likely to represent the Republican starting point on the issue.

**Elementary and Secondary Education Act.** The 112<sup>th</sup> Congress tried and failed to reauthorize the Elementary and Secondary Education Act (ESEA), also known as No Child Left Behind, which expired in 2007. The partisanship surrounding the bill's reauthorization kept the House and Senate from bringing legislation to their respective floors and we expect that these issues will remain in the next Congress. The House may continue to take its piecemeal approach to the NCLB reauthorization, while the Senate will work towards its goal of completing a comprehensive reauthorization bill. House Republicans, led by House Education and the Workforce Committee Chairman John Kline (R-MN), will likely continue to focus their reauthorization efforts on streamlining federal spending through removing ineffective programs, promoting flexibility for states and local school districts, improving teacher quality through performance pay, and allowing for more parental choice in decisions on where to send their children to school. The Senate Health, Education, Labor and Pensions (HELP) Committee had passed its NCLB reauthorization bill in the first session of the 112<sup>th</sup> Congress; however, the bill may not serve as a blueprint for reauthorization in the 113<sup>th</sup> Congress, as many Republican Senators, including Lamar Alexander (R-TN) who is poised to serve as Ranking Member, have serious reservations with provisions related to accountability, teacher qualifications, school improvement, and funding.

**STEM Education.** We expect science, technology, engineering, and math (STEM) education to remain an important focus of the Obama Administration, as well as for certain advocates on the Hill. Secretary of Education Arne Duncan recently stated that he plans to make STEM education a focus of his second term and would like to increase the use of technology in the classroom. Several pieces of legislation were introduced in the 112<sup>th</sup> Congress to raise the visa caps for highly skilled workers and grant permanent residency for foreign-born graduates with advanced degrees in STEM fields in order to keep these students working in the U.S. after graduation. These proposals are a high priority for high-tech companies in particular. While the previous efforts in Congress failed, it is possible that lawmakers will move forward on these issues next year given the bipartisanship seen on STEM education and visas for foreign-born graduates with advanced STEM degrees. We expect to see a Republican-backed measure (H.R. 6249, the STEM Jobs Act of 2012), which was brought to the House floor in September, emerge again next year. The bill would eliminate the Diversity Visa Program lottery process and reallocate visas through the new STEM program. While the bill won a

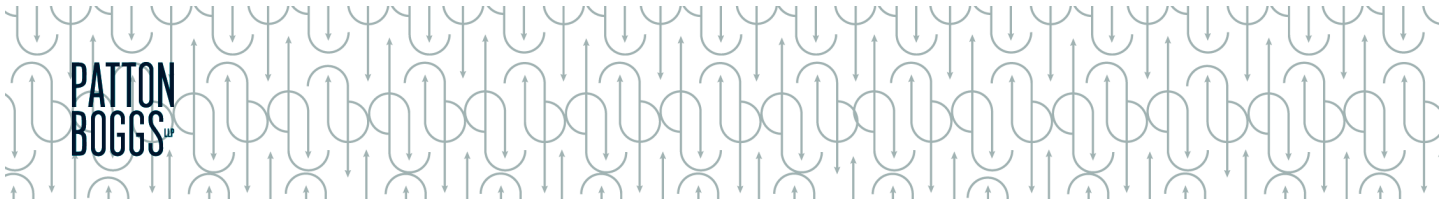




simple majority of votes in the House, it failed because it came to the floor under a procedure that required a two-thirds majority. Given significant differences with an approach favored by senior Senate Democrats, much work lies ahead to reconcile a bill that can be signed into law.

**Workforce Investment and Career and Technical Education Legislation.** The Workforce Investment Act of 1998 (WIA) expired in 2003. Since then, Congress has attempted to reauthorize the law without success. Partisan differences on how to approach WIA reauthorization will continue to plague the 113<sup>th</sup> Congress. House Republicans are likely to continue their effort to consolidate the existing workforce programs into a single Workforce Investment Fund and reorganize federal retraining programs into state block grants to ensure that training is coordinated with local schools and employers. We expect Senate Democrats to continue working on workforce investment legislation that will keep the basic structure of the WIA systems intact and address their concerns regarding how the Republicans' plan to consolidate the current programs would shift money away from under-served populations. The Carl D. Perkins Vocational and Technical Education Act of 2006 is set to expire in August 2013. We do not expect Congress to reauthorize the Act in the 113<sup>th</sup> Congress.

**Accreditation.** With the substantial growth of the for-profit college industry, online education, and the massive open online course (MOOC) trend, the college accreditation system will continue to be in the spotlight in the next Congress. This issue is likely to come up several times during the reauthorization of the Higher Education Act as Congress will have to revisit the current requirements for accrediting agencies in order to distinguish how to define universities that should receive federal aid dollars. The growth of online education and for-profits also has policy implications for college affordability, job training, and access to education. Thus, it could be the next "hot" policy topic in the new Congress. The growth of MOOCs has the potential to undermine many of the for-profit business models if a broader range of students are able to access high-quality courses from traditional university systems. Many Democrats, including Senate Health, Education Labor and Pensions Committee Chairman Tom Harkin (D-IA), have been skeptical about federal investment in for-profit colleges. Conversely, Congressional Republicans are generally more supportive of for-profit education. These arguments will likely come into play as lawmakers examine how to strengthen the accreditation system to ensure that federal funding is invested wisely and students see the benefit of attending accredited schools.



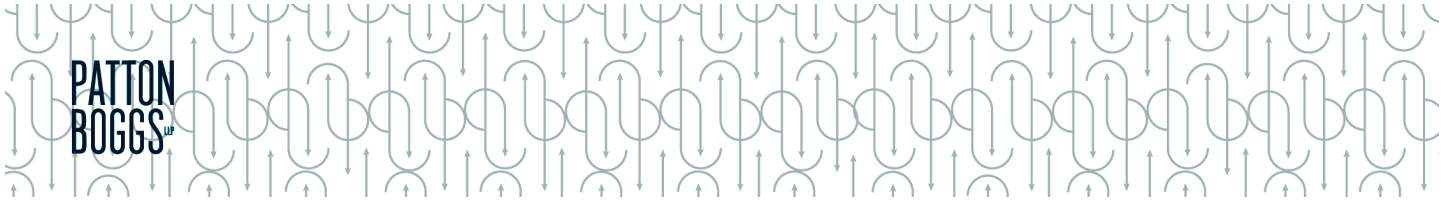
**Public Disclosure and Accountability.** Chairman Harkin will likely continue to pursue the for-profit college industry. We expect Senate Democrats to introduce legislation requiring additional public disclosure and accountability requirements for all institutions of higher education, and particularly for the for-profit sector, to serve as the blueprint for transparency and accountability provisions during the reauthorization of the Higher Education Act (HEA). Legislation will also be introduced to reform the 90-10 calculation by which for-profit schools receive federal funds. We also expect the Department of Education to continue its attempt to implement program integrity rules, including the gainful employment rule, which was struck down earlier this year by a federal court. Bipartisan support will remain in the House to pass legislation to repeal the state authorization rule; however, with closer margins in the Senate, there may be enough pressure to reform key aspects of the rule, but not repeal the rule in its entirety.

*Forecast for the 113<sup>th</sup> Congress*

With the Democrats retaining control of the Senate, they will likely strive to support many of the President's top priorities in K-12 and higher education. As such, reauthorization of the Higher Education Act (HEA) and No Child Left Behind (NCLB) will be on the agenda. However, given the significant divisions between the parties on reforming NCLB, agreement on a way forward may not be within reach. While it is rare to see secretaries in this position serve two terms, Secretary Duncan has committed to doing so, which could lead to improved working relationships and finding common ground with conservatives on certain issues, as some Republicans admire his positions on charter schools and teacher evaluation.

HELP Committee Chairman Harkin has said he would like to move forward with the reauthorization of HEA in the next Congress given that it is set to expire in 2013; however, we expect the reauthorization to occur in 2014. Two other laws related to education programs, the Elementary and Secondary Education Act and the Workforce Investment Act, are in line for renewal before the Higher Education Act—ESEA expired in 2007 and WIA was due for renewal nearly a decade ago. Also, Chairman Harkin is expected to continue to seek funding protection for certain non-defense discretionary programs as deficit reduction discussions progress.

Committees in both chambers already have been active over the past year in considering issues related to college affordability. We expect additional hearings to continue going forward, perhaps held in conjunction with deficit reduction and fiscal cliff discussions, as well as combined with



hearings on HEA reauthorization. Moreover, we expect to see a renewed push for the Race to the Top for College Affordability program, with committee hearings in the Senate likely. Additionally, on the Senate side, Senators Dick Durbin (D-IL) and Chairman Harkin will likely continue to champion legislation to regulate private lenders, particularly after the October 2012 release of the first “Annual Report of the CFPB Student Loan Ombudsman” required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The report details loan-servicing issues and complaints made by private student loan borrowers and compares the problems in the industry to those in the mortgage market. Lenders accused the agency of bias against the industry and noted that the database does not yet collect complaints about federal loans.

*Anticipated Committee Developments*

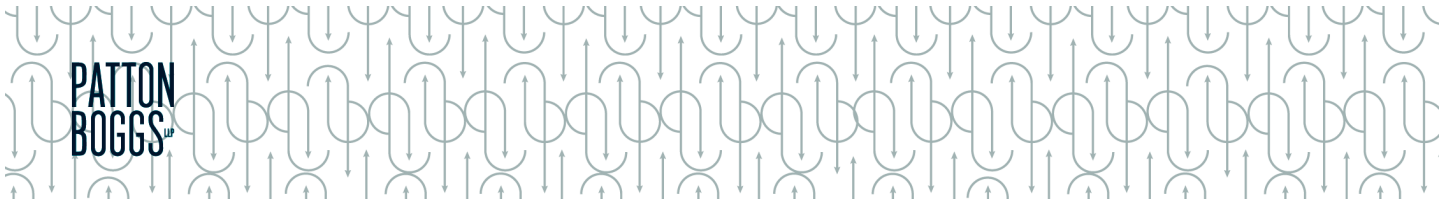
**House Committee on Education and the Workforce.** Representative John Kline (R-MN) will remain as Chairman and Representative George Miller (D-CA) will remain as Ranking Member. Committee Democrats will be losing at least five members with Representative Dave Kildee (D-MI) and Representative Lynn Woolsey (D-CA) retiring this year. Representative Dennis Kucinich (D-OH) and Representative Jason Altmire (D-PA) lost their primary races and will not be returning to Congress, while Representative Mazie Hirono (D-HI) will not be back, having successfully run for the Senate seat being vacated by Senator Daniel Akaka (D-HI). On the other hand, House Education Committee Republicans only stand to lose one member with the retirement of Representative Todd Platts (R-PA). A few other Members, particularly 2010 GOP Freshman class members such as Representative Trey Gowdy (R-SC), are expected to leave for other committee assignments.

**Senate Health, Education, Labor and Pensions Committee.** Senator Tom Harkin (D-IA) will remain Chairman. Given that Senator Michael Enzi (R-WY) is term-limited as Ranking Member, Senator Lamar Alexander (R-TN) likely will fill that role. Currently, the HELP Committee is only set to lose one of its members in the next Congress with the retirement of Senator Jeff Bingaman (D-NM).

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*Contact Information*

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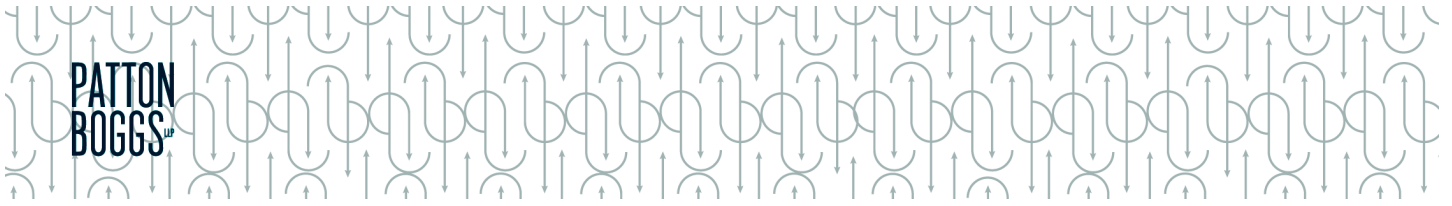
## ENERGY AND ENVIRONMENTAL POLICY

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### *Major Issues*

In his State of the Union Address, President Obama said: “This country needs an all-out, all-of-the-above strategy that develops every available source of American energy.” Speaking about his energy policy during the campaign, he amplified the point: “We’ve got to have a sustained, all-of-the-above strategy that develops every available source of American energy. Yes, oil and gas, but also wind and solar and nuclear and biofuels, and more.” In recent months, senior officials have made it clear that the Administration is hoping for a “reset” with the 113<sup>th</sup> Congress in order to move comprehensive legislation that would enjoy broad, bipartisan support. For example, Heather Zichal, the top White House energy and climate change aide, said the Administration hoped to boost collaboration on green energy issues next year. Among other things, the Administration wants to avoid the “boom and bust” cycles of support for renewable energy, while at the same time supporting measures that in its view would ensure that natural gas production continues to be undertaken “safely and responsibly.” The Administration also is committed to supporting investments in electric transmission infrastructure, as well as basic energy R&D.

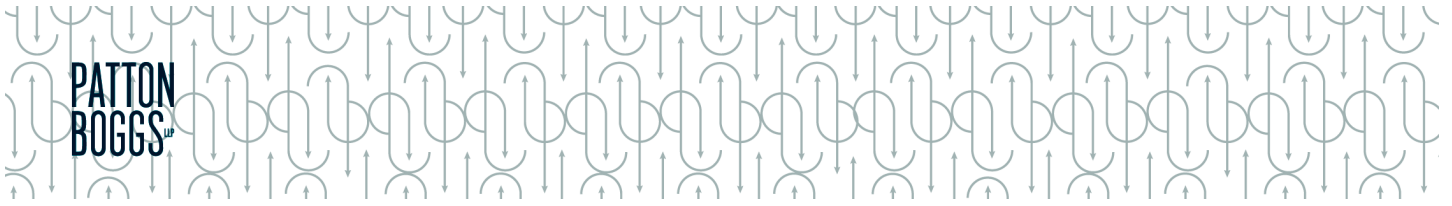
To put the Administration’s priorities in perspective, compare where things stood four years ago. Then, the Obama-Biden “New Energy for America” plan, if enacted, would have invested \$150 billion over ten years to create five million new “green” jobs, put one million plug-in hybrid cars on the road by 2015, substantially increased corporate average fuel economy standards for cars and trucks, developed new low-emission coal plants, created an advanced biofuels infrastructure, and developed commercial-scale renewable energy projects. In addition, the plan would have mandated that ten percent of electricity be produced from renewable energy sources by 2012 and by 25 percent by 2025, and would have implemented many other elements of the House Democratic agenda from the 110<sup>th</sup> Congress, such as forcing the industry to “use or lose” existing oil and gas leases. In addition, the Obama-Biden plan envisioned Congress implementing an economy wide cap-and-trade program to reduce greenhouse gas (GHG) emissions by 80 percent by 2050.



Although its plan was not enacted into law, the Administration did achieve its goal of imposing higher corporate average fuel economy standards, but only because it could do so administratively with the consent of the auto industry after GM and Chrysler had been rescued. Just recently, it proposed new standards for large trucks and buses, which likewise can be implemented without enactment of legislation and likewise appears to have the support of the affected industries, including engine manufacturers. In addition, through enactment of the stimulus bill in 2009, the Administration poured approximately \$90 billion into energy projects, including construction of new wind and solar farms and installation of 13 million “smart” electric meters. The Administration also achieved one of its major renewable energy goals of approving 10,000 MW of renewable energy on public lands. Under the Energy Policy Act of 2005, Congress had directed the federal government to develop 10,000 MW on federal land by 2015. With the project approval of the Chokecherry and Sierra Madre wind farms in Wyoming (3,000 MWs) on October 9, the Administration pushed the total slightly over 10,000 MWs on federal land—three years earlier than mandated by Congress.

Consider how much has changed in roughly the last five years, when that bill became law, when conventional wisdom held that the United States would soon become a net importer of liquefied natural gas, and when the focus of climate change legislation was mandates to reduce coal and oil consumption. The unconventional oil and gas boom that has occurred since then has changed not only our energy landscape, but the politics of energy as well. Some highlights from Daniel Yergin of IHS CERA about what has changed thanks to hydraulic fracturing and horizontal drilling technologies: “Shale gas alone is now 10% of the overall U.S. energy supply. And similar technologies to recover so-called tight oil trapped in rock formations are largely responsible for boosting U.S. oil production by 25% since 2008—the highest growth rate in oil output in any country in the world over that time period. . . . So far more than 1.7 million jobs are the result . . . . The number of jobs could rise to three million by 2020. The energy revolution will add an estimated \$62 billion to federal and state revenues this year.” Remarkably, given the current pace of increasing U.S. production of oil and other liquid hydrocarbons, including biofuels, which collectively are expected to reach 11.4 million barrels per day next year, the United States is on pace to soon surpass Saudi Arabia (11.6 million barrels per day of crude) as the top producer in the world.

This dramatic change in domestic production will likely have profound geopolitical ramifications as well. U.S. exports of natural gas, for example, could give the U.S. Government leverage over Russia, which has long used its power as the world’s top natural gas exporter in advancing its foreign policy agenda. Skyrocketing demand elsewhere in the world will have other significant consequences. The



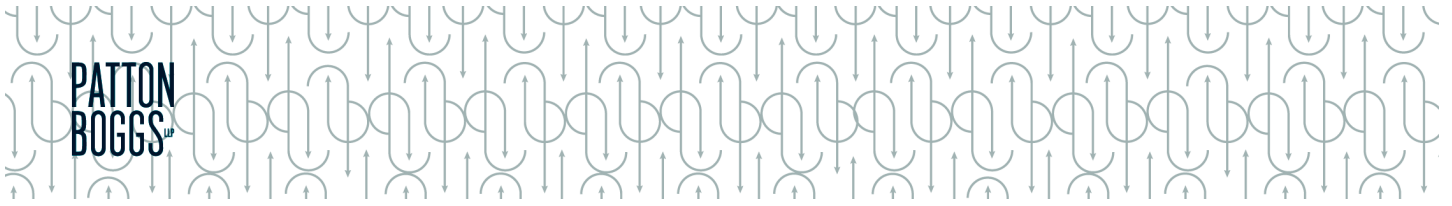
United States, for example, is no longer the world's largest energy consumer and will soon be eclipsed by China as the largest consumer of crude oil as well. As the world's largest consumer, China will exert greater influence over world oil prices than the United States. Perhaps as important, as the United States reduces its dependence on OPEC suppliers, our interests in the Middle East are likely to change as might those of countries that replace us as major purchasers.

The Obama Administration has been paying attention. Secretary of State Clinton recently gave a speech in which she indicated that her successor would need to put energy at the heart of U.S. foreign policy. In her view, “[e]nergy will be one of the most profound issues shaping the 21<sup>st</sup> century, and we are changing our foreign policy to reflect that.” In that connection, she has established a Bureau of Energy Resources and is tasking our embassies to elevate energy to the center of their mission.

Notwithstanding these profound changes, Congress has not passed a comprehensive, bipartisan energy bill since 2007 (near the end of the Bush Administration). Admittedly, the growth in domestic production has occurred without Congress having to take additional action to spur it. But Congress hasn't acted in part because nothing has emerged since then that could garner 60 votes in the Senate—certainly nothing comparable to what President Obama had put forward in his first Presidential campaign.

### *Anticipated Energy Agenda*

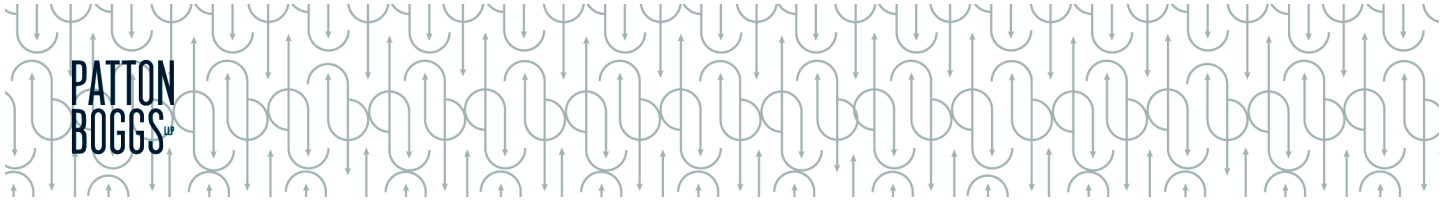
The development of successful energy legislation traditionally has been a nonpartisan issue, driven by where a Senator comes from rather than the party to which he or she belongs. In recent years, the number of “Energy State” Democrats and Republicans has fallen short of that magic number, as has the number of “Green” Democrats and Republicans. Hence, nothing with principally a pro-development or a pro-conservation focus has emerged that had the support of 60 Senators. As more states become “Oil and Gas States” as a result of the shale boom (*e.g.*, North Dakota and increasingly Colorado, Pennsylvania, and Ohio), the number of Senators who share the perspective of the traditional “Energy State Democrats” is likely to continue to increase. And thus the challenge of developing a more pro-development bill that could garner 60 votes should get easier over time. In the interim, a bill that combines pro-development provisions, pro-conservation provisions, and other consensus provisions could emerge in the Senate and serve as the basis of an energy bill President Obama could be expected to sign into law by the end of 2014.



If Democrats are willing to give on some pro-production measures and Republicans are willing to accept some pro-environmental measures, the Senate is likely to be able to coalesce around a bill that would have the support of at least 60 Senators. Such a bill would likely contain a variety of energy efficiency and conservation measures, a pro-nuclear component (*e.g.*, loan guarantees), a clean coal component (*e.g.*, funds to promote carbon capture and sequestration, possibly tied to enhanced oil recovery), and a host of other measures. For example, to promote the development of renewable energy, in particular wind resources, the bill is likely to contain new preemption measures to advance the construction of electric transmission lines to get power from where it is produced to where it is needed. Given increased concerns about climate change, the bill would likely contain mitigation and adaptation measures. The Senate is also likely to support compressed natural gas (CNG) provisions to complement the efforts underway in states such as Virginia, Colorado, and Oklahoma to promote CNG (where Governors are promoting efforts to encourage fleet conversions and infrastructure development). Given the importance of water to hydraulic fracturing operations, water policy may become part of the broader energy policy debate as well. We do not expect the final legislation to include the opening of the ANWR 1002 area, to permit offshore production off the coasts of states that traditionally have opposed it (*e.g.*, California, Massachusetts, and the Eastern Gulf of Mexico off the coast of Florida), or as noted below, to address hydraulic fracturing in the ways proposed in recent years.

Given the makeup of the House, we are not optimistic that something comparable will emerge, at least initially. With Republicans having maintained control of the House, they are likely to continue to focus the bulk of their attention on their pro-coal, anti-EPA agenda. As during the 112<sup>th</sup> Congress, none of those measures is likely to be enacted into law because none is likely to enjoy the support of 60 Senators and, in any event, would be vetoed if they reached the President's desk. At some point, House Republicans may find that they will be reacting to Senate action, rather than driving the debate. (The same dynamic occurred earlier this year, when the Senate took the lead in fashioning a comprehensive surface transportation bill that enjoyed broad bipartisan support. Because the House was unable to agree on anything that could clear the House floor initially, the House was effectively forced to react to the Senate. As a result, the Senate largely dictated the outcome of the debate.) And thus House Republicans may come together, working with Democrats, to produce a House counterpart to the Senate bill as it begins to emerge.

In the absence of legislation, the courts and the Executive Branch are likely to continue to drive the direction of energy policy. Should the 113<sup>th</sup> Congress find itself incapable of legislating, the Obama

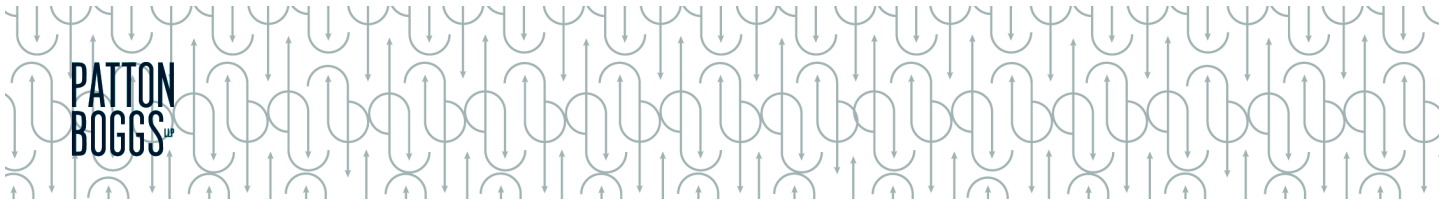


Administration is likely to use existing statutory authority to advance its energy agenda, but there are limits to what can be accomplished under current law. The Obama Administration, for example, is undertaking seismic studies off the coast of Virginia already and could ultimately authorize drilling but would need a change in the law for lease revenues to be shared with the Commonwealth (or other states outside the Gulf Coast). The BLM, as noted below, can continue with its hydraulic fracturing regulations without further legislation, and EPA can largely pursue its GHG regulatory agenda as well.

On two other issues, the President can and will act without further legislation. On May 4, 2012, TransCanada submitted a new application for a permit to build the northern leg of the Keystone XL pipeline. With TransCanada having developed a new route through Nebraska that is likely to receive broad support in the state, we expect the State Department to complete its ongoing review of the application and to make the necessary national interest determination in favor of the project in the first quarter of 2013.

We also expect the Administration to approve one or more of the pending applications to build LNG export facilities early in 2013, notwithstanding opposition from Democrats on Capitol Hill who argue that exports will lead to higher consumer prices. The Department of Energy is expected to complete by year end a review of the potential economic impact of LNG exports, including the potential impact on consumer prices. Under current law, the Department must approve proposed natural gas (including LNG) exports to countries with which the United States has a Free Trade Agreement (FTA) that calls for national treatment for trade in natural gas. For countries with which the United States has not entered into an FTA, the Department must determine whether exports would be in the public interest, with a rebuttable presumption in favor. (To date, the Department has approved only one LNG export project—Cheniere Energy’s Sabine Pass plant in Louisiana.) Opponents of exports must demonstrate why an export application would not be consistent with the public interest. To address concerns about an export application, the Department may impose conditions on exports to countries that do not have an FTA. Given the applicable statutory standard, we expect the Department to conclude that additional exports would be in the public interest, possibly subject to modest conditions that will not affect the ultimate overall economics of proposed projects.



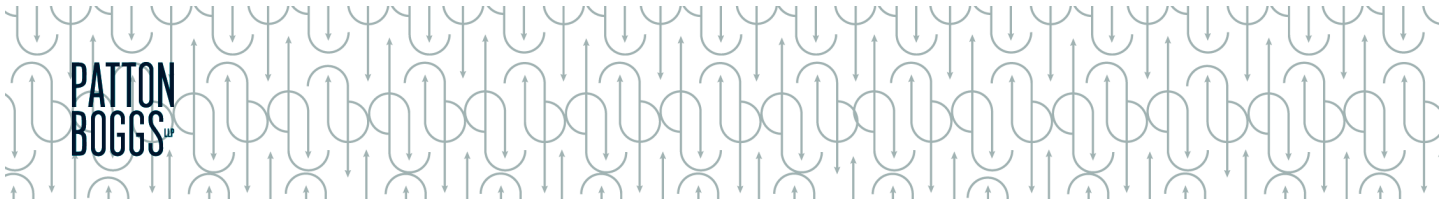


*Administration's Environmental Agenda.*

In its first term, the Obama Administration accomplished much of the President's environmental agenda through agency action, without the need for new legislation. While the merits of this approach were debated during the Presidential campaign, we expect history will view the President's first term as having left a precedent-setting mark on environmental policy. From the manner in which energy--be it fossil or renewable--is produced, transported, distributed, and consumed; to the improved efficiency of the motor vehicles we drive, to the buildings we work and live in, and to the appliances we use; and the use of "sustainability" as a key economic metric by which the federal government purchases goods and services, the policy decisions made during the last four years will have a considerable impact on the next four, and beyond.

In the absence of legislation and within the limits that federal courts allow, the Obama Administration will continue using its existing authority to effectuate its environmental goals of reducing GHG emissions and other pollutants, cleaning and restoring water resources, and, by extension, addressing climate change. At the same time, the Administration will continue to encourage energy production on public lands, reduce imports of crude oil, and mitigate potential environmental impacts of domestic production. The Administration also will continue to defend its regulations in court and where appropriate reconsider regulations. Additionally, the Administration will utilize the grant-making process to further influence decisions made at the state and local level, as well to provide incentives for the private sector, including small businesses and entrepreneurs, to drive innovations in new technology.

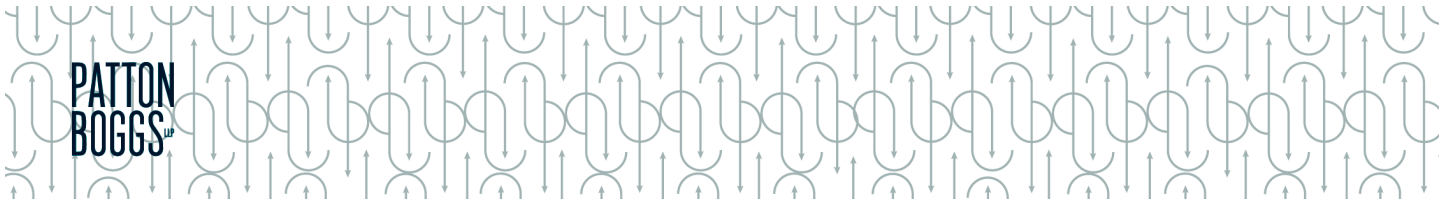
To advance its overall energy and environmental agenda, the Administration will likely a push for legislation that would provide business, and by extension the broader energy production economy, more certainty and eliminate the risks inherent in agencies writing rules based on statutes designed to address different challenges over 40 years ago. Could legislation addressing climate change be back on the agenda? President Obama dropped hints during the campaign, but stayed away from the issue, presumably out of concern that he would alienate voters in crucial battleground states. Many in the utility and industrial sectors would give legislation a fresh look, as they have continued to find that making capital-intensive decisions in the absence of regulatory certainty is not only bad for their customers, but also for shareholder value. In the absence of federal legislation, states and local governments will continue to forge ahead, as California has demonstrated in implementing its cap-and-trade program and low-carbon fuel standard. We thus can expect the President to ask the 113<sup>th</sup>



Congress to address a number of regulatory issues as an alternative to EPA proceeding on the basis of existing authority. The challenge of course will be to find a way to address the concerns of business without intruding too significantly on state and local governments, but we believe it can be done.

A bit of history to put the coming “carbon” debate in context: In 1987, President Reagan endorsed and encouraged the Senate to adopt the Montreal Protocol, an international treaty that ultimately led to enactment of a cap-and-trade system to reduce the use of ozone-depleting chemicals. With the President’s support, the Protocol was ratified by the Senate by a vote of 87-0 and implemented through regulations. (The Protocol was also implemented by China and other countries, without any apparent adverse economic impact on U.S. industry.) Three years later, President George H.W. Bush signed into law the Clean Air Act Amendments of 1990, which included his proposed cap-and-trade system to reduce sulfur dioxide emissions from power plants as a means of addressing acid rain. That bill cleared the Senate by a vote of 89-10 and the House by a vote of 401-25, with the support of Representatives Newt Gingrich (R-GA), Joe Barton (R-TX), Jim Inhofe (R-OK), and Fred Upton (R-MI). When signing the bill into law, President Bush said: “By employing a system that generates the most environmental protection for every dollar spent, the trading system lays the groundwork for a new era of smarter government regulation, one that is more compatible with economic growth than using only the command and control approaches of the past.” President George W. Bush then included a cap-and-trade mechanism in his “Clear Skies” bill, which would have amended the Clean Air Act. Recalling the success of his father’s legislation, he said: “The 1990 Clean Air Act Amendments have significantly reduced air pollution, especially through the innovative ‘cap-and-trade’ acid rain control program. . . . [It] has been a resounding success, cutting annual sulfur dioxide emissions in the first phase by 50 percent below allowed levels. Emissions were reduced faster than required, and at far less cost.” Although the Clear Skies legislation did not become law, his Administration did use the administrative process to promulgate, with utility and environmental organization support, its Clean Air Interstate Rule, which was designed to address the “downwind” pollution that crosses interstate boundaries and results in certain states becoming out of compliance with National Ambient Air Quality Standards.

In the broadest terms, the Obama Administration under the continued leadership of EPA Administrator Lisa Jackson will continue much of its environmental agenda, the focus of which will be on reducing the intensity of GHG emissions, improving water quality and infrastructure, mitigating environmental impacts from biofuels production and electronic waste, and continuing to

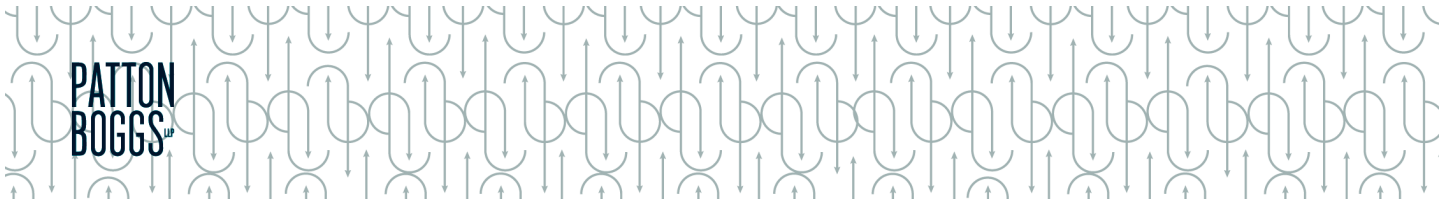


use sustainability as a key metric in its policy planning and analysis. Thus, for example, we expect the Administration to finalize its GHG emissions rules for new and future power plants and refineries, as well as continue to defend air regulations (*e.g.*, the Cross State Air Pollution Rule), and potentially to revise rules designed to reduce emissions of criteria pollutants (*e.g.*, the Mercury Air Toxics Rule) or delay implementation where appropriate (*e.g.*, Boiler MACT). There also may be new rules issued to cover methane emissions from oil and gas production operations. Notwithstanding continued opposition and legal challenges, we ultimately expect the Administration to prevail given the likelihood of the courts deferring to the Administration. Beyond that, opponents cannot reasonably expect to successfully challenge final rules under the Congressional Review Act. All of this should set the stage for the 113<sup>th</sup> Congress and the President to find common ground and make structural changes to improve upon the Clean Air Act for the 21st Century.

