



**Michael Phelps's future looks to go swimmingly**

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**A flagpole builder hits new heights in Central Asia**

ON OTHER FRONTS | PAGE 32

## What's News—

Business & Finance

World-Wide

**The dollar's resurgence** could ease U.S. inflation and help curb commodity prices, but it also threatens to slow the U.S. export boom and add to earnings pressure on multinationals like GE. Friday, the dollar hit a six-month high against the euro and rose against the yen. **Pages 1, 21**

**A drop in commodity prices** is raising hopes that inflation is peaking in many parts of the developing world. **Page 1**

**Lehman Brothers** is likely to report another big quarterly loss, analysts say, raising the prospect it will need to raise additional capital. **Page 7**

**The sale of Reed Elsevier's** trade-magazine division enters a crucial phase, with the company's bankers asking bidders to submit second offers. **Page 6**

**Auto makers** are angling to carve out their own niches in fuel-efficient design with new offerings in the U.S. **Page 6**

**The recent steep rebound** by small-cap U.S. stocks belies fundamentals and shows why many are having a hard time picking market winners. **Page 19**

**U.S. Treasuries** are near levels they haven't breached for several months, but more gains will be hard to come by. **Page 21**

**Gold futures** have given up all their gains for this year, and silver has fallen harder as the dollar's advance has caught investors off guard. **Page 21**

**BHP** is likely to report strong earnings, but the miner still could face increased hurdles in its bid for rival Rio Tinto. **Page 6**

**Wachovia** is buying back as much as \$8.8 billion in auction-rate securities under a settlement with regulators. **Page 8**

**Apple** is working on a software fix for its new iPhone 3G to remedy dropped calls that users are experiencing. **Page 8**

**The Persian Gulf** is suffering its own credit crunch as demand from expanding businesses outstrips the supply of cash. **Page 22**

### Markets

MARKET	CLOSE	NET CHG	PCT CHG
DJIA	11659.90	+43.97	+0.38
Nasdaq	2452.52	-1.15	-0.05
DJ Stoxx 600	287.25	+1.34	+0.47
FTSE 100	5454.8	-42.6	-0.77
DAX	6446.02	+3.81	+0.06
CAC 40	4453.62	+32.71	+0.74
Euro	\$1.4695	-0.0202	-1.36
Nymex crude	\$113.77	-1.24	-1.08

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**Medvedev said** Russia will begin pulling troops out of Georgia Monday, under rising U.S. and European pressure, but he provided no firm deadline for the completion of any withdrawal. Moscow's occupying actions have sent a brutal message. Merkel said NATO could help with reconstruction once Russia withdraws. **Pages 1, 2, 3, 16, 17**

**Russia's war** in Georgia has become a source of support for big U.S. weapons programs that have had to battle for funding. **Page 3**

**Pakistan's ruling coalition** stepped up pressure on President Musharraf to resign, as his legal team prepared to challenge his impeachment. **Page 11**

**India's prime minister said** Friday the peace process with Pakistan was in danger of failing because of attacks like the bombing of its embassy in Afghanistan.

**Indian police arrested** the alleged leader and eight others in a group they say was behind blasts that killed over 50 people in Ahmedabad last month. **Page 11**

**Obama raised** over \$51 million last month, more than McCain's \$27 million, but he spent several million dollars more than he took in. **Page 9**

**Clashes in Afghanistan** killed 73 Taliban fighters and nine private security guards over the weekend, while a roadside blast killed 10 policemen, officials said.

**A suicide bomber** in Baghdad killed a deputy district leader of Sunni security volunteers who had turned against al Qaeda and six of his bodyguards.

**Israel's cabinet approved** the release of 200 Palestinian prisoners as a goodwill gesture to the Palestinian government of President Mahmoud Abbas.

**Southern African leaders** concluded their summit, but a key committee will continue talks on Zimbabwe's political crisis.

**Two bombs blamed** on Basque separatist group ETA exploded at resorts in southern Spain, but no injuries were reported.

**Iran test launched** Saturday a rocket it plans to use to carry a research satellite into orbit, state television reported.

### EDITORIAL & OPINION

**Keeping Russia out**  
What NATO foreign ministers can do to contain Moscow.  
**Page 15**

# Dollar revival reaps roses and thorns for investors

*U.S. stocks could rise on profits, mergers; commodities caution*

BY JEFF D. OPDYKE AND CRAIG KARMIN

Suddenly, it is all about the U.S. dollar. But it won't necessarily get any easier to make a buck.

After struggling for several years, the dollar is back in vogue. It has gained 8% against the euro in the past month. On Friday, the dollar rose again and now one euro equals \$1.4673. Last month, a euro

### The buck is back

Dollar's gains may quell inflation and curb U.S. export boom .....21

was worth \$1.60, and bullish analysts say a euro could be worth just \$1.40 by next summer. The dollar has rallied the same amount against the British pound and a bit less against the yen.

Behind the surge: slowing economies across Europe. Data released last week show the euro-zone economy contracted 0.2% in the second quarter, the first decline since before the euro's introduction in 1999. Falling oil prices have helped, too.  
*Please turn to page 31*

## Easing prices of commodities soften worries

A sharp drop in commodity prices is raising hopes that inflation is peaking in many parts of the developing world, especially in Asia, providing welcome relief for the fragile global economy.

Lofty prices for oil, food and other essentials remain a big challenge, especially for poor developing countries such as Haiti, Egypt and India, where earlier this year

By Patrick Barta in Bangkok and John Lyons in São Paulo

soaring costs triggered violent street protests, transport strikes and other unrest.

But recently, many of those prices have fallen significantly. Oil fell \$1.24 a barrel on Friday to close at \$113.77, 22% below its record price earlier this year. Rice, a staple for the developing world, is down about 40% since May, while palm oil, a source of cooking oil, is down a similar amount since peaking in March. Wheat, copper and a host of other commodities also have seen sizable drops.

With economic growth slowing across the world, including in China, and demand for raw materials eas-

*Please turn to page 31*



Guy Chazan/WSJ

A coastal guard car was hit during a Russian bombing raid targeting a large commercial port in Poti, a Georgian town on the Black Sea coast.

## As pressure rises, Russia to begin leaving Georgia

Under rising pressure from Europe and the U.S., Russian President Dmitry Medvedev Sunday said he will begin pulling his troops out of Georgia Monday but provided no firm deadline for the completion of any withdrawal.

But even if Russian forces now start to withdraw, Moscow's actions

By Guy Chazan in Poti, Georgia, and Marc Champion in Gori, Georgia

over the past week—occupying chunks of Georgia's territory, strangling its economy, cutting transport links and damaging key investment projects, while the authorities in Tbilisi stood by helplessly—have sent a brutal message.

"They want to show nothing is

safe here if it isn't under their control," said Georgian Economy Minister Yekaterina Sharashidze. "The goal is to create an economic and humanitarian disaster that will rebound on the government" and topple it.

Events in Poti, a Georgian town on the Black Sea coast, highlight the way Russia has used the conflict to draw a noose around Georgia's economy. Though hundreds of miles from the fighting in Georgia's separatist province of South Ossetia and clearly not a military asset, Poti's huge commercial port was targeted 10 days ago in a Russian bombing raid. The town itself has seen daily incursions by Russian troops who have looted stores, trashed offices and systematically destroyed military infrastructure, ac-

*Please turn to page 4*

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THE RUSSIA-GEORGIA CONFLICT

Ethnic Georgians endure Ossetian prison

Civilians are held amid martial law; 'we want to go home'

BY ANDREW OSBORN

TSKHINVALI, Georgia—Tamaz Barbikadze tip-toed out of South Ossetia's Interior Ministry Sunday flanked by three armed guards.



A man stands near a damaged building in South Ossetia's capital. With the Georgian assault crushed by Russian troops, ethnic Georgian villages have paid the price.

Mr. Barbikadze's crime: He is Georgian. In South Ossetia, Georgians are regarded with visceral hatred after Georgian tanks rolled into this tiny pro-Russian separatist republic fewer than two weeks ago.

Mr. Barbikadze, an engineer who says he once helped build a sports center in the city, said that he and about 150 other ethnic Georgians had been locked up in the squat Interior Ministry building since Aug. 8.

"We are not fighters, we are peaceful people," he said. "We want to go home."

The only time he and the other Georgians see natural light is when they are forced to help clean up Tskhinvali's dusty debris-strewn streets, he says.

South Ossetia's prosecutor general, Taimuraz Khugayev, put the number of Georgian civilian captives at 131. They have been locked up under martial law "for their own safety," he added.

said the plan is to exchange the Georgians for Ossetians whom the authorities here believe the Georgians are holding.

For centuries, Georgians and Ossetians have shared this mountainous region, often tensely. In the early 1990s, warfare broke out when Georgia tried to revoke the autonomy that South Ossetia had enjoyed under Soviet rule.

With the Georgian assault crushed by Russian troops, a string of ethnic Georgian villages between the Russian border in the north and Tskhinvali have paid the price.

A Wall Street Journal correspondent counted at least 200 roofless, burnt-out Georgian homes Sunday.

A cinema, pharmacy and commercial center all had their glass facades smashed. No movement could be discerned in the destroyed houses, and only a handful of civilians could be seen in what was once a bustling Georgian enclave.

Russian officials have said they see no way South Ossetia, along with nearby separatist region Abkhazia, could return to Georgia. Eduard Kokoity, the Russian-backed president of South Ossetia, told a Russian newspaper Friday that "we've practically leveled everything" in the Georgian villages.

Ossetian forces, he said, had created a "humanitarian corridor" for Georgians to escape.

Mr. Khugayev, the prosecutor, said an additional 40 Georgian civilians who lived in South Ossetian villages had been dispatched to Georgia

with a Russian military escort. He said the authorities also were holding nine Georgian prisoners of war.

Ossetian authorities refused to show reporters the conditions in which the civilian captives are being held in Tskhinvali. Instead, after much persuasion, they agreed to let Mr. Barbikadze speak with a pair of Western reporters for five minutes.

Mr. Barbikadze said the conditions in which he is being held are "normal." Yet his trousers were covered with grime and a strong smell of urine emanated from him.

Asked whether the Ossetians had beaten the Georgian prisoners, Mr. Barbikadze answered only for himself. "No, no, no," he said, glancing nervously at his guards.

Mr. Khugayev said that so far the Georgian authorities haven't responded to his efforts to broker a prisoner swap. "They have abandoned their citizens," he said.

Witnesses say they have seen Georgian prisoners clearing rubble and rubbish from the streets of Tskhinvali, which is now completely under the control of Russian forces.

Mr. Khugayev denied making the prisoners work. They had helped bury the bodies of Georgian soldiers the previous day, he said, but "nobody forced them to do this."

A guard at the Interior Ministry contradicted his account. The guard said Georgian prisoners had been out clearing the downtown area on Saturday and that some of them were now clearing other parts of the city. Mr. Barbikadze also confirmed that the prisoners were being put to work, saying younger Georgian prisoners had volunteered to help clear the city's streets of detritus because it was an opportunity to get out of

the crowded jail.

In his office in a crumbling, low-slung whitewashed building, Mr. Khugayev said he was investigating "war crimes" against Ossetian civilians committed by Georgian forces during the roughly 24 hours between their initial arrival and being forced out by Russian forces.

Mr. Khugayev, unshaven but dressed in a gray suit and wearing a large, shiny watch, said he had opened 200 criminal cases, having positively identified 200 civilian corpses. He gave the example of six young girls he said had been abducted and raped by Georgian forces in the village of Khetagurovo. He said that witnesses had seen them being forced into tanks on Aug. 8 and that they hadn't been seen again.

"We suspect that they gathered up the young and beautiful girls," he said. Prosecutors had found a car packed with "dozens" of shovels in a field outside the village. That, he said, suggested they were planning a mass burial.

"Georgia wants South Ossetia," he said. "But without the Ossetians."

CORRECTIONS & AMPLIFICATIONS

An article Thursday detailing a study critical of a temporary U.S. Securities and Exchange Commission order barring a certain type of short selling omitted a comment from the agency's spokesman.

INDEX TO BUSINESSES

This index of businesses mentioned in today's issue of The Wall Street Journal Europe is intended to include all significant references to companies. First reference to these companies appear in boldface type in all articles except those on page one and the editorial pages.

