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Keystone Pipeline: A Nuclear Ripple Effect

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NYMEX Products mentioned in this report:
CL Light Sweet Crude Oil (WTI)
UX Uranium
NG Natural Gas Henry Hub

Companies mentioned in this report:
Shell Oil (NYSE: RDS.A)
Cameco (NYSE: CCJ)
Uranerz Energy (AMEX: URZ)
Strathmore Minerals (TSX: STM.TO)
Paladin Energy (AU: PDN)
Uranium Resorces (NASDAQ: URRE)
Uranium Energy Co. (AMEX: UEC)
Ur-Energy (AMEX: URG)
Dension Mines (AMEX: DNN)
Crosshair Energy (AMEX: CXZ)

Executive Summary

So here we go again. The US is facing yet another major challenge relating to its energy future. Rather than face that challenge head on, it is kicking the proverbial can down the road to appease environmentalists. By delaying the TransCanada Keystone oil sands pipeline expansion for the next administration to deal with and not advancing drilling projects along the East and West Coast, President Obama is only fueling the dependence on foreign sources of oil for this country. Sure, Obama is cautiously offering more areas for offshore drilling in Alaska but last we checked Shell Oil won leases to drill off the northwest Alaskan shore in 2008 and has yet to produce a drop of oil since they have faced massive environmental opposition and an air pollution permit delay that is mindboggling.

The delay/demise of the Keystone deal will ultimately cause a ripple effect in energy prices across the spectrum. With crude oil once again flirting with $100/pbl again, Blue Phoenix Inc. (BPI) believes this country can’t afford to be
idle on an energy policy for much longer or the economic recovery we are all hoping for may get derailed before it gets here due to surging gasoline prices at the pump coupled with higher electricity costs.

Roughly 71% of today’s oil production is used for transportation, but higher prices of crude oil could greatly lower that figure, especially as electric vehicles (EV) become the more economical choice over the next few years. As such, President Obama’s decision to forego the Keystone pipeline conversation only solidifies our view that one million EVs on the road by 2015 will prove to be a conservative forecast. Does anyone remember what the last gasoline spike did for Toyota’s Prius sales? Electricity has to come from somewhere and higher demand for EVs due to lofty gasoline prices helps supports our view that uranium prices have bottomed and are on track for our 2012 forecast for $65/lb on the CME (24% higher than present levels). This also means the real investment return is with uranium futures and miners, not with offshore drillers or oil service names.

Background

If President Barack Obama delays approval of the $7 billion Keystone pipeline, the country could lose an opportunity to gain 700,000 barrels of oil a day from our friendly neighbors up north. To put this in perspective, the President is looking to pass on what arguably is the fastest growing supply of oil outside a group you may have heard about called OPEC. What’s more is the fact that if the US decides it wants to stall the project, supplies could be sent to Asia. This is a troubling development since Canada and their oil sands have historically been the safety blanket for US energy supply. So if the project is being shelved “for now” by the US, is the US “quietly” making a case that it will support nuclear power? Is it a coincidence the Keystone news comes in the same week the US says it is ok for Russia to join the World Trade Organization (WTO)? Is Obama again playing the nuclear card “quietly”? We have been very vocal in recent months that the 2013 HEU deal between the US and Russia is in jeopardy. So maybe saying Russia could join the WTO was an olive branch so they don’t look to send their uranium to Asia to get better margins.

We firmly believe nuclear power is still a very compelling space for the US to be in, even more with the recent Keystone pipeline development. After trading below $40 per lb last year and just under $50 per lb in May, uranium prices finally seem to have bottomed and currently fetch $52.50 on the CME. BPI believes uranium prices are very undervalued considering present supply and demand forecasts we are anticipating over the next decade. We have repeatedly told clients over the past 18 months that crude oil
prices could see $150pbl within a few years (see May 9, 2010, “Special Edition: The Outlook For Oil” which called for crude oil prices to reach $150pbl within three years).

Not having an energy policy that lowers our dependence on foreign sources of oil only further make our case for higher oil prices. Other drivers of oil longer-term are:

- Supply and Demand (Mexico’s Cantarell field drying up; less supply from Venezuelan and Russian wells; Saudis sending less oil to U.S. and more to China)
- Inflation (Oil is priced in $USD’s; global economies will reflate thanks to various stimulus endeavors; possible hyperinflation scenario in coming years)
- Large oil discoveries (ex. Tupi field) years away from development
- Geopolitical instability (ex. Middle East, Africa, Europe)
- E&P players will be more cautious with CAPEX in coming yrs
- Speculation
- Substitutes are still years away
- Global population rising

Now, it seems our view for $150/pbl crude oil is becoming more widely accepted. In fact, the International Energy Agency (IEA) recently stated (November 9, 2011), “If, between 2011 and 2015, investment in the Middle East and North Africa (MENA) region runs one-third lower than the $100 billion per year required, consumers could face a near-term rise in the oil price to $150/barrel.\(^1\)

It is our view that surging crude oil prices would have a ripple effect across the entire energy complex. If prices for energy are expected to soar as we are predicting (natural gas included), the US should be prudent in looking at ways to keep electricity costs down while embracing alternative energy such as nuclear power to complement use of natural gas as cleaner substitute for coal in electricity generation. The last thing this country needs is to worry about rising electricity costs when jobs are scarce and our domestic financial recovery is shaky.