One issue likely to garner much more attention will be hydraulic fracturing. In the next few years, we continue to anticipate that the bulk of hydraulic fracturing legislative and regulatory issues will arise at the state level rather than in Washington, DC. With concerns growing about whether water shortages are being exacerbated by the volume of water consumed in hydraulic fracturing operations, the industry faces additional regulatory and legislative risks at the state level that go beyond chemical disclosure. In addition, twelve states have already proposed or are implementing new oil and gas tax or fee production policies to help close state budget gaps and incentivize energy development in sometimes hesitant communities. The industry is likely to continue to face increased taxes and fees as states continue to look for ways to address the infrastructure costs of large-scale energy development, including road repair in particular.

With the support of the industry, bills were introduced in the 112<sup>th</sup> Congress in both the Senate and the House to confirm that states have the sole authority to regulate hydraulic fracturing operations on federal lands within their borders. The so-called FRESH Act (Fracturing Regulations are Effective in State Hands Act) will not become law in the lame duck session. Similarly, we do not anticipate any legislative action by Congress on the FRAC Act. Barring some fundamental galvanizing event, we doubt either bill will go anywhere next year either. In the near term, to the extent the federal government has any direct impact on hydraulic operations, it will be driven by regulatory action and potentially oversight hearings in the House.

Late last year, EPA finally released its “study plan” for the major study Congress asked it to undertake in 2009. EPA is evaluating the full life-cycle of water used in hydraulic fracturing



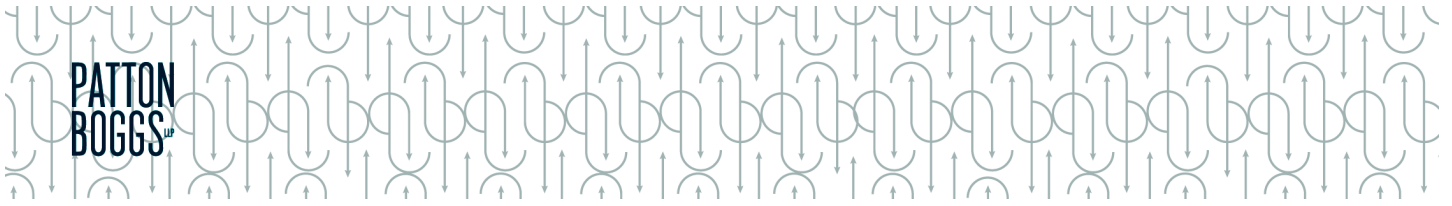
operations, from water acquisition through to the mixing of chemicals to conducting fracturing and post-fracturing activities, including the management, treatment, and disposal of flow-back water. Initial research results and study findings are projected to be released to the public later this year; the final report will not be issued until at least 2014. Until the final report is issued, we do not expect any federal legislation to emerge that could clear the House and the Senate.

Separately, the Department of Interior through the Bureau of Land Management has been engaged in a lengthy rulemaking to govern hydraulic fracturing operations on federal and tribal lands. Public comments were accepted by BLM through September 10 in order “to facilitate greater input from the public and key stakeholders, including industry and public health groups.” Some tribal leaders and Wyoming Governor Matt Mead (R) had questioned BLM’s procedural transparency and policy substance, the latter noting his concern that “the proposed rules will duplicate and possibly be sequential to Wyoming’s rules.”

The rule includes requirements that companies disclose non-proprietary chemicals used in hydraulic fracturing activities, implement new well design standards, and require new safety certification standards—including a requirement that producers “certify” that they are not endangering local water supplies through their hydraulic fracturing operations. The rule “would require operators to certify in writing that they have complied with all applicable Federal, tribal, state, and local laws, rules, and regulations pertaining to proposed stimulation fluids” and would further “require the operator to certify that it has complied with all necessary permit and notice requirements.”

The Administration also will continue to implement its final rule raising corporate average fuel economy standards for cars and light-duty trucks to 54.5 miles per gallon by model year 2025. While this accomplishment was met with differing industry reaction, it was cheered by environmentalists and other clean-air advocates many of whom are still smoldering over the earlier demise of comprehensive climate legislation. Alternative fuel vehicle manufacturers from electric to natural gas also reacted positively to the rule as it allows auto manufacturers to achieve compliance with the fleet averages with the use of these new types of vehicles. That said, at least two, if not three, future Administrations will have the opportunity repurpose, tweak, or alter the program based upon what the consumer market may demand or what the boundaries of technology may afford.

We also expect the Administration to urge the 113<sup>th</sup> Congress to address what most stakeholders concede are lingering problems and challenges facing the federal Renewable Fuels Standard program

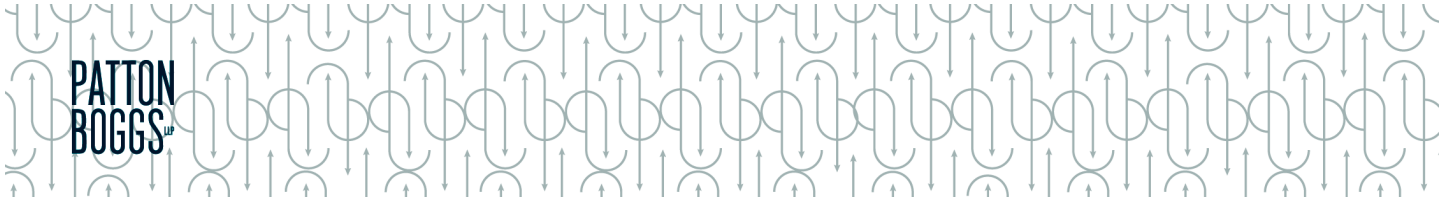


(RFS). The program was initially authorized in 2005 and subsequently amended in 2007. The EPA is firmly in the driver’s seat even as it has come under intense criticism over program management (*e.g.*, over RIN credits and fraud in the marketplace), which it will need to address. Along with stakeholders, the agency also will continue to examine the program’s commercial viability without further changes to the underlying law, such as to address concerns with next generation feedstocks of non-corn based fuels (*i.e.*, advanced biofuels), feedstock sustainability, and commodity market volatility. Finally, the outcome of pending federal litigation over California’s Low Carbon Fuel Standard and the way in which California regulators complete a life-cycle analysis of qualifying low-carbon fuels will have an impact on policy decisions at the EPA and on Capitol Hill.

Regarding water quality and water infrastructure, the EPA will focus a considerable amount of time on the challenges faced by private and public water systems, which in some areas of the country are under tremendous stress. Some have advocated that the landmark statute governing the nation’s water policy--the Clean Water Act--needs to be updated to reflect changes in the nation’s water infrastructure, land-use planning, and “point” sources of water pollution that the Act did not contemplate forty years ago. In addition, the EPA will continue working with state and local governments, as well as the private sector, on the use and application of “green infrastructure” to address storm water management and other sustainability initiatives.

With regard to federal lands and management issues, the EPA along with the Departments of Interior and Energy will continue to attempt to coordinate policy making and initiatives to advance the Obama Administration’s goal of developing the nation’s natural resources in a sustainable manner. We anticipate the continued leasing of land, both on and off shore, for oil and gas development, but with an emphasis on developing renewable sources and critical rare earth minerals and metals as well. Because permitting delays and National Environmental Policy Act (NEPA) and Endangered Species Act compliance issues have been obstacles not only for critical minerals, rare earth mining and the offshore oil industry, but also for transportation, housing construction, interstate high voltage electric transmission lines, and renewable energy projects, we anticipate additional attention from the Administration and the 113<sup>th</sup> Congress.

Where development meets the Administration’s goals and where there is a comprehensive stakeholder process, we expected permitting will be expedited. Two recent examples point the way: (1) The Department of the Interior’s promulgation of a final Programmatic EIS for Southwest solar development on federal land covering 285,000 acres across six states, with another 19 million acres



of “variance” areas that can be developed with certain restrictions; and (2) the Bureau of Ocean Management’s first commercial lease for offshore wind development in the Atlantic Ocean under its “Smart from the Start Program.”

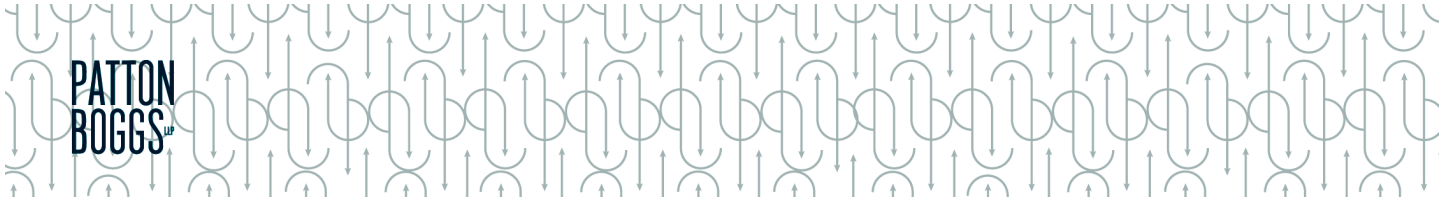
Finally, we anticipate continued oversight on Capitol Hill, led principally by the House. The House Energy and Commerce, Energy and Power Subcommittee, for example, intends to hold hearings on a number of items, including the level of cooperation (or lack thereof) between state air regulators and the EPA, as it continues to build a record for potential statutory changes to the Clean Air Act. The House Natural Resources Committee also will continue examining Administration policies as part of an ongoing effort to advance legislation that would amend the laws that govern federal land use and management.

#### *Anticipated Committee Developments*

**Senate Energy and Natural Resources Committee.** With Senator Jeff Bingaman (D-NM) having retired, Senator Ron Wyden (D-OR) will chair the Energy and Natural Resources Committee. This will be the first time since 1994 that a Senator from a state other than New Mexico or Alaska will head the committee. Senator Lisa Murkowski (R-AK)—whose father chaired the committee beginning in 1995—will continue as Ranking Member.

**Senate Environment and Public Works Committee.** We anticipate that Senator Barbara Boxer (D-CA) will continue as Chairman and Senator David Vitter (R-LA) will become the new Ranking Member as Senator Jim Inhofe (R-OK) is expected to become Ranking Member of the Senate Armed Services Committee. As in the House, other committees may attempt to assert their jurisdiction over energy legislation, most notably the Finance Committee, but the debate will be driven by the Energy and Natural Resources Committee.

**House Committees.** Many committees have jurisdiction over various aspects of energy legislation, including the Energy and Commerce Committee, the Natural Resources Committee, and the Ways and Means Committee. Representative Fred Upton (R-MI) will continue to serve as Chairman of the Energy and Commerce Committee. Representative Henry Waxman (D-CA) is expected to serve as Ranking Member. Representative Doc Hastings (R-WA) will continue to serve as Chairman of the Natural Resources Committee (unless he becomes the Chairman of the Rules Committee), with Representative Ed Markey (D-MA) staying on as Ranking Member. Finally, Representative Dave



Camp (R-MI) will continue to serve as Chairman of the Ways and Means Committee, and Representative Sander Levin (D-MI) continuing in his position as Ranking Member.

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### *Contact Information*

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## **FINANCIAL SERVICES**

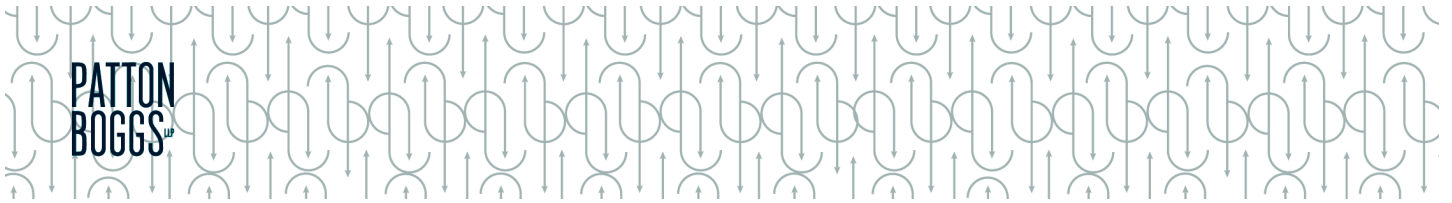
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### *Major Issues*

Two years after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), regulatory agencies such as the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) continue working steadily to implement financial services reform in the United States. Of the nearly 400 rules required under the Dodd-Frank Act, only about one-third have been finalized, with the rest not yet finalized or not yet proposed. With growing criticism over the international implications of the law, the delayed rulemaking process, and potentially burdensome regulations, the 113<sup>th</sup> Congress will face important questions regarding whether to make technical, or even substantial, amendments to the law.

During the 113<sup>th</sup> Congress, we expect financial services legislative activity to focus on continuing oversight of the regulatory process arising out of the Dodd-Frank Act to ensure that regulators stay within the “intent” of the Congress. In the regulatory space, a recently successful judicial challenge to a CFTC position limits rule may cause regulatory agencies to prolong implementation of the Dodd-Frank Act, as they seek to avoid promulgating rules that will not withstand judicial scrutiny.

Given the narrow control of the House and the Senate, it is unlikely that the 113<sup>th</sup> Congress will modify substantially or repeal the Dodd-Frank Act. Instead, we believe that legislative changes will focus on technical corrections where there was a clear error or in areas where the new Congress believes regulators require a clearer statement of congressional intent. Nonetheless, House

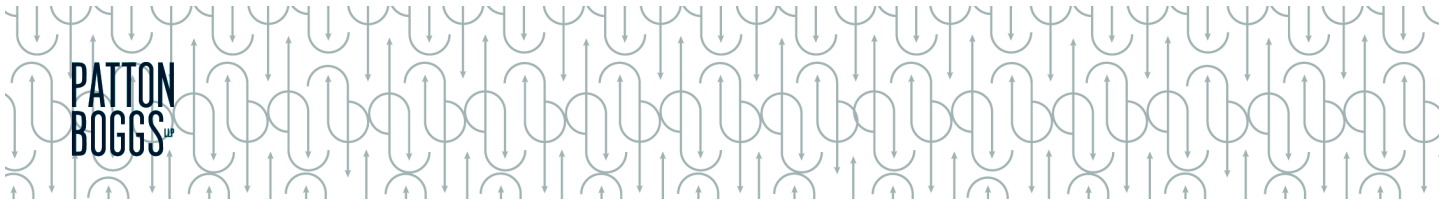


Republicans will continue pushing for substantive changes to the law and may attempt to use the CFTC reauthorization as a vehicle to make them. This will make for a contentious reauthorization process in an already divided Congress. Further, the Obama Administration can be expected to strongly resist substantive changes to the Dodd-Frank Act.

In 2013, there will be continued criticism over the regulatory agencies' funding and the importance of addressing housing finance reform. Indeed, both the Democratic Senate and the Republican House of Representatives can be expected to put forth proposals to address the reform of government-sponsored enterprises (GSEs) and the privatization of the housing market. Of note, passage of comprehensive housing finance reform will require bipartisanship and compromise, which will not be an easy feat to achieve in the 113<sup>th</sup> Congress. This could empower the Federal Housing Finance Administration (FHFA), the conservator of Freddie Mac and Fannie Mae, to play an even more direct role in the reformulation of those GSEs while the legislative process sputters, as evidenced by the recent Securitization Platform White Paper released by FHFA. An important Presidential appointment to watch will be the Director of the FHFA. This position has been held on an Acting basis by the previous Deputy Director, Edward DeMarco. The Democratic margin in the Senate is not significant enough to make it easier to confirm a permanent head of FHFA, but there nonetheless will be pressure on the Administration to fill the position and take control of these issues for the President.

Regulatory agencies will remain focused on implementation of the Dodd-Frank Act in 2013 and newly created agencies such as the Consumer Financial Protection Bureau (CFPB) and the Financial Stability Oversight Council (FSOC) will play important roles in regulating the financial services industry. The CFPB, the establishment of which was broadly opposed by Republicans, will increase its role of protecting consumers as it begins to finalize key rules such as those governing mortgage servicing standards, the qualified mortgage definition, credit insurance financing, and the treatment of larger participants in certain consumer financial products markets. The FSOC will make its initial designations of non-bank companies to be considered systemically important financial institutions (SIFIs) subject to enhanced prudential standards. Similarly, the CFTC and SEC will begin the implementation phase for various rules and will have to address difficult industry questions on issues such as the impact of the new regulatory regime for over-the-counter derivatives on end users, the registration of swap and security-based swap dealers and major swap and security-based swap participants, and various clearing, execution, recordkeeping and reporting requirements. Other agencies including the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office





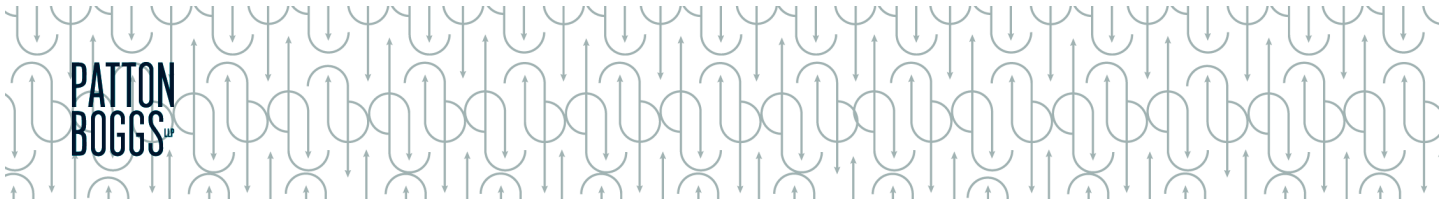
of the Comptroller of the Currency will continue interpreting numerous other Dodd-Frank Act provisions including those focused on enhanced prudential standards for SIFIs, orderly liquidation authority, and the U.S. implementation of international capital requirements for banks.

President Obama will likely have several SEC and CFTC Commissioner positions to fill, including potentially the two chair positions. SEC Chairman Mary Schapiro's term expires in June 2014, although press reports indicate she will resign with President Obama's re-election. Similarly, Commissioner Elisse Walter's term expired in June 2012 and, according to press reports, she is likely to leave the Commission as well. At the CFTC, Chairman Gary Gensler can continue serving until the end of 2013 despite his term having already expired. It remains unclear whether Chairman Gensler will seek another term (requiring Senate confirmation) or vacate his position. Commissioners Bart Chilton, a Democrat, and Jill Sommers, a Republican, have positions expiring in 2013 and 2014, respectively. While new appointments in the SEC and the CFTC will not change the political balance on the Commissions as the President selects the fifth member to each Commission, new members typically change the culture, tone, and chemistry of these independent regulatory bodies.

Another major appointment that will surely influence financial markets and financial services regulation is that of the Secretary of the Treasury. Secretary Timothy Geithner is widely expected to step down, leaving that crucial position to be filled, with rumors of potential appointees including former Clinton White House Chief of Staff Erskine Bowles, Current White House Chief of Staff Jacob Lew, Evercore CEO and Former Deputy Treasury Secretary Roger Altman, or BlackRock CEO Larry Fink. The Administration may also move to approve other pending financial regulatory agency nominations, including that of Federal Deposit Insurance Corporation Acting Chairman Martin Gruenberg, whose nomination has been pending since June 2011.

*Forecast for the 113<sup>th</sup> Congress*

**Financial Regulatory Reform Agency Implementation.** The CFTC began implementation of various Dodd-Frank rulemakings on October 12, prior to the elections. This implementation date came after dozens of open meetings, proposed rules, and industry comment letters, all of which are expected to continue in 2013. During the 113<sup>th</sup> Congress, we can expect the House Republican majority to continue promoting an implementation strategy for financial regulatory reform rulemaking that follows the principles of (1) individual choice over government supervision and (2)



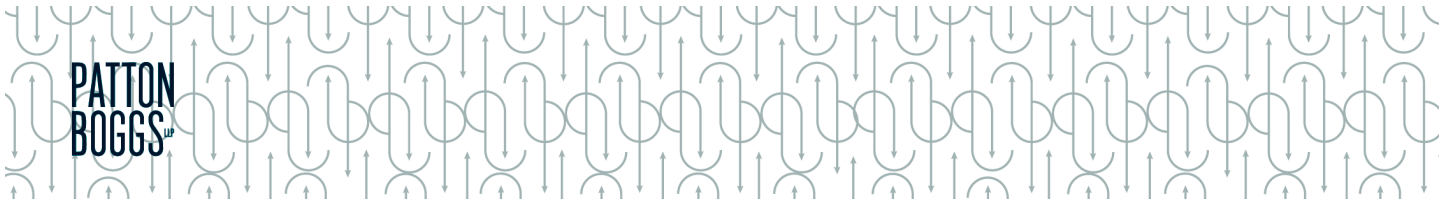
private-sector solutions over a “government only” approach. This can be expected to come into conflict with the perspective of the Obama Administration and the heads of the principal regulatory agencies involved in Dodd-Frank Act rulemaking.

In 2013, the CFTC will address the position limits rulemaking and will finalize rules related to the operation of swap execution facilities and the international application of the new swap regulatory regime. Further, the CFTC must continue its work in designating swaps subject to mandatory clearing and trade execution, registering and regulating swap dealers and major swap participants, and implementing the reporting requirements for swap transaction data. Moreover, following the collapse of MF Global and Peregrine, the CFTC will take on new rulemakings to bolster customer protection requirements. The CFTC will also increase its scrutiny over high frequency trading activity, including a forthcoming concept release on this matter.

**Financial Regulatory Reform Technical Corrections.** During the 113<sup>th</sup> Congress, we expect to see Republicans and Democrats in the House pursuing technical corrections to the law, as identified by the industry and relevant regulators. In any lengthy piece of legislation such as the Dodd-Frank Act, technical errors, omissions or other mistakes are bound to occur, and thus need to be corrected with subsequent legislation. Such an effort could be a platform for discussions about total or partial “repeal” of the Dodd-Frank Act. However, there is some speculation that Republicans, including House Agriculture Committee Chairman Frank Lucas (R-OK), will be reluctant to address technical corrections if Democrats, including Senate Agriculture Committee Chairman Debbie Stabenow (D-MI), are unwilling to consider actual substantive changes to the law.

In any event, any changes that come out of the split chambers of Congress will remain focused on slight modifications to the legislation, as opposed to repealing it. Even technical changes will be tough to achieve. The inability to legislate modifications to the Dodd-Frank Act and the expectation that regulators in a second Obama Administration could continue on a path of a more aggressive approach to Dodd-Frank implementation could lead to further legal challenges to the rulemaking process.

**Housing Finance Reform.** Government-sponsored enterprises were not addressed in the Dodd-Frank Act. As noted above, the 113<sup>th</sup> Congress is expected to attempt to deal with issues related to GSEs reform and the housing finance market in general. The FHFA and the Department of Housing and Urban Development have also begun dedicating significant resources to the reform

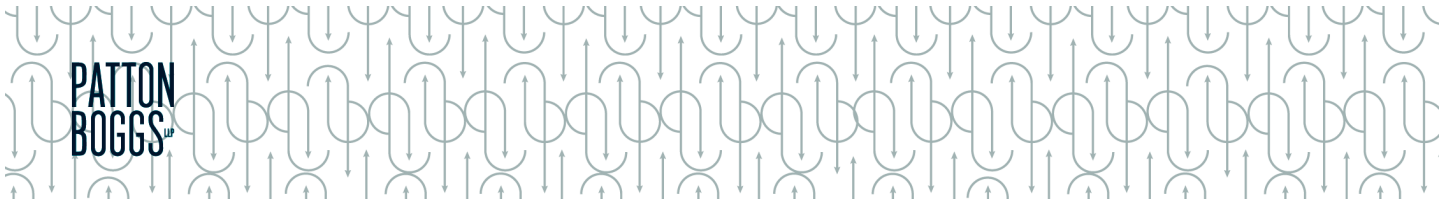


effort in 2013, as demonstrated by the FHFA’s recently released white paper on a new securitization platform and rumors regarding an Administration-supported “HARP 3.0” to increase access to refinancing for homeowners. Congress may consider a legislative proposal referred to as a legislative “HARP 3.0” authored by Senators Menendez and Barbara Boxer that would provide immediate refinancing relief to qualifying homeowners during the lame duck session.

**Insurance Reform.** Almost a year after missing the Dodd-Frank mandated deadline of January 2012, the Federal Insurance Office (FIO) has not released a report to Congress on how to modernize the regulation of the insurance industry. After this report is submitted, Congress will likely address insurance reform in proposed legislation. The FIO report is expected to consider systemic risk regulation, capital standards, and the relationship between capital allocations and liabilities. The report will also look at consumer protection and gaps between States, the degree of national uniformity of State insurance regulation, and the regulation of insurance companies and affiliates on a consolidated basis. Finally, the report will study the international coordination of insurance regulation and the impact of foreign insurance laws on potential federal regulation. Although the FIO Director, Michael McRaith, has engaged in dialogue with E.U. insurance regulators as recently as October 2012, there is still no estimated timeline for the release of the FIO report.

**Consumer Financial Protection Bureau.** This agency, created under the Dodd-Frank Act, was one of the most controversial developments during the legislative process. Director Richard Cordray was a recess appointment by President Obama and is allowed to serve as a recess appointee until the end of 2013, unless his nomination is confirmed by the Senate for the full five-year term. During the 113<sup>th</sup> Congress, Republicans in the House and Senate will continue to be critical of the CFPB and Director Cordray.

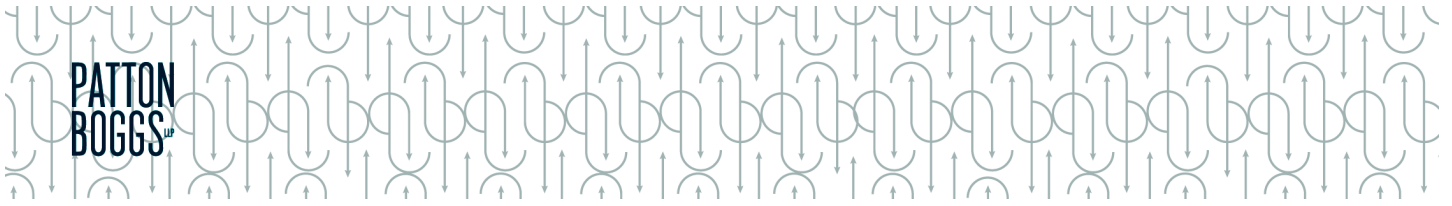
**Financial Stability Oversight Council.** The Dodd-Frank Act established the FSOC to identify and monitor excessive risks by financial institutions, including SIFIs and systemically important Financial Market Utilities (FMUs). The FSOC consists of ten voting members, including an independent insurance expert, and five non-voting members. Of the ten voting members, four are from agencies where a change in leadership is expected (Secretary of the Treasury, SEC Chairman, CFTC Chairman, and Director of the FHFA). Roy Woodall, the independent insurance expert with voting power, was confirmed in 2011 to serve a six-year term as an FSOC member.



### *Anticipated Committee Developments*

**House Financial Services Committee.** The committee will face significant changes in the 113<sup>th</sup> Congress, with Chairman Spencer Bachus (R-AL) reaching his six-year term limit and Ranking Member Barney Frank (D-MA) retiring. Representative Jeb Hensarling (R-TX) is expected to become the next Chairman and Representative Maxine Waters (D-CA) is expected to take Representative Frank's role as Ranking Member and the new chief Democratic defender of the Dodd-Frank Act. With both leaders already invested in housing finance reform—Representative Hensarling introduced an ambitious GSE reform bill in 2012 and Representative Waters was the outspoken Ranking Member of the Subcommittee on Capital Markets and GSEs—the committee will hold numerous hearings on housing reform and will look at ways to address the need to decrease the role of GSEs in the housing market. The Committee is also expected to continue hearing from market participants about issues related to market structure and high frequency trading, setting the stage for potential future legislative action on the topic. The committee will see some changes in membership as Republican Committee Members Judy Biggert (R-IL) (current Chair of the Subcommittee on Insurance, Housing, and Community Opportunity), Francisco Canseco (R-TX), Robert Dold (R-IL), Frank Guinta (R-NH), and Nan Hayworth (R-NY) were all defeated in their races.

**Senate Banking, Housing, and Urban Affairs Committee.** Current Chairman Tim Johnson (D-SD) will continue his leadership of the committee. Ranking Member Richard Shelby (R-AL), who will step down as Ranking Member due to caucus term limits, is expected to be replaced by the committee's second highest ranking Republican, Senator Mike Crapo (R-ID). With neither party having a sixty vote majority for a filibuster-proof Senate, we expect slow progress on all issues. However, Chairman Johnson and Ranking Member Crapo can be expected to attempt to explore where there is common ground, particularly on a Dodd-Frank Act technical corrections bill and housing finance reform. This potential collaboration could give the Senate leverage in negotiating deals regarding changes to the Dodd-Frank Act coming out of the Republican-controlled House of Representatives. The committee will see at least two new Members on the Democratic side, with the retirements of Senator Herb Kohl (D-WI) and Senator Daniel Akaka (D-HI). Senator Chris Coons (D-DE) and Senator-elect Elizabeth Warren (D-MA), who defeated incumbent Republican Scott Brown, are most likely to be appointed to the Committee.



The Senate and House Agriculture Committees will continue playing a significant role in the implementation of the Dodd-Frank Act, as these committees oversee the CFTC and were central to the debate on regulating over-the-counter derivatives markets. For a further discussion of the Senate and House Agriculture Committees and the 113<sup>th</sup> Congress, please see the Agriculture Policy portion of our analysis.

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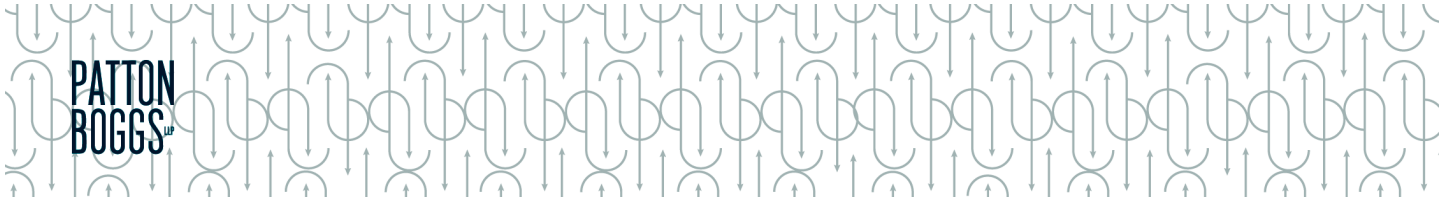
## **FOREIGN DIRECT INVESTMENT IN THE UNITED STATES**

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### *Major Issues*

When it comes to inward Foreign Direct Investment (FDI), the best that can be said about the election is that it is over. Manifestations of xenophobia inevitably appear during political campaigns. In the mid-1980s, Japanese exports were the source of much political rhetoric. This year was no exception, as Chinese trade and investments in the United States dominated much of the trade rhetoric. When the rhetoric is scrubbed away, there was very little daylight between the Obama and Romney campaigns when it came to FDI—both wanted more and both were light on details about what they would do to encourage it.

On the campaign trail, President Obama did not talk about the Committee on Foreign Investment in the United States (CFIUS), but he did block a proposed Chinese-controlled wind farm investment—the first President to use that power in decades. In addition, he expressed concern over Chinese companies “stealing” U.S. intellectual property and his Administration emphasized the risks of Chinese cyber-espionage. We can expect the Obama Administration will continue to use CFIUS as a useful tool to send a message that Chinese companies may be an unwelcome investor in security-sensitive areas. Notwithstanding those concerns, President Obama will be looking to deliver on his promise of accelerated job growth and will likely look to broadly welcome Chinese and other foreign investment in other sectors.



### *Forecast for the 113<sup>th</sup> Congress*

The Global Investment in American Jobs Act of 2012 was one of the few broadly supported, bi-partisan bills that was approved by the 112<sup>th</sup> Congress and then signed into law. The legislation got such support in part because it contains grand rhetoric on the need for more foreign investment to create American jobs. But it actually does nothing beyond calling for a report on incentives and disincentives to foreign investment. The report is due to Congress on May 7, 2013, and could set the tone for debate over FDI in the next Congress.

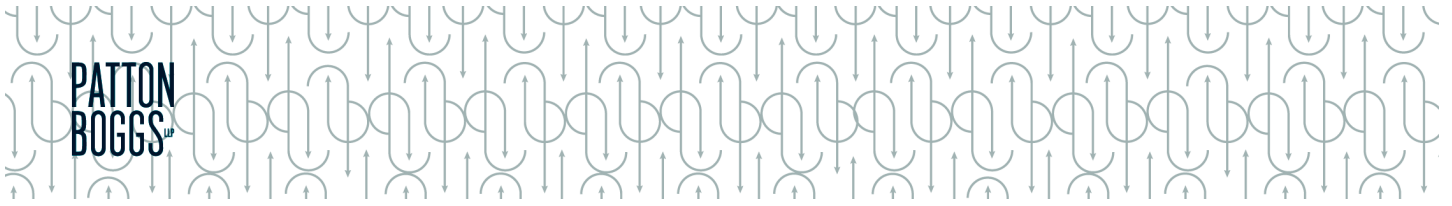
There appears to be growing sentiment in Congress to expand the jurisdiction of CFIUS. In an October 8, 2012 bi-partisan report, the House Intelligence Committee set out what it perceived to be national security risks posed by two Chinese telecommunications companies: Huawei and ZTE. The committee strongly recommended that U.S. government and government contractor systems, “particularly sensitive systems, should not include Huawei or ZTE equipment, including component parts.” It further stated that “the Committee on Foreign Investment in the United States (CFIUS) must block acquisitions, takeovers, or mergers involving Huawei and ZTE given the threat to U.S. national security interests.” Moreover, “U.S. network providers and systems developers are strongly encouraged to seek other vendors for their projects.” Of greatest significance, it called for legislation to authorize CFIUS to review purchasing agreements. If enacted, this would give CFIUS vastly greater powers to intervene in international transactions, far beyond the business acquisition deals it reviews today.

Whether the Obama Administration will welcome such an expansion is questionable. A week after the Intelligence Committee report, the White House issued its own report finding that there was no evidence that Huawei and ZTE were being misused by the Chinese government. We expect the Administration to continue to say that it broadly welcomes Chinese and other foreign investment while continuing to express concern over cyber security.

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### *Contact Information*

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## FOOD AND DRUG POLICY

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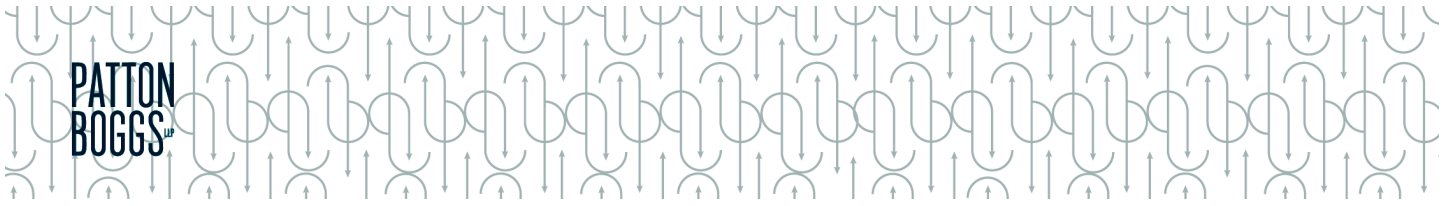
### *Major Issues*

With the re-election of President Obama, the broad-based coalition of FDA stakeholders that lobby for FDA funding can breathe a little more easily. In spite of budgetary constraints, President Obama has been unusually protective of the budget for the Food and Drug Administration.