Table listing various companies and their page numbers, including Abercrombie & Fitch, Banco Santander, Adidas, etc.

INDEX TO PEOPLE

This index lists the names of businesspeople and government regulators who receive significant mention in today's Journal.

WSJ.com For more people in the news, visit CareerJournal.com/WhosNews

Table listing names of individuals and their page numbers, including Andriessen, Marc, Arslan, Bathuran, etc.

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## THE RUSSIA-GEORGIA CONFLICT

## Tales of killings emerge

*In occupied areas, a roadtrip reveals lawlessness, carnage*

BY YAROSLAV TROFIMOV

TKVIAMI, Georgia—As armored columns rumble by, the body of Shamil Okroporidze is rotting for the fifth day in his garden, just two steps off the main north-south highway that bisects this village deep in Russian-occupied Georgia.

Mr. Okroporidze, a middle-aged farmer, made the mistake of coming within sight of one such convoy. "They shot him just like that," said a neighbor, Ruisa Kapanadze, who emerged from her hideout on Sunday to guide a reporter through Tkviavi's deserted streets of torched houses and looted stores.

"I am scared, scared, scared," she kept muttering, nervously glancing around. It was only after realizing that the visitors were unarmed that more than a dozen other Tkviavi women came out, gathering to tell of many other bodies scattered throughout the village.

"There are only women left here," said Zoya Razmadze, 50 years old. "The men have gone into hiding in forests because they are being shot dead on sight."

The Russian-occupied part of Georgia includes many villages like Tkviavi, gutted by Russian-backed Ossetian militiamen and other irregulars who followed Russian tanks on their way south, driving away most of the area's ethnic Georgians.

Since then, relative order has been installed in Georgia's biggest Russian-occupied city, Gori, where about one-fifth of the prewar population has stayed behind. In that city, there is still running water and electricity. Russian soldiers are keeping looters away, are permitting the Georgian civil administration to function and are giving some access to in-

ternational humanitarian aid.

Not so in a large swath of Georgia proper between the city of Gori and the breakaway Russian-backed province of South Ossetia. These areas of the Russian-occupied zone, a roadtrip on Sunday showed, remain spooky, depopulated badlands. Here, shooting still erupts, and even Russian soldiers caution about the presence of roaming bands of marauders.

Russian troops manning a roadblock on the main highway north of Gori said they have orders not to let reporters across; villages like Tkviavi could be visited only after bypassing Russian checkpoints on an unpaved backroad.

In one of the first villages north of Gori, a hamlet named Garedzhvari, former policeman Valeriy Perishvili pointed at the carbonized carcass of the Greek-style mansion owned by his cousin. Ossetian irregulars, he said, came into the village on Friday, choosing the best homes as their targets. The Ossetian gunmen wore white armbands atop their camouflage uniforms.

After torching the house, the militiamen tried to steal the Volvo 960 sedan parked in the garage, but failed to jump-start the engine, he says. A reporter saw yanked-out ignition wiring, and counted 17 bullet holes through the windshield and the hood.

Across the road, books, clothes and medicines discarded by looters were piled up in the ransacked living room of 83-year-old Arsen Muradashvili, a retired agronomist. "Four men came up here, and knocked down the door with their rifle-butts," he said. The irregulars took away Mr. Muradashvili's stereo, bed sheeting and carpets, but didn't bother with his 10-year-old television set, he said. "I was forced to carry it all down to the courtyard for them myself."

Like most Georgian villages north of Gori, Garedzhvari has received no food supplies since the Russian takeover, residents say. Power

and phone lines are also cut off.

Signs of destruction became more frequent—and survivors harder to find—in the next village, Karaleti, which once housed some 3,000 people.

Umari Ninikashvili, a small, wrinkled 67-year-old man with missing teeth, cautiously trod on Karaleti's back street. A white armband of the kind worn by Ossetian militiamen was tied around his checkered shirt sleeve.

"The Russian soldiers told us that everyone who lives in our village must absolutely wear these armbands, for our own safety," he said.

Tzismani Aduashvili, 54, said she saw a neighbor shot dead by Ossetian militiamen on Friday. She also heard of at least two young Karaleti men taken away by these gunmen as prisoners. Russian troops, who kept a position in her orchard, didn't interfere, she said.

"The Russians themselves are not harming us—they just drive their tanks and trucks up and down the road," she said. Russian armored personnel carriers—transporting both regular troops and militiamen wearing white armbands—clogged the road from Karaleti to Tkviavi on Sunday afternoon.

On the roadsides, broken glass, twisted wires and unhinged doors marked what had been grocery stores. Not a single living being could be spotted on Tkviavi's main street. Deeper inside the village, the few women who came out of hiding to speak to a reporter recounted the killings they had witnessed.

Ms. Kapanadze said that, shortly after gunmen sprayed Mr. Okroporidze with automatic fire, they shot a young man who died in her arms. By then, most of the villagers had fled through the forests and mountains toward Georgia's capital, Tbilisi. One younger man helped her drag Mr. Okroporidze's cadaver inside the garden, and covered it with a rug before escaping himself.

"There are many other bodies in



In the Russian-occupied village of Karaleti, Russian soldiers told Umari Ninikashvili and other villagers to wear a white armband of the kind worn by Ossetian militiamen.

the village—all left to rot like garbage," says a local pharmacist who would only identify herself by her first name, Fatima.

A resident of Gori, Fatima fled with her daughter Diana to her mother's home in Tkviavi after Russian planes started bombing that city on Aug. 9. Once the Russians crushed Georgian defenses and the Georgian army began to pull back or surrender in following days, the bombing here stopped. Fatima says she assumed the war was over.

But, after venturing onto the main road, she came face to face with militiamen who followed Russian tanks into Tkviavi. Some of them were wearing ski masks. One started to shout "Kill her, kill her," as he pointed at Fatima his Kalashnikov assault rifle, she says.

"No, we only kill men," interrupted another militiaman, she says. At this moment, the gunmen spotted a group of Georgian youths down the road and opened fire in their direction.

"I know they hit some of them because I heard the screams of the wounded," Fatima said. Escaping amid this commotion, Fatima says she grabbed her daughter, a perky 9-year-old with a black pony tail, and headed for a small concrete

shed used to keep pigs.

"The gunmen go after the big, rich houses, so we chose the smallest, least conspicuous building," she says. They stayed there four days, occasionally raiding a nearby orchard for peaches and nuts.

This past weekend, they spent daylight hours hiding inside the village—but moved out to nearby orchards and forests after dark.

"At night we hear shooting, every night. You never know when they can come," explained 73-year-old Mediko Chikhladze. Fatima says she was particularly apprehensive because her daughter Diana was the only girl still left in the village. Clutching her possessions in a transparent plastic bag, Fatima asked for a ride out of the war zone for herself and Diana in a Wall Street Journal vehicle. Fatima's mother stayed behind—one reason why she asked her surname not to be used.

On the checkpoint-studded road to Tbilisi late Sunday afternoon, Fatima warily stared through the windshield, looking out for Russian troops. Whenever she noticed them, she pushed down Diana's head, trying to make her child invisible to the many men with guns.

## Fighting gives a lift to big-ticket U.S. weapons programs

BY AUGUST COLE

Russia's attack on Georgia has become an unexpected source of support for big U.S. weapons programs, including flashy fighter jets and high-tech destroyers, that have had to battle for funding this year because they appear obsolete for today's conflicts with insurgent opponents.

Defense Secretary Robert Gates has spent much of the year attempting to rein in some of the military's most expensive and ambitious weapons systems—like the \$143 million F-22 Raptor jet—because he thinks they are unsuitable for the lightly armed and hard-to-find militias, warlords and terrorist groups the U.S. faces in Iraq and Afghanistan. He has been opposed by an array of political interests and defense companies that want to preserve these multibillion-dollar programs and the jobs they create.

When Russia's invading forces choked roads into Georgia with columns of armored vehicles and struck targets from the air, it instantly bolstered the case being made by some that the Defense Department isn't taking the threat from Russia and China seriously enough. If the conflict in Georgia continues and intensifies, it could make it easier for defense compa-



Whether high-tech weapons like the Zumwalt class destroyer, left, and the F-22 Raptor, center, lose priority to lower-cost alternatives such as destroyers exemplified by USS Arleigh Burke, right, could depend on Georgia.

nies to ensure the long-term funding of their big-ticket items.

For example, the powerful chairman of the House Appropriations Defense Subcommittee, Pennsylvania Democrat Rep. John Murtha, quickly seized on the Russia situation last week, saying that it indicates the Russians see the toll that operations in Iraq and Afghanistan

are taking on the U.S. military.

"We've spent so many resources and so much attention on Iraq that we've lost sight of future threats down the road. The current conflict between Russia and Georgia is a perfect example," said Rep. Murtha during a recent visit to his district.

Some Wall Street stock analysts early on saw the invasion as reason to

make bullish calls on the defense sector. A report from JSA Research in Newport, R.I., last week called the invasion "a bell-ringer for defense stocks."

Mr. Gates himself said the new conflict will cause the U.S. to rethink its strategic relationship with Russia. At a briefing on Thursday, Mr. Gates said the U.S. has no intention of using force in Georgia, nor does it seek a re-

prise of the Cold War. He did make clear, however, that Russia appears to be punishing Georgia, which has flirted with North Atlantic Treaty Organization membership, for aligning itself with the West and is warning other former Soviet states.

Until now, Mr. Gates has been the central focus of a pitched battle over where the U.S. should spend its defense funds: on conventional weapons needed for traditional opponents or preparing to fight insurgent groups and terrorists.

At an event in Colorado this year, Mr. Gates complained that the military services have "too much of a tendency towards what might be called 'Next-War-itis'—the propensity of the defense establishment to be in favor of what might be needed in a future conflict." In response, he has led an effort to seek or consider reductions to a long list of programs that seemed geared toward the wars of the past.

The change in administration comes at a time of record profits and sales in the industry, reflecting historic highs in defense spending. Yet budget pressure is already undeniable.

Now, the Russian situation makes the debate over the equipping of the U.S. military a front-burner issue. "The threat always drives procurement," said a defense-industry official.

## THE RUSSIA-GEORGIA CONFLICT

## Poland missile-defense pact angers Moscow

*Talks with the U.S. accelerated following crisis in Georgia*

BY JAY SOLOMON

WASHINGTON—In a move that will further stoke U.S.-Russian tensions, President George W. Bush's administration and Poland reached an agreement to base American missile interceptors on the Central European country's soil.

The missile-defense pact, described Thursday by U.S. and Polish officials, includes Washington's commitment to deploy Patriot missile batteries in Poland. It goes beyond the North Atlantic Treaty Organization's "mutual-commitment" provisions to protect Warsaw from outside aggression.

U.S. Secretary of State Condoleezza Rice said on "Fox News Sunday" that that she will go to Poland this week to sign the deal after attending a NATO meeting in Belgium on Tuesday, Reuters reported.

A top Russian military officer said over the weekend that the agreement put Poland at risk of attack, perhaps with nuclear weapons. U.S. Defense Secretary Robert Gates dismissed the statement as "empty rhetoric," Reuters reported.

"Russia is not going to launch nuclear missiles at anybody," Mr. Gates said on ABC News's "This Week." "The Poles know that. We know it."

The U.S. for years has wanted to build a system aimed at knocking down a long-range missile from Iran or elsewhere. But Russia has long resisted the proposal as a threat to its own strategic deterrent. That the deal was hammered out so fast, after

months of negotiations, is a sign of how Russia's invasion of Georgia last week has unnerved its neighbors and unsettled the geopolitical picture.

Polish officials stressed the need for such security guarantees, according to U.S. officials. Russia's invasion of Georgia "pushed the Poles, to be very frank," said one U.S. official. "It sends a signal to Moscow that people are not going to be intimidated."

Moscow's action has unnerved the leaders of many former Soviet states and raised the call in Eastern Europe for greater cooperative defense against Russia's renewed regional ambitions. "We have crossed the Rubicon," Polish Prime Minister Donald Tusk told reporters in Warsaw Thursday, in describing the deal. "Poland wants to be in alliances where assistance comes in the very first hours of—knock on wood—any possible conflict."

