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The Party's Over (Page 2)

This skewed view of the market is probably best exemplified by the contrasting situation between planning for future nuclear power plants and exploring for uranium. U.S. utilities are in the process of applying for early site permits, spending likely tens of millions of dollars to do so. They are motivated to do so because such an investment will shave years off of the licensing process once they get around to actually ordering a plant. Yet, somewhere in a parallel universe, uranium producers are for the most part not exploring for uranium, their version of an early site permit. This does not bode well for the future.

That 1970s Show - What's going on now is reminiscent of what happened during the mid-1970s, when price exploded from $6 to over $40/pound, far overshooting the long-term cost of uranium. In the 1970s, production was forced to expand rapidly to meet reactor needs that were largely dictated by inflated requirements in enrichment contracts. At that time, utilities and intermediaries were shocked to find that the uranium they had been counting on was not available, or at least not available at prices they were expecting, and price was bid up dramatically. Today, the reactor requirements are real, and the need to expand production is just as real, if not more so. As we have pointed out before, around 200 million pounds must be supplied by the 2010 mark or shortly thereafter, and we are dealing with a production base of less than 100 million pounds today.

In the 1970s there was a tremendous response in production to higher prices and also the U.S. was relaxing its embargo on foreign uranium, further contributing to the supply response. If this is true, you might ask how things got so bad. One cause was the massive influx of inventories that depressed price to extremely low levels, causing a cut-back in production and exploration efforts. In effect, inventory holders sold at the cost of the cheapest mines, not noticing that they were driving out higher cost mines and preventing new investment. Another has been the stealth-like quality of demand, with reactor requirements increasing significantly without much of the way in new reactors coming on line (at least none in the U.S.). A third factor was the over-reliance on the spot price, using what is essentially an inventory-driven price as an indicator of the future scarcity of uranium. In practice, the market has failed in the sense that it is not generating enough supply to meet future demand. We are thus setting up for a repeat of the 1970's, when absolute scarcity caused prices to go sky-high, well above what would have been necessary if the proper signals were sent to the supply industry.

The recent market experience shows what happens when inventory either runs out or inventory sellers decide to stop selling, finally realizing that they are selling too cheap relative to long-run supply costs. Prices are bid up to higher and higher levels to induce remaining inventory holders to part with their remaining supply. At the same time, these prices have not stimulated any more production, and what expansion takes place over the next five to ten years will be modest at best. This is because the extended liquidation of inventories at too low prices has gone on so long that there are not enough uranium mining projects in the pipeline to replace the fire-sale inventory material when it runs out.

For those who think that this is just a

However, much of today's supply is inelastic with respect to price, meaning that it will take rather large increases in price to generate more supply. Uranium that is produced as a byproduct of copper and gold will depend more on the price movement of the primary commodities. Russia and the U.S. aren't going to decide to liberate more supply from weapons just because the uranium price increases. Regulatory requirements are stricter today, and thus it takes longer to get a project off the ground. Most of the trade restrictions on uranium have already been removed, so there is little to be gained by improving the trade situation.

transitory phenomenon, ask yourself the following question: What's going to happen to make the supply situation better the next year, the year after that, or the year after that? We have already seen the situation develop where spot bids are met with no offers or incomplete offers. How long is it until the same happens when a utility goes out for long-term contract bids?

When the price increases begins to elicit some production response, it will be too little, too late, as supply will fail to keep up with demand, and higher and higher prices will be required to pry inventories out of the hands of their holders, if there are indeed any left. Ultimately, say 10 years from now, the requisite amount of new production will come on line in response to much higher prices. But, in the meantime, prices are likely to overshoot substantially.

It is perhaps too extreme to say that the situation will become so dire that reactors will be shut down due to a lack of fuel or because uranium prices have been pushed too high that it will be uneconomical to run a reactor. In any case, turn out the lights, because the party's over.

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