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BPI is still concerned hydraulic fracturing (frac) technology does release harmful methane and in turn more CO₂ than expected (Exhibit 3). This erodes the allure of natural gas as “the” cleaner alternative energy of choice versus coal. We do believe this country should consider a basket of energy sources to offset the dominance of crude oil demand.

With 2012 Republican Presidential nominees pushing for a smaller Environmental Protection Agency (EPA) and expedited permitting process for tomorrow’s energy needs, this is something President Obama may have no choice but to support, since his lack of a national energy policy is a sore spot for many voters. This leaves nuclear (i.e. small modular reactors) as the most immediate source of satisfying our growing electricity needs domestically. Clean coal technology is still a tricky conversation and one that is not proven—therefore aging coal plants in the US must be re-evaluated and that process to overhaul them to meet new emissions standards seems like a mountain to climb. We believe money will be better spent on developing small nuclear reactors and making sure natural gas is truly viable and not releasing any contaminants such as methane into the atmosphere. Keep this in mind: The IEA said earlier this month, “For every $1 of investment in cleaner technology that is avoided in the power sector before 2020, an additional $4.30 would need to be spent after 2020 to compensate for the increased emissions.” So if we are truly determined to get our economy back on track and lower our nation’s emissions output, than nuclear energy would beat natural gas as the most viable alternative to crude oil today. For tomorrow, we firmly believe there should be a basket of energy sources for the country.
Investment Thesis

The expected surge in electricity demand through 2030 due to increasing global population and higher living standards make investing in electricity sources very attractive. With BPI forecasting soaring crude oil prices over through 2013, we believe it may make sense to refocus on the uranium space, a sector badly battered post Fukushima. For many miners needing uranium prices to be in the mid $65 range to be profitable, the time to be more efficient as well as to exploit synergies in the space is now (especially as some juniors struggle to raise capital for new projects). This means 2012 could very well be the rebound year for the nuclear space. Also, it is our view that margins for uranium players will expand strongly considering our expectations for uranium prices and the potential for shorter-range uranium supply contracts to outweigh long-term deals.

In a world that hasn’t had much to feel energized about economically, it is our view that uranium needs to remain a vital component to our energy independence since the golden age of uranium may still be in front of us. By not endorsing the TransCanada pipeline, that independence doesn’t have to be completely lost.
The universe of investments with the uranium space, companies are in vastly different stages of operations. Companies range from microcap exploration companies to $7.7 billion dollar bellwethers such as Cameco (NYSE: CCJ). When it comes to making the trade though, Blue Phoenix Inc. (BPI) believes that there will be particular opportunity in the pure play uranium companies with accelerating production into 2012. Two companies fit this description, Denison Mines Corp. (AMEX: DNN) and Uranium Energy Corp. (AMEX: UEC). Although we like these companies for the same reasons, it is important to notice the differences in scale and production lifecycle. This is reflected in the market caps of the companies.

Denison has very intriguing mining operations and the production capacity to process ore into yellowcake in strategic areas within the US and Canada. DNN has mature mining operations throughout the southwest US and although they do not offer estimates on in ground reserves, the mines have been in operation for decades and continue to produce.

The most important characteristic of the company is the fact that management is revving up production for 2012, which suggests that they share BPI’s forecast for increasing prices in the uranium market. Over the lull in uranium spot prices in the post Fukushima world, DNN has been stockpiling both yellowcake and unprocessed ore to reach a total combined inventory of nearly 1.7 million lbs U₃O₈ and DNN stated that in early 2012, mining should begin at Arizona I, a facility that could prove to have 10 – 15 million lbs of reserves.

The smoking gun for a successful DNN might be in Saskatchewan at Cigar Lake. This is a mill located adjacent to the CCJ mine at Cigar Lake. Although this facility is not currently operational, CCJ does have plans to bring the facility online. Cigar Lake has some of the most highly concentrated uranium deposits on the planet. The mill has the ability to process 18 million lbs of U₃O₈ per year. So it is our view, when uranium prices rise, DNN may stand to see some of the best growth in operating income in the space based on the discussion above.

Uranium Energy Corp is not as far along the exploration lifecycle, but they are worth mentioning as they also have some very interesting activity. UEC began ISR mining at their Palangana mine this year in SW Texas, and accumulated 153,000 lbs of U₃O₈. Like

DNN, UEC own processing facilities as well as mines. UEC plans on increasing mining capacity at Palagana as well as increasing exploration in the neighboring regions of
Texas. Unlike DNN, UEC does not have any revenue, as they stockpiled yellowcake waiting for better market conditions. The company is solvent now, but this could be an issue as soon as 2013 as expenses are projected to require additional financing by at that point. Despite this relative downside, the fact that they are in the beginning stages of active mining makes them more attractive than others in the pure play uranium space.

Any investor in the space should be aware of UEC’s activity in Paraguay. The company has tripled their acreage to 750,000 in 2011 and CEO Amir Adnani is highly optimistic about this venture.

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Disclosure: Blue Phoenix Inc. is a consultant to Strathmore Minerals and does seek to do business with companies covered in its research reports; John J. Licata owns options in Strathmore Minerals and common shares in Denison Mines.

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