The White House touted the deal, describing it as central to stability in Europe. "We believe that missile defense is a substantial contribution to NATO's collective security," presidential spokeswoman Dana Perino said.

The missile-defense pact raised immediate hackles in Russia, with some Russian lawmakers saying it could cause worse frictions than the Georgia dispute. Polish officials said that soon after the agreement's announcement Thursday, Russian Foreign Minister Sergei Lavrov canceled a visit to Warsaw scheduled for next month.

Konstantin Kosachev, chairman of the International Affairs Committee in Russia's Parliament, told the Interfax news agency that "the main target" of the missile-defense system would be Russia's nuclear deterrent, not possible threats from rogue states like Iran.

"It is this kind of agreement, not the differences between the U.S. and Russia over South Ossetia, which could lead to a real rise in the tension in Russian-American relations," he said.

In another spillover from the Georgian conflict, Ukraine Thursday announced Moscow would need to seek approval before moving its Black Sea Fleet in or out of the crucial Crimean port of Sevastopol.

Ukraine controls the port but allows Russia to use it as the fleet's home port under a 1997 agreement. Moscow dismissed the Ukrainian statements, saying that Russia's navy would come and go as it pleases.

Other former Soviet states have been rattled by Russia's actions. Estonia flew 50 military officers to Tbilisi on Thursday.

—Gregory L. White and Neil King Jr. contributed to this article.

## Russia plans to begin withdrawing troops from Georgia

*Continued from first page*  
cording to Georgian officials.

The Russian military intervention that began Aug. 8, after Georgia launched an assault on South Ossetia, has since broadened. The Russian military this weekend dug in tanks, armored personnel carriers and other equipment that fanned out into hills and villages in a cordon around South Ossetia, creating what amounts to an occupation zone.

"What is a fact is that they have been expanding geographically since [Saturday]. I think they will be trading with us on every inch of the territory they are militarily holding," said Kakha Lomaia, secretary of Georgia's National Security Council, speaking on a visit to the Russian-held city of Gori Sunday.

Russian officials deny targeting civilian infrastructure, saying their forces are working to secure weapons caches abandoned by retreating Georgian forces. But events on the ground cast doubt on that.

Western officials say their Russian counterparts have in private conversations demanded the removal of Georgia's pro-Western President Mikheil Saakashvili. Publicly, Russian officials deny they set such a goal but don't hide their dislike of the fiercely anti-Russian Mr. Saakashvili.

On Saturday, Georgian officials said Russian troops blew up an important bridge, cutting the east-west rail route that carries oil from Azerbaijan to Georgia's Black Sea port of Batumi. It is also the main route for bringing construction materials and container goods from the west to Tbilisi, the Georgian capital. Russia denied responsibility for the explosion, which collapsed a 45-meter section of the 220-meter bridge. A Russian column had advanced toward Tbilisi to just beyond the bridge Saturday before pulling back to its previous position.

Mr. Medvedev's pledge to withdraw troops came as Germany's Chancellor Angela Merkel visited Tbilisi on Sunday. In a speech, she said the North Atlantic Treaty Organization, the Western military alliance that the Georgian government seeks to join, could help with reconstruction and rebuilding Georgia's military once Russia withdraws—a key signal of support. Ms. Merkel blocked Georgia's bid to start NATO membership talks earlier this year, in part because of Russian pressure.

But a full reconstruction pro-

gram will likely require external aid on a massive scale. Georgian officials have only just started drawing up estimates for the cost of repairing damage inflicted by the Russian military. The final figure will be \$1 billion "at the very least," said First Deputy Minister of Economic Development Vakhtang Lejava.

Poti was first targeted Aug. 8, when Russian planes bombed the port area, which contains the headquarters of Georgia's coast guard as well as a naval base, killing 10 people and wounding 40. In the attack, some bombs fell on the adjacent commercial port as well.

"The Russians deliberately targeted commercial operations to inflict economic damage on Georgia," says Alan Middleton, the English head of Poti Sea Port Corp. "Dropping bombs on Poti port, killing people—I don't see how you can connect that with South Ossetia."

Meanwhile, about eight Russian ships of the Black Sea fleet, including a cruiser, also sailed down the coast and took up position just off Poti harbor, according to city officials. "They effectively blocked the port," said Merab Kabunia, head of the border-police unit of the Georgian coast guard. "It amounted to an economic blockade." The ships stayed for eight days, he said, obstructing tankers trying to reach the harbor. Russian officials said the ships were there to support the ground forces and ensure transit of humanitarian cargoes.

"The Russians want to show that they are lords of the Caucasus," Vano Saginadze, mayor of Poti, said Saturday, as funeral guests gathered outside his office to mourn port workers killed in the Russian aerial bombings of the port Aug. 8.

Poti is a key gateway for goods destined for Azerbaijan and Armenia as well as the landlocked nations of Central Asia. Tajikistan imports alumina powder through Poti and exports finished aluminum. Azerbaijan ships in cars and clinker for cement and exports scrap metal to Turkey, while Kazakhstan exports grain through the port. Armenia, unable for political reasons to trade through either Turkey or Azerbaijan, relies almost entirely on Georgia's railway system, which has a terminus in Poti.

But Poti's port isn't the only Georgian economic asset that has come under threat. Russian-backed rebels in the country's second break-

away region, Abkhazia, have moved south to grab a big hydroelectric power station near the Inguri river. Russian planes have also dropped bombs on the Heidelberg cement factory near Gori, and near the BP PLC-run Baku-Tbilisi-Ceyhan pipeline, which carries 800,000 barrels of oil a day to the Mediterranean, according to Georgia's government. Russia denies targeting them.

The Poti port is now back up and running after three days of disruption. But the war is already interrupting the flow of goods out of Poti to Georgia and its neighbors. "We have 60 trucks waiting—Georgian, Armenian, Azerbaijani," says Gocha Narsia, a Georgian driver sitting idly in the subtropical heat in Poti's container terminal. "The port is working, but we can't shift the cargoes. We'll just have to wait till the road opens."

Poti was built near the site of the ancient Greek colony of Phasis, and locals say it is the place where Jason and Argonauts landed in their search for the Golden Fleece. Long part of the Ottoman Empire, Russia conquered it in 1858 and built it up into a flourishing port and the terminus of the Caucasian Railway. In Soviet times it was a Soviet naval base.

The port went into steep decline in the 1990s, but its fortunes improved after Mr. Saakashvili was elected president in 2004. He planned to turn Poti into a free economic zone, and sought foreign backers. They came in the shape of the investment authority of Ras Al Khaimah, one of the United Arab Emirates, which in April this year bought a 51% stake in the port for \$80 million. For an additional \$4 million, it purchased 400 hectares of land for an industrial zone and port-expansion program.

The emirate pledged to spend more than \$200 million on tripling the port's capacity and creating a new Dubai on the Black Sea.

Those plans look doubtful after the Aug. 8 Russian attack.

Fragmentation bombs landed in one of the container berths, punching holes in concrete walls and narrowly missing a huge oil-storage tank holding thousands of tons of aviation spirit. A transformer house was hit, cutting off power to the port for 12 hours.

Two days later, about 700 Russian troops trundled into town in tanks and armored personnel carriers. Tengiz Khukhia, the town's dep-

uty mayor, approached the Russian commander, who told him they had orders to eliminate all Georgian military facilities in Poti. He also issued a warning. "He said if any of you touch a hair on any of my soldiers' heads, we'll flatten the whole town," says Mr. Khukhia. The commander couldn't be located for comment.

The Georgians won one small concession. The Russians said they had plans to destroy the Georgian coast guard stationed in Poti from the air. Mr. Khukhia persuaded them to blow it up on the ground, "so as not to frighten people." The twisted hulks of eight coast guard and navy launches now clutter Poti harbor, leaking gallons of diesel into the Black Sea. In Moscow last week, a Russian military spokesman said vessels of Russia's Black Sea Fleet fired at the coast-guard boats "in self-defense" when they attacked.

Russian troops also ransacked Poti's newly built coast-guard headquarters, smashing computers, overturning filing cabinets and throwing furniture out windows before setting fire to the building. One soldier took a potshot at a portrait of Mr. Saakashvili hanging on one of the walls, scattering shards of glass around the office.

They then proceeded to plunder a nearby military warehouse, say witnesses. Video filmed by reporters at Poti's TV station, Ninth Wave, show trucks with the insignia of the Russian peacekeeping force in Abkhazia pulling up in the port and loading up with stolen supplies—including American-made Rothco military boots and police batons, Georgian army uniforms and electricity generators. They also wheeled out inflatable dinghies and motor launches belonging to the Georgian navy, hooked them onto their trucks and drove them away, witnesses say.

Russian officials denied reports of looting, saying Russian forces were securing weapons and equipment abandoned by retreating Georgian troops. "The weapons and ordnance are registered, counted and sorted," said Anatoly Nogovitsyn, a spokesman for the Russian General Staff. "A decision on their future use will be taken later. Our task is to prevent these arms from spreading out of control across the Caucasus."

Over the next few days, the Russians deployed to all Poti's military installations, systematically destroying infrastructure and material and looting stores, officials say.

As panic spread throughout Poti, city authorities wondered whether they should leave the town and set up elsewhere. They discussed evacuating all women and children to nearby villages. In the end they sat tight, hoping the Russians would limit themselves to military targets.

"We told people, whatever you do, don't provoke the Russians," says Mr. Khukhia. "They were looking for any excuse to bomb the place."

In the early days of the Russian invasion, troops occupied a Georgian military base in Senaki—a showcase that had been Georgia's first military base built to NATO standards. Senaki, about 40 kilometers east of Poti, has since become the main base for Russian operations in western Georgia.

Those operations have penetrated deep into Georgian territory. Georgia's government said Russian planes had set off forest fires in a national park in the central area of Borjomi that blazed all weekend. Moscow denies the claim.

Also on Saturday, three Russian helicopters landed at Poti airport, and about 40 paratroopers streamed out and burst into the main administrative building, breaking down doors, rifling through documents and smashing safes, according to witnesses.

A similar assault was carried out on a small military base on the outskirts of Poti, where helicopters landed and blew up a radar installation. Soldiers also ransacked the base's warehouse. Their choice of booty surprised the Georgians. "They cleaned out a store we used for old clothes—used underwear, old socks," said a Georgian soldier at the base, who declined to give his name. "They also took a black-and-white TV set and some tins of motor oil."

The container terminals of Poti's commercial port are now functioning normally, but the trading relationships that underpin Poti's success are in peril. The only functioning road to Azerbaijan and Armenia via Georgia now is an unpaved dirt track through mountain passes and hilly farmland southwest of Tbilisi. It is impassable for big, articulated vehicles of the kind that normally ply their trade between Poti and points east. After the weekend bombing, all rail links are cut, too.

Mr. Middleton, who arrived in Georgia only in June, admits he has a tough job on his hands. "Being in a war zone wasn't part of the job description," he says.

## CORPORATE NEWS

## RECRUITERS

## Adecco weighs an offer for U.K.'s Michael Page



Adecco

SWITZERLAND'S Adecco SA, the world's largest recruiting company in terms of sales, Friday said it is still considering a bid for Michael Page International PLC despite the smaller U.K. recruiter's rebuttal of its £1.3 billion (\$2.43 billion) indicative offer. The rejection curtails the chances of a smooth deal and stalls the latest round of consolidation in the recruitment sector.

Michael Page asked Adecco to walk away if it isn't prepared to make a formal offer and asked the U.K. Takeover Panel to set a deadline. Michael Page said it stopped discussions with the Swiss company as it considers the current indicative valuation too low. —Goran Mijuk

## MASS TRANSIT

## Deutsche Bahn bids to run Stockholm's subway lines



Associated Press

GERMANY'S national railway, Deutsche Bahn AG, said it is bidding to operate the subway system in the Swedish capital, Stockholm.

Deutsche Bahn bid in Stockholm on Friday via its S-Bahn Berlin subsidiary, which operates commuter trains in the German capital, senior company official Hermann von der Schulenburg said.

If successful, Deutsche Bahn would start running the subway, or T-bana, at the end of 2009. Mr. Von der Schulenburg didn't give financial details of the bid.

