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New Exotic Focus For Hedge Funds: Uranium Market

Speculators Drive Up Price, Irking Utilities; Adit Capital's Big Bet

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In a new type of nuclear-arms race, hedge funds and other institutional investors in search of higher returns are competing with energy companies to amass scarce fuel-grade uranium, hoping to profit from revived interest in nuclear power.

The intense quest for uranium by speculators has sparked a debate over private investors driving up the price and increasing the scarcity of the world's most sensitive natural resource.

Since investors first delved into the market two years ago, the price of processed uranium yellowcake powder -- the most commonly traded form of processed uranium -- has skyrocketed more than fourfold, from about $21 a pound, traders say. They say uranium prices climbed to $85 from $75 in February due to bidding for supplies offered by a tiny mining company in Corpus Christi, Texas, Mesteña Uranium LLC. The privately held company regularly includes hedge funds and other speculators in sales.

Uranium isn't traded on any exchanges. The somewhat infrequent sales of the commodity in the open market are private, so the price depends on the terms of any given transaction.

Financial investors aren't licensed to possess the radioactive mineral, which is subject to tight government controls aimed at keeping it out of the hands of terrorists and rogue states. Instead, several of those investors have secured access to ownership rights of material stored at licensed repositories in North America and Europe, exploiting legal channels previously used only by utilities and suppliers.

But even with only paper rights to the material, hedge funds are exacerbating what was already the biggest nuclear-fuel supply crunch in decades, according to utilities, miners and large traders. The market represents the latest corner in which hedge funds -- private partnerships that cater to wealthy investors and large institutions -- are seeking outsize returns, an increasingly challenging task as the number of funds multiplies.

Many funds say they are holding their uranium off the market because they expect the price to climb.

"They sweep the market clean. Every pound they can find," said nuclear-fuel broker Kevin Smith, who connects buyers and sellers of uranium for White Plains, N.Y., commodities-brokerage Evolution Markets.

Adit Capital, a small hedge fund in Portland, Ore., was an early uranium investor, buying millions of pounds for as little as $20 a pound beginning in December 2004, said Bob Mitchell, its founder.

It jumped into the uranium market after Mr. Mitchell noticed nuclear utilities allowing inventories to dwindle when the material was cheap, to avoid the cost of storing it. Meanwhile, some mining companies had been selling more future production than Mr. Mitchell figured they would be able to produce, and mines were closed when prices were depressed in the 1990s -- all evidence of a coming shortage.

QVT Financial LP, a $5 billion-plus New York hedge fund that was spun out of Deutsche Bank AG in 2003, won a big portion of a U.S. government stockpile of uranium gas at auction last August for $42.1 million, people familiar with the sale said. Uranium gas is refined from yellowcake as part of the multistep process that produces fuel for nuclear power plants. (Making weapons-grade uranium involves a much more complicated process.)

Two new publicly traded uranium investment funds are adding to the competition. The funds are similar to gold and silver exchange-traded funds, raising money from investors in initial public offerings of shares to buy uranium.

Unlike other fuels and metals, there is no futures market for uranium, but the mined supply is so scarce that some utilities now are striking deals to buy it on future dates at whatever the prevailing market price is on delivery, said Mr. Smith. It's a perilous bargain: The uranium market hasn't had a down week since June 2003, according to Ux Consulting Co., a Roswell, Ga., price-reporting service.

Production shortfalls at uranium mines around the world are helping drive up the price, says Jim Cornell, president of Connecticut nuclear-fuel trading firm NUKEM Inc. Production fell last year, in part because a flood this past October collapsed the underground infrastructure of Cameco Corp.'s Cigar Lake project, a major mine in Canada, soon before it was to begin production.

The investors' arrival has spurred questions about the economic viability of nuclear energy as an alternative to fossil fuels, including coal, that produce global-warming greenhouse gases. About a quarter of the cost of producing nuclear power goes toward uranium fuel, and prices are skyrocketing just as safety concerns over reactors are ebbing. Although uranium is abundant in the earth's crust, bulls see prices climbing to $200 a pound before supply can catch up to push them back down.

Currently, some of the fuel used in reactors comes from U.S. Department of Energy stockpiles and a program run for the U.S. government by USEC Inc., a publicly traded Bethesda, Md., energy company originally formed as a government corporation, to convert old Soviet warheads back into fuel. The rest comes from private mining companies and other suppliers.

When selling uranium, the Energy Department makes no distinction between financial investors and end users, so long as it's held in authorized storage facilities. Bidders must disclose their identity and the nature of their business.

The Nuclear Energy Institute in Washington, which represents utilities and fuel processors and producers, asked the Energy Department on Feb. 5 to exclude anyone but end users from federal auctions. In a letter, the institute asked the government to "protect utilities that cannot procure sufficient uranium in the open market."

Marvin Fertel, senior vice president of the NEI, said in an interview that investor stockpiling isn't in the industry's best interest: "All it does is take what's somewhat scarce and make it a little bit scarcer," he said.

Financial investors say they are just seizing on buying opportunities that the nuclear industry missed. Moreover, industry players say, high prices are encouraging hedge funds and others to invest in mining companies, which will help finance increased production and possibly drive down prices.

The NEI's Mr. Fertel conceded as much. In the long run, "I think we're going to end up with a much better situation than we even had before," he said.

The market began taking off about two years ago. In May 2005, several months after Adit entered the market, Uranium Participation Corp. raised about $80 million for a uranium investment fund via an initial public offering on the Toronto Stock Exchange, and has raised roughly twice as much since. Managed by executives of the Canadian mining concern Denison Mines Corp., UPC controls more than 6.8 million pounds of uranium yellowcake or gas. It says its average yellowcake acquisition cost was $31.75 a pound.

A similar fund, Nufcor Uranium Ltd., went public last July on the London Stock Exchange's AIM small-stock market and now controls 2.3 million pounds, the company says. Regulatory filings show that hedge funds invested in that IPO, including GLG Partners, Citadel Investment Group and QVT Financial LP.

Shares of both funds are trading at about 20% more than the current market price of their uranium, suggesting that investors see prices continuing to climb.

Ux says financial funds have purchased about 20 million pounds of yellowcake since entering the market in late 2004. That is roughly a fifth of the supply being mined each year. Such funds bought about 25% of the uranium sold on the spot market in 2005 and 2006. They are husbanding most of their supplies, having sold only two million pounds so far, Ux officials say.

Today, while the value of some funds' uranium has quadrupled, Cameco and other large miners are stuck with commitments to sell future production for a small fraction of today's prices. In the last three months of 2006, Cameco got an average of just $22.35 a pound for its uranium.

Tension over the issue was evident at a February energy conference in Houston. After John Rowe, nuclear-power producer **Exelon** Corp.'s chief executive, addressed the gathering, a man in a rainbow-hued jacket rushed up to introduce himself as a potential seller of uranium.

The man was Mitchell Dong, a Cambridge, Mass., entrepreneur who last September launched the Solios Uranium Fund, which recently reported having assets worth $46 million.

"I know who you are!" Mr. Rowe shot back with a laugh. "Are you the biggest villain in the energy industry?" Mr. Rowe later explained in an interview that he believes hedge funds are helping run up uranium's price.

Mr. Dong declined to discuss his fund's recent activities. He told a newsletter last fall that he expected demand to exceed supply for five years. "We're going to buy it, hold it, and when the price is right we'll liquidate a position," he said.

Indeed, eventually "the price of uranium will collapse," said Adit's Mr. Mitchell. "I don't know when, but the mining companies of the world will get their act together. The guts of the trade was getting into it before anybody even knew you could. But the art of the trade will be getting out before the price turns over."