For more than fifty years, Congress has routinely expanded the authority and responsibility of the FDA without providing additional resources to meet new challenges, and then watched as FDA's implementation of these new authorities has often faltered, only to repeat the pattern again and again. More recently, programs at FDA that involve a pre-market approval system (new and generic drug approval for human and animal use; medical device review; tobacco; and biosimilars) have increasingly been funded through a series of user fee acts ("UFAs") that materially supplement appropriated funds. Each of these UFAs predicates collection and payment of the user fee on Congress maintaining a pre-determined amount of funding in order that the user fees paid supplement appropriated funding as opposed to replacing it. These UFAs are generally credited with providing FDA something approximating sufficient funds to make a good-faith stab at meeting its varied statutory responsibilities, especially the performance goals for the user fee-funded programs and activities.

An unintended effect of reliance on UFAs is that important FDA programs that do not have significant user fee elements (food safety, for example) are disproportionately at risk in times of resource constraints. Failure to fund user fee activities at FDA at the level that triggers the payment of the user fee would have a cascading effect and thus, at least so far, Congress has always found enough money to trigger the user fees. Next year may well put that resolve to the test. The President's re-election is likely to provide a backstop against House-led efforts to cut back on funding for FDA.

The re-election of President Obama also means that the unprecedented backlog of regulatory activity--proposals and final regulations--that, among other things, has impeded FDA implementation of the Food Safety Modernization Act, which President Obama signed on January 4, 2011, will be over. Next year could bring a veritable flood of FDA regulatory activity across virtually all of FDA's regulated products as implementation of the recently-enacted UFAs along with



the food safety and tobacco laws provide FDA with plenty of opportunity to fill the Federal Register with rulemakings.

As is often the case with FDA, a crisis--in this instance involving compounded drugs produced in large quantities that were supposed to be sterile but which were anything but--will certainly produce multiple congressional hearings and may well yield yet another new piece of statutory authority for FDA. Congress will doubtless look to lay blame somewhere other than its doorstep (a 1997 effort by Congress to enhance FDA's authority over pharmacy compounding was eviscerated by a 2002 Supreme Court decision, a decision that left a cloud over FDA's authority and which arguably contributed to the recent pharmacy compounding mess). Congress will not find it easy to strike a correct and useful balance between FDA authority and responsibility and that of state boards of pharmacy, while preserving the important role that compounding pharmacies play in making specially formulated drugs available for patients who legitimately need them.

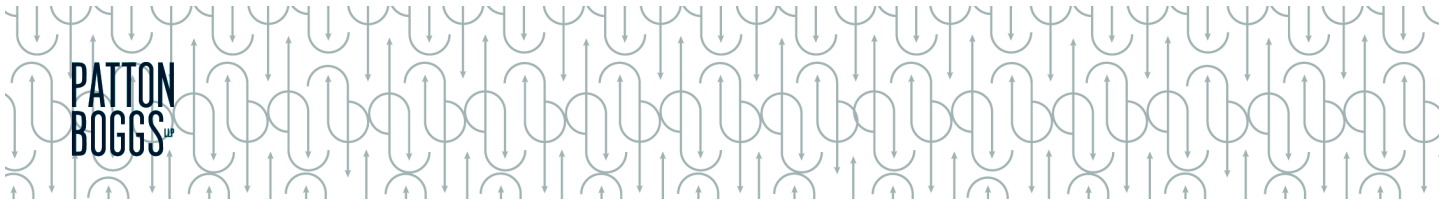
Finally, no one should be surprised if President Obama seeks broad authority to reorganize the federal food safety effort, now spread over several agencies, into a single entity, using "government efficiency" and the need to ensure a safe food supply as the rationales.

#### *Forecast for the 113<sup>th</sup> Congress*

With a divided Congress, schizophrenic oversight is likely to continue to be the norm for FDA. The House oversight effort led by Representative Darrell Issa (R-CA) will look for oversight opportunities that seek to highlight FDA shortcomings. Senate-initiated oversight, in contrast, will focus on shortcomings in FDA's authority (and, perhaps resources) and the need to enhance FDA's tools to police an increasing global supply.

Congressional attention to the risks of an increasingly global supply chain is probable. In the food safety legislation that was enacted in early 2011, Congress imposed on U.S. importers an obligation to ensure that the food products that they import are likely to meet U.S. standards (so-called "foreign supplier verification"). No one knows whether this new concept will work as its implementation has been slowed by the holdup in getting regulatory proposals cleared through OMB. Nevertheless, the 113<sup>th</sup> Congress will continue to look for ways to impose U.S. standards on imported products, especially those pharmaceutical and food ingredients that originate in China.





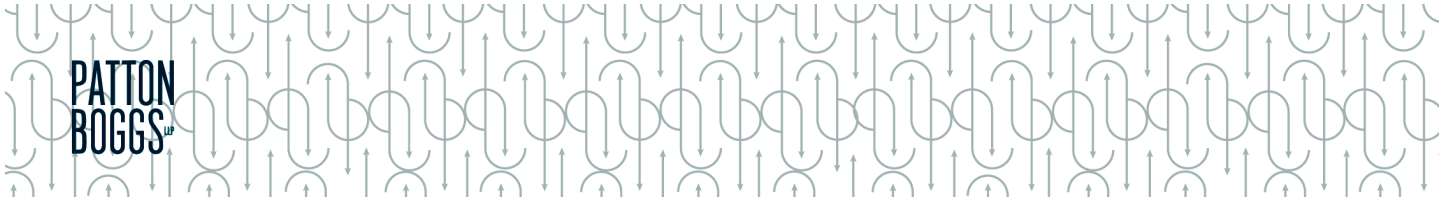
Industry and FDA increasingly share a concern about counterfeit products and foreign supply integrity. FDA product safety concerns meet China trade issues at this particular intersection.

To the extent that President Obama (and the First Lady) refresh their nutrition/obesity/healthy eating agenda in a second term, the food industry is likely to continue to turn to the House for support in warding off the notion that food companies, as opposed to individuals, play a leading role in the obesity epidemic. Oversight and funding battles are likely on those issues.

In the 113<sup>th</sup> Congress, consideration of “track and trace” legislation for pharmaceuticals (and perhaps other FDA-regulated products) is likely. This issue received considerable attention during consideration of the UFAs in the last Congress, but consensus on an approach proved elusive. As globalization of the supply chain continues without pause, congressional interest in giving FDA the ability to know where something came from and what route it traveled will continue to grow. The regulated industry is understandably wary of the cost and related burdens of those requirements, but we are probably only a crisis or two away from a mandate at the federal level, especially as state level requirements are adopted (including a 2015 California imposed deadline). It is generally thought that both the branded and generic drug industries will support a uniform national standard if differing state requirements are pre-empted.

Scrutiny of the dietary supplement industry and of FDA’s authority to regulate it is likely. There is a wide divide in the Congress between those who think that dietary supplements have been given a pass on regulation and those who are ever watchful over FDA’s efforts to assert authority over the industry. Powerful Senators (Senator Dick Durbin D-IL) on the one hand and Senators Orrin Hatch (R-UT) and Tom Harkin (D-IA) on the other) hold widely divergent views over supplements and FDA authority. A potential initial battleground involving supplements may be energy drinks, a growing category in the beverage industry with some major players marketing their products as supplements. FDA is being urged to rein this in and seems inclined to do so to a point. Congressional attention in multiple directions is probable.

Finally, there is increased likelihood of enhanced collaboration between FDA and CMS on drug efficacy and pricing, especially for new products.



*Anticipated Committee Developments*

**House Energy and Commerce Committee.** Representatives Fred Upton (R-MI) and Henry Waxman (D-CA) will continue to serve as Chair and Ranking Member, respectively. Representatives John Dingell (D-MI) and Ed Markey (D-MA) will continue as active Members of the Committee on FDA issues.

**House Appropriations Committee.** Representatives Jack Kingston (R-GA) and Sam Farr (D-CA) will continue as Chair and Ranking Member of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Subcommittee. Representative Rosa DeLauro (D-CT) will continue as an active member of the Subcommittee.

**Senate Health, Education, Labor, and Pensions (HELP) Committee.** Senator Tom Harkin (D-IA) will continue as Chairman. Senator Michael Enzi (R-WY) has run up against a deadline as Ranking Member. Senator Lamar Alexander (R-TN), who is next in seniority, is in line for the Ranking Member position.

**Senate Appropriations Committee.** The retirement of Senator Herb Kohl (D-WI) leaves an opening in the chairmanship of the subcommittee that handles FDA appropriations. Senator Roy Blunt (R-MO) is likely to remain as Ranking Member.

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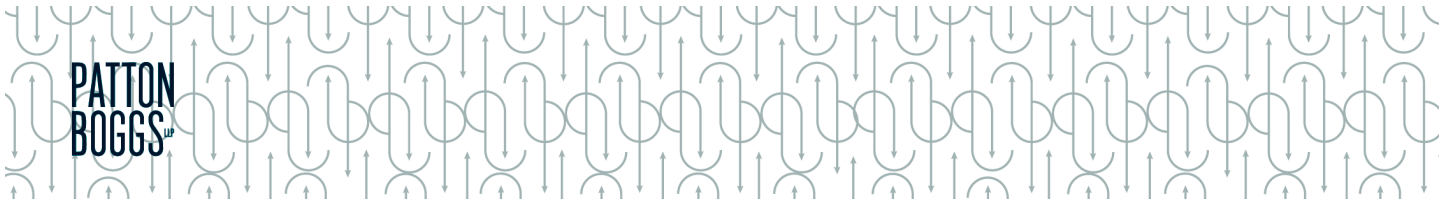
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## **GOVERNMENT CONTRACTS**

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*Major Issues*

The general tension between pro-labor and pro-business agendas has a significant impact on federal procurement policy and oversight. The Obama Administration in its first term succeeded in implementing many pro-labor procurement policies, through ARRA and otherwise. This included a substantial in-sourcing effort that took tens of thousands of jobs off contractor payrolls and moved



them into government, expansion of Davis Bacon and other prevailing wage requirements, increased whistleblower protections, and more assertive enforcement against contractors who violate labor laws. These and related efforts will remain priorities in President Obama's second term. In particular, the Administration will continue to push to cap compensation of government contractor executives and potentially other employees. The Administration will also continue to attempt to place additional constraints on contractors' ability to participate in political activity.

In the past two Congressional sessions there have been numerous proposals to expand the application of government-wide suspension and debarment. This includes provisions enacted in the 2011 National Defense Authorization Act (NDAA) which make imposition of suspension and debarment an automatic requirement with respect to companies which have been found in violation of criminal and certain civil and administrative laws. While vigorously opposed by industry and many professionals, additional proposals in this vein continue to be introduced and we expect this trend to extend into the next Congress. Senator Claire McCaskill (D-MO) has been a strong proponent of these measures and her re-election likely means added emphasis behind such proposals. There may be some resistance to these measures in the House, but these proposals have a populist appeal which may make it difficult for a Republican majority to hold its ranks in opposition to them.

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### *Contact Information*

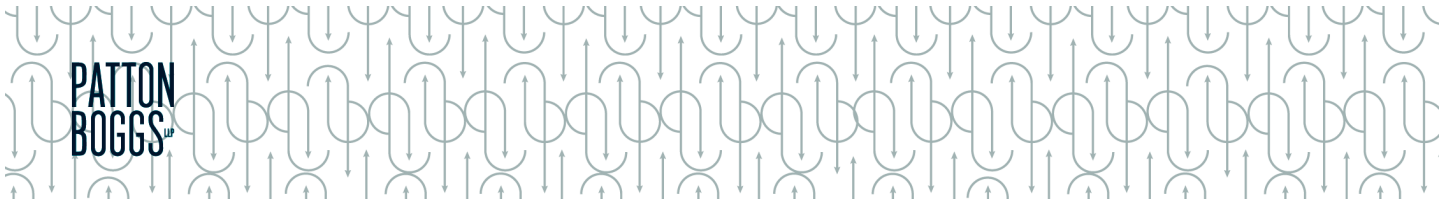
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## **HEALTH CARE**

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### *Major Issues*

With President Obama's re-election, the Patient Protection and Affordable Care Act (ACA), his signature first-term achievement, has survived another threat of repeal or serious modification, and implementation of the largest expansion of the health care safety net will proceed. The health care policy agenda in the upcoming year will again focus on the continued implementation of the ACA with deadlines for major elements of the law quickly approaching. States have held off making decisions regarding the development of health insurance exchanges, Medicaid expansion, benchmark plans and participation in demonstration projects until after the election, so time is now of the

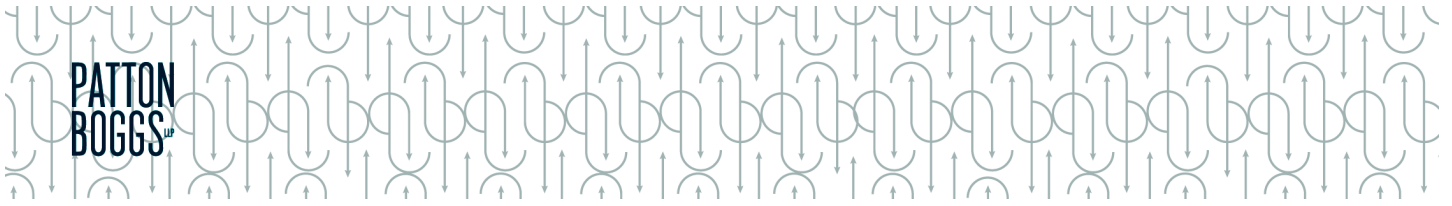


essence. While implementation delays remain a serious possibility, the Administration will be working furiously to release necessary guidance to encourage states' participation and compliance.

First, however, Congress must address key health care policy issues facing the lame duck session, notably staving off an anticipated twenty-seven percent cut to Medicare payments to physicians, as well as a sizeable package of Medicare extenders. The projected cost of a one-year "doc fix" alone comes in at roughly \$18.5 billion, but Members on both sides of the aisle have publicly reported their optimism in reaching a deal. Offsets will mostly come from the Medicare program, and could include reductions to a number of hospital payments (outpatient evaluation and management services payment cuts, reductions to graduate medical education programs, etc.) health reform subsidy recoupment, and Prevention Fund cuts, as well as potential savings from Overseas Contingency Operations (OCO). Medicare extenders will be viewed with increased scrutiny, as the current Congress grapples with how to address the looming fiscal cliff.

Given the status quo outcome of the elections, Members are likely to focus on an extension of up to one year to allow additional time to address other health care issues and also to consider a full overhaul of the Sustainable Growth Rate (SGR) formula used to determine physician payments in Medicare. The "GOP Doctors Caucus" in particular has identified this as a key priority for the 113<sup>th</sup> Congress, but consensus on policy and "pay-fors" remains elusive. Over one hundred physician groups have also weighed in to advocate for a full repeal of the SGR formula and promoted principles that could serve as the foundation for a new payment system, including both incremental and broader changes to improve the quality of patient care and to lower the rate of cost growth.

Members will also pick up negotiations on deficit reduction in the lame duck session in order to avert automatic spending cuts on January 2, 2013 triggered by sequestration, as required by the Budget Control Act (BCA) of 2011. Social Security, Medicaid, the Children's Health Insurance Program (CHIP), and benefits received by Medicare patients are shielded from the cuts, but Medicare provider payments and other health programs will be subject to across-the-board reductions. The BCA limits Medicare cuts to two percent, which amounts to roughly \$11 billion in 2013, according to the Administration's report on the effects of sequestration. Other program cuts include \$318 million from the Food and Drug Administration (FDA), \$76 million from the ACA's Prevention and Public Health Fund, and \$2.5 billion from the National Institutes of Health (NIH). Members on both sides of the aisle have warned that sequestration's across-the-board cuts would have a devastating impact on public health programs and access to health services, and should be

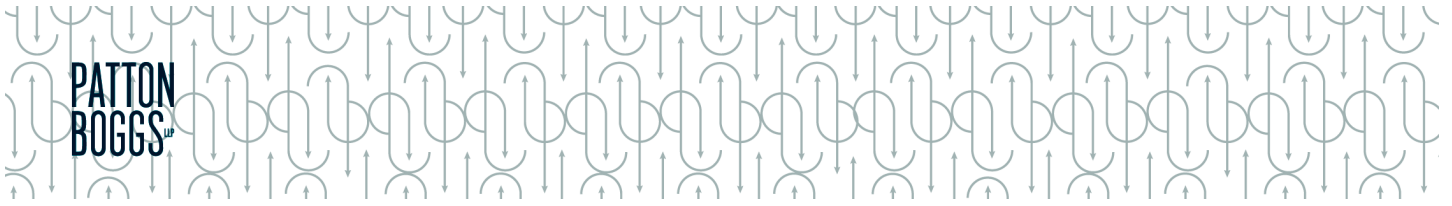


replaced with a thoughtful, policy-based approach at deficit reduction. The President has indicated he is looking for a balanced approach to avert sequestration, but congressional negotiators will have to overcome Republican opposition to increased taxes and Democratic opposition to major cuts in entitlement programs. The so called “Gang of Eight”—Republican Sens. Saxby Chambliss (GA), Mike Crapo (ID), Tom Coburn (OK), Mike Johanns (NE) and Democratic Sens. Mark Warner (VA), Dick Durbin (IL), Kent Conrad (ND), and Michael Bennet (CO)—have been meeting for months to craft a bipartisan deficit reduction proposal that will address health care spending and other components. The group is optimistic about the prospect of reaching a deal, and has discussed a down payment of roughly \$60 billion in deficit reduction to allow discussions to continue in the next Congress. As noted at the outset of this piece, much work needs to be done before a consensus is likely to emerge that can be embraced by the President and the leadership of both Houses.

Another issue, but one whose fate is not as certain, is the repeal of the Independent Advisory Payment Board (IPAB). Commonly referred to as Medicare Payment Advisory Commission (MedPAC) on steroids, this entity authorized by the ACA would need to be formed early in 2013 to meet its first deadline of recommendations for 2014 that would be implemented in 2015. On April 30, 2013, the CMS Chief Actuary must report on whether Medicare per-capita growth rates exceed target growth rates with projections to 2015. The first draft proposals must be provided to MedPAC and the Secretary of HHS by September 1. If Medicare spending exceeds target growth rates by a statutorily defined amount, the IPAB must develop recommendations that the Secretary of HHS will be required to implement unless Congress adopts an alternative proposal that results in equivalent savings and the President does not veto the alternative package. While some have called the IPAB the only way to reduce Medicare spending, many in Congress have voiced strong concern about the Board and called for its repeal. The President remains supportive. Repeal will not be cheap. CBO estimated that the savings from the IPAB would be \$15.5 billion over 10 years.

### *Forecast for the 113<sup>th</sup> Congress*

Split control of the House and the Senate suggests more of the same in the 113<sup>th</sup> Congress, with the Republican House of Representatives likely moving health bills throughout the year that will die in the Democratic Senate. The House can be expected to advance Republican health policy priorities with legislation addressing symbolic ACA repeal, premium support for Medicare, beneficiary co-pays, Medicaid reform and block grants, promoting market competition in health care, defunding

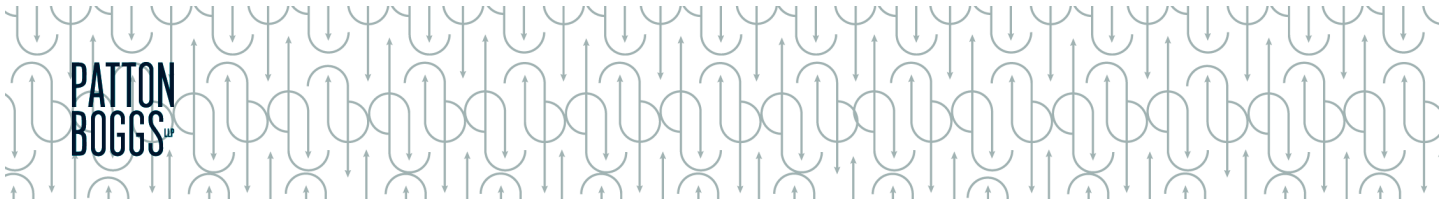


Planned Parenthood, and deficit reduction measures including cuts in health care spending. The Senate will instead focus on supporting ACA implementation activities.

As the Administration proceeds through the ACA implementation process, the Republican House will also continue to pursue aggressive oversight of health care reform. Committees with oversight jurisdiction will carry over a number of outstanding issues from the 112<sup>th</sup> Congress, including recent investigations regarding Medicare Advantage bonus payments, dual eligible demonstration initiatives, electronic health records incentive programs, and a review of the 340B drug discount program. Compounding pharmacies are expected to remain in the spotlight in response to the recent meningitis outbreak resulting from contaminated injections, with a review of FDA policies and potential legislation calling for increased regulation. Drug track-and-trace legislation also remains a bipartisan priority for consideration. New investigations are certain to include a careful look at health reform implementation activities at the state level, as well as progress at the federal level to meet ACA deadlines.

Deficit reduction will remain at the top of the health care policy agenda in 2013, as Congress will be under continued pressure to find savings from Medicare, Medicaid, and public health programs. Health reform implementation activities will not be immune from review, though an Obama Administration and Democratic majority in the Senate will fight to protect patient benefits and key safety-net programs. Delivery system reform will continue to be part of the discussion in 2013, as one of the few areas where Congressional Republicans and Democrats may find common ground.

The current SGR formula for determining Medicare payments to physicians could undergo revision or outright repeal in the 113<sup>th</sup> Congress as part of a larger overhaul of the current Medicare payment system. Representatives Allyson Schwartz (D-PA) and Joe Heck (R-NV) introduced legislation in the 112<sup>th</sup> Congress to combat the recurring problem of potentially cutting physician reimbursements and thus avoiding the need for regular Congressional intervention. Their legislation would repeal the current SGR and establish a new, stable system of paying doctors that is not based on the quantity of procedures performed on patients. The bipartisan bill is focused on increasing access to preventative and primary care for seniors by increasing payment updates to those physicians. Senate Finance Committee Leadership has also expressed support for SGR reform and has held a series of roundtable discussions on the subject and formal hearings with key stakeholder groups. The cost of overhauling the SGR will be the biggest hurdle, with estimates surpassing a staggering \$300 billion

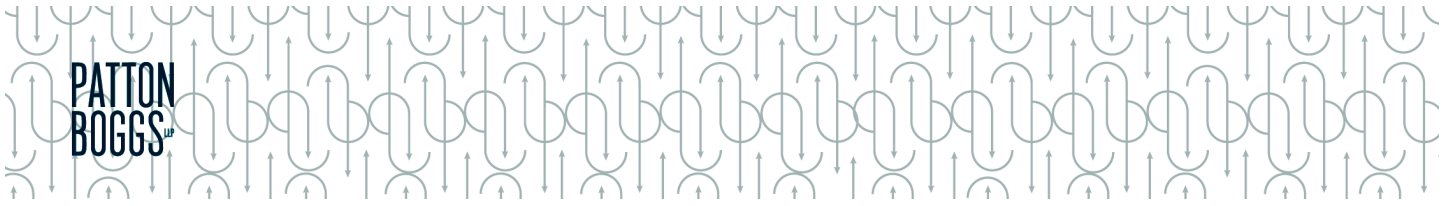


over ten years and growing as the formula matures, making folding overhaul into a broader budget deficit deal the greatest promise for a permanent fix in the near term.

Tax reform efforts (described in a separate section below) will also pick up steam in the 113<sup>th</sup> Congress and could serve as a potential vehicle to modify the ACA. Congressional Republicans will target the medical device tax, repeating their efforts from the 112<sup>th</sup> Congress where Representative Erik Paulsen's (R-MN) repeal bill successfully passed the House but stalled in the Senate. Offsets remain a concern, but growing bipartisan support, including quiet acknowledgement by key Senate Democrats of the negative implications of the tax on jobs and innovation, as well as pressure from American manufacturers increases the likelihood of intervention. The tax is scheduled to go into effect in 2013, yet the Internal Revenue Services (IRS) has yet to release final guidance on how the tax will be executed leaving the industry to wonder if an administrative delay may be announced at the end of 2012 or the beginning of the year. Tax reform could also include revisions to the status of Health Savings Accounts (HSAs) as some Republican legislators have contended that the ACA's Medical Loss Ratio (MLR) and use of "actuarial values" currently limit the effective use of HSAs in particular.

In 2013, much of the work of ACA implementation will shift to the state level. States are required to submit a blueprint of their plans for their individual health insurance exchanges to the Department of Health and Human Services (HHS) by November 16. In those blueprints, states must declare their intent to operate insurance marketplaces through their own state-based exchange or through a partnership with the federal government. States that do not submit plans will be subject to a federally-facilitated exchange administered and regulated by the federal government (though guidance remains outstanding). To date, seventeen states and the District of Columbia have submitted plans to operate their own exchanges or have indicated their intent to implement state-based exchanges, and six have expressed plans or are considering opportunities to partner with the federal government.

States must also decide if they will expand Medicaid coverage under the ACA, and, if so, to what income level. The Supreme Court ruled in June that the federal government cannot require states to expand their Medicaid programs in order to secure ongoing federal support, but states may opt to expand eligibility to 133 percent of the federal poverty level (FPL) and receive enhanced federal support. States are still awaiting guidance from the Centers for Medicare and Medicaid Services (CMS) to determine whether they may receive enhanced federal support for expanding Medicaid



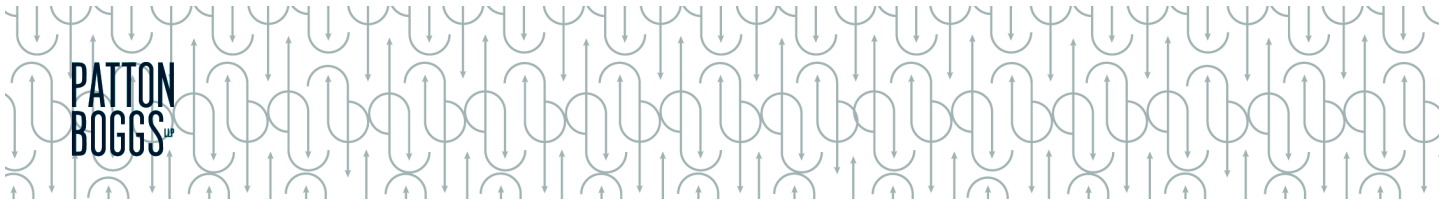
coverage to income levels below 133 percent of the FPL. Medicaid expenses for low-income individuals have traditionally been a joint venture between federal and state governments, with the federal government covering at least half of the costs depending on a state's match rate. The federal government will cover 100 percent of the costs of expanding Medicaid to 133 percent of the FPL from 2014 to 2016, decreasing to 90 percent in 2020 and thereafter. Individuals in states that choose not to expand their Medicaid coverage will still be subject to the ACA's individual mandate, but they may be eligible for sliding-scale subsidies through the health insurance exchanges. Medicaid is one of the states' biggest fiscal challenges, particularly as the loss of jobs and health insurance coverage has led to swelling rolls.

Most Republican Governors have indicated they will not participate in the expansion, fearing the federal government's ability to maintain financial support of expanded populations over time. The ACA does not preclude future Congresses from rolling back federal support of Medicaid, which could leave states footing the bill. Before the election, Republicans held 29 governor mansions, Democrats held 20, and an Independent held one. Only North Carolina has elected a Republican Governor to replace a Democrat and thus it might now alter its position on the Medicaid expansion issue.

Although President Obama's re-election eliminates the near-term prospect of legislative action that would result in repeal of the ACA in its entirety, legal challenges will continue to threaten the viability of particular provisions of the law. Lawsuits targeting the contraception coverage rule that requires insurance policies, including those offered by faith-based employers, to provide birth control with no copayment continue to mount. Over thirty suits have been filed to date despite a "compromise" announced earlier this year designed to address the concerns of certain institutions. For example, East Texas University and Houston Baptist University have filed challenges to the ACA's requirement that employers provide no-cost coverage for birth control as part of employee insurance benefits. Although the ACA contains provisions that shift the cost for birth control from the institution to insurers in cases of religious objection, the universities maintain that the policy is nonetheless a violation of their religious freedom. Liberty University has filed a lawsuit against the individual mandate and employer responsibility provisions on similar religious grounds.

Another challenge comes from the state of Maine, which is suing under an interpretation of the Supreme Court's decision in June that states may also reduce their current Medicaid rolls because the ACA's maintenance-of-effort provision no longer applies. A recent challenge to IRS regulations



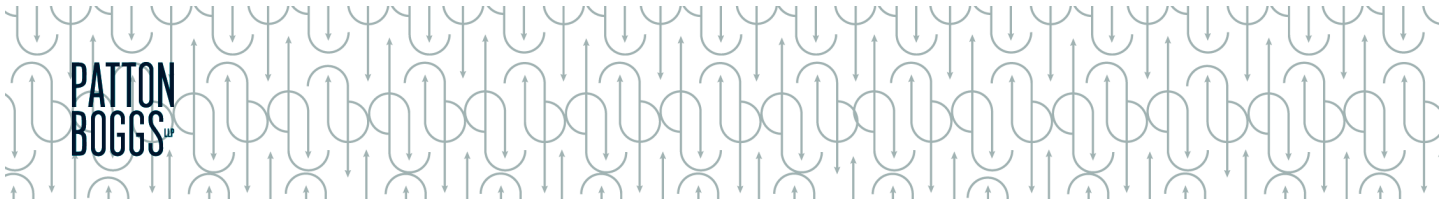


regarding health insurance subsidies through a federally-facilitated exchange will re-litigate the question of congressional intent versus statutory language, with the potential to undue a major element of coverage expansion. The Oklahoma Attorney General challenges the IRS regulation that permits tax subsidies under the ACA to flow through the federal health exchanges, claiming the ACA only allows for subsidies through state-based exchanges. The Goldwater Institute has also filed suit against the constitutionality of the Independent Payment Advisory Board (IPAB) as a violation of the separation of powers between the three federal branches of government, arguing the IPAB is not answerable to either Congress or the Supreme Court.

The regulatory arena also promises a busy agenda next year, which will be jam-packed with ACA implementation deadlines and tremendous preparations for 2014. Major provisions in effect next year include state notifications regarding exchanges, establishment of the essential health benefits (EHB), Medicaid payments for primary care, limitations to flexible spending account contributions, the excise tax on medical devices, establishment of the Consumer Operated and Oriented Plans (CO-OPs), and Medicare and Medicaid Disproportionate Share Hospital (DSH) payment cuts. Planning for 2014 will also include regulatory activity on Medicaid expansion and eligibility, individual requirements for health insurance, health insurance exchanges, employer coverage requirements, health insurance premium subsidies, multi-state health plans, and penalties for hospital-acquired conditions.

The Administration is also likely to increase its efforts to implement innovative ways of restructuring how care is delivered to improve quality and care coordination. For example, more demonstration projects seeking to integrate care and reward provider coordination are likely to be approved by the Center for Medicare and Medicaid Innovation. In addition to expanding accountable care organization (ACOs), it will explore new bundled payments for groups of providers (such as in the post-acute care arena) and ways to incentivize providers to reduce hospitalizations and readmissions. Value-based purchasing will likely be incorporated into these new payment models as well.

The continued implementation of the ACA also raises a regulatory concern with the introduction of the Modified Adjusted Gross Income (MAGI) standards in 2014. The MAGI standard will impede states from locking residents with income fluctuations into Medicaid eligibility. That policy has produced uncertainty among administrators in anticipating the future cost of Medicaid coverage. The Medicaid and CHIP Payment and Access Commission (MACPAC) is currently conducting



studies to determine how to avoid having individuals with fluctuating incomes move repeatedly between private insurance and Medicaid services based on those shifts in income.

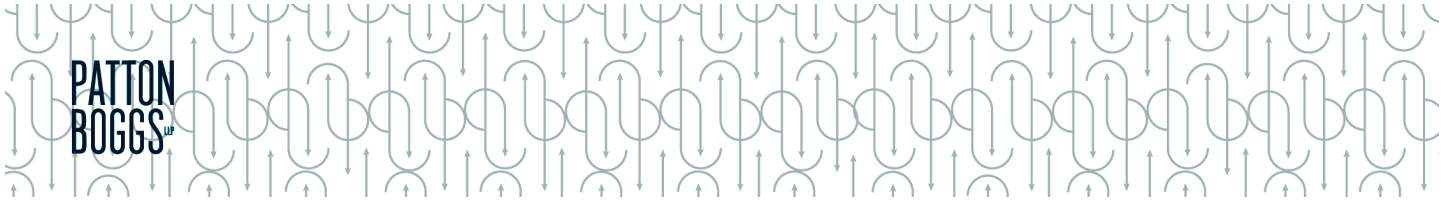
The Obama Administration has also expressed concern about potential abuses in Medicaid and Medicare electronic billing, after uncovering a sharp increase in federal reimbursements that accompanied the introduction of new billing coding procedures. A subsequent letter from Attorney General Eric Holder and HHS Secretary Kathleen Sebelius sent to several hospital trade associations warned that the Administration takes instances of fraud seriously and is considering reforming how the federal government reimburses hospitals going forward. The President must find a way to balance the need for detecting fraud and abuse with appropriate contractor oversight, given the exponential growth of entities engaging in audits of Medicare providers.

In addition, the Administration will be faced with the ongoing challenge of providing adequate Medicare payments as providers try to offset inadequate Medicaid payments and the loss of higher commercial plan rates that have historically offset such losses.

The Secretary also must promulgate the final update to the HIPAA Privacy Rule and implementation of the privacy provisions of the Health Information Technology for Economic and Clinical Health Act, which Congress enacted in 2009. The Agency published a proposed rule in 2011 and received many comments, but the final rule has not yet been published.

#### *Anticipated Agency and Committee Developments*

**Secretary of Health and Human Services.** The consensus view is that Secretary Kathleen Sebelius will remain in her current position for a second term. She has weathered the storm surrounding the ACA implementation and has voiced a strong interest in implementing the law. The Acting Administrator of CMS, Marilyn Tavenner, received high praise from Republicans and Democrats alike, but her confirmation by the Senate was derailed because of partisan politics surrounding other nominations and the ACA debate. She has been a strong advocate for implementing the ACA and reforming the Medicare program. It seems likely she would be willing to remain in her position for a second term as well. What is less clear is whether or not the Senate would be able to overcome divisions over the ACA now that implementation rests within CMS and confirm her in early 2013. An attempt at confirmation seems likely because, while technically a successive recess appointment is permitted, there are questions about whether or not she could be compensated.