A decision on the bidder to operate the subway, which has some 3,000 employees, is expected early next year, Deutsche Bahn said. —Associated Press

## HEDGE FUNDS

## Soros Fund Management takes bigger Lehman stake



Associated Press

BILLIONAIRE George Soros's hedge fund reported raising its stake in financial firm Lehman Brothers Holdings Inc. to 9.5 million shares as of June 30 from 10,000 shares at March 31.

In its quarterly holdings report filed Thursday with the U.S. Securities and Exchange Commission, Soros Fund Management LLC said the new reported stake in Lehman is valued at about \$187.7 million.

Based on Lehman's shares outstanding in its latest quarterly report, the fund's stake amounts to 1.4%. In New York Stock Exchange trading Friday, Lehman shares fell three cents to \$16.17.

—Bhattachipolu Murti

## Investors see opportunity in papermakers

## Companies revamp as stocks struggle; room to improve

BY GUSTAV SANDSTROM AND JOEL SHERWOOD

SHARES IN EUROPE'S paper companies have had a bad year, hit by credit downgrades, rising costs for energy and raw materials as well as a global oversupply of paper. But even with more challenges on the horizon, some investors are starting to see an opportunity because the shares are so cheap.

Europe's major forest, paper and packaging companies, including Finland's Stora Enso Oyj, UPM-Kymmene Oyj and Svenska Cellulosa AB of Sweden have been shedding staff and closing mills to adjust to a paper glut, which has brought down prices just as the companies' costs are rising. Furthermore, the companies have lost a major market in China, which, having ramped up its own paper production, has become a net exporter of paper itself. Meanwhile, growth in Europe, the

Nordic papermakers' most important market, has slowed, bringing demand for paper down with it.

"They (paper companies) are facing challenging times," said Timo Sallinen, a Finland-based fund manager at Varma Mutual Pension Insurance Co., which owns a 2% stake in Stora Enso, Europe's largest paper company by sales, and a 3% stake in third-largest UPM-Kymmene. "Capacity must come down; more closures, that's obvious."

In the past year, shareholders like Varma have seen the value of their investment in the paper sector dwindle. The Dow Jones Stoxx TMI Forestry & Paper index, a measure of the share performance of some of Europe's largest paper companies, has fallen 35% compared with a 21% drop in the Dow Jones Stoxx 50 index.

Still, the prospects for investors aren't necessarily bleak. Like any other European manufacturer, the paper companies have been suffering from the rising price of oil and the strength of the euro and should benefit as those trends reverse. The euro, having climbed more than 35% since the end of 2005, has fallen about 6.5% against the dollar since April. Meanwhile the price of oil has



dropped 21% from records in July.

All analysts agree that European paper companies have a long way to go before they recover a sound financial footing. But some are arguing that recent rises in the share prices could indicate that investors overreacted and sent the shares down too far. Some are saying the rises could even mark the start of a sustained recovery, so long as the companies

make good on pledges to cut capacity.

Stora Enso shares, which more than halved in value to €5.48 (\$8.04) in July from €11.98 in August last year, have surged 36% in the past month, closing Friday at €7.45 Friday. UPM shares have followed a similar pattern, falling 39% to €9.76 in July and have since rebounded 21% to €11.81 Friday. SCA Class B shares closed at 78.25 Swedish kronor (\$12.27) Friday, 16% higher than the stock's July low and the moves are leading some investors to predict that the rises mark a sustained turnaround.

Hans Thrane Nielsen, head of Norwegian investments at Norwegian insurance company Storebrand ASA, said paper stocks represent buying opportunities because the fall in share prices makes the sector attractive with good valuations.

Goldman Sachs Group upgraded ratings on Stora Enso and UPM shares to "neutral" from "sell" in July, noting the companies' low gearing and high cash returns would help them withstand tougher economic conditions in the future.

However, a weaker euro and drop in oil prices aren't enough on their own to restore profitability to the pa-

per industry. Increased competition from Asia as well as plans by Russia to increase tariffs on its wood exports could dilute the restructuring efforts and prolong volatile share movements. Merrill Lynch downgraded Stora Enso shares in June to "underperform" from "neutral," noting that the longer-term outlook for the European paper industry is very challenging. The bank said sustainable improvement is conditional upon long-anticipated restructuring in the industry, which it said isn't a certainty.

For its part, Stora Enso said in October it will close mills and cut its annual paper capacity of 16.5 million metric tons by 1.6 million tons. Also, the company last year agreed to a \$2.52 billion sale of its North American paper business and has signaled more restructuring will come.

Similarly, UPM-Kymmene will reach the end of a three-year plan next year resulting in a 10% cut in its capacity and the loss of around 3,600 of its 26,000 staff.

SCA is also in the midst of a restructuring program, cutting capacity at its sawmills and packaging and tissue units. In June it said it will close a U.K. containerboard mill by 2010.

## Pickens favors drilling 'every place' in U.S. for oil, gas

BY JEFFREY A. TRACHTENBERG

In his coming book, "The First Billion is the Hardest," oilman T. Boone Pickens provides a series of vignettes that he believes reflect key turning points—defeats and triumphs—in his business career.

Mr. Pickens, who today is the chief executive of BP Capital, a Dallas-based hedge fund, also has a message about the U.S.'s reliance on foreign oil. He wants the U.S. to cut back on imports and invest aggressively in renewable energy resources, particularly wind power. In May, his Mesa Power LLP placed a \$2 billion order for wind turbines.

The 80-year-old Mr. Pickens started out as a geologist at Phillips Petroleum. Before he quit in 1954, he was supporting his wife and two

children on \$500 a month, which he describes "as a pretty good salary" at the time. At the age of 26, he bought a station wagon and went into business as a consultant.

Two years later, he and several investors formed an oil company that evolved into Mesa Petroleum, which eventually became one of the largest independent oil companies in the U.S.

Excerpts from an interview:

**The Wall Street Journal:** BP Capital invests in the commodity markets. Do speculators play a constructive role?

**Mr. Pickens:** When you look at a commodities market you need hedg-

ers and speculators. If you don't have one, you don't have a market. That's how it works. I don't think speculators are destructive. They are an infinitesimal part of the market.

Fundamentals make the market. I'm amused when Congress tries to place the blame on somebody but never themselves. I've never heard any of them ever say, "I've made a mistake." I do. I say I called it wrong. But they just try to find somebody to blame.

**WSJ:** You've become a representative for renewable energy, which seems odd for an oilman. Did you have a conversion?

**Mr. Pickens:** It's not a conversion. It's a necessity to save the country.



T. Boone Pickens

have to import. I'm for anything American. I'm opposed to only one thing: foreign oil. Heck yes, drill. There is nothing wrong with drilling. We haven't had an oil spill in 20 years. If you don't like the appearance of rigs, don't look.

**WSJ:** How can the U.S. lower the amount of gasoline, and therefore imported oil, it uses?

**Mr. Pickens:** The answer is natural gas. We are so fortunate to have an abundance of natural gas. It's cleaner, cheaper, and it's ours. How could we ever have imported so much oil when we have so much natural gas? The answer is we didn't have leadership. We have 142,000 natural-gas-powered vehicles, mostly trucks. We sit here like dumb-dumbs. We have plenty of natural gas.

**WSJ:** What are your views on lifting the federal moratorium on offshore drilling for oil and gas?

**Mr. Pickens:** I'm for drilling every place. And I'm for nuclear, and I'm for ethanol, because it means another one million barrels we don't

## CORPORATE NEWS

# Carving out hybrid niche

Car makers travel own paths to design fuel-efficient models

BY MATTHEW DOLAN

Auto makers are angling to carve out their own niches in fuel-efficient design for the U.S. market, from expansion of the gasoline-electric hybrid technology already available in the Toyota Prius to the new plug-in hybrid vehicle known as the Volt under development by General Motors Corp.

Hot off its success with its Prius sedan, Toyota Motor Co. announced Friday that it would make hybrid engine systems available on all of its models by 2020.

Ford Motor Co., which has few hybrid options among its vehicles, plans to double its hybrid-vehicle lineup and production next year. And Honda Motor Co. said last week at an industry conference in Traverse City, Mich., that in 2009, it will import a new hybrid to compete directly against the Prius in the U.S. market—and at a lower price.

The Chevrolet Volt still is scheduled to go on sale in 2010, and its chief designer, Bob Boniface, gave the Center for Automotive Research's management briefings seminars an early look at the most recent styling changes adopted to create a sleeker front end and to extend its range on battery power through better aerodynamics.

The Volt will be able to go at least 40 miles on its lithium-ion battery, but the vehicle also will contain a



Toyota's new rechargeable Prius hybrid prototype being charged at one of Paris's charging stations.

small gas tank that would recharge the battery if necessary. Consumers would be able to recharge the vehicle at home using a conventional household outlet.

The auto industry has scrambled to meet shifting U.S. consumer demand toward small, fuel-efficient cars and away from trucks and sport-utility vehicles. Even though gasoline prices have recently retreated from above \$4 a gallon, most auto makers have said they consider the shift toward small cars to be more or less a permanent change in the overall mix of vehicles customers want. And the companies intend to build them.

Toyota and Ford have said they haven't been able to build enough hybrid vehicles to meet consumer demand. Though most auto makers are

assumed to lose money on hybrids, Toyota's Bob Carter, head of North American sales, said in an interview that his company makes a profit on its Prius hybrids, which recently exceeded sales of one million units globally.

In another sign of the shifting market demand away from trucks, Toyota confirmed last week that the Japanese auto maker abandoned its plans to resume pickup-truck production at its plant in Indiana this fall. Originally, the company planned to restart production of its Tundra pickup there in November after a suspension earlier this year. Production instead will be revived only at its Texas facility this fall, and the plant in Princeton, Ind., will take on production of the Sequoia and Highlander, which are both SUVs.

# Swatch net declines 9% on investment downturn

BY MARTIN GELNAR

>ZURICH—Swatch Group AG reported a 9% drop in first-half net profit as the downturn in financial markets hit its investment portfolio, but the company gave a bullish outlook for the second half.

On Friday, the watch and jewelry maker's shares rose 6.50 Swiss francs each to 257.75 Swiss francs (\$234.89).

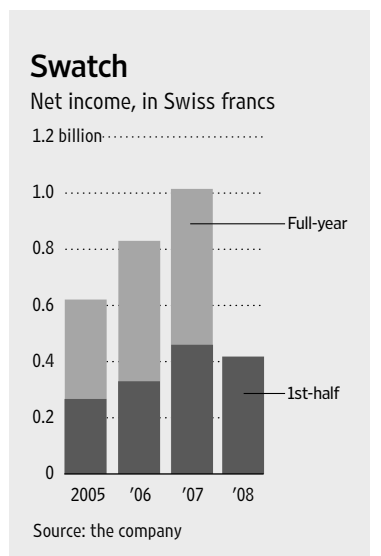
The world's largest watchmaker in terms of sales and the owner of brands such as Breguet and Omega said net fell to 416 million Swiss francs, from 457 million francs a year earlier, after a 120 million-franc write-down on its portfolio of stocks and bonds.

An estimated 47 million francs of the charge was tied to Swatch Group's 8% stake in Chinese retailer Xinyu Hengdeli Holdings Ltd., its single-biggest financial investment. Hengdeli stock lost around 30% of its value in the first half amid the market downturn.

First-half sales increased 8.6% to 2.82 billion Swiss francs from 2.6 billion francs and the operating margin rose to 21% from 19.6% in the year-earlier period.

Chief Executive Nick Hayek said he was optimistic about the second half, citing strong demand in July and August, favorable exchange rates and prospects for a stabilization of financial markets.

Swatch Group sales so far this month show a double-digit increase



measured in local currencies, Mr. Hayek said. He added the recent recovery in the dollar against the Swiss franc also improves prospects for the second half.

Swatch expects to continue to benefit from a higher profile in China, where Omega is an official sponsor of the Olympic Games, Mr. Hayek said.

Citigroup cited prospects for higher prestige-watch margins as one of Swatch's edges over its peers. Swatch Group last month acquired a stake in Dubai-based luxury-goods retailer Rivoli Group, which operates more than 245 retail outlets in Persian Gulf countries. Terms weren't disclosed.

# Bids sought for Reed Elsevier unit

BY DANA CIMILLUCA

The sale of Reed Elsevier's trade-magazine division will enter a crucial phase as early as Monday, with the company's bankers at UBS AG inviting bidders including Bain Capital LLC and McGraw-Hill Cos. to submit their second round of offers, people familiar with the matter say.

An initial round of bids for the Anglo-Dutch company's division, due Aug. 11, value it at between £1 billion and £1.25 billion (\$1.87 billion to \$2.33 billion), the people said. With many of the 12 or so bids clumped around the same level, a majority of the suitors will be asked to rebid in coming weeks in order to

whittle down the list further, the people said. A final round of offers will likely be due in early October.

The auction, dominated by private-equity firms, is being closely watched not only because the business includes well-known titles such as Variety, the Hollywood trade magazine, but for clues as to the health of the private-equity market, which has been ailing ever since the credit bubble popped last year.

The relatively large number of bidders bodes well for Reed's desire to sell the hundreds of titles in one batch. Still, one person briefed on the auction said the bidders have been given relatively little information so far. Other bidders include Providence

Equity Partners Inc. and Apollo Management LP, the people said. U.S. private-equity firms are the strongest contenders because they have a greater level of visibility into the U.S. portion of the business, which is known as Reed Business Information, one of the people said. RBI's revenue is split roughly evenly between the U.S., the U.K. and the rest of Europe.

Reed's chief executive, Sir Crispin Davis, has said the trade-publication unit is growing too slowly and is too reliant on advertising revenue.

Officials for the bidders declined to comment or couldn't be reached. Reed officials declined to comment.

—Aaron O. Patrick contributed to this article.

# Healthy BHP may still find Rio Tinto harder to acquire

BY ROBERT GUY MATTHEWS

On Monday, BHP Billiton, the world's largest miner, is expected to shatter its own earnings record for the fiscal year as it rakes in cash from historically high prices for petroleum, iron ore, copper and coal.

Its rival and acquisition target, Rio Tinto, is also expected to post very strong earnings when it reports on Aug. 26 because of high commodity prices. Unlike U.S. companies, which report earnings quarterly, the Melbourne, Australia-based BHP reports earnings every six months.

A strong earnings performance by both companies may actually work against BHP's proposed \$131.28 billion bid for Rio. Many investors own shares in both companies and may think a linkup isn't necessary since both are doing well on their own. Rio has rejected BHP's offer, saying the price is too low.

"Actually, this could put Rio a little further out of reach," said mining analyst Damien Hackett of Canaccord Adams. He noted that strong earnings for both companies puts Rio in a better position to demand more money from BHP, which is hoping to win regulatory approval in various countries by the beginning of 2009.

BHP's bid for Rio faces other hurdles. Earlier this month, Australia's competition regulator delayed its ruling on the proposed takeover, saying it needed more information from BHP. The U.S. has

already given preliminary approval, and the European regulators—the biggest hurdle in the proposed deal—aren't expected to rule until early next year. At issue is whether the combined company would control too much of the world's iron ore, a main ingredient in the making of steel, and result in yet higher prices.

On the earnings front, BHP is benefiting from higher iron-ore contract prices, which jumped more than 80% in April, and oil prices, which have fallen recently but remain high. BHP has oil and gas exploration and production operations in the U.S., U.K., Australia and elsewhere.

Last month, the miner said it had record production for several of its commodities, including iron ore, copper, manganese and alumina. That bodes well for the bottom line because the selling prices for many of its metals and minerals were at or near their peaks during the first six months of 2008. For example, prices of iron ore are about 70% higher than year-ago levels, while copper prices are 20% higher.

"Clearly, we will have record-breaking numbers from BHP," said Charles Cooper, a mining analyst for Evolution Securities.

BHP, Rio and other mining companies have been ramping up production to take advantage of increased industrial demand, particularly in China. China's industrial production rose about 16% in the first six months of 2008.

# Failing grade for ETS kills testing deal

BY DAVID ARMSTRONG

The U.S. testing company that administers the SAT exam has lost a big contract in England after it missed a deadline for scoring more than a million standardized tests for British schoolchildren.

The early termination of the British contract comes at a time when Educational Testing Service, of Princeton, N.J., has made international expansion a priority. The private testing and assessment company said the "dissolution of the contract was entirely mutual and agreeable." It made the announcement in a joint press release with Britain's Qualifications and Curriculum Au-

thority, the government agency overseeing the testing program.

The move comes just one year into what was to be a five-year deal valued at about \$291 million.

ETS won the contract to score the national curriculum tests in February 2007. The exams are given to 11- and 14-year-olds in England and cover three subject areas: English, science and math.

The test results were slated to be delivered to schools by July 8, but ETS didn't make the deadline. An ETS spokesman, Thomas Ewing, said that the company had graded about 90% of the exams, but that the government decided it didn't want to deliver partial results. Some schools

still haven't received the scores.

Mr. Ewing said 99% of the results for 11-year-olds have been delivered to the schools while 95% of the tests for the older students have been sent. He said he was prohibited by contract from discussing the reasons for the grading snafu. A government spokesman said the delays were caused by a combination of issues, including computer problems and a lack of support for graders who had questions on how to score the exams.

The botched exam scoring has prompted calls for the resignation of some education officials in England, as well as for government inquiries to determine what went wrong.

## CORPORATE NEWS

# Spacesuit pact in doubt

NASA seeks to end contract due to error in evaluating costs

BY J. LYNN LUNSFORD

Officials of the U.S. space program want to reopen the competition for next-generation spacesuits after determining they made a mistake in evaluating costs when choosing to unseat incumbent Hamilton Sundstrand last month and go with another company.

The move is an apparent effort to head off a similar decision by the U.S. Government Accountability Office, which was already considering a protest by Hamilton's parent, **United Technologies Corp.**, and its partner, **ILC Dover**. The GAO still must approve a recommendation by the National Aeronautics and Space Administration to partially reopen the competition.

NASA declined to discuss details but said that "a compliance issue" requires it to terminate its contract with winner **Oceaner** International Inc.

The Wall Street Journal, however, reviewed a letter in which NASA informed the GAO that NASA had failed to request a "cost-accounting standards disclosure statement" from Oceaner during its deliberations. "The agency must re-examine both offerors' cost proposals," the letter says. "To the extent that any irregularities are identified, appropriate re-evaluation must be made."

Hamilton and ILC Dover had been the sole suppliers of spacesuits since the Apollo missions in the 1960s and 1970s, making the signature white suits seen in the moon walks. While the contract isn't large in terms of dollars, providing the spacesuit has long been a point of pride.

Both United Technologies and ILC Dover protested NASA's decision to choose Oceaner, in part be-



NASA wants to reopen bidding for its **next-generation spacesuits**. Astronaut Ronald Garan Jr. during a June spacewalk on the International Space Station.

cause they disagreed with the way NASA evaluated costs. According to people familiar with the bids, NASA officials added \$300 million to the United Technologies team's cost estimates because they didn't believe the spacesuit maker's figures. NASA added roughly \$100 million to Oceaner's estimates, giving Oceaner an edge.

Friday, Hamilton Sundstrand—speaking on behalf of Exploration Systems & Technology, the joint venture it formed with ILC Dover—said it was concerned that NASA's proposal to reopen the competition in a limited way "may not provide any opportunity to correct the significant errors and deficiencies" that the team identified in its protest.

"It is surprising that NASA would allow our competitor to revise its proposal to cure a disqualifying legal deficiency, without affording EST—which was determined to be fully eligible for award of the contract—to address any lesser issues."

Officials at Oceaner didn't return a phone call seeking comment.

Challenges such as this have picked up as government contracts

have become more scarce, adding an incentive for companies to complain, especially when they feel they haven't been offered a full accounting of how the award was made.

United Technologies in recent months disputed the Pentagon's award of an Air Force search-and-rescue contract to **Boeing Co.**, forcing a new competition. And Boeing won a new contest after it protested the Air Force's decision to award a \$40 billion contract for aerial-refueling tankers to **Northrop Grumman Corp.** and **European Aeronautic Defence & Space Co.**, parent of Boeing rival Airbus.

The spacesuit contract is valued at an initial \$184 million for design and development through September 2014. Subsequent options to make a variety of the suits for use in orbit and on the moon could add roughly \$562 million to that total, stretching through 2018.

Oceaner teamed up with **David Clark Co.** to win the spacesuit competition. David Clark has a long history of providing equipment to NASA, including the orange pressure suits used by astronauts.

# American Airlines faces FAA fine of \$7.1 million

BY PAULO PRADA AND ANDY PASZTOR

The U.S. Federal Aviation Administration, proposing one of its biggest penalties ever, said it plans to fine AMR Corp.'s American Airlines \$7.1 million for allegedly violating employee drug- and alcohol-testing procedures and knowingly flying airplanes that broke maintenance regulations.

The fines, unrelated to the groundings of American jetliners earlier this year, are the latest in a series of clashes between airlines and the agency that oversees them. The latest problems aren't considered to have been serious threats to aviation safety, but they reflect persistent problems in supervising and documenting maintenance work.

The fine proposed Thursday covers four different enforcement actions by the agency. The largest portion of the fine, amounting to \$4.1 million, stems from allegations that American's mechanics failed to properly identify and fix certain problems with malfunctioning autopilots and other systems in December 2007. In the most serious instance, the airline used a McDonnell Doug-

las MD-80 aircraft on several flights with a malfunctioning autopilot.

The agency alleges that even after an FAA inspector alerted the airline about the problem, the airline used the plane to carry passengers on 10 more flights before it was taken out of service. In total, the FAA said American flew passengers on 58 flights in aircraft that weren't fit for service.

The FAA also alleged that American operated more than 320 flights in 2005 and 2006 without doing mandatory checks of emergency cabin-floor lighting at the proper times. The FAA also said that between 2005 and 2007 the airline failed to properly oversee drug tests for flight attendants and a smaller number of mechanics. In some cases, employees knew beforehand that they would be tested, the agency said.

In a statement, American said, "We do not agree with the FAA's findings and characterizations of American's action in these cases. We believe the proposed penalties are excessive." In line with FAA procedures, the airline said it would meet with agency officials to discuss the issues and proposed fines.



The reunion tour of the Police, a **Live Nation** production, took in \$360 million.

# Lehman faces another big loss

BY RANDALL SMITH AND SUSANNE CRAIG

Lehman Brothers Holdings Inc. has been taking its time as it wrestles with how to escape the problems haunting the investment bank. It probably can't wait much longer.

With the end of the New York company's fiscal third quarter less than two weeks away, some analysts are girding for a loss of \$1.8 billion or more, instead of the modest profit they previously expected. If the dour projections come true, Lehman's losses since the start of March would total at least \$4.5 billion—or more than the firm churned out in profit during fiscal 2007.

The likelihood of back-to-back quarterly losses, fueled by widely anticipated write-downs in a portfolio saddled with more than \$50 billion in risky real-estate and mortgage assets, puts even more pressure on Lehman Chairman and Chief Executive Richard S. Fuld Jr. to show the losses won't keep piling up. If they do, Lehman could need to raise additional capital beyond the \$6 billion it got in June. Lehman is considering pre-announcing its earnings this month, according to a

person familiar with the matter. If it does, it will give investors a window into any losses.

In the past few months, Lehman officials have examined an array of options to bolster the company's financial position, ranging from selling of troubled real-estate assets at a discount to divesting a piece of profitable asset-management unit Neuberger Berman, according to people familiar with the matter.

Another stock offering would be hard to pull off without angering existing shareholders, largely because the tidal wave of common shares floated in June has since plunged in value by 42%. On Friday, Lehman stock slipped three cents, or 0.2%, to \$16.17 in New York Stock Exchange composite trading at 4 p.m.

Lehman has been working hard to reduce its exposure to assets causing it big headaches, and the firm's balance sheet shrank 19% to \$639 billion in the fiscal second quarter ended May 31. Lehman is aiming to further winnow its exposure to risky assets by at least 20% per quarter, two Wall Street analysts said last week. But those moves aren't coming fast enough to offset the misery caused by continuing stress in the housing market, where prices

are falling with no end in sight. For example, Lehman holds \$10.2 billion of Alt-A mortgages, or loans made to borrowers who didn't fully document their income. The firm has an additional \$11.5 billion in exposure to leveraged-buyout financing.

David Trone, an analyst at Fox-Pitt, Kelton, predicts that Lehman will write down its Alt-A portfolio by about \$1.7 billion, or 17%, at the end of the current quarter.