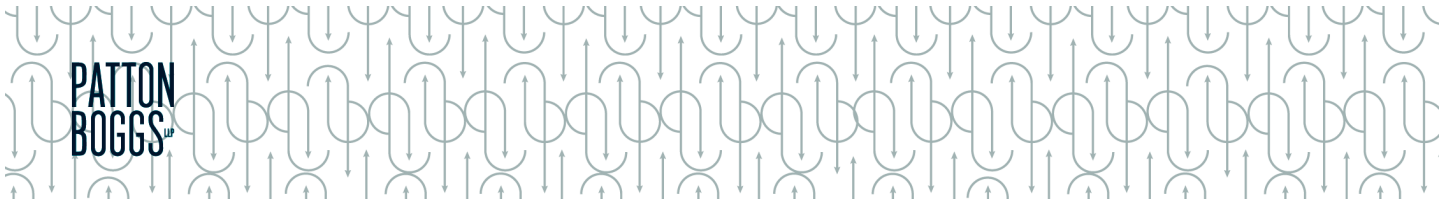
**Senate Committees.** The Senate Finance Committee will see the return of Chairman Max Baucus (D-MT), and Senator Tom Harkin (D-IA) will keep his post at the Senate Committee on Health, Education, Labor, and Pensions (HELP). Republicans in the Senate are term-limited to six years, so Senator Michael Enzi (R-WY) has run up against a deadline as Ranking Member on the HELP Committee. Senator Lamar Alexander (R-TN), who is next in seniority, is in line for the Ranking Member position. Senator Orrin Hatch (R-UT) will continue to serve as the Ranking Member of the Finance Committee. Senator Herb Kohl's (D-WI) retirement leaves the gavel open at the Special Committee on Aging, with Senators Ron Wyden (D-OR) and Bill Nelson (D-FL) following in succession. Senator Bob Corker (R-TN) is not expected to remain as the Committee's Ranking Member, but his successor is not apparent yet.

**House Committees. House Committees.** The House committees of jurisdiction also will remain largely intact, with the exception of the House Ways and Means Health Subcommittee. Representatives Dave Camp (R-MI) and Sander Levin (D-MI) will continue to serve as Chairman and Ranking Member, respectively, of the Ways and Means Committee. With Representative Pete Stark (D-CA) having lost his 15<sup>th</sup> district seat to fellow Democrat Eric Swalwell, there will be an opening for the Subcommittee's Ranking Member slot, which we expect to go to Representatives Jim McDermott (D-WA) or Xavier Becerra (D-CA). With Representative Wally Herger (R-CA) retiring, the Subcommittee Chairman's gavel will likely go to Representatives Sam Johnson (R-TX) or Charles Boustany (R-LA), a physician who is rumored to be interested in a move from chairing the Oversight Subcommittee. Representatives Fred Upton (R-MI) and Henry Waxman (D-CA) will keep the top seats on the House Committee on Energy and Commerce, with Representative Joe Pitts (R-PA) and Frank Pallone (D-NJ) leading the Health Subcommittee.

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*Contact Information*

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## HOMELAND SECURITY

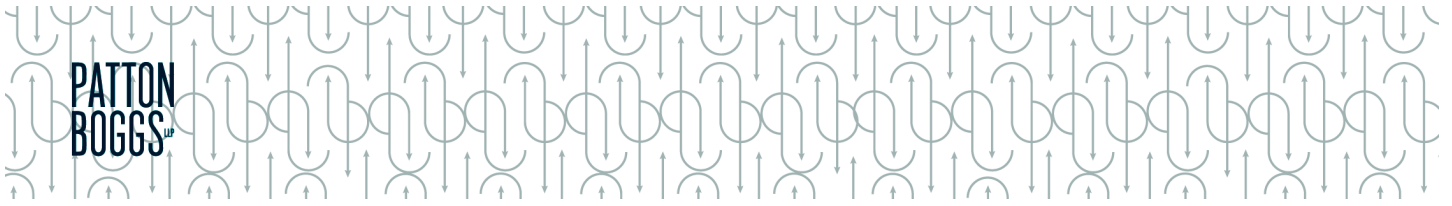
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### *Major Issues*

Of the many issues facing the U.S. Department of Homeland Security in 2013, cybersecurity, comprehensive immigration reform, border security, and other issues will dominate the agenda before Congress and the Obama Administration.

**Cybersecurity.** Given disagreements between key Members of Congress and the shortness of the September schedule, the Senate failed to take action on cybersecurity legislation before it adjourned for the elections. Majority Leader Reid has indicated that he will bring a bill to the floor in the lame duck, but time constraints dictate that it is unlikely we will see final action this year. Thus, the issue will almost certainly remain a vital issue for DHS and the Congress to address next year. With Senator Joe Lieberman (I-CT) retiring and Senator Susan Collins no longer serving as Ranking Member on the main oversight committee, Majority Leader Reid and incoming Chairman Tom Carper (D-RI) and Senators Jay Rockefeller and Dianne Feinstein (D-CA) will likely lead the debate in close coordination with the Obama Administration.

In the absence of legislation, the Obama Administration has been drafting an executive order (EO) that would address cybersecurity. While the draft order is currently under review and thus subject to change, however we understand that it would establish DHS as the lead agency on cybersecurity and direct it to set up a consultative process under the Critical Infrastructure Partnership Advisory Council (CIPAC) to work with critical infrastructure. DHS, working with Sector Specific Agencies (SSA's), would create a voluntary program with critical infrastructure sectors to encourage the adoption of voluntary standards. The order is also said to give DHS 150 days to identify critical infrastructure where a cyber incident could "reasonably result in a debilitating impact on national security, national economic security or national public health or safety." In addition, the EO would also direct DHS to work with U.S. Department of Defense, the Director of National Intelligence and the Attorney General to create an enhanced cybersecurity information sharing program with critical infrastructure. The Executive Order cannot give agencies would direct agencies to review existing regulations and report back on whether or not they believe they are sufficient to provide the cybersecurity needed. . In addition, the Obama Administration is poised to release a rewrite of the 2003 presidential directive (HSPD-7) that more effectively integrates the physical and cybersecurity standards for addresses critical infrastructure.



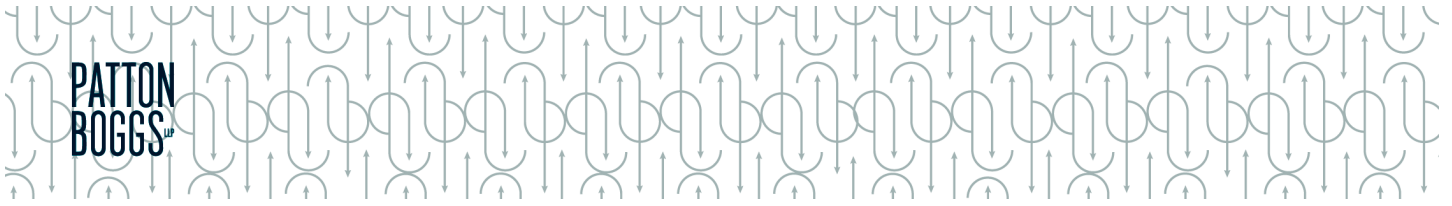
Those efforts, however, are not expected to replace the need for legislation in the areas of liability protections for information sharing with the private sector, updating of the Federal Information Security Management Act (FISMA), workforce development issues, and research and development needs. In a bipartisan move, the short-term Continuing Resolution for FY 2013 provided a substantial increase in funding to DHS for its cybersecurity efforts, one of the few increases granted to any agency, for any purpose.

We expect the National Programs and Protections Directorate to continue to focus on cybersecurity. Efforts began some months ago to better integrate the efforts of DHS when it comes to working closely with Critical Infrastructure in the areas of cybersecurity and physical security. We expect those efforts to continue, along with increased investments in cyber in general for the Executive Branch.

**Immigration Reform.** Although President Obama did not introduce comprehensive immigration reform during his first term, we expect him to undertake a major immigration reform initiative. President Obama's efforts to administratively implement some components of the popular, yet failed, DREAM Act through the Deferred Action for Childhood Arrivals (DACA) program signaled a renewed focus on immigration reform. Democrats in Congress will look to the President to fulfill his 2008 campaign promises on immigration, and Republicans, who have stymied progress on this issue over the last four years (and even stopped George W. Bush's immigration reform efforts), may be more willing to compromise as they look at the growing electoral share of the Hispanic vote.

As a matter of both policy and pragmatic politics, the Administration is likely to balance this liberalizing approach with a continuation of its efforts at workplace enforcement and further bolster border security by tracking down and deporting criminal aliens and visa overstays, dealing harshly with repeat offenders, and complementing a beefed up Border Patrol with reliance upon technology (though not the comprehensive technological solution that the costly and ambitious "SBInet" program was intended to be).

**Border Security: Customs and Border Protection (CBP).** Border security will remain the political flash-point for CBP. The Administration will continue to say that the border is more secure than ever and try to shift resources to other CBP and DHS missions such as trade facilitation and immigration enforcement. House Republicans will continue to highlight border violence, especially the risk that it will spill over from Mexico into the United States, and will seek to push for ever



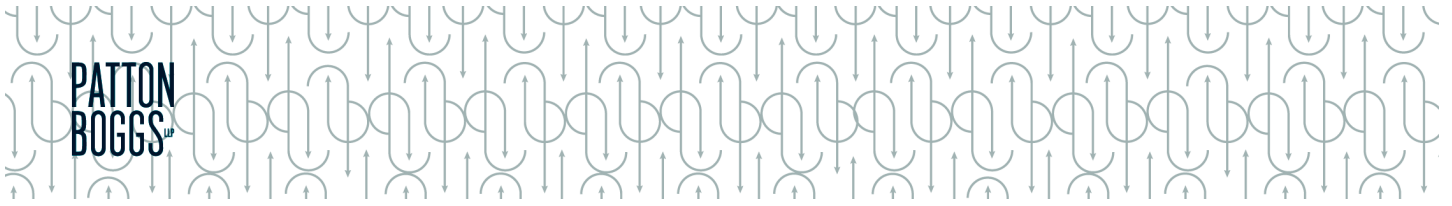
greater measures to secure the border with longer and higher fences, more technology, no reduction in the Border Patrol, and further easing of environmental and other laws that they say impede CBP's access to the border. The fight over border security and CBP resources will only intensify under a sequester, which could result in reductions of \$1.2 billion in CBP's budget and almost 7,000 Border Patrol officers and CBP inspectors.

CBP has had an Acting Commissioner since December 2011 when Alan Bersin resigned. President Obama has not nominated anyone to succeed him and is unlikely to do so until any changes are solidified in the higher level leadership of DHS.

**Aviation Security: Transportation Security Administration (TSA).** We expect the agency to continue to expand its trusted traveler Pre-Check program, which it hopes will cover thirty percent of passengers by the end of 2014. This effort will need to be accelerated if the sequester comes into force because TSA estimates it would be required to reduce its security checkpoint staff by over ten percent, which would lead to longer lines and extended delays at airports around the country. As more people who can be "pre-cleared" pass through security lanes more quickly, the fewer screeners that will be needed overall.

**Intelligence and Analysis (I&A).** The key challenge for the department's intelligence unit remains the same as always, carving out a unique and useful role in the intelligence community. Ever since its inception, the component has struggled to find its footing and to be taken seriously by the other agencies with greater seniority and recognition. The unit remains largely a consumer of intelligence from others in the community, and it then disseminates aggregate intelligence to state and local law enforcement officials and to the owners and operators of critical infrastructure in the private sector. While there have been improvements in this regard, complaints persist that I&A's "intelligence" is little more than a distillation of what its customers can learn by watching CNN or reading The New York Times. The recent investigation by the Senate Homeland Security Committee's Permanent Subcommittee on Investigations concluding that the \$1.4 billion spent by DHS to fund "fusion centers" which share intelligence with state and local partners and the private sector has resulted in largely "useless" reports will only add fuel to the fire, especially in a strained budget environment that requires appropriators to question the "value add" of every dollar requested.

DHS might be perceived as largely a consumer of intelligence, but it is also a collector. The intelligence it collects is unique to the community. Its nationwide network of airport screeners,



Border Patrol agents, and Customs inspectors all pick up bits and pieces of information every day that can be indicative of terrorism or crime, and yet the department and the intelligence community as a whole have been slow to grasp the contribution that could be made to the larger threat picture.

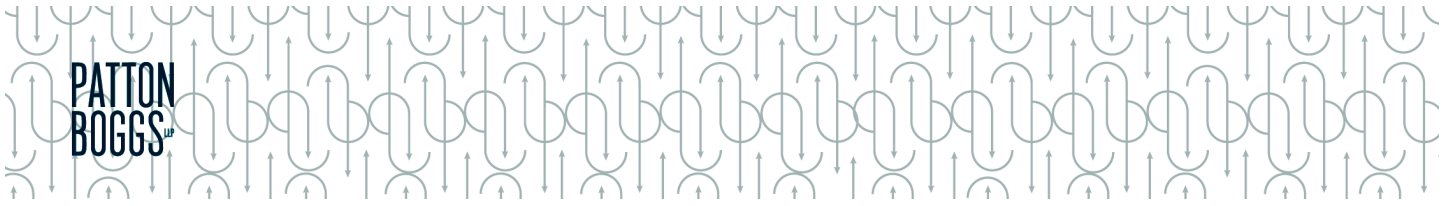
**Coast Guard.** For the next four years, the Coast Guard’s challenge will remain “doing more with less.” It maintains an aging fleet. Faced with sequestration concerns elsewhere in the Department, along with prior concerns with cost overruns on the Deepwater program, the Coast Guard is unlikely to see a substantial uptick in its budget. As a consequence, the service will be continue to be severely challenged in its ability to perform age-old missions like search and rescue, and, even more so, to contribute to the fight against terrorism and drug trafficking.

An additional, short-term challenge is working with TSA to make progress on further implementation of the TWIC (Transportation Workers Identification Card) biometric identification card program for port workers. TWIC cards have been issued to more than two million workers, but those of the workers who were first to receive them will start expiring this fall. DHS has yet to issue guidelines for card-reading machines, and so, for now, the cards are merely costly forms of visual identification.

**Science and Technology.** For some time, S&T has struggled to provide a useful and unique contribution to the homeland security enterprise. Over time, it has been unable to balance the particular research and development needs and agendas of the various components against those of the department as a whole. The creation of the Homeland Security Advance Projects Agency in the 2002 Homeland Security Act was meant to create an agency at DHS that could mirror the efforts of the U.S. Department of Defense’s Defense Advance Projects Agency, but it has never been able to achieve anything near those goals for DHS, nor has it been able to distinguish its work from work done in the defense and intelligence communities.

#### *Anticipated Agency and Committee Developments*

**DHS Secretary.** Given her strong relationship with President Obama, Secretary Janet Napolitano will remain at the helm of the Department if she decides to stay. She has done a successful job of managing an agency that continues to slowly grow into a more cohesive entity. But she is rumored to want to become the Attorney General (AG), a job that would become vacant with the anticipated stepping down of current AG Eric Holder. She is sure to be on the short list for that job in the



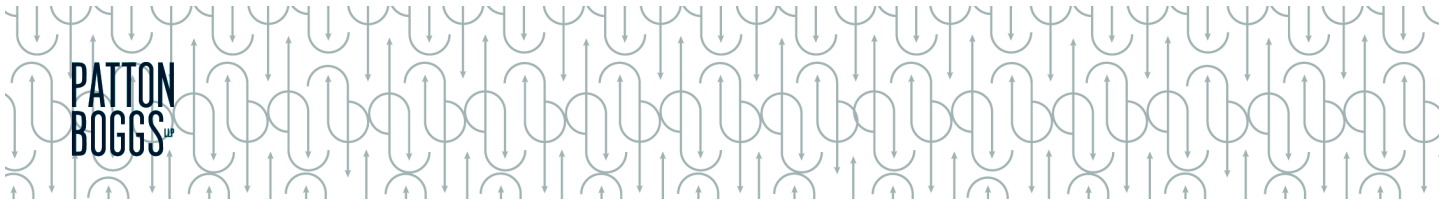
President's second term. If Secretary Napolitano does move to Justice, other possible contenders could be retiring Senator Joe Lieberman, current New York City Police Chief Ray Kelly, former Los Angeles Police Chief and New York City Police Commissioner Bill Bratton, former Representative Jane Harman or former Coast Guard Commandant Thad Allen.

**TSA.** Administrator John Pistole has served just over two years and shows no signs of leaving. Pistole has been clear about his hostility to the privatization of airport security and has just signed a collective bargaining agreement with the screeners' union, which also strongly opposes privatization. While House Republicans will continue to call for more privatization, there will be little support in the Administration or the Democratic Senate.

**House Homeland Security Committee (HHSC).** Representative Peter King (R-NY) is term-limited as Chairman but he, like some other House Chairman, may seek a waiver to maintain his position. A longtime moderate in the House Republican Caucus, Representative King has been known to push for bipartisan compromise on issues ranging from labor policy to numerous key homeland security matters. He has worked hard to try to support the agency while being just as strong on oversight of key agency issues. If his waiver-bid does not succeed, he will leave behind a strong legacy of support for first responders, the need to focus on and combat homegrown Islamist radicalism as well as an ongoing desire to streamline Congressional oversight of DHS, to name a few issues.

Based on existing seniority on the committee, Representative Candice Miller (R-MI) is considered the leading candidate to replace Chairman King. However, Representative Michael McCaul (R-TX) and Representative Mike Rogers (R-AL) are viewed as strong possibilities for the Chairmanship as well. Most expect Representative Bennie Thompson (D-MS) will continue to serve as Ranking Member. As full committee Chair, Representative Miller would be expected to emphasize the common Republican view that the Administration needs to be significantly more vigilant with regard to the nation's southern, northern, and maritime points of entry. In response, Ranking Member Thompson and fellow Democrats likely would point to recent advances in radiological detection and cargo scanning more broadly, while decrying GOP-proposed cuts to the broader homeland security budget. Meanwhile, Representative Miller and the Administration likely would form common cause on a selective, risk-based approach to maritime cargo screening in foreign ports, whereas most Committee Democrats would continue their public push for 100% scanning of such cargo.



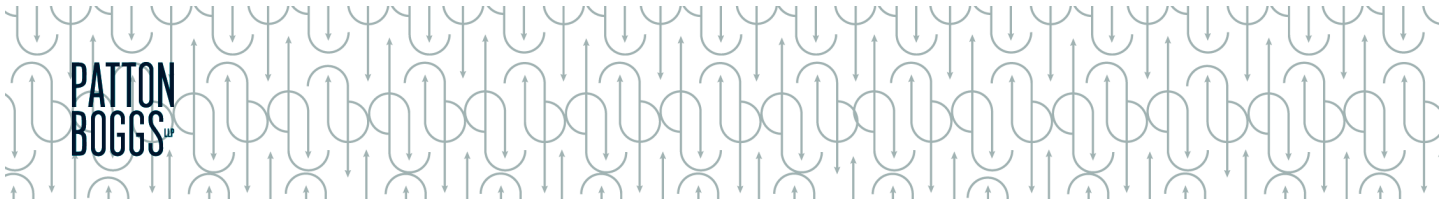


**Senate Homeland Security and Government Affairs Committee.** Chairman Joe Lieberman (I-CT) is retiring after a four terms in the Senate. Current Ranking Member Susan Collins (R-ME) is term limited as Ranking Member. Both Lieberman and Collins have been known for their ability to work collaboratively on a host of issues, being almost at times indistinguishable in their views—one of the rare instances of bipartisanship in the current political environment.

We expect that Senator Tom Carper (D-DE) will take over as the Chairman. Senator Carper was an active Member, working with Lieberman, Collins and others on the Cybersecurity Act of 2012. Carper has also been active on a host of transportation security issues, including maritime security issues based on concerns for the Port of Wilmington, along with aviation security and critical infrastructure in general. He has also been an advocate for immigration reform which will be an active area of interest as well. Under his leadership, expect Carper to focus on cybersecurity issues in detail. It is likely that the Obama Administration will issue an Executive Order focusing on cybersecurity prior to them leaving office.

With Senator Collins term limited as Ranking Member of the full committee, Senator Tom Coburn (R-OK) will take over as the Ranking Member. It is expected that the Senator will take up the mantle of those proponents of the SECURE It Act, calling for no government role in regulating critical infrastructure and reforming the information sharing component of cybersecurity. It is also expect that the Senator will focus on the Government Affairs side of the committee, using it as a platform for his annual “Waste book,” which he uses to criticize government “waste.” How those positions will be reconciled with those of Chairman Carper is unclear, potentially calling into question the prior bipartisan work of the committee under Lieberman and Collins.

**House Appropriations Committee.** As full committee Chairman, Representative Harold Rogers (R-KY) will continue to play an active role in homeland security appropriations issues. Meanwhile, we expect that Representative Robert Aderholt (R-AL) will continue as Homeland Security Appropriations Subcommittee Chairman, while Representative David Price (D-NC) will maintain his position as Ranking Member on the Subcommittee. At the full committee level, Representative Nita Lowey (D-NY) is considered to be more active on homeland security issues than her primary competition to serve as Ranking Member, Representative Marcy Kaptur (D-OH). Representative Lowey currently serves on the Committee’s Homeland Security Subcommittee.



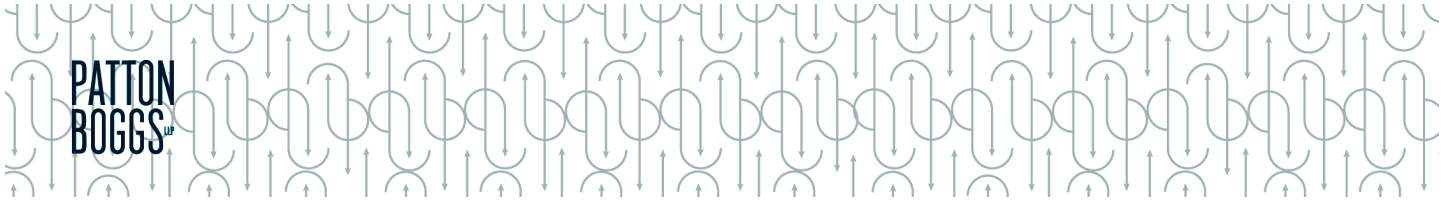
Chairman Rogers, Chairman Aderholt, and other Committee Republicans will continue to support the likely proposed cuts to the Administration's homeland security budget. They particularly will advocate for cutting programs that tend to favor more urban areas, such as the Transit Security Grant Program, the Urban Areas Security Initiative, and other first-responder-oriented grants, noting the currently unused allocations associated with many of those funding streams.

**Senate Appropriations Committee.** Senator Mary Landrieu (D-LA) is likely to continue as the Chairman of the Senate Appropriations Committee's Homeland Security Subcommittee. Given Louisiana's susceptibility to hurricanes, Chairwoman Landrieu will continue to emphasize disaster preparedness and recovery issues. Senator Dan Coats (R-IN) likely will serve as the Subcommittee's Ranking Member.

At the full committee level, Chairman Daniel Inouye (D-HI) will continue his active interest in aviation security matters, as well as other homeland security concerns. Because Ranking Member Thad Cochran (R-MS) is subject to term limits, we expect Senator Richard Shelby (R-AL) to replace him. As a current member of the Homeland Security Appropriations Subcommittee, Senator Shelby has worked with Senators Cochran, Landrieu, and others on Gulf Coast recovery efforts.

Senators Inouye, Landrieu, and other Appropriations Committee Democrats are likely to oppose many of the proposed cuts in the Administration's homeland security budget, including grant programs for first responders and transportation security. Their efforts are likely to meet with modest success.

**House Permanent Select Committee on Intelligence.** Representative Mike Rogers (R-MI) will continue as Chairman of one of the few committees that operates in a bipartisan fashion. Representative Dutch Ruppersberger (D-MD) will continue as Ranking Member. The areas of focus over the next two years will likely remain the same as before: cybersecurity and the need for information sharing with the private sector; the implications of the Arab Spring for U.S. security; the prospect of a nuclear armed Iran and what more needs to be done to stop it; terrorism; and organizational issues within the intelligence community, with a particular focus on the Office of the Director of National Intelligence that is, notionally at least, supposed to oversee and rationalize the community so as to maximize efficiencies and optimize performance.



**House Energy and Commerce Committee.** Representative Fred Upton (R-MI) will remain Chairman and Representative Henry Waxman (D-CA) will remain the Ranking Member. On the security side, we expect cybersecurity to remain at the top of the committee’s agenda. Representative Upton cosponsored the Cyber Intelligence Sharing and Protection Act (“CISPA”), which passed the House in the 112<sup>th</sup> Congress with strong bipartisan support. However, CISPA does not address data breaches, which has been the subject of much debate in the Senate. However, this is an issue that both parties acknowledge as important, and they will likely be working toward a solution in both chambers in the next Congress. The debate, similar to cybersecurity, will be focused on looking at how much regulation is needed and whether there are ways to streamline the data breach notification laws that currently exist.

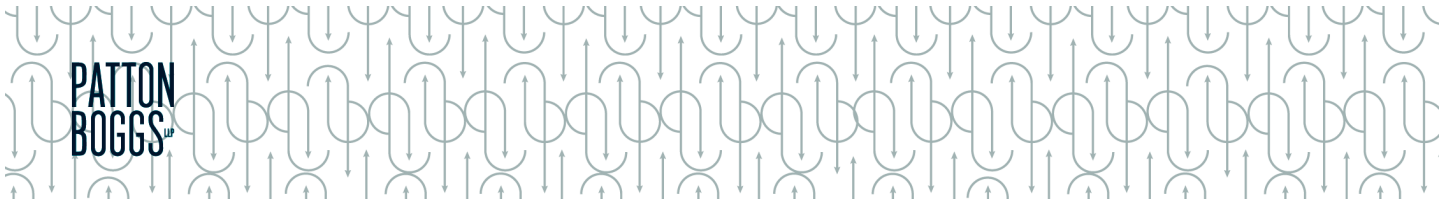
**Senate Commerce, Science, and Transportation Committee.** Senator Jay Rockefeller (D-WV) will remain Chairman. Due to the retirement of Ranking Member Kay Bailey Hutchinson (R-TX) and Senator Olympia Snowe (R-ME), Senator Jim DeMint (R-SC) will become Ranking Member. We expect Chairman Rockefeller to focus on cybersecurity issues in detail. Rockefeller will continue his outreach to the private sector in the areas of critical infrastructure. His recent letter to all of the Fortune 500 CEOs on cybersecurity is indicative of his desire to continue to push for a comprehensive cybersecurity bill in the next Congress. The homeland security focus of the Senate Commerce Committee will remain largely the same in the next Congress. In addition to cybersecurity, the committee will continue to push for effective aviation and transportation security, and increasing the effectiveness of customs and border patrol programs.

Senator Maria Cantwell (D-WA) will remain the Chair of the Subcommittee on Aviation Operations, Safety and Security. Senator Frank Lautenberg (D-NJ) will remain Chairman of the Surface Transportation Subcommittee. The Ranking Republicans on both subcommittees might change as the Members reassess their interests with Senator DeMint moving to Ranking Member of the full committee.

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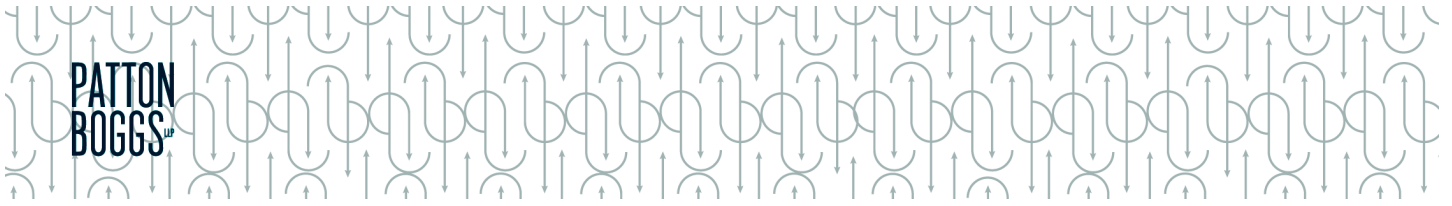
## NATIVE AMERICAN AFFAIRS

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### *Major Issues*

President Obama’s first term featured unprecedented support for Indian Country initiatives, with increased public engagement that featured three annual White House summits with elected leaders from the 565 federally recognized tribes in the United States. Significantly, the President added two key White House Senior Advisors for Native American Affairs, one on his Domestic Policy Council and the other as Deputy Director of Intergovernmental Affairs and Outreach. The Obama Administration facilitated and negotiated settlement of several long-standing conflicts over management of Indian trust resources, water rights, and administration of loan programs, including settlement of *Keepseagle v. Vilsack*, a class action lawsuit in which Patton Boggs attorneys successfully represented Native American farmer plaintiffs. As part of the stimulus provisions of the American Recovery and Reinvestment Act (ARRA), the largest ever allocation of urgently needed funding flowed to Indian country for construction of hospitals, detention facilities, and long-needed transportation, housing, and infrastructure projects. Notably, the ARRA also included authority for a \$2 billion volume cap for tax exempt Tribal Economic Development (TED) bonds to finance certain economic development projects. As part of the Affordable Care Act (ACA), Congress included permanent authorization of the Indian Health Care Improvement Act (IHCA) that had been pending for 12 years. Also enacted were the Tribal Law and Order Act and the Helping Expedite and Advance Responsible Tribal Homeownership (HEARTH) Act. Significant improvements to tribal transportation programs passed in the Moving Ahead for Progress in the 21st Century Act (MAP-21) (further discussed in the Transportation and Infrastructure chapter), with \$450 million provided annually for projects that improve access to and within Tribal lands, and new set asides for tribal bridge projects and tribal safety projects. A new statutory formula for distributing funds among tribes will be phased in over four years and will be based on tribal population, road mileage, average previous funding, and an equity provision.

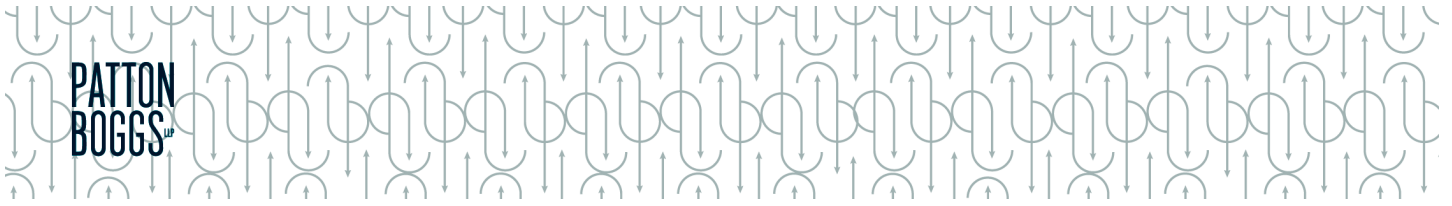
**Consultation Policy.** The Obama Administration also made a substantial commitment to expand government-to-government consultation between the United States and tribal governments by re-



issuing the existing Executive Order on consultation and requiring each executive agency to develop or revise extensive written consultation policies. The Administration also succeeded in encouraging a number of significant independent agencies (not bound by the Executive Order) to commit to consultations with Indian Country. As a result of this expanded commitment, the Administration hosted numerous successful consultations through agencies traditionally serving Indian Country, like the Bureau of Indian Affairs (BIA) and the Indian Health Service (IHS), but also the U.S. Departments of Agriculture (USDA), Commerce, Homeland Security, Treasury, the Internal Revenue Service, and the Small Business Administration (SBA). The re-election of President Obama signals the likelihood that consultation will become entrenched as the “best practice” for engaging tribal governments, Alaska Native, and Native Hawaiian leaders on proposed policies affecting their members and shareholders.

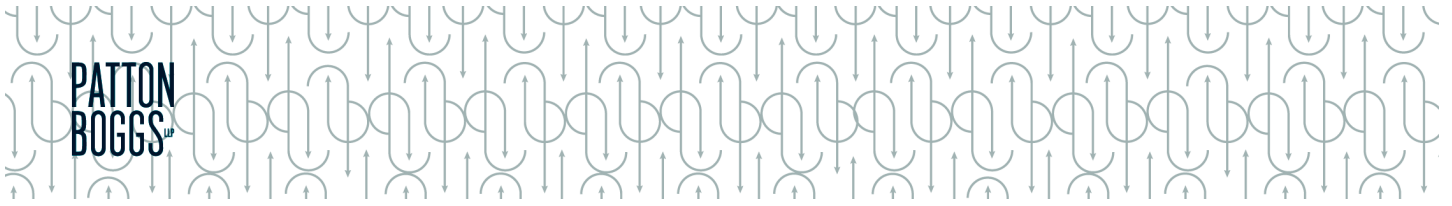
**Federal Funding and Budget Issues.** While tribal governments and Native American interests having successfully maintained or increased funding for many programs during President Obama’s first term, sequestration pursuant to the Budget Control Act of 2011 threatens those gains. The mandated deficit reduction measures have resulted in painful spending cuts and looming sequestration actions that could slash many Indian Country programs as much as 14% to over 32% from FY 2010 levels, when adjusted for inflation. If enacted, the House Republican Budget proposals could result in even deeper cuts. Although some IHS funding may be exempt from harsh cuts, other federal health program reductions could cause substantial loss of funding for tribal health programs that are chronically underfunded. The Obama Administration and Indian Country supporters in Congress will press for a FY 2013 omnibus appropriations agreement or other final measure that will provide close to the FY 2013 budget requests for some increase for the Tribal General Assistance Program and public safety initiatives, higher IHS funding levels for IHS hospitals and hundreds of tribally-operated clinics and health programs and for key investments in clinical services staffing and health facilities construction, and at least level funding for Indian programs in education, housing, transportation, economic development, telecommunications, agriculture, energy, natural resources and cultural preservation. To address Native Americans’ staggering unemployment rates (up to 80% on some reservations), efforts will be made to increase grant funding for tribal and other native organizations that provide employment and training services to unemployed, low-income Native Americans, Alaska Natives, and Native Hawaiians.

**Food Security and Agricultural Programs.** The Farm Bill is another major reauthorization bill whose timely enactment would benefit Indian Country. Both the House and Senate bills contain



provisions to make permanent the USDA’s Office of Tribal Relations and to link the Farm Services Agency’s Highly Fractionated Land Loan Program (that provides loans to eligible Native Americans and tribes to purchase tribal land and consolidate fractionated interests) with the BIA’s structured process for purchasing fractionated land. The bills also continue vital food security programs that affect Native American and Alaska Native communities, including tribal governments’ participation in the Supplemental Nutrition Assistance Program (SNAP) (formerly known as the food stamp program) and the WIC program for mothers and small children. While the Senate bill would restructure some of the SNAP rules on how to calculate benefits and thereby “save” \$4.3 billion, the House bill would reduce the SNAP program by more than \$16.1 billion over 5 years. Such SNAP cuts would devastate American Indian and Alaska Native families (24% now participate, compared to 14% in the general U.S. population). Also reauthorized would be the Food Distribution Program on Indian Reservations (FDPIR) through which commodity foods are distributed to low-income households living on or near Indian Reservations. The bills also include grants for tribal colleges to build essential community facilities, including health, education and public safety facilities and to help provide education in food and agricultural sciences to their students and surrounding communities (36 tribal institutions are currently served). Final action on the Farm Bill has stalled, in part over the differences in SNAP funding. As noted in the separate Agriculture Policy section of this paper, we do not expect action on a new Farm Bill until next year.

**Tax Reform.** On tax reform, tribal governments are advocating for numerous changes in the tax treatment of tribal benefits paid to tribal members, and tax treatment of tribal bond financing more on par with state and municipal bond financing authorities. Building on the parity provisions enacted in the Affordable Care Act to exempt tribally-provided health benefits from federal income taxes owed by tribal members, tribal advocacy groups are promoting additional exemptions for tribal benefits extended to tribal members for general welfare, cultural, and educational purposes. Other tax reform proposals would repeal the “essential government function” test as it relates to tribal pensions and to tribal tax-exempt debt, including a definition of Indian lands to provide coverage for projects on or near a reservation or Alaska Native village. As to streamlined sales tax proposals, tribes seek parity treatment so that they may collect sales taxes on any product sold within their territorial jurisdiction. The tax treatment of trust distributions to minors also is under review. In conjunction with tax issues related to investment and financing, tribal groups are seeking exemptions from Security Act registration requirements for certain tribal bond financings similar to exemptions granted to other governments’ bonds. Energy-related tax proposals are under consideration as well.

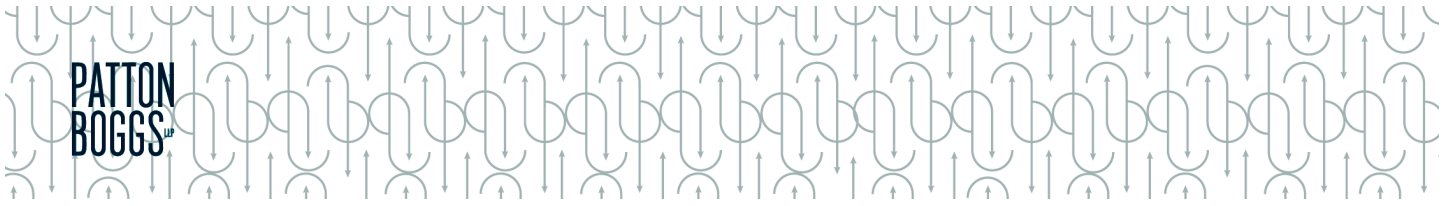


**Internet Commerce.** Congress could revisit federal internet gaming legislation in the lame-duck session. Since we do not anticipate final action this year, it likely remains a key issue in the next Congress. Senator Akaka released a discussion draft of a Tribal online gaming bill to raise issues of concern to tribes, including respect for tribal sovereignty, non-taxation of tribal revenues, and continuation of existing rights under Tribal-State gaming compacts. Tribes will resist any attempts to amend the Indian Gaming Regulatory Act for on-line gaming or other purposes. Also of interest to tribal governments is Senator Merkley’s SAFE Act legislation targeting the growing on-line lending industry in Indian Country. A growing number of tribes are entering the short-term small-dollar financial services market, and see Merkley’s legislation and recent actions by the Consumer Financial Protection Bureau as a direct threat to sovereignty and business operations.

**Carcieri Fix.** Another pending Indian Country facing high hurdles is legislation to address the U.S. Supreme Court decisions in *Carcieri v. Salazar* and another case that cripple the ability of tribal governments to have land taken into trust on their behalf. President Obama’s FY 2012 and 2013 budget requests included legislative language to amend the Indian Reorganization Act of 1934 to reaffirm the Secretary of the Interior’s authority to take land into trust for all federally recognized tribes. Bills to accomplish this so-called “Carcieri fix” (S.676, H.R. 1234, H.R. 1291) have been stalled.

**Violence Against Women Act.** Another must-pass measure, the Violence Against Women Act (VAWA) reauthorization, is stymied over Senate amendments to protect the rights of Native American women (who suffer the highest rates of domestic violence) by restoring tribal jurisdiction over non-Indians for crimes of domestic violence and dating violence committed in Indian Country. Currently tribes are the only governments in the U.S. lacking jurisdiction to protect Native Women from domestic and sexual violence in their communities.

**Native Hawaiian Government Reorganization Act.** As his legacy, Senate Indian Affairs Committee Chairman Daniel Akaka (D-HI) seeks enactment of this measure to enable Native Hawaiians to build a government-to-government relationship with the United States to place this indigenous group on parallel footing with the indigenous members of the 565 federally recognized tribes in Alaska and other 48 states. The Obama Administration strongly supports the measure.



*Forecast for the 113<sup>th</sup> Congress*

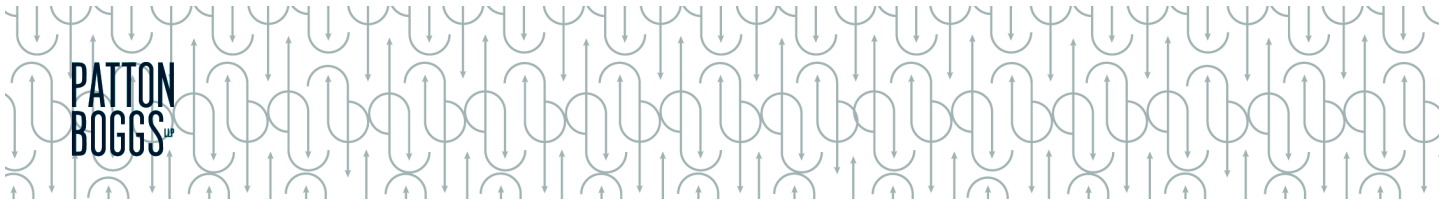
Top Indian Country priorities for the Administration and 113<sup>th</sup> Congress will be enactment of key unfinished business. Such measures could include the VAWA reauthorization with the jurisdictional provisions to protect Native American women against domestic and other violence, and reauthorization of the Farm Bill with the tribal provisions and funding sufficient to meet the demands of the food stamp/SNAP, WIC, and food distribution programs on Indian reservations and Alaska Native communities. If not enacted in the lame duck session, we expect that proposals will be reintroduced to effectuate the *Carieri* “fix” and the Native Hawaiian Government Reorganization, as well as legislation to allow a tribal government to request the President to issue a disaster declaration to trigger federal responses to a disaster devastating its tribal community (without having to rely on a state’s decision whether or not to request a disaster declaration).

Tribes also will actively engage in any negotiations to resolve budget issues in ways that protect essential federal program funding for tribal governments and tribal members. In negotiations over tax provisions in these budget measures, or more comprehensive tax reform, tribal groups will advocate for needed clarification and parity treatment in the area of bond financing, investments, pensions, and benefits extended by tribes to their members. Ongoing consultations on various tax issues could result in promulgation of new rules or guidance on taxation of tribal trust distributions to minors, allocations for TED bond financing, and other tax exempt bond issues of concern to tribes.

In health care, tribal organizations may have to continue to fight to preserve the permanent reauthorization of the Indian Health Care Improvement Act in the face of any effort to repeal part of the Affordable Care Act. Another key priority will be reauthorization of the Special Diabetes Program for Indians, due to expire September 30, 2013, so as to avoid any disruption in funding of that important and effective program.

Heightened activity in the energy field will be very likely, giving tribes more opportunities to press their energy-related agendas. Since several key legislators with large tribal constituencies will have stronger roles in energy legislation, there could be more viable legislative vehicles on which to advance tribal energy provisions.





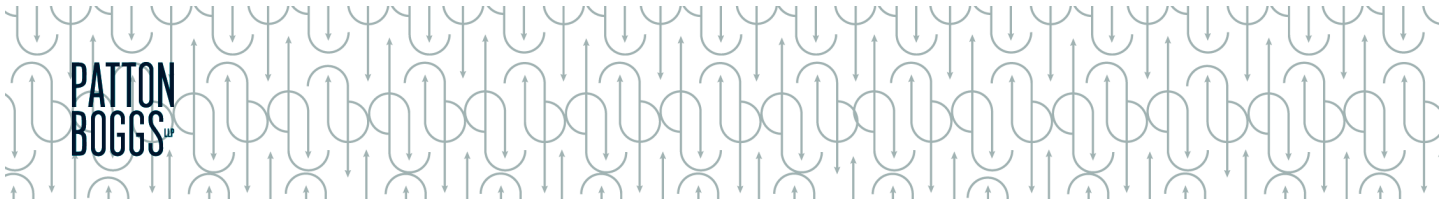
On the gaming front, the National Indian Gaming Commission (NIGC) will conclude its comprehensive review of all of its regulations and promulgate new final rules beyond those already published regarding appeals to the Commission, facility licenses and Class II gaming minimum internal control standards. Important remaining regulatory issues, including those relating to sole proprietary interest, will be subject to tribal consultations and public comments. As the three-year terms of each of the three NIGC Commissioners will expire in 2013, there will likely be nominations and confirmation hearings for any new Commissioner, and that process could delay the rulemaking.

Other federal activity will include BIA's implementation of the Helping Expedite and Advance Responsible Tribal Homeownership (HEARTH) Act. Tribes will urge the BIA to develop guidelines for tribes to establish their own rules for surface leasing of tribal lands and then submit those rules for approval by the Secretary of the Interior within 120 days of submission. Thereafter, the tribe could lease its own tribal lands without having to seek any further approval by the Department.

#### *Anticipated Agency and Committee Developments*

**Administration.** President Obama will likely retain his current team of Administration officials, including Tribal Affairs directors in most federal agencies, to implement his robust portfolio of Native American policies during his second term.

**Senate Committees.** Indian Affairs Committee Chairman Daniel Akaka (D-HI) is retiring and will likely be succeeded by Senator Marie Cantwell (D-WA). The Committee's Ranking Member, Senator John Barrasso (R-WY), is expected to retain that position. Senate Appropriation Committee Chairman Daniel Inouye (D-HI) will continue in that position, but the Ranking Member, Senator Thad Cochran (R-MS), is term limited and likely will be replaced by Senator Richard Shelby (R-AL). Senate Banking Committee Chairman Tim Johnson (D-SD) is expected to stay on in place, but current Ranking Member Richard Shelby (R-AL) is term limited and likely to be replaced by Senator Mike Crapo (R-ID). Senate Energy and Natural Resources Committee Chairman Jeff Bingaman (D-NM) is retiring and will likely be replaced by Senator Ron Wyden (D-OR). Senator Lisa Murkowski (R-AK) will continue as Ranking Member. The Senate Finance Committee Chairman Max Baucus (D-MT) will remain in place, with Senator Orrin Hatch (R-UT) continuing as Ranking Member. The Senate Small Business Committee Chair Mary Landrieu (D-LA) is expected to remain in place, but with Ranking Member Olympia Snowe (R-ME) retiring, either Senator Jim Risch (R-ID) or Senator Mike Enzi (R-WY) will become Ranking Member.



**House Committees.** Natural Resources Committee Chairman Doc Hastings (R-WA) may become Rules Committee Chairman, which could open the way for other Western State Members to advance to Chairman. Ranking Member Ed Markey (D-MA) is expected to stay in that position. Chairing that Committee’s Subcommittee on Indian and Alaska Native Affairs is Representative Don Young (R-AL) who will stay on, and Representative Ben Ray Lujan (D-NM) will likely become Ranking Member, the position currently filled by Representative Dan Boren (D-OK) who is retiring. Also important will be the House Ways and Means Committee, whose Chairman Dave Camp (R-MI) will remain in place, as will Ranking Member Sander Levin (D-MI).

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*Contact Information*

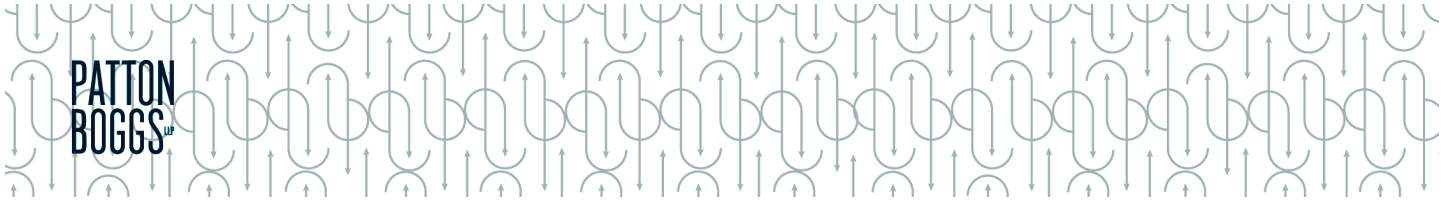
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## TAX POLICY

Over the last year, election politics have weighed heavily on the tax policy debate. There has been broad agreement among Republicans and Democrats that the fiscal cliff must be avoided and that a comprehensive overhaul of our tax code is necessary. At the same time, the parties have strongly disagreed on how to approach these issues, with President Obama and Congressional Democrats arguing for significant tax increases as a means of deficit reduction and Governor Romney and Congressional Republicans rejecting the idea that tax increases are necessary, preferring that any new revenue come from assumed economic growth once tax reform is enacted. The result has been a continued legislative stalemate, with a heavy dose of political posturing by both sides.

A narrowly divided electorate now having spoken, we expect discussions to begin anew in the lame duck session. Given major philosophical differences on tax policy issues between the parties, it remains to be seen whether such discussions will lead to an agreement to avert the fiscal cliff while, at the same time, paving the way for comprehensive tax reform. In our view, it is likely both will occur, beginning with an agreement in the lame duck session (or shortly thereafter) on a Bush tax cut extension coupled with a broad framework for tax reform, with the hard work of detailed reform



to span through 2013. Although there are a range of possible outcomes in the lame duck session and beyond, one thing is certain: in stark contrast to the last year, over the next few months we will see the parties undertake a serious discussion about tax policy.

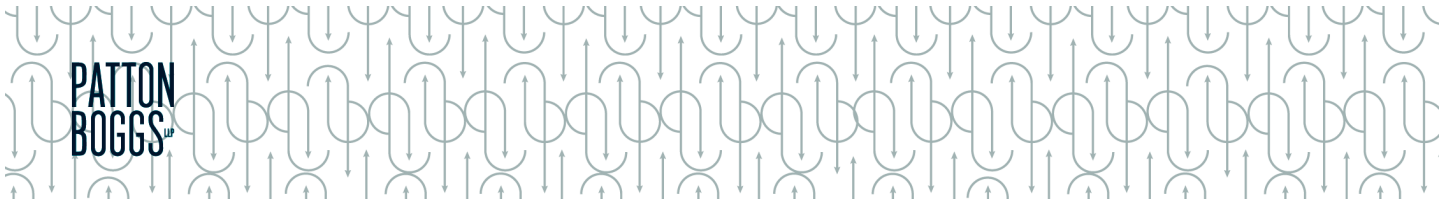
### *Major Issues*

**Bush Tax Cuts Extension.** The first order of business in the lame duck session will be preventing the country from toppling over the fiscal cliff presented by the looming expiration of the Bush tax cuts and automatic spending cuts (sequestration), both of which, absent a signed law to the contrary, will take effect in January 2013. The Bush tax cuts, enacted in 2001 and 2003 and extended several times since then, include individual marginal, capital gains, and dividend tax rates, as well as a host of other provisions. Last extended for two years at the end of 2010, they are set to expire and revert to pre-2001 rates should Congress not affirmatively take action to extend them by December 31, 2012.

If the Bush tax cuts were to expire:

- All individual marginal tax rates will increase, with the lowest bracket rising from 10 to 15 percent and the highest marginal tax rate rising from 35 to 39.6 percent;
- The tax rate on qualified dividends will rise from 15 percent to a maximum rate of 39.6 percent;
- The maximum rate on long-term capital gains will rise from 15 to 20 percent;
- The estate tax will revert from a \$5.12 million individual exemption with a 35 percent rate to a \$1 million individual exemption level and a 55 percent maximum rate;
- Limitations on itemized deductions and personal exemptions will be reinstated for upper-income individuals; and
- The child tax credit will be reduced from \$1,000 to \$500 per child.

Rather than allow such a reversion to occur, President Obama will likely request that Congress pass during the lame duck session a one-year extension of the Bush tax cuts limited to income below



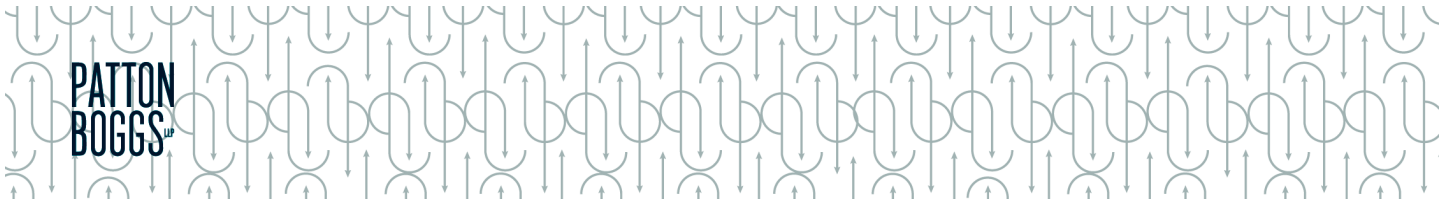
\$200,000 (in the case of single filers) and \$250,000 (married filers). This has been the President's preferred approach since the 2008 campaign, and his position has only hardened since the end of 2010, when Congressional Republicans, fresh off of a sweeping electoral victory, forced the President's hand by demanding he sign a two-year straight extension. Over the last two years, the President's consistent threat to veto any legislation that deviates from his stated policy could not be clearer.

Given the attention paid to this issue in the 2012 elections, and before that during debt ceiling and Super Committee negotiations in 2011, the President may firmly believe that, having won a hard-fought campaign, his position should prevail. What is far from clear, however, is whether Congressional Republicans will acquiesce to this demand. The House Republican majority, in particular, might be in no mood to agree to this. They, along with their Senate Republican colleagues, are likely to insist upon a one-year straight extension of the Bush cuts. Given their continuing majority in the House, they will argue that the President does not have a clear mandate on fiscal issues.

Even if both sides are willing to compromise, negotiations will be neither easy nor quick. For the Administration, an opening bid might include a commitment to reform the tax code while reducing entitlement spending in 2013, tied to an insistence that all the Bush cuts are eliminated, now and forever, for income above \$200,000/\$250,000. For Congressional Republicans, an opening bid might include a willingness to discuss raising revenue as part of tax and entitlement reform next year, predicated on a straight one-year extension of the Bush tax cuts in the interim. It is doubtful either position will take flight, at least initially during the lame duck session. But if neither side budges from its pre-election position, the fiscal cliff has real potential to materialize.

This potential collision no doubt looks like a virtual replay of the clash between the President and Congressional Republicans that dominated the last two years of the President's first term. In fact, it could be. However, elections, even close ones, can be clarifying events, and in this instance failure to move past rigid ideological differences is a recipe for fiscal calamity both parties want to avoid. They now have an opportunity to demonstrate that they are willing to compromise in an effort to avert disaster.

Assuming, as we do, that serious negotiations will occur, what might compromise look like? A first step could be a willingness to extend the Bush cuts for one year, either income limited or not (at, for



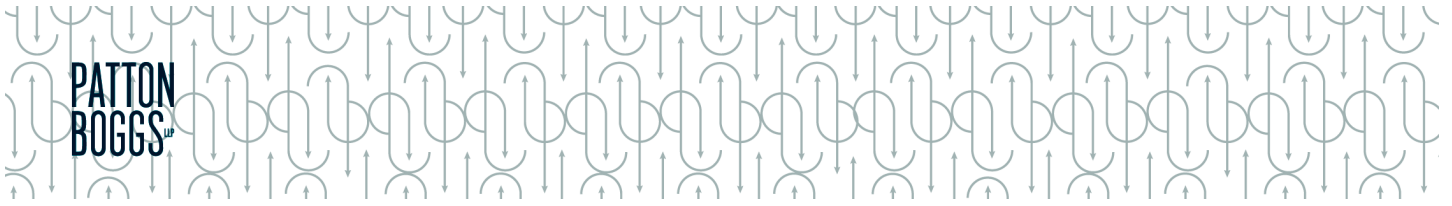
example, \$500,000-\$1,000,000), while including a process with agreed-upon numbers for revenue-raising tax reform and entitlement spending reform in 2013. Tax reform could both raise revenue for deficit reduction purposes, as desired by President Obama and Congressional Democrats, while broadening the tax base and lowering marginal rates, as Congressional Republicans have insisted upon. Entitlement reform would allow Congress to tackle the most significant drivers of the long-term debt, consistently championed as necessary by most Congressional Republicans, and increasingly acknowledged as necessary by the Administration and some Congressional Democrats.

Such an agreement, which could be similar to the “grand bargain” contemplated by Speaker Boehner and President Obama in 2011, would give both sides a good measure of what they want, while allowing for some compromise. This would represent a significant step forward in the beginning of a second Obama term by which the President would demonstrate he is serious about governing, and Congressional Republicans would acknowledge that they cannot achieve their goals without working with the incumbent President. And yet, and yet.

Grand bargains being elusive as they are, it is also possible that the President and Congress will agree to a stop-gap measure extending the Bush cuts (likely with an income limitation) for a period of months, or perhaps a year, leaving bigger decisions surrounding tax and entitlement reform to next year. Or, in the worst case scenario, current tax policy could plausibly expire at the end of the year, with Congress and the Administration left to pick up the pieces come January.

With respect to process and timing, much is to be determined. While both sides surely want to avoid a fiscal catastrophe, it remains to be seen whether compromise can occur this year. It is worth noting that if an agreement is not reached in November or December, both sides will have plenty of opportunities to engage early next year when the current authorization for the debt ceiling is expected to be breached, currently anticipated to occur sometime around March.

Should a deal be reached that extends the Bush cuts (of the grand bargain variety or otherwise), it could be enacted in several different ways. Both the House and Senate have already passed differing versions of legislation extending the Bush tax cuts through 2013 (though for reasons pertaining to Constitutional authority, the Senate bill will continue to sit at the Senate desk). The House bill, H.R. 8, extends all the Bush tax cuts and patches the alternative minimum tax (AMT) for individuals, also through 2013. However, H.R. 8 does not include any of the traditional business, individual, and energy tax “extenders,” such as the research and development credit and active financing exception

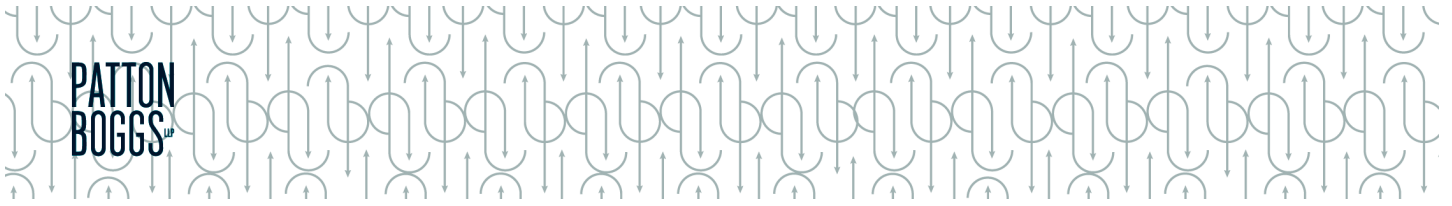


that expire on a year-to-year basis. In addition to any changes limiting the Bush tax cuts to an income threshold, it is likely that final legislation will incorporate most of those provisions, extending them through 2013 (though it is possible that some extenders will be modified or left to lapse).

Immediately after passing H.R. 8 in early August, the House also passed H.R. 6169, which would create a bicameral expedited legislative process for tax reform in 2013, whereby the House and Senate would be forced to vote on legislation under specific timelines, with no Senate filibuster. This, too, could be incorporated in some form or fashion into an end-of-year bill, depending upon the scope of agreement reached.

**Comprehensive Tax Reform.** Over the last two years, the possibility of comprehensive reform of the Tax Code, last accomplished over two decades ago in 1986, has progressed from chatter amongst tax policy leaders to seeming near inevitability. It has been discussed frequently in the House, the Senate, and the Administration, while also permeating Presidential and Congressional election rhetoric. But while both Republicans and Democrats agree that corporate tax reform generally should be revenue neutral, significant disagreements on revenue persist in connection with individual reform. President Obama, along with House and Senate leaders, will have to agree upon a basic framework in order for tax reform to proceed in a meaningful manner. Whether in the lame duck session or afterwards, President Obama and Speaker Boehner, along with the other Congressional Leaders, will probably have to decide if a grand bargain of the type that eluded them in 2011 can be resurrected in order for tax reform to come to fruition next year.

With divided government and deep philosophical differences, a number of challenges to enactment of such legislation remain. But as a point of departure there is a lot to agree upon, beginning with widespread, bipartisan consensus that our corporate tax code is in need of significant reform. The corporate sections of the tax code are anticompetitive, with a high rate and a narrow base; to wit, the U.S. average combined federal-state corporate tax rate of 39.2 percent is the highest statutory corporate rate among the OECD countries, while a litany of complex deductions and credits brings the United States back to the middle of the pack with respect to average effective tax rates. (Effective rates also differ significantly between industries and companies). Together, these elements of the code are widely understood to both diminish and distort business investment in the United States. There also is consensus that the tax code as relates to individuals, including pass-through business entities, needs to be reformed, though less agreement exists as to what magnitude of



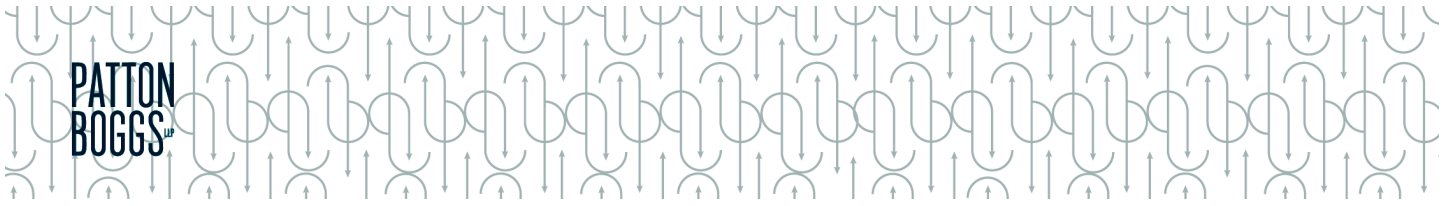
changes are necessary. And significant disagreements persist as to whether, and to what extent, new revenue should be used for deficit reduction purposes as opposed to paying for marginal tax rate reductions.

Although President Obama would have preferred to undertake comprehensive reform with Democrats controlling both the House and Senate, the process for tax reform will require significant bipartisan buy-in given a Republican-controlled House and narrowly divided Senate. President Obama has put forward broad ideas on corporate tax reform, while keeping the focus in individual reform on increasing taxes for upper-income individuals. Congressional Republicans are likely to insist that both robust corporate and individual reform occur simultaneously.

If an agreement with a basic framework is reached by the President and congressional leaders, the tax writing committees will begin work next year on the very important details of how to restructure the tax code. Those details will be difficult to agree upon, but much work has already been done. Serious discussions have been ongoing for months—they would not be starting anew. In addition, disagreements will not always be partisan fights. Often, they may be skirmishes between political constituencies, rather than left-right disagreements. The Tax Reform Act of 1986, for example, was accomplished with Democrats controlling the House, Republicans controlling the Senate, and Ronald Reagan as President.

### *Business Tax Reform*

A considerable portion of the 2012 campaign was waged over taxes. Earlier this year, the Administration released a Framework for Business Tax Reform in which the President advocated reducing the top corporate rate from 35 to 28 percent, while providing manufacturers with additional tax preferences that would effectively lower their tax rate to 25 percent, with even lower rates for firms engaged in “advanced manufacturing.” In addition, the Framework would expand, simplify, and make permanent the R & D tax credit. The Administration proposed revenue raisers to fully offset the cost of these changes. Specific items include repeal of Last In First Out (LIFO) accounting; repeal of tax preferences available for fossil fuels; limitations on tax preferences allowed for the purchase of insurance products, and by insurance companies; taxation of carried interest as ordinary income; and new rules that change the depreciation schedule for corporate jets from five to seven years.



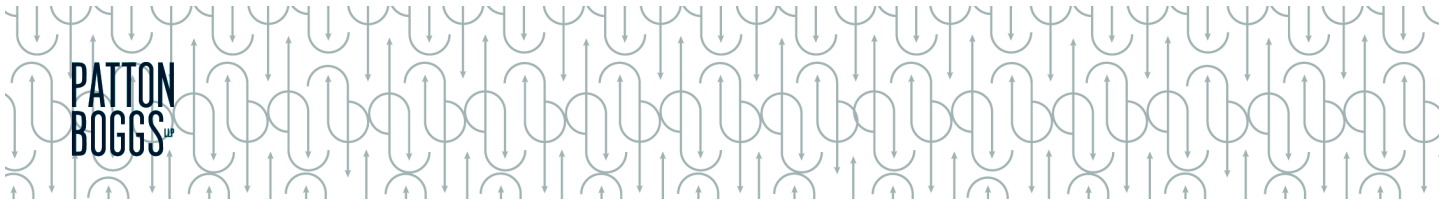
Since those changes alone do not come close to paying for the proposed tax rate reduction, the Framework also includes a menu of options that, while short on detail, suggest the types of additional corporate tax base “broadeners” the Administration will pursue during tax reform. These include lengthening depreciation schedules; reducing the deductibility of interest as an ordinary and necessary business expense; and encouraging greater parity between large corporations and “large non-corporate counterparts” (presumably by subjecting some large pass-through entities to entity-level taxation).

International tax issues will be a significant focus in the tax reform debate, both with respect to the international operations of U.S. businesses and the treatment of inbound investment. In contrast to the Congressional Republican view that corporate reform should also be used to transition from a worldwide system of taxation toward a territorial system, the President’s proposal would establish a minimum tax on U.S.-based multinational corporations’ foreign earnings, eroding the use of “deferral” of foreign-source income. The Administration punctuates its position by stating that a “*pure* territorial system could aggravate, rather than ameliorate, many of the problems in the current tax code” (emphasis added). However, should corporate reform negotiations take place, it is likely this would be a point of negotiation with the Congress rather than a hard-and-fast view; rejecting a “pure” territorial system still leaves plenty of room for discussion with those who are seeking to move towards a territorial system, as most countries have neither pure territorial nor pure worldwide systems of taxation, but rather combine elements of both.

For their part, House and Senate Republicans will continue to push for a lower target corporate rate of 25 percent, working from a corporate tax reform draft proposal tabled in late 2011 by Ways and Means Committee Chairman Camp, who supports moving towards a territorial system. While that document focused on international taxation and did not spell out which revenue raisers might be utilized to buy down the corporate rate, there will assuredly be points of overlap between Congressional Republicans and President Obama on this front, including lengthening depreciation schedules.

In addition to the corporate tax provisions that have long been targeted by the Administration (*e.g.* LIFO accounting), numerous tax deductions, credits and preferences will thoroughly be examined during the tax reform process. For example, while Republicans will be willing to examine various preferences enjoyed by the oil and gas industry, they will certainly want to include in their examination tax incentives for renewable energy. In addition, they will consider whether the Section





199 deduction for domestic manufacturing should be eliminated to pay for lowering the corporate rate for all taxpayers.

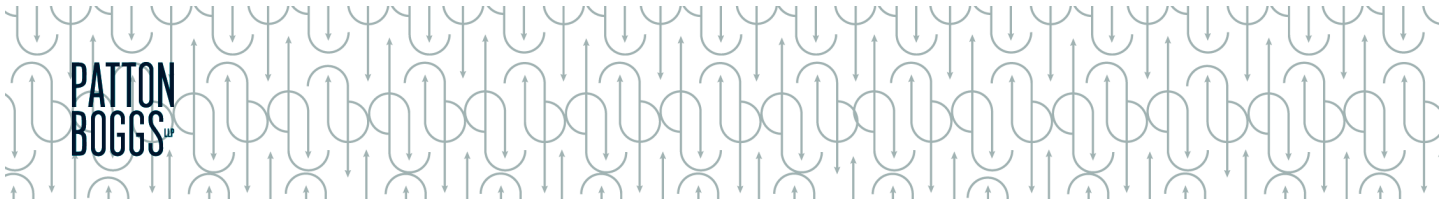
Tax “extenders” will continue to be thoroughly vetted, a process that started earlier this year when Chairman Camp formally asked Select Revenue Subcommittee Chairman Pat Tiberi (R-OH) to lead a top-to-bottom review of the business, individual, and energy provisions that expire on a year-to-year basis. These approximately 80 provisions include the R & D tax credit, active financing exception for Subpart F income, New Markets tax credit, 15 year depreciation for qualified leasehold, restaurant, and retail improvements, and deductions for private mortgage insurance.

The purpose of the ongoing review of these provisions is to determine which ones continue to serve the policy purposes for which they were enacted. This process has thus far included two public hearings, but only modest legislative action. The Senate Finance Committee, which has marked up an extenders bill, dropped several extender provisions in the process.

Even assuming that most of these provisions will be extended through 2013, the tax committees have made clear that such an extension should not be viewed as a reflection of support for making these provisions permanent. Supporters of most extenders will bear the burden of demonstrating that they should be made permanent (as opposed to being eliminated with the resulting revenue used to lower rates across the board). Over and above extenders, additional items that will be on the table for discussion include major corporate tax expenditures, including the tax credit for low income housing, and the exclusion of interest on public purpose State and local government bonds. In addition, a significant item that will be discussed relates to the deductibility of interest as an ordinary and necessary business expense, which, if altered, could affect both U.S.-based companies and foreign companies with operations in the United States.

### *Individual Tax Reform*

As mentioned above, the dominant feature of President Obama’s plan is to income-limit the Bush tax cuts at the \$200,000/\$250,000 level. The Administration has been circumspect about other changes it would like to see, save for a proposal to further increase taxes on the same group of upper-income taxpayers by reducing the value of itemized deductions and exclusions to 28 percent. Taken together, these proposals would generate nearly \$1.5 trillion to be utilized for deficit reduction.