J.P. Morgan Chase & Co.'s write-down of \$1.5 billion in Alt-A and other mortgages, disclosed in a securities filing last week, also prods Lehman to take its own haircut on home-loan exposure. Mortgage write-downs also might be triggered by price levels in sales related to the recent restructuring of structured investment vehicles such as Cheyne Finance PLC.

Mr. Trone expects Lehman to pile up overall write-downs of \$3.6 billion, offset by \$800 million in hedging gains. While that obviously would be painful, it is "not meaningful enough, in our view, to necessitate additional capital raises," Mr. Trone concluded. He expects Lehman to post a net loss of \$1.8 billion, far worse than his previous estimate of a \$250 million profit.

# For Ticketmaster, big client set to become big competitor

BY ETHAN SMITH

On Thursday, Ticketmaster, a division of Barry Diller's **IAC/InteractiveCorp**, begins trading as a standalone company—just as the ticketing giant faces one of its biggest challenges.

Ticketmaster's biggest client, **Live Nation Inc.**, plans to launch its own ticketing business in January, after their current 10-year contract expires. Live Nation concerts last year represented 14% of Ticketmaster's \$1.2 billion in revenue, and Live Nation has made no secret of its desire to compete with Ticketmaster for other clients in the future.

Among Live Nation's productions this year was the reunion tour by the Police, which took in \$360 million at the box office, according to trade magazine **Billboard**, making it the third-highest-grossing tour yet, behind tours by the Rolling Stones and U2.

Ticketmaster has spent more than a year preparing for the split from Live Nation, aggressively looking for ways to offset the effects of the lost revenue through acquisitions, inter-

national expansion and cost cutting.

Ticketmaster is one of four units being spun off by IAC in an attempt to jump-start the parent company's share price. Ticketmaster, of West Hollywood, Calif., last summer acquired Paciolan, which sells tickets to college sports events; in January it bought two big resale services, **TicketsNow Inc.** and **Get Me In Ltd.**

The company hopes this summer's Olympic Games will serve as a springboard to an expanded presence in China. Ticketmaster is part of a joint venture that has an exclusive contract to sell Olympics tickets, and is also a partner in **Emma Ticketmaster**, which stages concerts by Western acts in China.

The company hasn't offered analysts projections on earnings in China or other new markets including Germany, Turkey and Spain. Chief Financial Officer Brian Regan said in recent years, Ticketmaster's international business has grown faster than the company overall. International revenue has grown an average 30% a year, compared with 14% a year for the company as a whole, he said.

## CORPORATE NEWS

# Apple to correct problem of iPhone's dropped calls

Software fix coming for version of device released last month

BY NICK WINGFIELD  
AND AMOL SHARMA

Apple Inc. is working on a software fix for its new iPhone 3G to remedy dropped phone calls that some users are experiencing, according to people familiar with the matter.

The move by Apple could help address a chorus of online complaints from users who have said the device suffers from an unusually high number of phone calls that are dropped in mid-conversation.

A spokeswoman for Apple declined to comment. Michael Coe, a spokesman for AT&T Inc., Apple's wireless-carrier partner in the U.S., said the iPhone 3G, like all devices it carries, has varying performance based on factors like the proximity of the user to a cell tower and interference from buildings and trees. Mr. Coe wouldn't say whether the iPhone is more prone to dropped calls than other phones on the company's network.

Glitches are common for new entrants in the mobile-phone busi-

ness. But the effectiveness and speed with which Apple comes up with a solution for the dropped calls could affect the long-term success of the iPhone, an important growth market for the company.

"It's not about whether you have problems or don't have them," said Ken Dulaney, a mobile analyst at research firm Gartner Inc. "It's how quickly you address them that matters. If Apple addresses them, people will cut them slack."

New iPhone software aimed at addressing the problem is expected to be made available in the coming weeks to iPhone 3G users, who will be able to download and install it through Apple's iTunes Store.

Apple believes the problems are related to a chip inside the iPhone 3G made by Germany's Infineon Technologies AG, people familiar with the matter say. According to the preliminary findings of a dissection of the iPhone 3G by Gartner, Apple appears to be using a custom-made Infineon chip as the "base-band processor," a component that handles the connections between the device and cellular networks. Mr. Dulaney said that decision to use a custom chip, rather than a more standard part, could be related to the iPhone's dropped calls.

An Infineon spokeswoman didn't return calls for comment.

# Wachovia joins other banks in buying back securities

BY DAN FITZPATRICK

Wachovia Corp. is buying back as much as \$8.8 billion in illiquid auction-rate securities, but the decision should have minimal impact on the Charlotte, N.C., bank as it works its way through more-serious headaches relating to the U.S. mortgage rout, analysts said Friday.

Under an agreement between the U.S.'s fourth-largest bank by assets, the Securities and Exchange Commission, New York Attorney General Andrew Cuomo and the Missouri secretary of state, Wachovia Securities LLC and Wachovia Capital Markets LLC will buy back \$5.7 billion in auction-rate securities by Nov. 28, according to the SEC. The two units will buy an additional \$3.1 billion of the securities by next June, the SEC said.

A person close to the New York attorney general said the buyback numbers are estimates and that Mr. Cuomo's office expects the bank to purchase \$6.4 billion in November and a further \$2.1 billion in June. Wachovia, which neither admitted nor denied wrongdoing, also will pay \$50 million in civil penalties.

The announcement came a day after J.P. Morgan Chase & Co. and Morgan Stanley agreed to buy back more than \$7 billion in auction-rate securities as part of an agreement to end probes by regulators into how they

marketed the complex securities.

Mr. Cuomo said J.P. Morgan would pay \$25 million in civil penalties while \$35 million in penalties will be paid by Morgan Stanley. The penalties will be divided between New York, which will get about \$25 million, and members of the North American Securities Administrators Association, which is made up of state securities regulators.

Morgan Stanley had previously said it would buy back \$4.5 billion in auction-rate holdings from clients. In recent weeks, Citigroup Inc., UBS AG and Merrill Lynch & Co. announced plans to buy back billions of dollars of the securities.

In other developments:

■ Mr. Cuomo sent a letter Friday to Merrill Lynch & Co. indicating he intends to take legal action against the firm despite an offer from Merrill to buy back auction-rate holdings from individual, or retail, investors between Jan. 15, 2009, and Jan. 15, 2010.

Merrill's retail clients hold about \$12 billion in auction-rate securities, but the firm expects that number to drop to less than \$10 billion by January 2009 as a result of expected issuer redemptions. "We have been discussing this issue with New York and other regulators" and "we thought we were making progress," the company said.

■ Mr. Cuomo's office said it is investigating Fidelity Investments and Charles Schwab Corp. as part of his probe into the marketing and sales of auction-rate securities. Schwab is "cooperating with these requests," said Greg Gable, spokesman for the San Francisco mutual-fund company. Boston-based Fidelity declined to discuss communications with regulators.

—Chad Bray, Judith Burns and Jennifer Levitz contributed to this article.

## GLOBAL BUSINESS BRIEFS

## Harmony Gold Mining Co.

### Loss narrows amid sales rise and drop in production costs

Harmony Gold Mining Co., which has been selling off assets and cutting jobs since the departure of its chief executive a year ago, said its fourth-quarter loss narrowed. The Johannesburg company reported a net loss of 71 million rand (\$9 million) for the quarter ended June 30, compared with a 636 million rand loss a year earlier. An impairment charge of 316 million rand following the reassessment of certain assets, as well as higher taxes and the cost of job losses and restructuring efforts, hit the bottom line. Revenue rose 39% to 2.62 billion rand, although production fell 29%. Production costs dropped 12%; however, production improved 13% from the previous quarter, when power shortages forced South African miners to suspend operations for five days.

## Hennes & Mauritz AB

Sweden's Hennes & Mauritz AB reported a 15% rise in July sales, defying an economic slowdown as cost-conscious shoppers appeared to favor its moderately priced clothes. Europe's second-largest fashion retailer by revenue, behind Spain's Inditex SA, said sales from stores open longer than a year increased 3%. In June, sales in established stores dipped 2% as economic gloom weighed on the retail sector. The gains came despite recent downbeat news from Germany, H&M's biggest market, where total clothing sales were down 2% according to industry data—still better than the 11% slump in June. In Sweden, one of H&M's other key markets, July clothing sales fell 7.7%, according to the Swedish Trade Federation, compared with a 12.2% decline in June.

## GlaxoSmithKline PLC

GlaxoSmithKline PLC said results from a trial studying Advair for the treatment of chronic obstructive pulmonary disease, or COPD, suggest the asthma inhaler can slow progression of the disease, which accounts for more than three million deaths world-wide each year. This is the first time a treatment has been shown to slow the decline in lung function and progression of the disease, the drug maker said. The results showed using Advair can decrease the excess decline in lung function by more than 50%, compared with patients receiving a placebo. COPD is an umbrella term for lung diseases that inflame airways and obstruct breathing. Advair, also sold as Seretide, is the drug maker's top-selling product, reporting sales of €3.5 billion (\$5.1 billion) in 2007.

## UAL Corp.

Jake Brace, executive vice president and chief financial officer of United Airlines parent UAL Corp., will retire Nov. 1 after 25 years in the industry. He will be succeeded by Kathryn Mikells, who is United's vice president of investor relations. Mr. Brace, 50 years old, joined United in 1988 and became finance chief in 2001, just as the industry headed into a financial tailspin after the Sept. 11 terrorist attacks. He presided over UAL's three-year bankruptcy-court reorganization. Mr. Brace also was at the forefront of UAL's post-Chapter 11 strategy of finding a merger partner. But the industry's recurring financial pressures brought on by skyrocketing fuel prices caused UAL to instead settle on a plan to form a close marketing alliance with Continental Airlines Inc.

## Vodafone Group PLC

Vodafone Group PLC of London Sunday said it has completed the acquisition of a 70% stake in state-controlled fixed-line and mobile operator Ghana Telecom for \$900 million on a debt-free basis. Last week, the Ghanaian Parliament approved the sale, despite criticism from the opposition party, whose members believe the shares are undervalued and say the deal isn't in the national interest. Ghana Telecom is the leading fixed-line operator in Ghana, with a 17% share of the mobile market, which Vodafone intends to increase to 25%.

## Cadence Design Systems Inc.

Cadence Design Systems Inc. withdrew its \$1.49 billion proposal to acquire Mentor Graphics Corp. after being rebuffed by the rival semiconductor-design-software company's board and management. After the withdrawal, Mentor shares fell 26% to \$10.33 Friday. Cadence shares rose 6.7% to \$7.64. In June, Cadence offered \$16 a share for Mentor, a 30% premium over what the shares were trading at before the deal was announced. At the time, Cadence Chief Executive Michael Fister said the deal would allow greater integration of its product line, which focuses on initial steps in designing semiconductors, with Mentor's software, which specializes in steps associated with manufacturing. Mentor responded to the withdrawal saying that it was inconsistent with Cadence's recent communications with the company.

## Hershey Co.

Hershey Co. again raised wholesale prices, this time nearly 10%, to offset rising raw-material and fuel costs. The U.S. company also voiced some near-term pessimism. "Commodity costs have been volatile over the last several years and continue to remain at levels that are well above historical averages," said David J. West, president and chief executive. "Market prices for ingredients such as cocoa, corn sweeteners, sugar and peanuts are up 20% to 45% since the beginning of the year." Hedging strategies for 2009 will add \$10 million to \$12 million, or three cents a share, to its original estimate for a \$100 million increase in 2008 raw-material costs. Hershey expects 2008 earnings per share from operations to be at the low end of its forecast of \$1.85 to \$1.90. The company expects net sales growth of 3% to 4% for the year, with volume falling below expectations because of the price increases.

## Mrs. Fields Famous Brands LLC

Mrs. Fields Famous Brands LLC, which serves up fresh-baked cookies and TCBY frozen yogurt at more than 1,200 franchises across the U.S. and at 80 locations internationally, is planning to file for Chapter 11 bankruptcy protection, according to a U.S. Securities and Exchange Commission filing. The company was trying to negotiate a restructuring accord with senior noteholders but warned in June that it might have to seek protection from creditors if it couldn't complete the deal out of court. Mrs. Fields indicated it would file a prepackaged bankruptcy reorganization plan with the U.S. Bankruptcy Court in Wilmington, Del. The plan calls for noteholders to exchange \$195.7 million in notes for \$90 million in cash, \$50 million in new senior secured notes and 87.5% of new common stock. Noteholders are expected to recover 86.5% on their claims.