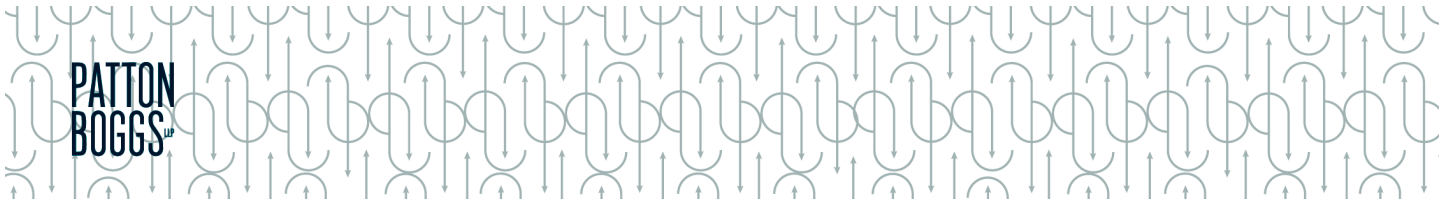


Congressional Republicans will continue to push for revenue-neutral individual tax reform, though in order for a deal to materialize they will have to compromise to some degree. While also generally avoiding specifics, Republicans are somewhat more forward leaning in advocating robust individual tax reform whereby deductions (and perhaps exclusions) would be sharply limited in order to lower marginal tax rates, akin to the plan offered by Governor Romney during the campaign. Chairman Camp, Ranking Member Hatch, and others have noted that the differential between the top corporate rate and top individual rate should be minimized so as to avoid incentivizing sheltering of income through C-corporations as occurred pre-1986. While ideally they would prefer a top individual rate no greater than 28 percent, that target will be very difficult to achieve given that some new revenue will have to be earmarked for deficit reduction. This is especially so because, for both parties, significant political considerations will intervene as Congress sets about determining what deductions and exclusions it can eliminate or modify.

Those provisions likely to undergo the closest examination during reform are the litany of politically popular deductions from income currently allowed, including those for home mortgage interest, state and local property and income taxes, and charitable contributions. In addition, the committees may look to limit some tax exclusions, including those for interest on State and local municipal bonds, employer health care contributions, and retirement contributions for both defined benefit and defined contribution plans.

**Estate Tax.** In addition to income, dividends, and capital gains taxes, another significant item to be addressed in the context of tax reform is the federal estate and gift tax. It is likely that the current policy of a \$5.12 million per individual exemption, indexed for inflation, and a 35 percent maximum rate will be incorporated into any agreement to extend the Bush tax cuts into 2013. While President Obama has proposed to reduce the exemption level to \$3.5 million and increase the top rate to 45 percent, many Democrats in Congress support the agreement on the estate tax provisions that was reached in 2010.

Apart from possible changes in the rate and exemption levels, the Obama Administration has included in its previous budget submissions proposals that would scale back (or eliminate altogether) commonly used estate planning strategies, including the use of grantor retained annuity trusts and applying valuation discounts for certain types of assets in determining the size of an estate subject to taxation. While the Administration will likely continue to support such estate tax revenue offsets in its second term, these proposals to date have not gained traction due to strong opposition from

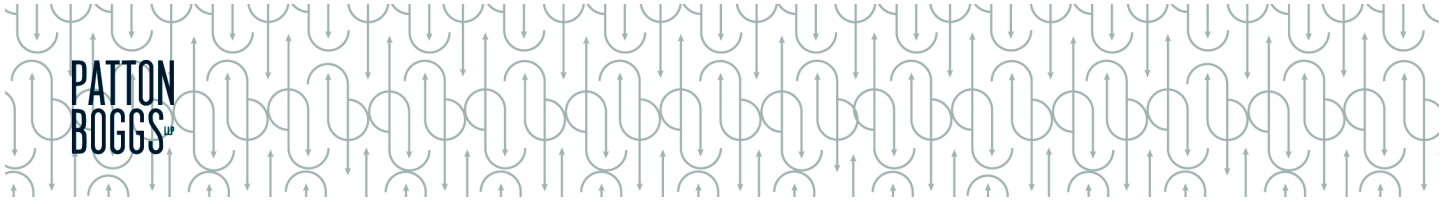


family farm and business groups and Congressional Republicans. We therefore believe the odds favor permanent extension of current law beyond 2013, assuming a short-term extension later this year.

**PPACA Taxes.** The Patient Protection and Affordable Care Act (PPACA), enacted in 2010, included a number of tax increases that are scheduled to take effect in January. These taxes include several provisions that will affect taxpayers with adjusted gross income above \$200,000 (\$250,000 for married taxpayers), such as a 0.9 percent Medicare surtax on earned income and a 3.8 percent Medicare surtax on investment income. The legislation also included, among other revenue provisions, a 2.3 percent excise tax on medical devices. With President Obama having been reelected, changing any of the individual components of PPACA will be met with great skepticism by the Administration and Congressional Democrats alike. However, the House has passed, with the support of a significant number of Democrats, legislation introduced by Representative Erik Paulsen (R-MN) to repeal the medical device tax. While the Senate has not yet taken up that legislation, it is one of the few PPACA policies for which some bipartisan support for repeal exists, and thus could be addressed during tax reform.

**Pension Reform.** Two events will drive pension reform in the 113th Congress: Tax reform and expiration of the Pension Protection Act (PPA) at the end of 2014.

With Members of Congress on both sides of the aisle searching for new revenue sources, the tax-advantaged status of qualified retirement plans has been and will continue to be under scrutiny. During the past year, the key congressional committee staff, both majority and minority, have been building a foundation of retirement savings reform principles and options for both defined benefit and defined contribution plans. The bottom line of any change to the current system will be a general desire to avoid harming the current system--especially changes that will limit the long-term ability of workers to save for retirement. However, there are questions as to whether the cost of the program is too high--that is, whether, as Senator Baucus asked at a recent hearing on retirement savings, taxpayers are getting enough "bang for the buck"--and whether the private retirement system's tax benefits are properly allocated along the socio-economic spectrum of workers. At a more fundamental level the key issue is how to use the retirement system to broaden the tax base in a way that won't undermine its effectiveness and that is palatable to the American public.



In the run up to expiration of the PPA, the reauthorization debate will center on the need to modify the funding rules for single and multiemployer defined benefit plans. Multiemployer plans have been particularly hard hit by the weak economy, the aging participant workforce, and the consolidation of traditionally union industries that feed participation in these plans. The challenge here is to establishing a framework for preserving the plans, relieving the funding burden on participating employers (who can be driven out of business by the escalating costs), and avoiding the label of a bailout.

#### *Anticipated Agency and Administration Developments*

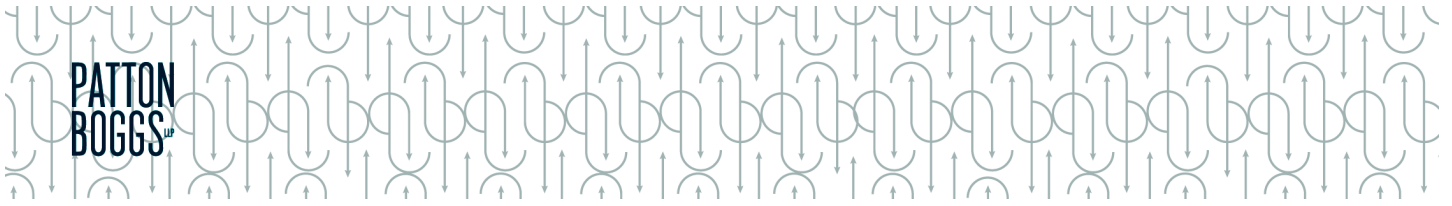
**Secretary of the Treasury.** Secretary Tim Geithner is expected to step down next year. Given that the Secretary will have such a vital role in tax and entitlement reform discussions, the President is likely to choose a successor who is capable of helping drive a deal to completion. The Secretary will get significant input from Treasury staff as well as the staff of the National Economic Council.

**Congress.** Who, aside from the Congressional Leadership, will President Obama and the Administration be working with to advance fundamental reform? The leadership of committees with jurisdiction over tax issues will not change in the 113<sup>th</sup> Congress, with Representatives Dave Camp (R-MI) and Sander Levin (D-MI) continuing as Chairman and Ranking Member, respectively, of the House Committee on Ways and Means Committee, and Senators Max Baucus (D-MT) and Orrin Hatch (R-UT) continuing as Chairman and Ranking Member, respectively, of the Senate Finance Committee. Due to retirements, there will be several members added to both committees, though final committee ratios will not be set until later in the year or early next year. In addition, Vice Presidential candidate Paul Ryan, who will remain a senior member of the Ways and Means Committee and, likely, Budget Committee Chairman, will continue to be a highly influential thought leader for conservatives on all fiscal matters.

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#### *Contact Information*

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## TECHNOLOGY AND COMMUNICATIONS

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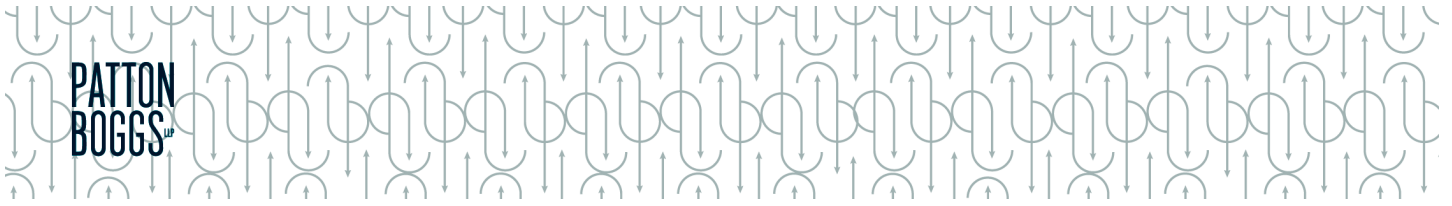
### *Major Issues*

With President Obama securing re-election, stakeholders can expect continuation of his ambitious technology policy direction, with significant focus on broadband deployment, broadband management (net neutrality and data caps), privacy, spectrum initiatives, online piracy, cloud computing, and regulation of the evolving video marketplace. In the administrative agencies and in Congress, there will be significant change in communications leadership, which will impact communications policy for all stakeholders, and could set the stage for a rewrite of the Telecom Act.

**Broadband Regulation.** President Obama committed to ensuring that 98 percent of the country has access to high-speed wireless broadband in conjunction with Universal Service Fund modernization. Substantial work on universal service reform was completed during Obama's first term and work will continue. Policy debates about broadband, in the courts, in Congress, at the FCC, and before international regulatory bodies will focus on several issues, including net neutrality regulations, data caps, and the nature of global Internet governance. There will be a concerted effort by Internet companies to command a more meaningful presence in Washington, and influence how broadband is regulated.

**Open Internet / Net Neutrality.** President Obama supports an "open Internet" that fosters free speech. He pledged strong support for net neutrality and endorsed the Open Internet rules adopted in 2010 by current FCC Chairman Julius Genachowski. Either through the courts, the FCC, or Congress, we anticipate that net neutrality and broadband usage or "data" caps will come to a head next year. Thus far, Chairman Genachowski's enforcement of his Open Internet rules has been moderate, but his likely successors as Chairman (if he chooses to step down) may take a more aggressive enforcement posture on the Open Internet rules.

The FCC is defending its Open Internet Rules in the U.S. Court of Appeals for the D.C. Circuit. We believe there is still a significant chance that the FCC's rules will be struck down because of jurisdictional issues, but the FCC has mounted a strong defense to the arguments made by Verizon and MetroPCS. The FCC argues that its net neutrality rules have resulted in more Internet investment: "Subsequent to the adoption of the Open Internet Rules, investment has surged, with venture capital funding for Internet-specific companies rising 68 percent, and investment in wired

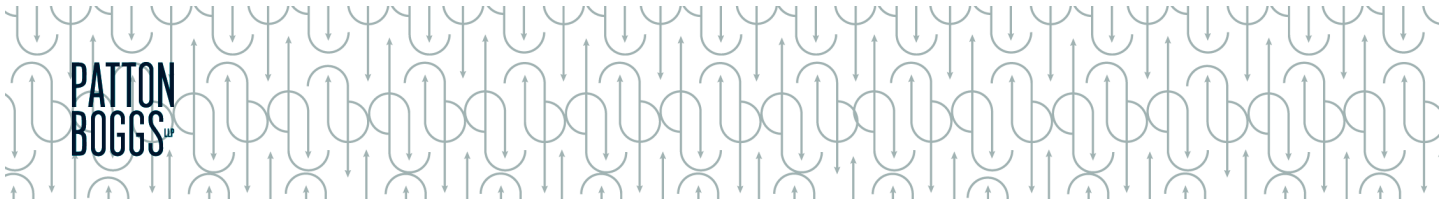


and wireless network infrastructure rising by 24 percent from 2010 to 2011.” On the jurisdictional issue, the FCC claims that Section 706 of the Communications Act, which directs the FCC to “encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans,” provides it with the authority to promulgate net neutrality rules. A decision is expected from the D.C. Circuit in 2013.

**Broadband Data Caps - Tiered Pricing.** Chairman Genachowski’s thinking on data caps and tiered pricing has evolved and will fuel debate in 2013. During the FCC’s consideration of net neutrality rules in 2010, the Chairman voiced support for Internet Service Providers (ISPs) experimenting with broadband usage caps or tiered broadband plans in an effort to explore better management of their broadband networks. In May of 2012, Genachowski confirmed support for usage-based billing, arguing that “[t]he framework we adopt today does not prevent broadband providers from asking subscribers who use the network less to pay less, and subscribers who use the network more to pay more.” However, in early September 2012, Chairman Genachowski voiced concern about broadband caps: “Anything that depresses broadband usage is something that we need to be really concerned about.” “We should all be concerned with anything that is incompatible with the psychology of abundance.”

Consideration of broadband data caps and tiered pricing has been contentious in Canada and will be in the United States. Internet companies see tiered pricing as a method for big carriers and cable operators to act in an anticompetitive manner. Representative Henry Waxman (D-CA) and Representative Edward Markey (D-MA), both of the House Communications and Technology Subcommittee, have expressed concern that Internet companies may not be given a “fair shot” to compete against carriers that own the networks without some protections. With the support of the Internet Association, which includes the most influential Internet companies, and the i2Coalition, an association of cloud computing companies, we expect that President Obama and the FCC will be more vigorous in promoting regulations consistent with the FCC Chairman’s most recent position on broadband data caps. Consumer groups are expected to push the DOJ, the FCC and Congress to investigate tiered billing practices and formulate legislation and regulations to prohibit lower cap models with high overage fees.

**International Regulation of the Internet.** The framework for International Telecommunications Regulations (ITRs) will be reconsidered later this year, December 3<sup>rd</sup> through December 14<sup>th</sup>, at the International Telecommunications Union in Dubai, United Arab Emirates, as part of the World

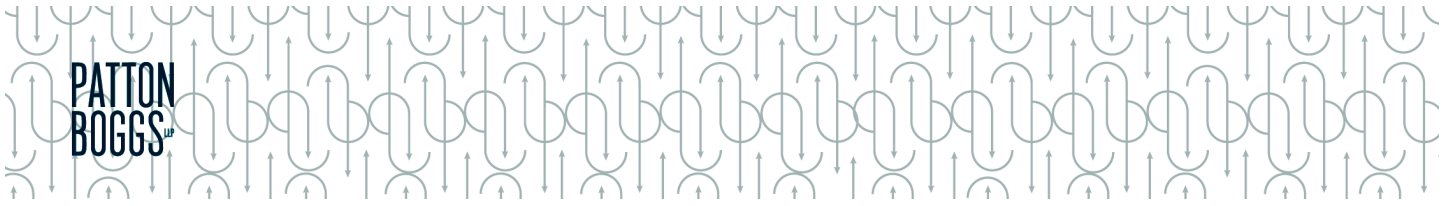


Conference on International Telecommunications (WCIT). The ITRs are an international treaty that guides the exchange of international telecommunications traffic among members of the International Telecommunications Union. The ITR treaty was negotiated in 1988. In the intervening years telecommunications technology and traffic has evolved, concurrent with global trends towards liberalized international markets and packet-switched broadband networks.

The U.S. delegation once feared that international community members from developing nations, along with China and Russia, might attempt to dramatically revise the scope of the ITR regime. Proposals circulated among WCIT-12 participants late last year sought to expand the ITRs to include provisions related to cybersecurity, Internet domain name rights, a role for governmental regulation of IP-traffic routing, and content-related proposals framed as “information security” that could conceivably permit authoritarian regimes to block Internet content and depress civil rights. The U.S. delegation pushed back aggressively with a set of alternative proposals that have reportedly gained consensus within the WCIT-12 delegation. Republicans and Democrats are united in their opposition to international efforts to expand the scope of the ITRs.

**Privacy.** In his second term, President Obama will advocate for federal legislation that adopts the “Consumer Privacy Bill of Rights” he proposed in February 2012, strengthening consumer rights to control use of their personal data. This Bill of Rights would expand the definition of personal data to encompass information that can be linked to a specific device used by a consumer. The Administration supports the development of a voluntary code of privacy practices through a multi-stakeholder effort spearheaded by the National Telecommunications and Information Administration (NTIA). Privacy legislation may be difficult to pass in the 113<sup>th</sup> Congress due to different approaches by Republicans and Democrats. This could mean advancement of industry self-regulatory programs. The Administration also proposes to overhaul the Children’s Online Privacy Protection Act (COPPA), which could significantly broaden the list of corporate entities that must protect children against behavioral advertising and plug-in services on websites that are directed to children.

Efforts to amend the Video Privacy Protection Act and to pass cybersecurity legislation are expected when Congress returns for the lame duck session. The Senate Judiciary Committee will continue its work on the Video Privacy Protection Act, which the House passed in December of 2011. The video-privacy law bars the disclosure of a consumer’s video rental records without written consent. Committee Chairman Patrick Leahy offered an amendment to the bill to change the 1986 Electronic

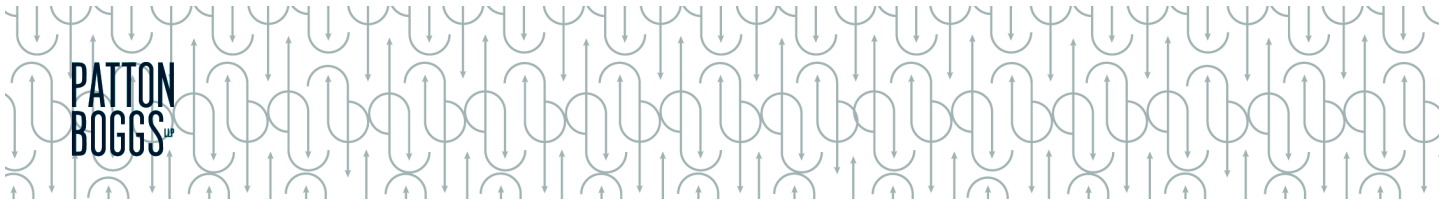


Communications Privacy Act (ECPA), which addresses government access to electronic communications. A coalition of tech companies and privacy and civil-liberties advocates has been working to reform ECPA, saying that its protections are out of date. Leahy's substitute, which was approved by voice vote, would require the government to obtain a search warrant based on probable cause to access e-mail or other electronic communications from a service provider, with some exceptions. The amendment would eliminate current rules that apply different legal standards depending on the age of the communications. The amendment also would require government agencies to notify the owner of communications they are seeking within three days, but would allow officials to seek a court order to delay this notification for 90 days. Some House Republicans have objected to amending ECPA in response to significant opposition from law enforcement groups. Representative Bob Goodlatte (R-VA), one of the leading candidates to chair the House Judiciary Committee, has voiced concern about adding ECPA amendments to his VPPA bill.

In the 112<sup>th</sup> Congress, several bills were introduced to increase privacy protections for consumers and to address issues such as the collection and use of personally-identifiable information, behavioral advertising and tracking, data breach notifications and general data security protections. Senators John Kerry (D-MA) and John McCain (R-AZ) introduced comprehensive privacy legislation entitled the Commercial Privacy Bill Rights Act of 2011 (CPBR), which was criticized as not going far enough by consumer groups and privacy leaders because it did not contain a "Do Not Track" provision modeled after the "Do Not Call" Registry administered by the FTC. Chairman of the Senate Commerce, Science and Transportation Committee, Senator Jay Rockefeller (D-WV) introduced the Do Not Track Online Act of 2011 (DNTOA), which was complemented by the introduction of the Do Not Track Me Act in the House by Representative Jackie Speier (D-CA). Representative Representative Cliff Stearns (R-FL), who recently lost his seat in a close primary, also introduced legislation entitled the Consumer Privacy Protection Act of 2011, which requires both online and offline companies to provide consumers with clear and concise notification of the information collected about them as well as an opt-out option for the selling or sharing of such information. Lastly, Senators Ron Wyden (D-OR) and Al Franken (D-MN) introduced legislation to prohibit geo-location tracking and sharing without prior consent.

In view of the significant focus on privacy, the emergence of new technologies, and the perceived need to regulate the collection of consumer information, several industry self-regulatory programs have been put forward to advance protection through self regulation in lieu of comprehensive federal legislation. The Direct Marketing Association (DMA), along with the Better Business Bureau

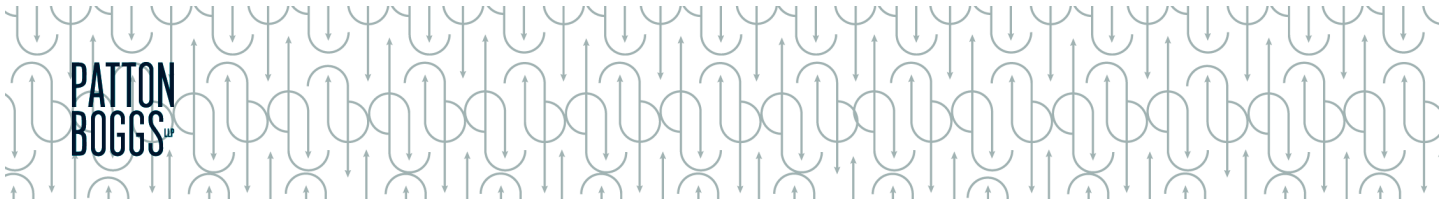




(BBB), the Interactive Advertising Bureau (IAB), the American Association of Advertising Agencies (AAAA), and the Association of National Advertising, launched the Digital Advertising Alliance (DAA) with a set of principles to educate consumers about online behavioral advertising, provide notice and choice mechanisms, and promote greater transparency. Groups such as the National Advertising Initiative (NAI) and TRUSTe are working with the DAA as well as providing independent programs for their members and partners. Finally, the World-Wide Web Consortium (W3C) is working with associations, companies and federal officials to develop a Do Not Track system. The FTC has been working with the W3C. Microsoft's recent announcement that it would establish a Do Not Track default program in its Internet Explorer 10 browser and the follow-on announcements by other browser companies to establish Do Not Track options bring the consumer privacy issues into further focus. In response, the DMA recently launched the Data-Driven Marketing Institute to promote the consumer benefits of focused, data-driven marketing. These industry and public interest initiatives will have a significant voice in the public policy debates regarding consumer privacy in the 113th Congress.

**Anti-Piracy Legislation.** President Obama called “online piracy by foreign websites ... a serious problem that requires a serious legislative response.” Despite bipartisan support for bills in the 112<sup>th</sup> Congress to combat piracy (the theft of intellectual property online) through the Stop Online Piracy Act (SOPA) and the Protect IP Act (PIPA), Congress was unable to enact these bills. Critics of the legislation claim that it is tantamount to censorship and would undermine the essential functioning and technical integrity of the Internet. Supporters of the bills argue that in order to reduce digital piracy and online counterfeiting which are rampant on rogue websites overseas, new enforcement mechanisms are critical. Moreover, supporters claim that the Digital Millennium Copyright Act has not solved the problem.

We anticipate the legislation will resurface in the new Congress because it has found broad support among companies in the content, pharmaceutical, technology and fashion industries that rely on strong copyright protection. However, success on anti-piracy legislation in the 113<sup>th</sup> Congress will depend on whether supporters and opponents can come to agreement on controversial definitions and practical implications. PIPA would mandate that ISPs alter records for looking up website names so that U.S. Internet users cannot access sites that are deemed to be infringing by the Attorney General. Critics argued that the provision would undermine government-approved efforts to secure the Domain Name System against hackers and will break the Internet's unified naming system. While the Administration does not support SOPA in its current form, it endorses both a

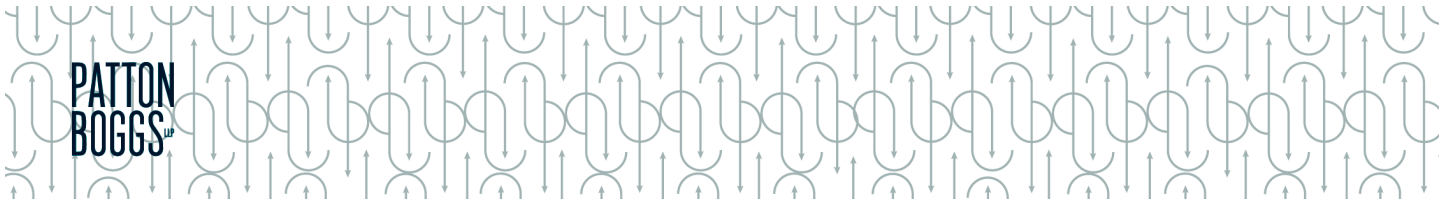


legislative approach that provides new legal tools to combat foreign online piracy and voluntary actions by privacy parties to combat online piracy by foreign websites.

**Foreign Ownership of, and Involvement In, Domestic Communications Networks.** Recent actions by Congress and by the FCC suggest that foreign ownership of, and involvement in, domestic communications networks will be a significant topic of debate in 2013. The House Permanent Select Committee on Intelligence recently released a bi-partisan report recommending that U.S. companies not do business with Chinese telecommunications companies—Huawei and ZTE—and that the Committee on Foreign Investment in the United States (CFIUS) block acquisitions, takeovers, or mergers involving these companies. The report questioned the foreign companies’ relationship with the Chinese government, although no government involvement was proved, and raised concerns about possible foreign and economic espionage. The Committee called on Congress to consider potential legislation that could require CFIUS approval of equipment purchasing agreements, something that is not required today. Although President Obama appears particularly interested in building a cooperative relationship with China, the Administration recently blocked a company with ties to China from building wind turbines close to a Navy military site in Oregon due to national security concerns. We believe the President may be open to expansion of CFIUS reviews of acquisitions and potential transactions involving foreign investors in the technology and communications sectors.

At the same time, the FCC has been taking actions to encourage more foreign investment in domestic networks. The FCC recently decided to forbear from certain restrictions on foreign investment in common carrier licensees, making it easier for foreign companies to own more than 20 or 25% of domestic carriers. The FCC also initiated a rulemaking to eliminate or simplify the test that applies to FCC review of foreign applications to provide international telecommunications service and cable landing stations.

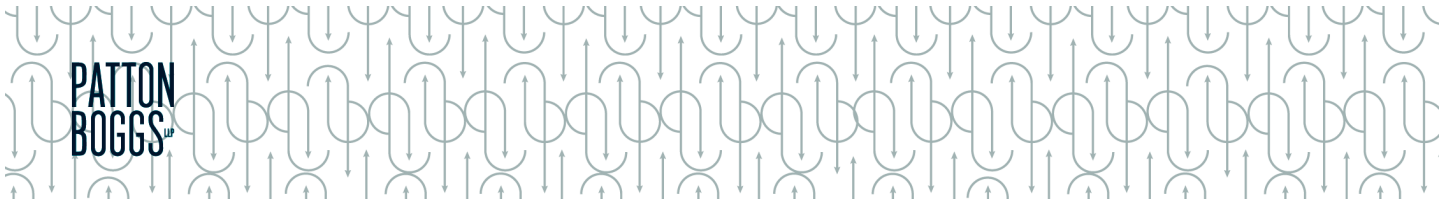
**Spectrum Initiatives.** Freeing more spectrum for wireless broadband was a significant focus of the Administration and the FCC over the past four years, and it is central to President Obama’s technology policy. Spectrum initiatives, including the voluntary broadcast incentive auctions, the nationwide public safety network, the spectrum screen, MSS reform and spectrum sharing schemes between public and private interests all will figure prominently in 2013.



**Voluntary Broadcast Incentive Auction and the Public Safety Broadband Network.** The National Broadband Plan issued by the FCC called for finding 500 MHz of spectrum for commercial networks for mobile broadband use. This continues to be the Administration’s goal. To this end, voluntary incentive auctions for broadcast spectrum, authorized by Congress in 2012, are expected to yield additional spectrum, but the amount will vary depending on how many broadcasters participate in the auctions. The uncertain compensation structure may affect participation. In September, the FCC initiated the incentive auction rulemaking. The auction is planned for 2014. The success of this effort will be critical for the FCC and the Obama Administration. Presuming success, part of the auction proceeds from the incentive auctions will fund the first wireless, public safety broadband network. Until the incentive auction is held, Congress will continue to exercise an oversight role to ensure that the FCC, the NTIA and the First Responder Network Authority (FirstNet) implement the Spectrum Act in accordance with congressional intent. For Chairman Rockefeller, the top priority will be ensuring that a dedicated nationwide network for emergency responders is deployed and operable. For Energy and Commerce Committee Chairman Fred Upton (R-MI) and Communications and Technology Subcommittee Chairman Walden, ensuring flexible use of the relinquished broadcast television spectrum for mobile broadband use, protecting broadcast television signals during the transition, and securing sufficient revenue to offset the deficit will be important.

**Spectrum Screen.** A rulemaking just initiated by the FCC is exploring how much wireless spectrum a carrier can hold, will affect which carriers will be allowed to bid for spectrum relinquished by broadcasters. This rulemaking, along with antitrust enforcement, will shape the market and will dictate how large carriers can grow, especially Verizon Wireless and AT&T. Known as the “spectrum screen,” current FCC rules generally allow a single carrier to hold up to one-third of the mobile spectrum in a market. The screen considers the availability of cellular, PCS, SMR, 700 MHz band, AWS-1 and BRS spectrum. To date, the FCC has held the top limit to 145 Mhz. Larger carriers are pushing to add spectrum bands to the spectrum screen equation, thus increasing the denominator used in spectrum screen assessments. Public interest groups and competitive carriers argue that current rules already allow too much concentration, and they advocate for placing a premium on spectrum below 1 GHz. This proceeding should conclude before the FCC commences the “forward auction” of vacated broadcast spectrum.

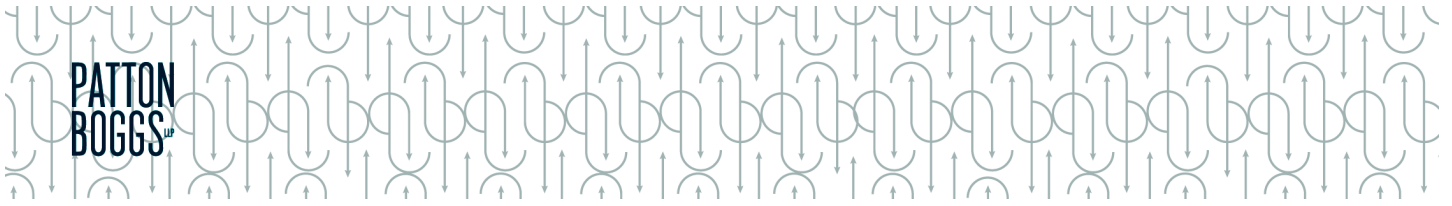
**MSS Spectrum Reform.** In March of 2012, the FCC initiated a rulemaking to free up 40 MHz of spectrum (2000 MHz - 2020 MHz and 2180 MHz - 2200 MHz) for mobile broadband by removing



regulatory barriers and providing for flexible use of spectrum from the Mobile Satellite Service (MSS). The recommendation, consistent with the National Broadband Plan, is to enable stand-alone terrestrial use of MSS spectrum. The rulemaking is particularly significant for Dish Network, which paid \$2.78 billion for spectrum in the band. Dish hopes to use the spectrum to launch a terrestrial wireless broadband network, using LTE technology, by 2016. The FCC is pushing to conclude this rulemaking by the end of 2012. Two issues to be resolved include buildout requirements and a 5 MHz shift in the spectrum (to 2005 MHz - 2025 MHz) advocated by Sprint to permit the auctioning of an additional 5 MHz of spectrum. The FCC proposes that providers using the spectrum reach 30% of the total population within three years and 70% within seven years. Dish has pushed for a buildout plan to serve 60 million people over four years and coverage for 200 million in seven years.

**Sharing Government Spectrum.** Another avenue for freeing spectrum for wireless broadband is to allocate for commercial use spectrum that is currently allocated to the federal government. The Administration supports sharing government spectrum with commercial users. Speaking to the President’s Council of Advisors on Science and Technology (PCAST) on the eve of the House Subcommittee hearings, Chairman Genachowski announced that the Commission will “initiate formal steps” by the end of the year to utilize the 3550-3650 MHz band in what some analysts have called a “launching pad” for public-private spectrum sharing.

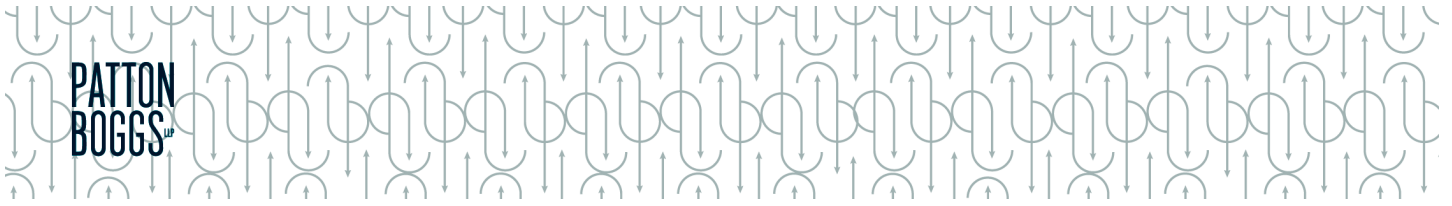
**Cloud Computing.** Early in his Administration, President Obama pushed for migration from traditional IT systems to cloud computing, including implementation of a “Cloud First” policy, requiring agencies to conduct a cloud-computing solution analysis prior to making new IT investments. These efforts reflect an overarching view by federal leaders that a migration to cloud computing will lead to a more efficient and effective government, will save costs, and will improve IT infrastructure, agility and capabilities. We anticipate these efforts will continue through the President’s second term. At the same time, regulators are sensitive to the implications of rapid adoption of cloud technologies. For example, in September, Senator Amy Klobuchar (D-MN) introduced the Cloud Computing Act of 2012, which reflects concern about the security of system data, the dependence on the security practices and assurances of vendors, the sharing of computing resources amongst users, and the transmission of high volumes of data across agency and public networks. Although it is doubtful that this bill will pass, it reflects growing concern about cloud computing. We expect to see emerging regulation in records management, standards setting, and privacy related to cloud computing.



**Streamlined Sales Tax, State Sales Taxation of E-Commerce.** President Obama is expected to support new measures to capture revenue on sales by e-commerce companies. To fulfill his pledge to address debt reduction without compromising essential public services, a uniform system to collect sales taxes by states on e-commerce could present a promising opportunity to “close a loophole” created by the Supreme Court. States and localities face serious budget shortfalls and will face greater challenges as Congress is poised to make sizeable federal budget cuts. There is renewed interest on both sides of the aisle to provide struggling states with un-captured revenue.