## J.C. Penney Co.

J.C. Penney Co. said second-quarter profit fell 36%, but the retailer's shares moved higher on cost controls and inventory management. Penney also gave a third-quarter earnings forecast that missed analysts' estimates as it expects back-to-school sales to be weaker than last year's and to occur later. Even so, the Plano, Texas, retailer's shares rose Friday. Net income fell to \$117 million, or 52 cents a share, in the three months ended Aug. 2, from \$182 million, or 81 cents, a year earlier. The company said last week that sales dropped 2.5% to \$4.28 billion in the quarter. Penney said it expected per-share profit to be 70 cents to 75 cents a share for the third quarter, with sales forecast to decline at a rate in the low single digits. It said it wasn't providing a full-year outlook because of economic uncertainty.

## Abercrombie & Fitch Co.

U.S. apparel chain Abercrombie & Fitch Co. said its fiscal second-quarter profit fell 4.2%, hurt by consumers cutting back on discretionary purchases, and it gave a weaker-than-expected full-year outlook. Abercrombie sales have been curtailed by a slowdown in mall traffic and by consumers who have curbed spending or turned to lower-cost rivals such as Aeropostale Inc., analysts said. Net income in the quarter ended Aug. 2 fell to \$77.8 million, or 87 cents a share, from \$81.3 million, or 88 cents, a year earlier. Sales rose 5.1% to \$845.8 million. Comparable-store sales dropped 4%. Abercrombie forecast full-year profit of between \$4.95 and \$5 a share, with the low end of the outlook reflecting a 7% decline in same-store sales.

## Hynix Semiconductor Inc.

Hynix Semiconductor Inc. will purchase a smaller-than-expected stake in rival ProMOS Technologies Inc. for 25% less than originally planned due to recent declines in the Taiwan company's share price. ProMOS Technologies said it will now sell 576 million shares at six New Taiwan dollars (19 U.S. cents) each to Hynix, down from 640 million shares at NT\$7.96 each that they agreed in mid-June. The transaction was approved by ProMOS's board Friday, ProMOS said. The transaction will be valued at NT\$3.46 billion (US\$110.3 million) based on the new terms, compared with NT\$5.09 billion previously. Hynix, the world's second-largest computer memory-chip maker by revenue after Samsung Electronics Co., will hold roughly an 8.6% stake in ProMOS after the transaction.

## Ping An Insurance (Group) Co.

Ping An Insurance (Group) Co. of China Ltd. said first-half net profit fell 2% from a year earlier after a drop in investment gains more than offset a rise in premiums. Net profit in the six months fell to 9.49 billion yuan (\$1.38 billion) from a revised 9.69 billion yuan a year earlier. The result was well above the average forecast of 8.3 billion yuan by analysts who had expected Ping An's earnings to be badly hit by declines in both the Hong Kong and China equities markets. Ping An's premiums rose 24% to 54.19 billion yuan. Net investment income fell 64% to 9.28 billion yuan. Ping An is 16.8%-owned by HSBC Holdings PLC and is China's second-largest life insurer by premiums after China Life Insurance Co. It also owns a 5% stake in Dutch financial company Fortis NV.

—Compiled from staff and wire service reports.

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## ECONOMY &amp; POLITICS

## LIECHTENSTEIN

## Banks aim to clamp down on tax dodges from abroad



Associated Press

LIECHTENSTEIN said its banks will do more to cooperate with other states after a German scandal over tax dodgers who parked their cash in the tiny principality. But Prince Alois von und zu Liechtenstein, left, the head of the tiny Alpine state, stopped short of giving details on the level of cooperation Liechtenstein would now offer countries such as Germany.

He said the days were long past when the principality could rely on its renowned banking secrecy for the success of its banking business.

Earlier this year, a German investigation forced the resignation of Deutsche Post Chief Executive Klaus Zumwinkel. —Reuters

## OPEC

## Economic slowdown could damp oil-demand growth



IndexOpen

THE Organization of Petroleum Exporting Countries warned that a global economic slowdown will lead to further weakening of oil-demand growth and highlighted the potential

for a sharp build in crude-oil inventories.

The current "contango" structure of the crude market, in which near-term futures contracts months are cheaper than delivery dates in the future, indicates current supply is more than sufficient and would further encourage stock building, the group said. It reiterated that demand for OPEC crude is expected to decrease by around 700,000 barrels a day next year. —Angela Henshall

## U.S.

## Manufacturing sector shows improvement



Fotosearch

THE U.S. manufacturing sector is showing signs of life even as consumers stay gloomy.

Industrial production increased 0.2% in July after rising a revised 0.4% in June, the Federal Reserve said. Manufacturing output rose 0.4%, driven by a 3.6% rise in motor-vehicle and parts production.

It isn't clear how much of the improvement in manufacturing production was due to temporary factors, like the end of a strike at an auto-parts maker. But the data suggest that exports continue to prop up an otherwise anemic American economy.

A separate survey showed that consumers are staying glum but are more hopeful about the future.

## Obama lays out tax plan

## Proposed higher levy on gains, dividends comes under fire

BY DEBORAH SOLOMON

DEMOCRATIC U.S. presidential contender Barack Obama sought to quiet critics by offering specifics about his tax plan, but his proposal to raise tax rates on investment income and expand payroll taxes is continuing to draw fire from some who say it will harm workers and the economy.

Sen. Obama outlined a plan Thursday to raise tax rates on capital gains and dividend income from 15% to 20% for individuals and families making more than \$200,000 and \$250,000, respectively. He also detailed a plan to levy payroll taxes on earnings above \$250,000 at a rate between 2% and 4%, though that increase wouldn't occur for at least a decade. Right now, payroll taxes, used to fund retirement benefits, are levied on income up to \$102,000.

Jason Furman, Sen. Obama's economic-policy director, said the plan would cut taxes to less than 18.2% of gross domestic product. "That's lower than the level of taxes when Ronald Reagan was president," he said.

The proposed rates are below the levels many had expected, given Sen. Obama's campaign rhetoric. Nonetheless, critics said the plan would exacerbate an economic slowdown and harm workers.

"The U.S. economy is in a weak state. We've got a credit crunch, high oil prices...this is not the time to be raising anybody's taxes," said John Taylor, a Stanford University economist who is advising Sen. Obama's rival, Republican Sen. John McCain.

"When the investment tax rate is higher it affects behavior because we see a retrenchment of companies paying dividends," said Bruce Josten, executive vice president of government affairs at the U.S. Chamber of Commerce.

Dividends and capital gains lure investors to participate in the stock market, and their investment provides capital for companies to use to expand their business. A reduction

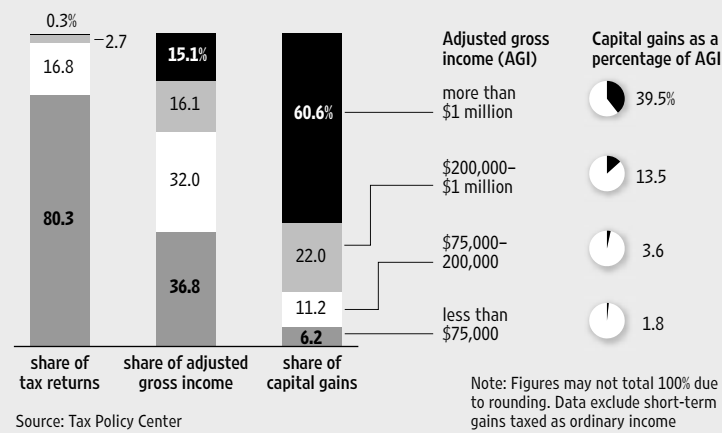
in that capital could hurt business and the U.S. economy, Mr. Josten said. He said the business community also is concerned that Sen. Obama's broader tax plan would remove more individuals from the income-tax rolls, a situation that could lead to future tax increases on wealthier Americans.

The Obama campaign called on former Clinton administration Treasury Secretary Lawrence Summers to defend Sen. Obama's plans. "At a time when the 10-year interest rate is in the three's, at a time when it is clearly lack of demand for products rather than the cost of capital that is inhibiting investment, the idea that a return to the tax policies of the 1990s would somehow damage the economy in a substantial way seems to me supported by neither theory nor evidence nor the longer-term history," Mr. Summers said.

The Securities Industry and Financial Markets Association, a trade group, criticized the proposed investment-income tax increases as dangerous. "The next occupant of the Oval Office is going to face some tough choices on fiscal policy, but

## Aiming high

High-income taxpayers account for the vast majority of reported capital gains in the U.S.



raising taxes on capital gains and dividends will only further endanger an already-weakening economy and punish the more than half of all American households that are invested in the stock market," said Travis Larson, a spokesman for the group.

Both Sens. Obama and McCain promise to cut taxes for the majority of Americans. Sen. Obama would skew his cuts toward lower- and middle-income groups and has said his plans could remove as many as 17 mil-

lion individuals from the income-tax rolls. He would roll back some of President George W. Bush's 2001 and 2003 tax cuts and raise taxes on families earning more than \$250,000. Sen. McCain's plan would benefit wealthier Americans because he has vowed to keep all of Mr. Bush's tax cuts in place.

The Obama campaign has said that repealing the Bush tax cuts would boost revenue by \$100 billion a year, including \$15 billion from higher capital-gains and dividend taxes.

## Obama raises nearly twice McCain's tally, but outlays soar

BY CHRISTOPHER COOPER

WASHINGTON—U.S. presidential hopeful Barack Obama beat John McCain in fundraising for July, but the Illinois Democrat appears to have needed every penny, because the expense of his large field operation ate up several million dollars more than he took in for the month.

The Obama campaign said over the weekend it raised more than \$51 million last month, typically a slow time for fund raising. Sen. McCain reported \$27 million in July donations.

While Sen. Obama's fund raising has smashed records—his campaign claims two million people have given a cumulative \$390 million to his campaign—the Illinois senator is spending at a record clip. The campaign said it



Barack Obama

ended the month with \$65.8 million in cash, about \$5 million less than it reported on hand June 30, excluding debt. That suggests the campaign's spending more than doubled month to month, to nearly \$56 million in July from \$25.7 million in June. Sen. McCain also spent more than he took in: He ended July with about \$4 million less on hand. But his monthly spending remained steady in July at about \$31 million.

The spending of the two offers a view of their strategies. Sen. McCain trails Sen. Obama in overall fund raising and is apparently shepherding his money, aiming to run a conventional campaign that will rely on a targeted television blitz. Sen. Obama, whose fortunes have ridden on getting new and irregular voters to the polls, has spent tens of mil-

lions of dollars on a ground organization manned by hundreds of staffers. This organization is concentrating on registering new voters. The campaign focus likely will shift to a voter-identification strategy, in which the campaign will attempt to guide these new registrants to the polls.

Neither campaign has released itemized expense figures for July. In early June, the Obama campaign unveiled a volunteer program that called on supporters to donate 30 hours of time a week, with the promise they would be put on the paid staff if they did this for six weeks. Some 3,500 people responded. Converting those volunteers to paid staff could account for much of the organization's ballooning expenses in July.

The other likely reason for the

Obama campaign's burgeoning expenses is the number of field offices it has opened. The campaign reports it has 131 such offices in five potential battleground states, compared to 13 reported by the McCain campaign. In Florida, for example, the Obama campaign lists 32 local offices, compared to three for Sen. McCain. In Missouri, the ratio is 29 to 1, while in New Mexico it stands at 23 to 1.

Democratic and Republican strategists differ on the wisdom of Sen. Obama's strategy. Scott Reed, who ran the presidential campaign of former Republican Sen. Bob Dole, said Sen. Obama's deficit spending in July should trouble him. "That's the first sign that they're going to have difficulties in the fall," he said. "Maintaining local offices is really expensive—and if

you have to close one, it can become a huge local news story."

But Joe Trippi, who ran campaigns for Democrats Howard Dean in 2004 and John Edwards this year said the ground presence could put Sen. Obama over the top. "Any political operative, Obama's included, will tell you that a big field operation is good for three or four points, and in a close state, that could be enough," he said.