As Congress adjourned for the November elections, sponsors of legislation that would allow states to collect sales tax on online purchases said they would seek a Senate vote during the remaining weeks of the 112<sup>th</sup> Congress. Senators Dick Durbin (D-IL), Mike Enzi (R-WY), and Lamar Alexander (R-TN) offered an updated version of their Marketplace Fairness Act (S. 1832), as an amendment to the Small Business Jobs and Tax Relief Act, but the effort failed to secure the necessary votes for inclusion in the bill. The sponsors will attempt to have the legislation included in other bills during the lame duck session and, if not successful there, will begin their effort again in the 113<sup>th</sup> Congress. Meanwhile, the House Judiciary Committee held a hearing on a companion bill, the Marketplace Equity Act (H.R. 3179), introduced by Representative Steve Womack (R-AR), but no action has been taken on that measure. The bill’s authors must secure GOP support and overcome erroneous arguments that the legislation creates a new tax or amounts to a tax increase when the aim is simply to recover tax revenue that is already owed. Going forward, the focus of the discussion will be on the size of the small business exception contained in both the House and Senate bills. Critics of the legislation would like to see the exception increased from \$500,000/\$1,000,000 to \$20/\$30 million, while supporters counter that it should be closer to \$150,000.

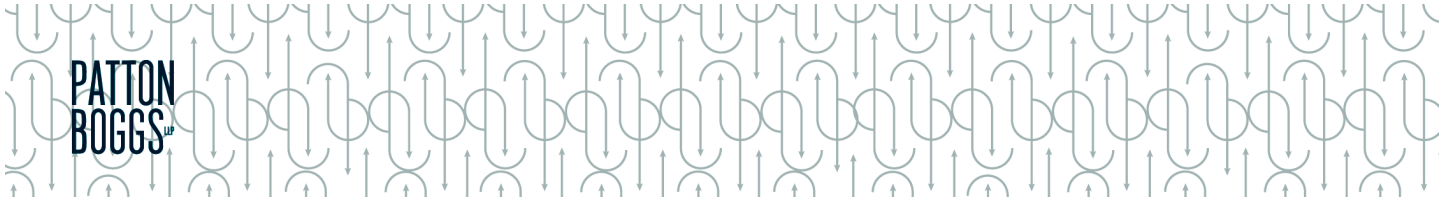
**Telecom Act Rewrite.** It has been seventeen years since the Telecom Act of 1996, the last major effort to reform the 1934 Communications Act (Communications Act) and foster a more competitive telecommunications market. Broadband deployments, technology, and marketplace developments have outpaced the statutory and regulatory grasp. Bipartisan calls for another “Telecom Act rewrite” are starting to come from a number of quarters, but there is clear recognition that reform is likely not a “one-session” task. Passing comprehensive telecom reform through regular order will require bipartisan cooperation because neither party has sufficient votes to overcome a filibuster if a vote occurs along party lines. If comprehensive reform is stymied, some reforms may push through individually.



Calls for a rewrite of the Telecom Act started after the U.S. Court of Appeals for the D.C. Circuit decided in the 2010 Comcast case that the FCC did not have authority to enforce informal net neutrality rules. Clarifying the FCC's authority to regulate the Internet will be one of the principal drivers to reform the Telecom Act. Another driver is consumer migration from traditional television and cable to online video delivery platforms. This development has brought into focus shortcomings of the twenty-year-old provisions of the Cable Television Consumer Protection and Competition Act of 1992. Both Chairman Rockefeller and current Communications Subcommittee Chairman John Kerry (D-MA) signaled that video competition policy reform is necessary to protect consumers. Senator Jim DeMint (R-SC), who will likely emerge as the lead Republican on the Commerce Committee in the 113<sup>th</sup> Congress, introduced the Next Generation Television Marketplace Act (S-2008) to repeal must carry mandates, retransmission consent, compulsory copyright licenses and media ownership rules. DeMint has an aggressive deregulatory agenda and has been considering comprehensive Telecom reform. Chairman of the House Subcommittee on Communications, Technology and the Internet, Greg Walden (D-OR), also recognizes that changes in the video marketplace may require reassessment of the law.

**Retransmission Consent.** Retransmission consent reform continues to be a contentious issue and is expected to be the focus of further discussion in the 113<sup>th</sup> Congress. Although the FCC began a retransmission consent rulemaking in March 2011, Chairman Genachowski expressed the view that the FCC has limited statutory authority to reform the rules under existing law. As a result, any substantive retransmission consent reform will require Congressional action. The Next Generation Television Marketplace Act (H.R. 3675/S. 2008), introduced by Senator DeMint and Representative Steve Scalise (R-LA), may serve as a catalyst. The legislation is widely viewed as having little chance of passage in its original form, but is expected to serve as a basis for discussion in the new Congress. Additionally, the upcoming reauthorization of the Satellite Television Extension and Localism Act, set to expire in 2014, could provide a vehicle for comprehensive review of television marketplace regulations.

**PEG Channels.** During the 112th Congress, Representative Tammy Baldwin (D-WI) and Congressman Steve LaTourette (R-OH) introduced H.R. 1746, the Community Access Preservation Act of 2011, to protect Public, Educational, and Governmental (PEG) station issues. The CAP Act would ensure funding from cable providers for local programming, digital literacy training, public safety and workforce development. The legislation removes the distinction between capital and operating uses of PEG support fees; ensures funding for PEG channels; requires cable operators to



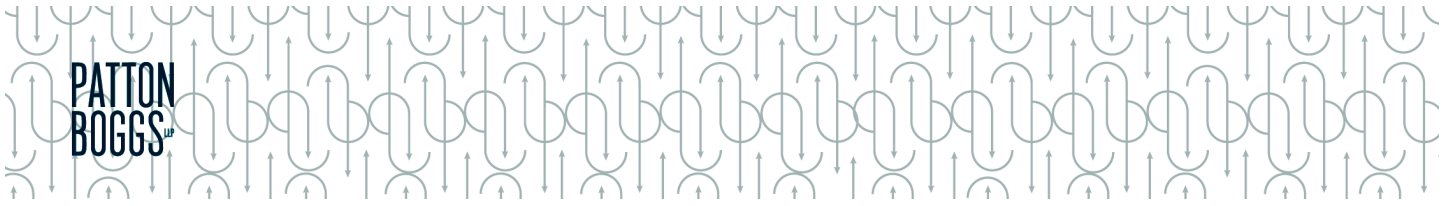
transmit PEG channels without charge to the local government; and requires the FCC to undertake a study of PEG operations. There are an estimated 5,000 PEG channels across the country that connect residents with local government, televising city council and county board meetings and hearings. There has been no major action on this bill and it has no Senate companion. It is unlikely to advance during the lame-duck session, but it may resurface in the new Congress with new sponsors since Representative LaTourette retired and Representative Baldwin won the seat vacated by Senator Herb Kohl.

#### *Anticipated Agency and Committee Developments*

**Federal Communications Commission.** Current Chairman Julius Genachowski is expected to resign sometime in 2013. It is unclear who will replace him. Leading candidates include the two sitting Democratic Commissioners, Jessica Rosenworcel and Mignon Clyburn, NTIA Administrator Larry Strickling, and Blair Levin, who was the Executive Director of the Omnibus Broadband Initiative at the FCC and oversaw development of the National Broadband Plan.

Mignon Clyburn's term expired in 2012. President Obama renominated her, but it is unlikely she will be confirmed before the end of this legislative session. We expect that President Obama will renominate Commissioner Clyburn in 2013. Many anticipate that Commissioner McDowell will resign sometime during the first six months of 2013, as he has served the FCC for six years. For Senate confirmation, his replacement will be a Republican selection and will likely be paired with Commissioner Clyburn and any new nominee for FCC Chairman.

**Federal Trade Commission.** Multiple sources are reporting that FTC Chairman Jon Leibowitz, who already has served eight years, will step down as Chairman early next year to return to the private sector. Leibowitz, who was confirmed for a second term in March of this year, was originally appointed to the Commission by President Bush in 2004 and was designated Chair by President Obama in 2009. His likely replacement is one of the two sitting Democratic commissioners, Julie Brill or Edith Ramirez. Both women were nominated by President Obama and sworn in as commissioners in 2010. In addition to the possibility of a new Chair, there should be a new Republican commissioner in 2013, but the pending nominee will face challenges getting through the Senate in the near term. Joshua Wright, a professor at George Mason Law, was nominated by President Obama in September to replace retiring Republican Commissioner Tom Rosch. Wright served as the scholar in residence for the FTC's Bureau of Competition from 2007-



2008 and had originally been recommended by Senate Minority Leader Mitch McConnell (R-KY). However, his nomination has become controversial because of his ties to Google and his paper, “Google and the Limits of Antitrust: The Case Against the Antitrust Case Against Google.”

### *Forecast for the 113<sup>th</sup> Congress*

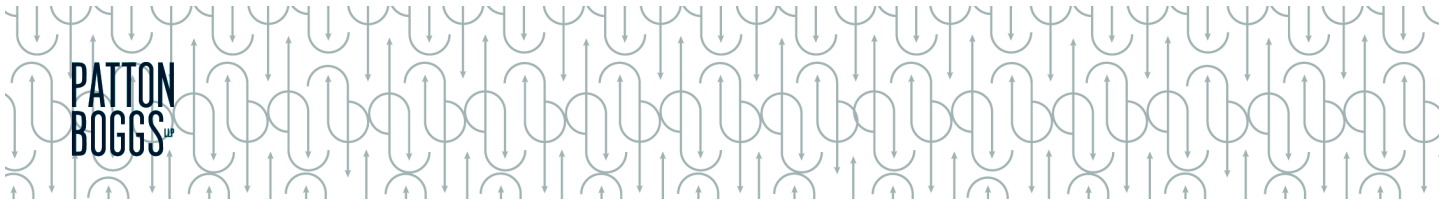
The new Congress will take on a fresh look in the primary committees with jurisdiction over technology and communications policy. Key committee and subcommittee gavels and ranking member positions will change hands in both the Senate and House. Consequently, the stage could be set for a significant burst of legislative and oversight activity for the technology and communications sector.

**Senate Commerce Committee.** With the Senate remaining under Democratic control, Commerce Committee leadership will remain within Chairman Jay Rockefeller (D-WV) and his key lieutenant, Senator John Kerry (D-MA), who will continue to chair the Subcommittee on Communications, Technology and the Internet (unless he should move to the State Department as Secretary). A new Republican ranking member will emerge to fill the role left by retiring Senator Kay Bailey Hutchinson (R-TX), who will relinquish her Senate seat in December. That position is likely to be filled by Senator Jim DeMint (R-SC), the current ranking member for the Subcommittee on Communications, Technology and the Internet.

Senator DeMint’s conservative, free-market inspired philosophy will take committee leadership in a new direction, and will inject new energy into the panel membership. He has already introduced legislation that would reform the video marketplace, removing many rules upon which broadcasters and cable companies have relied. His legislation removes many of the rules that broadcasters have used to ensure carriage and compensation for their programming (*i.e.*, must carry and retransmission consent). DeMint is spending time thinking about broader telecommunications reform, and his approach may remove much of the FCC’s current authority. DeMint’s more aggressive framing of the issues from a tea party perspective, along with a Republican controlled house, may drive debate in the next Congress.

**Senate Judiciary Committee.** Senator Patrick Leahy (D-VT) will continue to serve as Chairman while Senator Charles Grassley (R-IA) will continue as Ranking Member. The Judiciary Committee is one to watch, as it became a hotbed of technology and communications policy activity in the 112<sup>th</sup>





Congress. A new subcommittee was created that is devoted to Privacy, Technology and the Law. Subcommittee Chairman Al Franken (D-MN) led an aggressive oversight agenda and staged several high-profile hearings focused on privacy policy and new media. While Senator Franken's Subcommittee possesses limited legislative authority in the area of privacy and social media law, we expect the Subcommittee and the full committee to remain actively engaged with the communications industry in the 113<sup>th</sup> Congress.

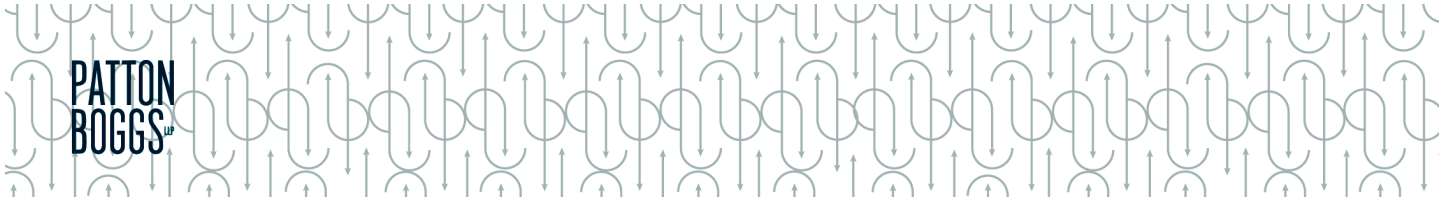
**House Energy and Commerce Committee.** Republican control of the House will lead to a second term for current Chairman Fred Upton (R-MI). Representative Greg Walden (R-OR), the current Chairman of the Communications, Technology and the Internet Subcommittee, might give up his position to assume full-time leadership over the National Republican Congressional Committee. (Republican Conference rules would not require him to give up his subcommittee leadership role but the time requirement of the NRCC position may essentially force him to do so.) If Chairman Walden departs, several senior Republican subcommittee members will vie for his position (including Representative Lee Terry (R-NE) and Representative John Shimkus (R-IL)). We do not expect the Democratic roster at the top of the Committee leadership to change in the coming year, as Representative Henry Waxman (D-CA) will continue serving as Committee Ranking Member and Representative Anna Eshoo (D-CA) will continue serving as Communications, Technology and the Internet Ranking Member. However, we do expect the current makeup of the senior Republican rank-and-file membership to change considerably, as long-time members Representative Cliff Stearns (R-FL), Representative Sue Myrick (R-NC) and Representative John Sullivan (R-OK) are leaving Congress this year.

**House Judiciary Committee.** The House Judiciary Committee, with jurisdiction over compulsory license issues, the Copyright Act, and other critical intellectual property issues, will face a transition in leadership. Representative Lamar Smith (R-TX), the current Chairman, is term-limited and will depart his position to assume the top position at the Science Committee. Representatives Howard Coble (R-NC), Bob Goodlatte (R-VA), and Darryl Issa (R-CA) are reportedly vying to become Chairman. Representative John Conyers (D-MI) will continue serving as Ranking Member.

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## TRADE POLICY

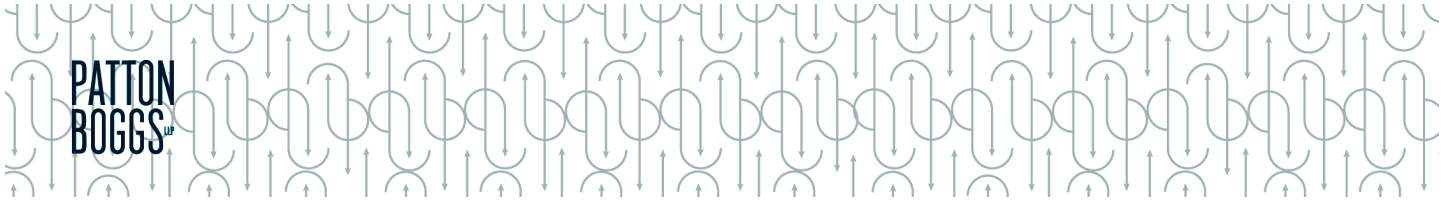
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### *Major Issues*

President Obama's re-election, as well as the return of a Democratic-led Senate and a Republican-led House, should help to produce a rough continuation of the last two years of U.S. trade policy. We expect gradual progress on trade liberalization, intermingled with recurring political disputes over the pace and scope of such liberalization and the labor, environmental, agricultural, and intellectual property policies that accompany it. President Obama will seek to make significant advancements both multilaterally, via agreements including the Trans-Pacific Partnership (TPP) and the initiation of trade negotiations with the European Union (EU), as well as bilaterally, such as by seeking to secure Permanent Normal Trade Relations (PNTR) status for Russia and Moldova.

Pro-trade majorities in the Senate and the House generally will offer support for such endeavors. By wide margins in both chambers last year, Congress approved Free Trade Agreements with Korea, Panama, and Colombia. But as demonstrated by the halting pace of Russia/Moldova PNTR legislation in Congress this year, geopolitical factors and competing legislative priorities suggest that ardent trade advocates on both ends of Pennsylvania Avenue, and in the private sector, will have to continue to tailor their arguments on a case-by-case basis. Moreover, as major decisions on trade come to the fore in the Senate, President Obama will need to continue to rely on his political alliance with Senate Majority Leader Harry Reid (D-NV), a noted skeptic on trade, to move issues across the legislative finish line.

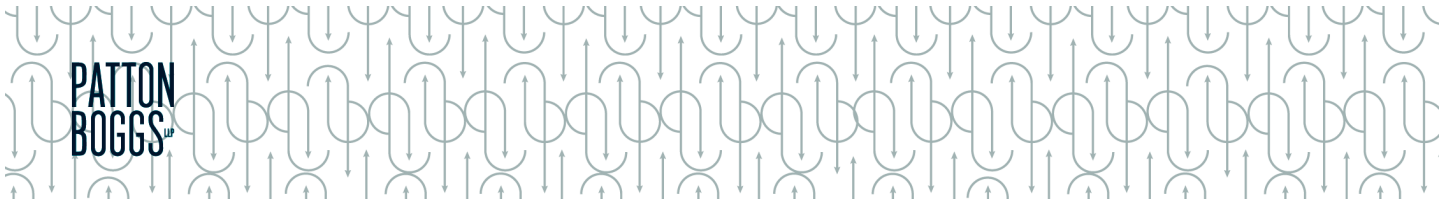
**China.** One way for President Obama to address the concerns of Senator Reid and other congressional allies with close ties to the labor movement, especially those from the swing states in the Industrial Midwest that proved so crucial to the President's re-election, will be to continue to



target China selectively over perceived unfair trade practices. President Obama's first-term record, which included seeking bilateral and multilateral trade remedies on goods ranging from automobile tires to rare earth metals to solar panels, is instructive. The Obama Administration's targeted approach placated enough congressional critics of China's trade practices to allow time for improvements in the overall bilateral trade picture. The Obama Administration also created a new special trade enforcement unit focusing on China, which may increase its level of activity in the second term. At the same time, this selectivity has helped to calm anxious U.S. and international investors, who feared the consequences of a broader U.S.-China trade dispute.

Meanwhile, China's currency has continued its gradual rise against the dollar. That development has dampened, although certainly not eliminated, one of the most common and vociferous arguments made by China trade skeptics in Congress for the last several years. Specifically, the argument holds that by refusing to name China as a "currency manipulator" that allegedly keeps its currency, the renminbi (or yuan), artificially low, the Obama and Bush Administrations have enabled Beijing to avoid retaliatory sanctions and effectively subsidize Chinese exports and penalize their U.S. counterparts. In fact, Governor Romney himself, normally identified as a free-trader, leveled this charge against the President and promised to label China as a currency manipulator on his first day in office. For the foreseeable future, the President is unlikely to attempt to penalize China for currency manipulation. We do not expect Congress to pass binding currency legislation either. The U.S. business community continues to tell Congress that the value of China's currency is not its key concern in the country, and Speaker Boehner will continue to block currency legislation from the House floor.

**Trans-Pacific Partnership and Trade Promotion Authority (TPA).** The Obama Administration likely will attempt to complete the multilateral TPP negotiations in 2013, with the aim of submitting a final agreement to Congress in 2014. Whereas the Bush Administration had negotiated the Colombia, Panama, and South Korea FTAs that nevertheless dominated much of President Obama's first-term trade agenda, the White House considers TPP to be an opportunity to put its own stamp on U.S. trade policy (even though the U.S. first embraced TPP in the George W. Bush Administration). The Office of the U.S. Trade Representative (USTR) will push hard for a final document in 2013, particularly given the tangible benefits the Administration sees emerging from the TPP for the U.S. services and agricultural industries, among other economic sectors.

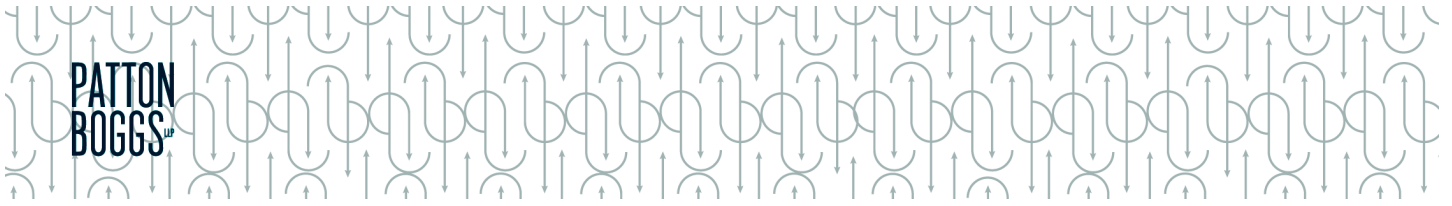


However, the Administration's target dates on TPP could slip for several reasons. First, the TPP's final membership is not yet certain. Chances are good that Japan (which has vacillated on its interest in joining the TPP) and South Korea (which has been more circumspect about joining) will not join the trade pact in the near term. If they do, the multilateral negotiations would necessarily slow down. That is particularly the case if Japan were to join, given Tokyo's reluctance to make agricultural concessions, as well as the concerns among some in the U.S. auto industry about potentially including Japanese cars and trucks in the agreement. South Korea has trade agreements with the other TPP members (Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam), which would help ease Seoul's participation. Meanwhile, the addition of Canada and Mexico to the TPP talks this year has proceeded relatively smoothly so far. Canada and Mexico only recently became full TPP Members, and the December negotiating round in New Zealand will serve as their debut session as active participants.

Second, significant challenges remain in mollifying key stakeholders on intellectual property issues and other TPP provisions. Several prominent Democrats, including some with generally pro-trade voting records such as Ways and Means Committee Members Jim McDermott (D-WA) and Earl Blumenauer (D-OR), have voiced concerns about the TPP discussions' lack of transparency in general, and draft IP provisions in particular. The Obama Administration will forge ahead nonetheless, but will continue to take the time to consider disparate views, largely in order to avoid broader problems during the eventual Congressional approval process.

Finally, a larger issue that is likely to reemerge during the Congressional approval process for TPP is the possible reauthorization of "fast track" Trade Promotion Authority. The first-term Obama team did not make a formal request to renew TPA, which lapsed in 2007. Furthermore, a Republican-led trial vote failed to garner the required 60 votes in the Senate in 2011, as USTR did not want to jeopardize Democratic votes for the Colombia, Panama, and Korea FTAs by pushing for TPA at that time. However, the Administration will have had more time to generate Democratic support for, or at least acquiescence to, TPA by the time TPP is ready for congressional consideration.

**Russia/Moldova PNTR.** Trade experts are increasingly confident that Congress will pass legislation to grant PNTR for Russia and Moldova in the lame duck session. The Senate Finance Committee and the House Ways and Means Committee both reported out PNTR bills over the summer as Russia joined the World Trade Organization, and the U.S. business community sought to repeal Cold War-era Jackson-Vanik bilateral trade restrictions. However, final action stalled on the

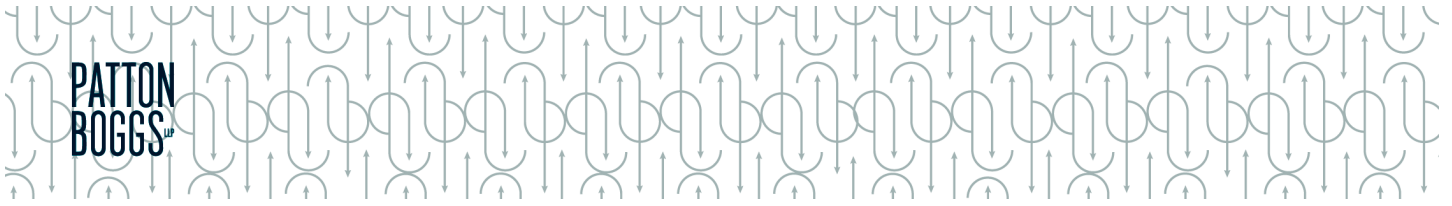


floor of both chambers, largely due to disagreements about how to address Russia's human rights record as part of the final legislative package.

During the lame duck session, we expect the House to act first on the PNTR package (possibly in its first week back), with the Senate following closely behind. Many House Democrats will voice support for a more stringent, more globalized version of the "Magnitsky" Russian human rights legislation that the Republican Leadership plans to attach to the PNTR bill. However, we expect the leadership's approach to carry the day. Senate human rights advocates, such as Senator Ben Cardin (D-MD), are then likely to accept the House bill as a significant improvement over the status quo. The Senate is then expected to vote in favor of PNTR, possibly without amendments, barring complications imposed by the compressed lame duck calendar.

**U.S.-EU Free Trade Agreement.** Especially if TPP and Russia/Moldova PNTR show the expected signs of progress in the coming months, the Administration is likely to focus additional attention on its next "big-ticket item," namely the possibility of an FTA between the United States and the European Union. USTR is essentially ready and willing to enter into formal negotiations with the EU. Moreover, with a sufficient degree of spadework, the White House believes it can line up sufficient political support for the concept from Congressional Democrats, given the EU's strong regulatory framework on labor and environmental issues.

The larger "known unknown" lies on the EU's side of the equation. The question remains whether officials in Brussels and EU capitals feel they have the bandwidth and political standing to undertake inevitably complicated and intermittently controversial trade negotiations with Washington while the Eurozone and several Southern European economies remain in varying degrees of peril. The Obama Administration and certain EU officials are likely to describe an FTA as a jobs-boosting "win-win," but it remains to be seen if generally dour and inward-looking European voters, and the politicians who represent them, will agree. In October, the European Parliament also called for the U.S. and EU to initiate trade negotiations in the first half of 2013, as long as the talks focus sufficiently on augmenting food safety, protecting geographical indications, and establishing greater market access in maritime and air transportation services.



### *Other Trade Issues*

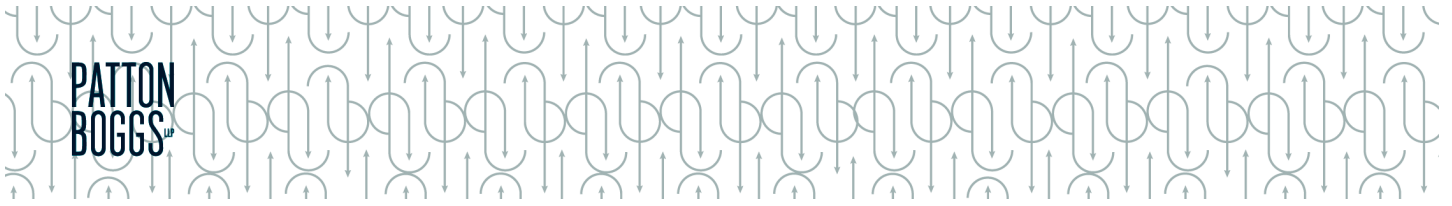
The Obama Administration, particularly the Commerce Department, will continue to boost its National Export Initiative (NEI), in which the President has promised to double exports within five years. If the economy continues its gradual improvement, the Administration has a chance to meet its goal for the NEI.

The Administration may also seek to complete work on a long-stalled Trade and Investment Framework Agreement (TIFA) with Taiwan. Taiwan may be ready to compartmentalize its concerns about the safety of U.S. beef, which waylaid the previous round of TIFA talks in 2007. A successful TIFA with Taiwan could lead to discussions on a bilateral FTA, for which supporters of Taiwan in Congress have long advocated.

The Administration will need to decide on a longer-term plan for renewal of the Andean Trade Promotion and Drug Eradication Act (ATPDEA) and the broader Generalized System of Preferences (GSP) program, both of which expire in mid-2013. The ATPDEA program is currently in effect only for Ecuador, which would like to continue to participate. It is unclear if the Administration might consider broadening the program to include other Latin American countries in order to help generate support in a region of the world for which the White House has been criticized for ignoring. It is also unclear whether the new Congress will resuscitate earlier efforts to consider more comprehensive global “trade preference reform” initiatives as part of this effort.

In August, President Obama signed into law the extension, for three years into 2015, of the African Growth and Opportunity Act’s important “third country fabric program.” USTR has since publicly committed to a “seamless renewal” of AGOA before the program expires entirely in 2015, most recently during Deputy USTR Demetrios Marantis’ trip to Africa in October, where he reiterated support for Africa’s efforts toward regional integration, including efforts to establish the Tripartite Free Trade Area in Africa by 2014.

Congress is not likely to move a Miscellaneous Tariff Bill (MTB) during the lame duck session, and the Obama Administration is not likely to push the issue. We expect additional action on the MTB next year.



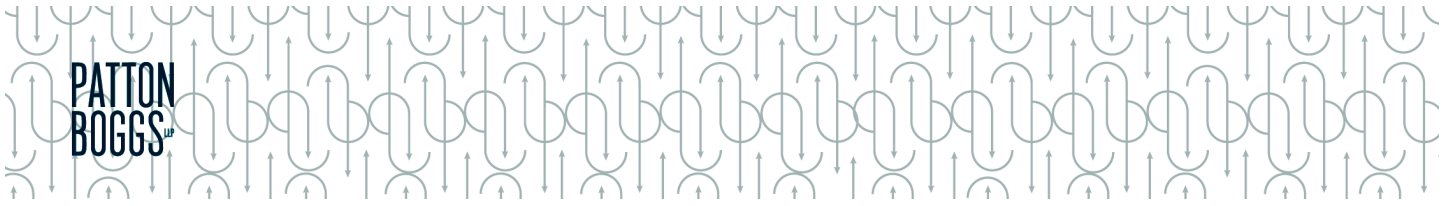
We expect the Obama Administration and Congress to continue to scale back U.S. sanctions against Burma (Myanmar). The Administration and Congress are moving together in a carefully calibrated manner to ease U.S. sanctions, as the South East Asian nation continues to take tangible steps to reform. This “principled engagement” is being supported by a U.S. business community eager to invest in the country, which desperately needs to build an economy capable of supporting its people.

#### *Anticipated Agency and Committee Developments*

**USTR.** Most observers expect Ron Kirk to leave as USTR as President Obama’s first term comes to a close. Many trade experts view Michael Froman, who heads the National Security Council’s international economic team, as the most likely choice to succeed Kirk. The well-liked, well-regarded Froman has developed many allies in both the private- and public-sector sides of Washington’s trade policy community. Ambassador Kirk’s two Washington deputies, Miriam Sapiro and Demetrios Marantis, also have cultivated strong support within the trade ranks. If President Obama seeks to bring in someone from outside his current Administration to serve as USTR, he might tap Representative Howard Berman (D-CA), who is an expert on intellectual property issues, and has compiled a generally pro-trade voting record. If the President wishes to cross party lines with his choice, outgoing House Rules Committee Chairman David Dreier (R-CA) is an ardent trade advocate with a track record of bipartisan deal-making.

**Department of Commerce.** The Department of Commerce has been operating with an “acting” secretary, Dr. Rebecca “Becky” Blank, since the June 2012 resignation of Secretary John Bryson for health reasons. President Obama may appoint another leader from the private sector, although several Administration figures, such as Ambassador Kirk, and outgoing Members of Congress also could be considered.

**Senate Finance Committee.** Chairman Max Baucus (D-MT) and Ranking Member Orrin Hatch (R-UT) will continue in their current positions in the next Congress. Senator Baucus faces a potentially challenging re-election bid in 2014, and he will be anxious to demonstrate his longstanding penchant for bipartisan progress on Finance Committee issues in general and trade issues in particular. Senator Hatch will continue to push the Obama Administration to act as fast and as comprehensively as possible on trade liberalization, as he did in the lead-up to the vote on the Colombia, Panama, and Korea FTAs. Several spots are opening up on the highly sought-after Finance Committee at the end of this Congress. Retiring Committee members include Senator Kent



Conrad (D-ND), Senator Jeff Bingaman (D-NM), Senator Olympia Snowe (R-ME), and Senator Jon Kyl (R-AZ).

**House Ways and Means Committee.** Ways and Means Committee Chairman Dave Camp (R-MI) and Ranking Member Sander Levin (D-MI) are expected to remain as Chairman and Ranking Member. Both Members will continue to play very active roles on trade matters, as they did during their support for revisions of the auto provisions of the U.S.-Korea FTA in late 2010. Ways and Means Trade Subcommittee Chair Kevin Brady (R-TX) and Ranking Member Jim McDermott (D-WA) likewise are expected to continue to serve as key voices for their parties on trade in the next Congress. Congressional Democrats view Congressman Brady as a genial, if highly conservative, honest broker. Similarly, Congressional Republicans consider Congressman McDermott, who combines general support for free-trade with staunch liberalism, as a valuable Democratic barometer on globalization issues.

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#### *Contact Information*

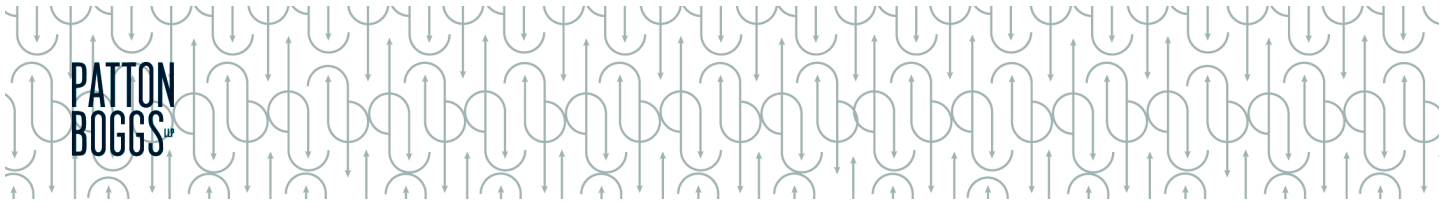
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## **TRANSPORTATION AND INFRASTRUCTURE**

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The Obama Administration and 113<sup>th</sup> Congress will have a full transportation and infrastructure agenda. Having completed a long-term reauthorization of the nation's aviation programs in the 112<sup>th</sup> Congress, action will focus on implementation at the Department of Transportation (DOT) and, in particular, the Federal Aviation Administration (FAA). On the heels of a significant but short-term reauthorization of the nation's surface transportation programs, the incoming Congress will again confront the need to reauthorize or extend the nation's highway and transit programs—and the same fundamental question of how to pay for them. Rail issues will also be an important part of the agenda, including Amtrak funding and operational issues, the future of the Obama Administration's high speed rail initiative, and the impending compliance deadline for controversial Positive Train Control (PTC) requirements. Finally, water infrastructure may indeed be an area of increased focus, with Congress confronting the need to enact a Water Resources Development Act (WRDA) and





exploring new innovative financing approaches to help meet the nation's large and growing water infrastructure needs.