The donor figures belie a more level playing field between the two. Sen. McCain has chosen to receive federal campaign funds, so his total independent fund raising is limited by federal rules. Come September, after the Republican nominating convention, he will be entitled to \$84.5 million in taxpayer money to bankroll his general election bid. Sen. Obama has opted out of public financing, and so won't receive any public money. But he isn't constrained by the program's spending limits.



John McCain

## ECONOMY &amp; POLITICS

# Partytime for U.S. parties

*Lawmakers, lobbyists to skirt ethics rules at convention fetes*

BY BRODY MULLINS  
AND ELIZABETH WILLIAMSON

WASHINGTON—When the Democratic Party holds its convention starting Aug. 25, members of the U.S. Congress will be able to hear singer Kanye West at an all-expenses paid party sponsored by the recording industry.

They can play in a poker tournament with actor Ben Affleck, courtesy of the poker industry. They can try to hit a home run at Coors Field, home of the Colorado Rockies professional baseball team, thanks to AT&T Corp. Free drinks and cigars will be on offer at a bash thrown by the liquor industry.

The corporate largesse is on tap despite new ethics laws and rules that both chambers of Congress adopted in 2007, aimed at weakening the links between lawmakers and lobbyists. Spearheaded by the Democratic Party, the ethics effort included an attempt to ban corporations and lobbyists from throwing lavish parties for members at the national political conventions.

But in the months since the new rules took effect, lawmakers have watered down the guidelines and, working with lobbyists, have found ways around the guidelines as written. Politicians and lobbyists are now preparing about 400 of the biggest parties—both at the Democratic gathering in Colorado and when Republicans convene the following week in Minnesota—that conventioners have ever seen.

“Despite a slight chilling effect, the types of events you can hold really hasn’t changed very much,” says Elliot Berke, a Washington campaign-finance and ethics lawyer. “It’s just a question of adhering to the new guidance.”

The ethics rules that legislators drafted for themselves in response to the law sought in principle to ban lawmakers and their staff from accepting gifts, meals, trips or tickets from lobbyists and from corporations that employ lobbyists. But they also included dozens of exceptions.

The rules don’t apply to charitable fundraisers. So lawmakers and aides are free to play in a poker tournament sponsored by the Poker Players Alliance. Funding for the event and charitable contributions come from the alliance and various other sponsors. Because proceeds will go to the Paralyzed Veterans of America, the poker lobby can pick up the tab for the event and attend along with about 200 poker celebrities, lawmakers, aides and delegates. Guests will be given \$5,000 worth of chips for the four-hour tournament, with the winnings going to the veterans group. A spokeswoman for the alliance says the event complies with the law.

Another popular party exemption is the so-called widely attended event clause. Under that rule, corporations can pick up the tab for parties if they meet two conditions. One is that at least 25 people invited aren’t members of Congress or staff. The second condition, which applies only to House members: The party must have some element that relates to official congressional business.

So when the Recording Industry Association of America decided to throw the Kanye West party, it teamed up with the One Campaign in



Despite ethics laws adopted by Congress in 2007, politicians and lobbyists will be hosting a slew of lavish parties at this year’s Democratic National Convention in Denver.

order to promote solutions to global AIDS and poverty. Literature on the topic will be available at the event and several speakers will address poverty relief before the concert.

“The truth is the ethics changes haven’t affected our parties very much,” said Jonathan Lamy, a spokesman for the trade association.

Likewise, when the Distilled Spirits Council throws the “Spirits of Denver,” party goers will hear a brief presentation on how to prevent underage drinking.

The council also is adapting to another new rule that forbids gifts for anything more than “nominal” value—a phrase interpreted as under \$10. (Under the old rules, anything worth up to \$50 was acceptable.) People who attend the spirits party will get the traditional gift bag with cigars from Rocky Patel Premium Cigar Co. But the cigars will be lower-grade than in previous years.

“We want to showcase our fine products and be 100% within the rules and the law,” says Frank Coleman, the spokesman for the distilled spirits industry.

Lawmakers and aides who attend the Republican convention will be treated to their own set of concerts and bashes. A conservative organization run by former Rep. Tom DeLay is throwing a concert with the rock band Smash Mouth. Mr. DeLay has made the event a fundraiser for his organization, the Coalition for a Conservative Majority, and thus aides say it complies with the law.

Parties like this weren’t supposed to happen at this year’s conventions. On the first day Democrats took control of Congress in 2007, they introduced legislation and new rules banning or forcing broader disclosure of a range of campaign contributions, travel, gifts and meals given to lawmakers by corporations and the lobbyists they employ.

House Speaker Nancy Pelosi of California called it the Democrats’ signal effort to “drain the swamp.” Breaking the ties between lobbyists and lawmakers was necessitated, Democratic lawmakers said, by a host of scandals under the Republican-run Congress.

Brendan Daly, a spokesman for Rep. Pelosi, said Congress made progress by banning parties at conventions in honor of specific members, but acknowledged that people have found ways around that rule. “If those parties prove to be a problem, then we can revisit it when we do the ethics rules next year.”

Tommy Vietor, a spokesman for

Democratic Sen. Barack Obama, said Sen. Obama wants to change the way the conventions are funded, but wasn’t able to do so this year “due to the very late end to the primary season.” The McCain campaign declined to comment.

The convention parties are the latest examples of how lawmakers and lobbyists have been finding ways to skirt such rules since they were passed. Faced with a ban on giving tickets to pricey charity events directly to lawmakers, corporations have in recent months been buying tickets at hundreds of dollars apiece, then donating them back to the sponsoring charity to give away—along with a list of lawmakers the companies wish to attend.

Corporations and trade groups say that they are paying strict attention to the letter of the new law. In preparation for the conventions, their lobbyists and lawyers have been presenting convention party plans to the House and Senate ethics committees, seeking an official nod on their legality. Lawmakers too have been seeking published guidance from their colleagues on those committees for acceptable convention-time behavior.

That guidance has so weakened Congress’s own curbs on convention parties that some ethics experts say the parties are potentially more lavish now than they were in 2004.

The new thicket of rules has “had the effect of making people more thoughtful and more careful,” says Robert L. Walker, a former chief counsel to both the House and Senate ethics committees and now an attorney with Wiley Rein LLP. “But at the end of the day, the application and interpretation of those rules...may allow a fairly significant amount of entertainment at most of these events.”

Take the new rules banning parties that honor a specific lawmaker. Ethics committees for the House and Senate have helped lobbyists and corporate sponsors by issuing loose interpretations of that rule for the conventions. Neither committee commented for this story.

The House is allowing corporations to fete a group of individuals—even if the group consists entirely of lawmakers. That will allow dozens of companies to throw a late-night “Blue Night in Denver” party for the 47 fiscally conservative House Democrats who belong to the Blue Dog Coalition.

“That is flatly absurd,” said Craig Holman, government-affairs lobbyist at Public Citizen, a nonpartisan government watchdog group. The Blue Dog Coalition couldn’t immediately be reached for comment.

# Some Democrats face challenge from the left

BY BRAD HAYNES

FACTORYVILLE, Pa.—In 2006, liberal and centrist Democrats put aside longstanding differences to support candidates across the political spectrum in pursuit of the party’s first congressional majority in 12 years. Now, as Democrats have grown confident about expanding that majority, old fissures are re-emerging as some left-leaning activists once again emphasize loyalty to their ideas over loyalty to the party.

One of the first big battlegrounds is in northeastern Pennsylvania, where liberal bloggers who boosted Rep. Chris Carney’s 2006 upset win over a four-term Republican incumbent have this year turned against the freshman Democrat, actively campaigning for his defeat in November. Upset by Mr. Carney’s advocacy of President George W. Bush’s domestic-surveillance legislation, his former supporters have attacked him with television, radio and newspaper ads as he faces a tough re-election fight against millionaire Republican Chris Hackett.

The narrator in one commercial blames the congressman for approving “the same un-American spying powers they have in Russia and Communist China.” A series of full-page newspaper ads accused him of having “sold out the Constitution for tens of thousands in campaign contributions.”

Mr. Carney is the most vulnerable target so far this year for online activists unified under the political action committee Blue America. But the organizers behind the attack call it a “template” for punishing the most “right-wing” Democrats in future elections and have raised half a million dollars for efforts of its kind.

Mr. Carney’s liberal detractors haven’t endorsed his Republican challenger but say they wouldn’t be bothered if the seat turned Republican once again.

“Our goal is to attach a real price to the type of things Chris Carney is doing. If that means he ends up losing, then so be it,” said Glenn Greenwald, a columnist at Salon magazine and one of the organizers behind the effort. “I would rather see a smaller majority but fewer Blue Dogs than a big majority with the Blue Dogs in charge.”

The Blue Dogs are a coalition of more fiscally and socially conservative Democrats who trace their roots to the party’s historical stronghold in the South. Mr. Carney is a member of the caucus, whose ranks have grown in recent years as Democrats have picked up seats in conservative bastions, making their 47 votes—out of 236 Democrats—a crucial swing bloc in the House.

But even as the newest round of self-proclaimed conservative Democrats works to expand the majority and the Blue Dogs’ role within it this November, they face party members openly calling for their defeat.

“We’re not just Democrats, we’re progressives. We’re not about getting the leadership of the Democratic party more power,” explains online activist Howie Klein of Blue America, which has raised more than \$1 million since he co-founded it in 2005. “Blue America is about better Democrats, not more Democrats.”

In northwestern Pennsylvania, where two-time Democratic challenger Steven Porter has launched an independent progressive bid against Republican Rep. Phil English, Blue America has endorsed Mr.

Porter rather than the Democratic nominee, Kathy Dahlkemper. Mr. Klein has praised the third-party run and helped Mr. Porter raise money despite Democratic concerns that a divided liberal vote will hurt the odds of a party pickup in a tight race.

In 2006, Mr. Carney “portrayed himself as a progressive to us,” says Mr. Klein, who now calls him a “master triangulator.”

Meanwhile, just as Blue America has rebuked Mr. Carney, he has backed away from the party’s liberal wing. “If the extremes on both sides are attacking me, I’m probably where I need to be,” he said, while shooting skeet at a campaign event in his sprawling rural district.

The first Democrat to represent his conservative-leaning district since 1961, the freshman representative has distanced himself from the 2006 support of liberal groups such as Blue America, MoveOn and the Brady gun-control campaign. Instead, he is courting prominent local Republican leaders and proudly pointing out that half of his staff is Republican.

“He doesn’t ask anybody about party affiliation,” said supporter Eric Grimes, who has served on his county’s Republican committee and voted for Ron Paul in the presidential primary this year. Wearing a “Sportsmen for Carney” hat, Mr. Grimes gestured toward the congressman and the dozens of National Rifle Association members gathered at the range, wearing the same orange hats. “He’s one of us.”

A lieutenant commander in the Navy Reserve with rural roots and a big family, Mr. Carney has put his conservative supporters at ease and is at home in his tiny town outside of Scranton, where he taught political science. “Between me, my wife Jen and our five kids, we make up about 10% of the population,” he said.

With his politics, too, Mr. Carney has blended with his surroundings. The first two positions he emphasizes on his campaign Web site are a defense of Second Amendment gun rights and a crackdown on illegal immigration. Mr. Carney rejects amnesty for unregistered aliens and supports English as the official national language.

When Mr. Carney joined 20 Blue Dogs this spring in pushing House leadership to approve domestic-surveillance legislation that protected telecommunications companies from prosecution, Blue America formed a fund to “get even” with Democrats like him. Mr. Carney said his firsthand experience with military intelligence convinced him of the importance of the domestic spying program.

Of the \$350,000 Blue America has raised, nearly \$100,000 went into ads against Mr. Carney in May. Mr. Greenwald expects to spend at least \$100,000 more in September and October, when the advertising will have maximum effect. This month, through a related group, Accountability Now, Mr. Greenwald and another blogger raised an additional \$150,000 for the cause.

Blue America has also spent \$30,000 on robocalls and ads against Majority Leader Steny Hoyer this year to try to “soften him up” for a 2010 challenger in his Maryland district. The group has spent thousands against Democratic Rep. John Barrow in Georgia as well but curtailed spending when internal polls showed Mr. Barrow was “not vulnerable enough.”