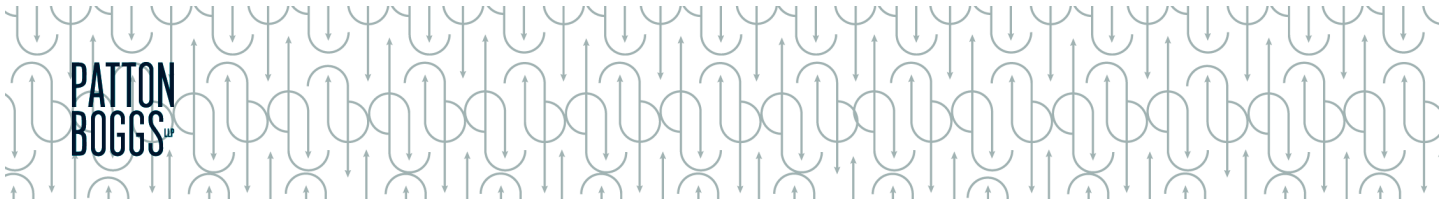
## AVIATION

### *Major Issues*

The authorization of FAA programs was enacted in February 2012, and expires September 30, 2015, and so a comprehensive aviation bill is not likely to move until 2014 at the earliest. While the focus of the aviation industry in the next two years will primarily be on DOT—the Office of the Secretary (OST) and the FAA—both airlines and airports may push Congress to act before the next reauthorization debate begins. The major challenge confronting the FAA, the airlines, and business and general aviation, is the Next Generation Air Transportation System (NextGen), which will move air traffic control from a land-based system to a satellite-based system, and includes numerous other efficiency improvements in air traffic management and control.

### *Forecast for the 113<sup>th</sup> Congress*

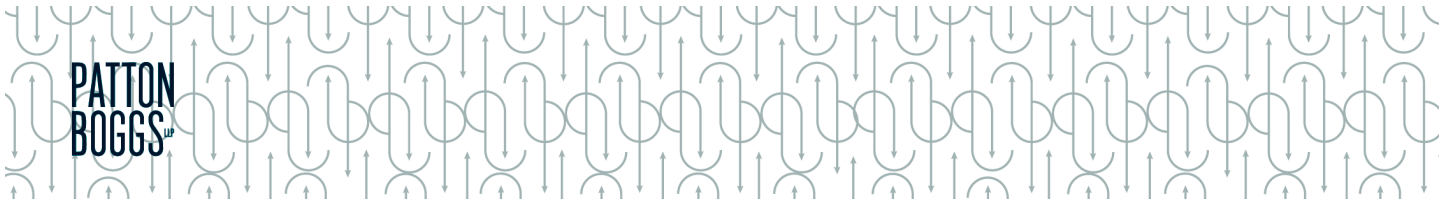
The first aviation issue likely to be considered by Congress concerns the European Union Emissions Trading System (ETS), which requires U.S. carriers (and other non-EU carriers) to obtain emission permits based on emissions from the entire flight from the United States to Europe, not just the portion of the flight over EU airspace. Air carriers have asked the Obama Administration to file a complaint with the International Civil Aviation Organization (ICAO) charging that the EU ETS is an extra-territorial measure at odds with the Chicago Convention. The EU is adamant that it will not back down unless and until ICAO adopts one or more market-based measures to reduce aircraft emissions. The EU ETS charges begin in January 2013. ICAO is currently considering several market-based measures, and will meet in March to winnow its options, but will not adopt any measure until the ICAO General Assembly meets in the fall of 2013, at the earliest. At the request of the airlines, both the House and Senate this year passed bills to prohibit U.S. airlines from participating in the EU ETS. The language in the bills is different and thus must be reconciled. We expect there will be an effort to pass a compromise bill in a lame duck session, or early in 2013. The Obama Administration is not likely to file a complaint with ICAO, a process that could take over a year, especially if ICAO continues to make progress in adopting one or more market-based measures.



While preferable to another of the 23 short-term extensions that preceded it, the FAA reauthorization legislation left many issues important to airlines and airports unaddressed. Airports, for example, were pleased that the authorized levels of Airport Improvement Program (AIP) funding were maintained, and the multi-year reauthorization finally returned the airport funding schedule to the norm after several years of extensions. But the legislation did not address the airports' number one objective: increasing the maximum Passenger Facility Charge (PFC), which has remained \$4.50 since 2000. Moreover, the Airport and Airway Trust Fund, from which both Airport Improvement Program grants and a substantial portion of FAA operations are funded, is not on solid footing, despite the enactment of the FAA reauthorization legislation. The downward arc in the Trust Fund balance is a product of several factors including the reduction of airline capacity and the airlines' unbundling of pricing, as ancillary fees are not subject to the 7.5% ticket tax, the major source of revenue for the Trust Fund. There may be an effort from Democrats to subject ancillary fees to the ticket tax, but it would be resisted vigorously by the airlines. And the Department of Transportation, whether or not Secretary LaHood continues to serve, is not likely to hold back, much less reverse, its zeal in pushing more passenger protection regulations and imposing significant fines to incentivize compliance.

The biggest challenge facing the FAA over the next few years is implementing NextGen. Next Gen comprises many improvements in technology, equipment, data collection and communication, and requires coordination among the FAA, DOD, and all industry stakeholders. Apart from the sheer complexity of NextGen, there is uncertainty about whether there will be enough funding to move these projects forward. If sequestration hits, it will likely set back NextGen funding by a year or more. One of the key advances is Automated-Dependent System-Broadcast (ADS-B) technology. Simply put, ADS-B Out broadcasts aircraft information to Air Traffic Control, and ADS-B In broadcasts aircraft information into the cockpit. The issue of how to equip all commercial and general aviation aircraft with ADS-B-In and -Out technology has not been resolved, (even as the FAA moves to require equipage), as well as how the navigable airspace will be managed with varying degrees of equipage among the airlines and other non-commercial operators. A push for a NextGen Equipage Infrastructure Bank may pick up steam.

The other major challenge to the FAA is to adopt rules and procedures to integrate civil Unmanned Aerial Vehicles (UAV) into the National Airspace System. Congress required the FAA to submit an Integration Plan to Congress by February 14, 2013 and to issue a final rule within 18 months thereafter (no later than August 14, 2014). At present, FAA grants Certificates of Authorization only



to federal, state, and local government UAV operators. Apart from issues of safety, FAA must address an increasing level of public anxiety over privacy intrusions. The FAA reauthorization bill also required FAA to select six test sites for testing of Unmanned Aerial Systems. The FAA is expected to select these sites by the end of this year or early 2013.

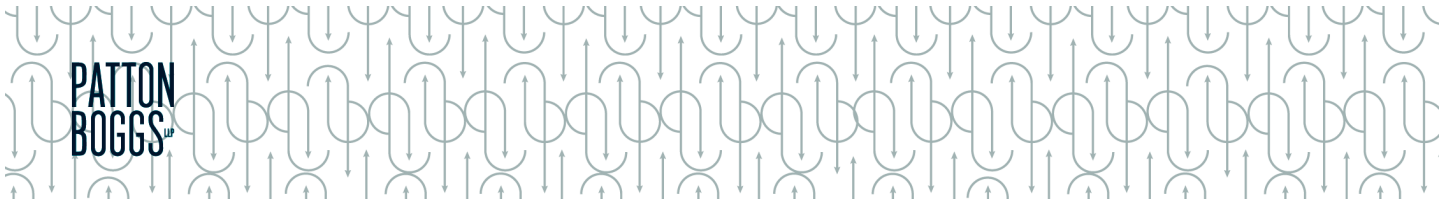
In the next several months American Airlines may emerge from Chapter 11. The bankruptcy court has given American until December 28 to come up with a plan of reorganization, although the court could extend this exclusivity period into 2013. It is uncertain whether American will emerge as a stand-alone airline or will agree to a merger with U.S. Airways, as American's unions want. A merger of these two major airlines would face Department of Justice (DOJ) scrutiny, and if not blocked by DOJ, would have many impacts on other airlines and airports. Congress may hold hearings, but there is not much Congress can do to prevent a merger. There may yet be more consolidation of the U.S. airline industry, though none likely as momentous as Delta-Northwest, United-Continental, and Southwest-Air Tran.

## **SURFACE TRANSPORTATION**

### *Major Issues*

On July 6, 2012, President Obama signed into law the Moving Ahead for Progress in the 21<sup>st</sup> Century Act (MAP-21), a two-year reauthorization of the nation's surface transportation programs. As MAP-21 extends only through September 30, 2014, the Obama Administration and 113<sup>th</sup> Congress will again confront the need to reauthorize or extend the nation's highway and transit programs and the fundamental question of how to pay for them.

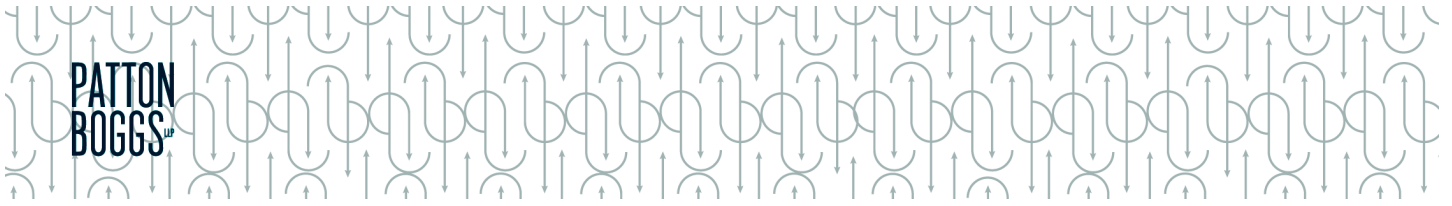
The most important issue underlying the future of the surface transportation program is the financing question. Incoming revenue into the Highway Trust Fund, primarily from the gas tax, is insufficient to support current expenditure levels. The federal gas tax is set at a fixed 18.4 cents per gallon and has not been increased since 1993. At the same time, increases in fuel efficiency and changes in driving patterns due to higher gas prices have led to a decrease in gas tax revenue, resulting in an ever-widening gap between revenues and authorized spending levels. The Congressional Budget Office estimates this shortfall will further accelerate with implementation of the new Corporate Average Fuel Economy (CAFE) standards announced in August 2012.



Increasing the gas tax was not a consideration during the debate over MAP-21, reflecting the political forces that have kept the gas tax frozen in place for nearly 20 years—and that have been magnified by record gas prices and a sluggish economy. Just to keep the program at current levels, MAP-21 transfers \$21.2 billion from the General Fund and other sources into the Highway Trust Fund. Since 2008, Congress has transferred approximately \$56 billion into the Highway Trust Fund to maintain its solvency. Merely extending the program at current levels beyond September 30, 2014 is projected to require approximately \$15 billion in additional revenue per year to supplement declining Highway Trust Fund receipts.

Against this backdrop, MAP-21 is a transitional bill, providing two years of funding certainty and time to address the fundamental long-term financing question—while also setting a policy direction for the future. Responding to the constrained funding environment, MAP-21 places a core focus on maximizing the value of existing resources. It expands innovative financing opportunities, increasing funding for the TIFIA low-interest loan program nearly tenfold. It broadens tolling opportunities and takes steps to facilitate public private partnerships (PPPs). It streamlines the environmental process to accelerate project delivery and encourages innovative delivery methods. It consolidates programs, and eliminates most discretionary programs, to give states and transit agencies more flexibility and certainty. It moves towards a more performance-based planning process to focus investments on achieving strategic outcomes. And it takes steps to define and prioritize systems that are in the federal interest, targeting over 60 percent of highway funding to preserving and improving an expanded National Highway System consisting of the nation’s most important highways; and requiring the designation of a Primary Freight Network consisting of the nation’s most significant freight corridors.

MAP-21 also authorized appropriations for a new Emergency Relief program at the Federal Transit Administration (FTA), paralleling the Federal Highway Administration’s (FHWA) existing program. While there are available funds for FHWA’s program, the current CR does not provide funding for FTA’s program as it only extends existing appropriations from FY2012. In the aftermath of Hurricane Sandy, funding for both the FTA and FHWA Emergency Relief programs may be revisited as part of a potential supplemental appropriations bill during the lame duck session.

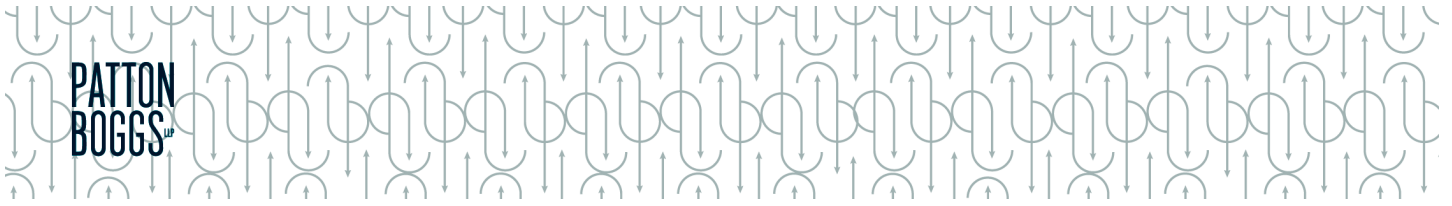


### *Forecast for the 113<sup>th</sup> Congress*

While MAP-21 serves as a bridge, it ends at a crossroads. The Obama Administration and 113<sup>th</sup> Congress face three fundamental choices for the future of the program: (1) increasing the gas tax or raising dedicated new revenue from other sources; (2) reducing spending to align with available revenue; or (3) continuing the General Fund transfers and short-term policies that have sustained the program since 2008. These choices of *how* to finance and how much revenue to generate are in turn intertwined with questions of *what* to finance and what the federal role in transportation investment should be.

There remains broad opposition to an increase in the gas tax, especially given current prices at the pump. Neither the President nor the House or the Senate is likely to endorse one, especially standing on its own. There have been a wide range of other ideas floated on how to raise additional revenue. The President campaigned on a proposal to use the “peace dividend” from winding down the wars in Iraq and Afghanistan as a financing source. There have been various proposals to link transportation and energy revenues, either through new taxes on wholesale oil sales and speculative trading of oil futures (a Democratic proposal from the 111<sup>th</sup> Congress); or expanding domestic oil and gas drilling and devoting the new revenues to transportation (a Republican proposal from the 112<sup>th</sup> Congress). Others have proposed indexing the gas tax for inflation or converting the current fixed per-gallon tax to a percentage sales tax. There does not appear to be any political will for converting to a mileage-based fee or Vehicle Miles Traveled (VMT) tax, although many experts point to the VMT as the most sustainable and equitable long-term solution.

Another possibility receiving increasing attention is addressing transportation finance as part of a “grand bargain” or comprehensive fiscal reform package. In its final report, the Simpson-Bowles Commission recommended gradually increasing the gas tax by 15 cents over three years and limiting spending to those receipts. During the Super Committee process, the “Gang of Six” proposed maintaining the current gas tax but raising \$133 billion over ten years for transportation as part of comprehensive tax reform. Turning to non-transportation revenue sources, however, raises separate concerns about departing from the user fee principle embodied in the gas tax. Because highways and transit are funded through a Trust Fund with their own dedicated user fee, the funding is not subject to annual appropriations—nor to sequestration—and authorizing legislation is able to provide guaranteed multi-year funding or “contract authority.” If the user fee link is severed, so too may be the special budgetary status of the surface transportation program.

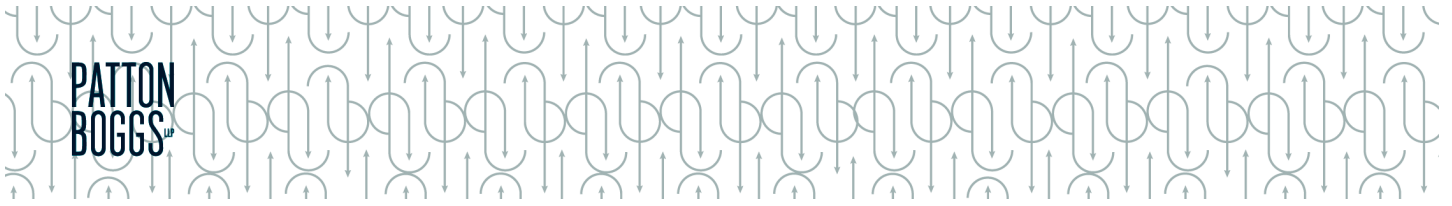


The other fundamental choice is to reduce spending to align with Highway Trust Fund receipts. Without additional revenue, spending would have to be cut by 30% to stay within available Trust Fund balances. There is a view that if additional revenue cannot be raised, the federal program has no choice but to live within its means and should be refocused on the core elements of the nation's transportation system – those of clear and longstanding federal interest. Those holding this view generally call for available revenues to be bolstered through further expansions in innovative financing, tolling and PPPs; and for federal requirements to be further streamlined to reduce costs and provide states with maximum flexibility.

Under continued Republican leadership, the House is likely to favor accelerating the direction set in MAP-21 and—under any funding level—will likely seek to prioritize investment in the higher order systems, further streamline the environmental process, and make greater use of tolling, innovative financing and PPPs. The Senate and Obama Administration will want to maintain the policy compromises established in MAP-21 and not go further. During consideration of MAP-21, for example, two of the most significant bi-cameral debates were about (1) the extent of environmental streamlining; and (2) whether to modify or eliminate altogether the set-aside for bicycle and pedestrian projects, which became a proxy for the broader debate about the scope of the federal program and federal role. In both cases, the House wanted to go farther than the Senate – and that dynamic is expected to continue. While the Republican House has generally been less supportive of funding for urban transit systems, MAP-21 confirmed there is a fundamental core of bi-partisan and bi-cameral support for dedicated transit funding.

Ultimately, the fundamental question facing the 113<sup>th</sup> Congress is whether and how to raise additional revenue, followed by the question of what the federal program will look like under the various constraints. In the 112<sup>th</sup> Congress, the Republican House, Democratic Senate, and Obama Administration grappled with these choices and in the end came together to enact a short-term bill that maintained current spending levels and relied upon another General Fund transfer.

The same players now return for the 113<sup>th</sup> Congress, but facing a greater challenge. The financing gap continues to grow, such that even another two-year bill at current levels would require some \$30 billion in additional revenue. Policymakers will also have to address the reauthorization with only limited time to see the effects of the policies put in place in MAP-21. Short on the heels of MAP-21 and facing an even larger revenue shortfall, Congress will confront the future of the program with



heightened recognition that fundamental decisions need to be made, but faced with difficult and complex choices.

With respect to key discretionary programs funded outside of the Highway Trust Fund, the President's re-election and return of a Democratic Senate provide the greatest likelihood that the TIGER program will be continued. The New Starts program will also continue to be a priority for the Obama Administration and Senate. Unlike programs funded through the Highway Trust Fund, however, the discretionary TIGER and New Starts programs are subject to sequestration and would be impacted by automatic across-the-board cuts should they occur. In the event of any cuts to the New Starts program, the FTA would be expected to prioritize existing Full Funding Grant Agreements and maintain those commitments, as it has historically.

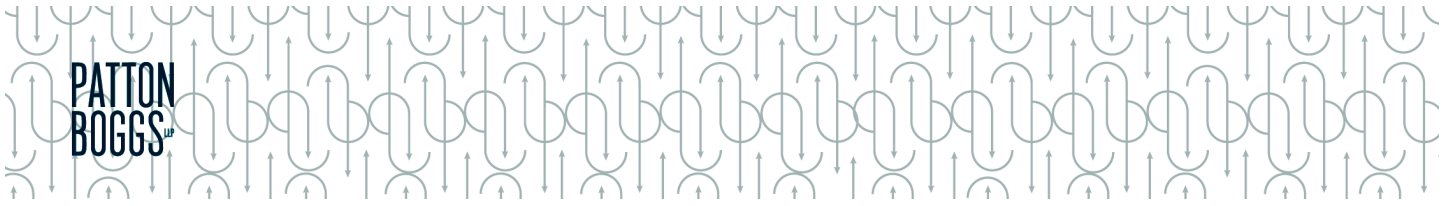
## **RAIL**

### *Major Issues*

Rail issues will be an important part of the transportation agenda in the next Congress driven, in part, by the decision not to include a rail title in the MAP-21 bill. That decision frees up the 113<sup>th</sup> Congress to focus on comprehensive rail safety and policy issues and, in particular, reforms to the Railroad Rehabilitation and Improvement Financing (RRIF) program; Amtrak funding and operational issues; the future of the Obama Administration's high speed rail initiative; and the controversial 2015 deadline for implementation of PTC requirements—a deadline that the Federal Railroad Administration (FRA) has said cannot be met.

### *Forecast for the 113<sup>th</sup> Congress*

Congress has not enacted a major piece of rail legislation since the Passenger Rail Investment and Improvement Act (PRIIA) and Rail Safety Improvement Act (RSIA) of 2008, which established the 2015 PTC deadline. While both the House and Senate included rail policy titles in their respective surface transportation bills, they ultimately were unable to reach an agreement within the Conference timeframe and include a rail title in the final bill. With the impending PTC deadline serving as the main driver, but with a host of issues to address, the 113<sup>th</sup> Congress is likely to consider substantive rail legislation.



The release in August 2012 of FRA’s Report to Congress on PTC implementation is the critical catalyst for legislative action. The report concluded that most railroads will not be able to meet the PTC deadline, citing significant technological and programmatic challenges. In addition to an extension of the deadline, Congress is expected to consider other strategies including phased implementation and options for “alternative technological compliance” to provide greater flexibility while achieving an equivalent level of safety.

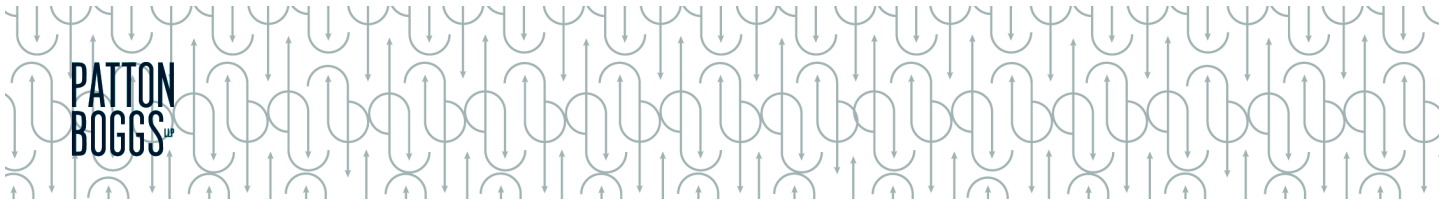
In addition to PTC, Congress is also likely to seek reforms to the RRIF loan program. The RRIF program is widely regarded as being underutilized, and there is broad consensus that certain reforms—primarily to the application and review process—could substantially increase its effectiveness. Building on reform proposals developed as part of the surface transportation reauthorization, there is considerable bipartisan momentum behind efforts to reform the RRIF program and strong desire to see it function more like the popular TIFIA program.

Amtrak subsidies and operating practices will continue to be high-profile issues. While Governor Romney explicitly called for an end to Amtrak subsidies, the Obama Administration (and Vice President Biden in particular) along with the Democratic Senate have been strong supporters of Amtrak and will continue to prioritize funding to meet Amtrak’s operating, capital and debt service requirements.

With respect to Amtrak operations, the House Transportation and Infrastructure (T&I) Committee under Chairman John Mica (R-FL) focused intensely on Amtrak’s cost structure and put forward a proposal, along with Rail Subcommittee Chairman Bill Shuster (R-PA), for the privatization of the Northeast Corridor. While Governor Romney also expressly called for full Amtrak privatization during the campaign, a re-elected President Obama and Democratic Senate will continue to oppose privatization initiatives.

If Chairman Mica is not granted a waiver, it is widely expected that Chairman Shuster will take over the full committee. While it is unclear to what extent Chairman Shuster will pursue the proposal for privatization of the Northeast Corridor that he released along with Chairman Mica, the House is very likely to continue pressing for the use of competitive private sector contracting for Amtrak services such as food and beverage concessions and track maintenance work. The House has also highlighted the use of competitive private sector contracting for the operation of certain commuter rail routes and is likely to emphasize that as a model that should be expanded.





The future of the Obama Administration’s high speed rail initiative will be another highly visible issue. President Obama has made high speed rail a signature transportation priority, and the 111<sup>th</sup> Congress provided \$10.1 billion for high speed and intercity passenger rail projects across the country. Since the turnover in the 112<sup>th</sup> Congress, however, House Republicans have zeroed out the program and high speed rail has not received any further appropriations. The pending Senate transportation appropriations bill would provide a minimal level of funding (\$100 million) to continue the program—a similar effort to what was proposed in FY2012 when ultimately no funding was provided. U.S. DOT, however, has used the TIGER program to fund targeted high speed rail projects to sustain some continued federal investment in this top Administration priority.

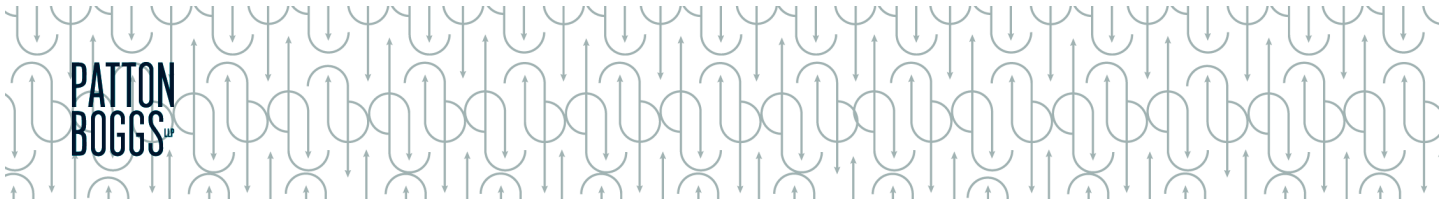
## **WATER**

### *Major Issues*

A number of significant water infrastructure issues will be on the agenda in the 113<sup>th</sup> Congress. Congress will confront the need to reauthorize WRDA, which sets the direction for the U.S. Army Corps of Engineers Civil Works program. WRDA is intended to be taken up every two years, but has not been reauthorized since 2007. There is also increasing awareness of the nation’s large and growing municipal water infrastructure needs and interest in new innovative financing solutions. In the 112<sup>th</sup> Congress, a proposal for a Water Infrastructure Finance and Innovation Act (WIFIA) modeled on the TIFIA program received serious bi-partisan consideration, and efforts to enact WIFIA legislation are likely to gain further steam in the 113<sup>th</sup> Congress. Finally, driven in particular by the widening of the Panama Canal locks, expected to be completed by 2014, the condition of our nation’s ports, harbors and inland waterways will continue to be an important and high profile subject.

### *Forecast for the 113<sup>th</sup> Congress*

Senator Barbara Boxer (D-CA), Chairman of the Senate Environment and Public Works (EPW) Committee, has called for action on WRDA legislation during the lame duck session. While it is unlikely the Senate will be able to consider a WRDA bill given the breadth of the fiscal issues that must be addressed before the end of the year, there are likely to be stepped-up efforts to enact WRDA legislation in the next Congress. WRDA legislation has traditionally been bipartisan, and during a September 2012 hearing on WRDA, EPW Ranking Member James Inhofe (R-OK) indicated that the Committee leadership was already “working hard to negotiate a WRDA bill.”



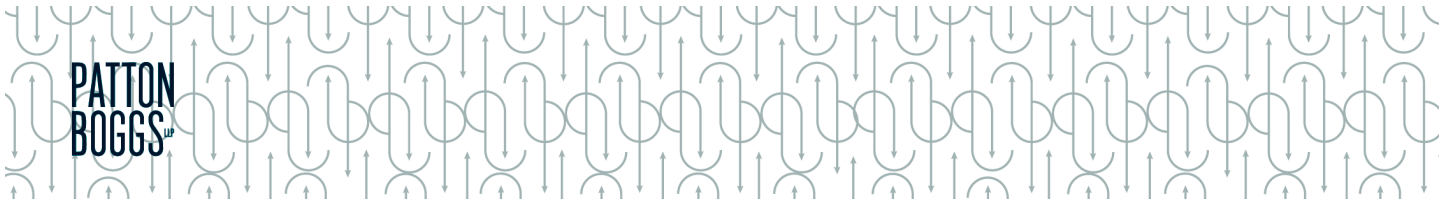
During the 112<sup>th</sup> Congress, Chairman Mica also expressed his desire to see the Congress take up a WRDA bill.

The issue of earmarks is one of the main challenges in enacting WRDA legislation, as one of the primary functions of WRDA legislation is providing project specific authorizations to direct the Corps of Engineers. As such, there has been some discussion of exempting WRDA project and study authorizations from the definition of an earmark, and that is expected to receive increased attention. In addition to project authorizations, there is significant interest in advancing a WRDA bill to address a range of policy issues, with particular focus on further reforming and streamlining the Corps of Engineers process.

There are also likely to be increased bi-partisan and bi-cameral efforts to advance WIFIA legislation to provide low-cost, long-term financing for water infrastructure projects. Reports such as the American Water Works Association's *Buried No Longer* have increased attention on the fact that the nation's aging water infrastructure is nearing its replacement age en masse. Similarly, high profile national media reports are shining light on rapidly increasing water bills as communities address the demands of both aging water infrastructure as well as environmental compliance.

In the 112<sup>th</sup> Congress, Chairman Bob Gibbs (R-OH) of the House Water Resources and Environment Subcommittee held two hearings on innovative financing for water infrastructure and released draft WIFIA legislation. As the WIFIA program allows every \$1 in federal funding to leverage up to \$10 in low-interest loans, WIFIA legislation has been hailed as a highly cost-effective solution in a constrained budget environment and endorsed by the leading organizations representing water and wastewater utilities as well as the U.S. Conference of Mayors. Innovative financing titles were also included in a range of other bills discussed in the 112<sup>th</sup> Congress, including Ranking Member Tim Bishop's (D-NY) Water Quality Protection and Job Creation Act. In August, Senator Jeff Merkley (D-OR) announced his intention to move forward with WIFIA legislation.

The nation's port infrastructure will also be an important part of the agenda in the 113<sup>th</sup> Congress. In addition to potential deepening projects at Gulf of Mexico and East Coast ports, in response to the Panama Canal lock widening, continued focus on the use of the Harbor Maintenance Trust Fund (HMTF) can be expected. The current Fund pays for 100% of the Corps annual Operations and Maintenance (O&M) dredging, required at most ports to keep the channels at the authorized depth. However, the amount appropriated each year from the HMTF for the Corps O&M program



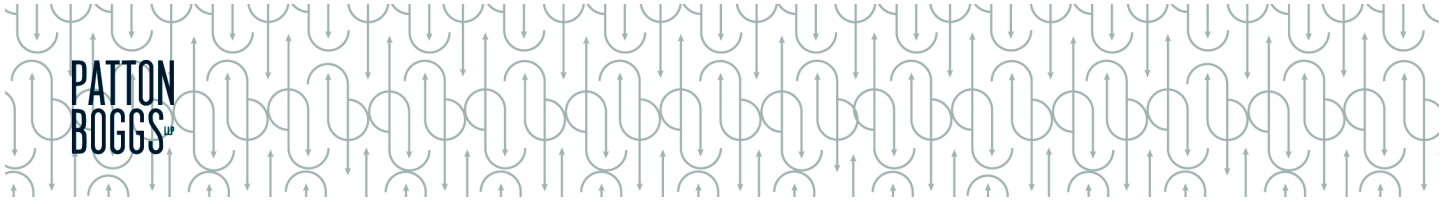
is significantly less than what is collected annually through the Harbor Maintenance Tax and placed into the Trust Fund. In 2011, for example, over \$1.5 billion was collected and placed in to the HMTF, but only \$826 million was expended. Legislation was introduced in the House and Senate last Congress which would have required that the amount expended each year for Corps O&M dredging be equal to the amount collected. Though the original concept was met with opposition by Leadership in the House and Senate, MAP-21 ultimately included language expressing the Sense of the Congress that all revenues collected through the HMTF be fully used for dredging and maintaining the nation's federal channels. The use of funds from the HMTF—as well as the way those funds are allocated among the nation's harbors—will again be a significant issue in the 113<sup>th</sup> Congress.

#### *Anticipated Agency and Committee Developments*

**Secretary of Transportation.** There remains considerable speculation about whether Secretary of Transportation Ray LaHood will stay on into President Obama's second term. Last year, Secretary LaHood was quoted in media reports as saying that he was not intending to stay on for a second term, but his recent statements have seemed to leave the door open. If Secretary LaHood steps down, other high-profile candidates being mentioned include Antonio Villaraigosa, the term-limited Mayor of Los Angeles who has made transportation a signature issue, and former Pennsylvania Governor Ed Rendell, who has long been a leading voice on infrastructure issues.

**Congressional Committees.** While there are many committees with jurisdiction over transportation and infrastructure programs and funding, the major program authorizing committees are House T&I; Senate EPW; Senate Commerce, Science and Transportation; and Senate Banking, Housing and Urban Affairs.

**House T&I Committee.** As noted above, Representative Bill Shuster (R-PA) is widely expected to become Chairman as Chairman John Mica (R-FL) is term limited. Term limits will also affect the current Subcommittee Chairs for the Aviation, Highways and Transit, and Coast Guard subcommittees, Representatives Tom Petri (R-WI), John Duncan (R-TN), and Frank LoBiondo (R-NJ), respectively. It is expected that they will swap and each move to take the helm of one of the other newly open Subcommittees.



**Senate EPW Committee.** Chairman Barbara Boxer (D-CA) will likely remain in control of the Senate EPW Committee, with jurisdiction over both highways and water infrastructure. (If Senator John Kerry (D-MA) were to become Secretary of State, Boxer would have the option of assuming the gavel of the Foreign Relations Committee.) Ranking Member Jim Inhofe (R-OK) faces term limits and is next in line to be Ranking Member of the Armed Services Committee, where Senator John McCain (R-AZ) also faces term limits. Senator David Vitter (R-LA) is likely to become Ranking Member.

**Senate Banking, Housing and Urban Affairs Committee.** Senator Tim Johnson (D-SD) is expected to remain Chairman of the committee with jurisdiction over transit. However, Ranking Member Richard Shelby (R-AL) also faces term limits. Senator Crapo (R-ID) is next in line. This would keep the Ranking Member seat in a relatively rural state, but would end a tenure that had Senator Shelby as the leading Republican force in shaping transit policy for both SAFETEA-LU and MAP-21.

**Senate Commerce Committee.** Senator Jay Rockefeller (D-WV) will remain the Chairman of the committee, which has jurisdiction over aviation and rail policy; and Senator Frank Lautenberg (D-NJ) will remain Chairman of the Surface Transportation Subcommittee. With Ranking Member Kay Bailey Hutchison's (R-TX) retirement, Senator Jim DeMint (R-SC) is expected to become the Ranking Member of the committee. Given Senator DeMint's standing as the most conservative member of the Senate (as ranked by *National Journal*), his assumption of the Ranking Member position is likely to have a significant impact on the aviation and rail policy debates in the 113<sup>th</sup> Congress.

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#### *Contact Information*

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