



U.S. NUCLEAR REGULATORY COMMISSION

In the Matter of LOUISIANA ENERGY SERVICES, LP

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USEC – Heading Into the Perfect Storm?

A Public Policy White Paper

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USEC -- HEADING INTO THE "PERFECT STORM"?

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USEC Inc. is at a crossroad. It has the opportunity to be profitable, hold onto its market and build a new uranium enrichment plant, the American Centrifuge, that will assure its future and energy security for the nuclear power industry in the United States. PACE believes that USEC must cut dividends, pay down its debt and start saving to build a new plant in order to do that. USEC is also vulnerable to a "perfect storm" of events that can destroy any hope of profitability. These events can drive USEC to abandon production at the only remaining uranium enrichment plant in the U.S.; lose its market to imports from government controlled Russian and European producers; and force it to give up building a new plant.

If the storm hits, the U.S. government, and thus U.S. taxpayers, must either bail out USEC or take back production and control of uranium enrichment in the United States. The alternative is to become dependent on Russia and Europe for all of the uranium fuel necessary to generate 20% of this country's electricity. Most of the factors for success are in USEC's control, but it is currently dissipating cash and profits instead of paying down its debt and saving to build the new plant.

The Paper, Allied-Industrial, Chemical and Energy Workers International Union (PACE), which represents 1,172 workers at two USEC plants, believes that regulators and Congress have paid insufficient attention to this developing "perfect storm" and the continued missteps by USEC's board and managers. While USEC is a private corporation, the Company plays a unique and sensitive role in national security by being a major supplier of energy and an important cog in bringing about global nuclear disarmament. A failure of USEC will cause a crisis in American public policy. PACE offers this report as a "storm warning" to avert a potential national disaster by calling for greater government oversight. If Congress and regulators wait for USEC to be in the eye of the storm, it will be too late. Sound public policy should seek to steer around the pending storm rather than allow USEC to head directly into it.

Background on USEC

- USEC was created out of the uranium enrichment operations of the Department of Energy and was privatized by the government in 1998. USEC made an agreement with the U.S. Government in 2002 to maintain a reliable domestic source of nuclear fuel so U.S. utilities with nuclear power plants would not be totally dependent on fuel imports from foreign government-controlled enrichment plants in Russia and Europe.
- In accordance with the policy of the U.S. Government, USEC purchases low grade enriched uranium blended down from Russia's arsenal of decommissioned nuclear warheads and sells it for fuel to U.S. electric utilities. The sole purpose is to keep bomb-grade uranium out of the hands of terrorists or rogue nations. This program will run until 2013. These imports command half of U.S. utilities' annual nuclear fuel demand and are about half of USEC's supply. The other half comes mostly from USEC's operations at the plant in Paducah, KY but is threatened by more imports from Russia and Europe.

- The U.S. Government allows USEC to be the exclusive agent to obtain this uranium fuel from the Russians and approved a new USEC contract with the Russians in June 2002 that will assure USEC of a profit on this deal until 2013. In return USEC agreed to run the nation's only remaining enrichment plant at Paducah until 2010 and replace it with the new state-of-the-art plant.

USEC Finances – Profit and Debt Crunch

- USEC was created by an "insider takeover" instigated by its government managers, who issued \$1.425 billion in stock and borrowed \$500 million more to buy the enrichment business from the government in 1998. USEC's managers have spent almost \$450 million on dividends and buying back some of its stock. The stock is now worth only \$595 million, less than half of its value when first issued. USEC has not repaid any of its debt, and its credit rating is now at "speculative" or "junk bond" status. Profits have dropped steadily from \$152 million in 1999 to a loss of \$14.7 million by the end of 2002. Profits are projected to be \$9 to \$10 million in 2003. Profits will remain low for at least the next two years due to low-priced, long-term sales made in 1999 to 2002, and increased spending to accelerate the R&D on the new American Centrifuge project.
- USEC currently spends \$45 million per year on dividends (\$0.55/share), which is a 7.5% return on a share price of \$7.25. USEC spends \$36 million on interest on its \$500 million debt. USEC plans to spend \$150 million from earnings to complete R&D and run a pilot plant over the next four years. USEC must then have the financing in place by January 1, 2007 to build its new plant estimated to cost \$1.5 billion. USEC must get a joint venture equity partner or come up with 25% to 40% of that \$1.5 billion to finance it. That is on top of the \$500 million it already owes and at least \$350 million of that comes due in 2006 and the rest in 2009.
- Even with high dividends, there is no long-term value for shareholders of USEC unless it builds a competitive replacement plant as soon as possible. USEC has agreed with DOE to do that by 2010 as part of the quid pro quo to get control of the Russian imports and a profitable contract with the Russians. If USEC does not maintain operations at the Paducah plant and build the new plant on schedule, including having its financing in place by January 1, 2007, it stands to lose control of the Russian deal and its profits. That would be a disaster for USEC's shareholders, creditors and PACE workers at the Kentucky and Ohio plant sites.
- To meet its obligations under the DOE agreement, USEC must reduce its debt, improve its credit rating and increase savings by January 1, 2007. Based on its current financial statements, it cannot do that without reducing or eliminating dividend payments for at least the next three years. There is no other available source of funds to meet these financial objectives, absent a significant increase in the price of uranium fuel, which does not appear likely under current conditions. The risk of a drop in that price is greater, if imports increase and production at Paducah decreases. That risk is part of the "perfect storm".

Critical Elements of USEC Profitability

PACE issued a report in May 2003, based on USEC's 1st Quarter 2003 report, which questioned whether USEC's profitability is currently sufficient to attain its objectives. USEC's profits are too low, and its dividends and debt are too high. USEC's 2nd Quarter Report indicates no significant changes, except USEC's decision to accelerate its R&D effort and its application to the Nuclear Regulatory Commission (NRC) for the license to build a new plant.

Average Contract Selling Price per SWU – estimated at approx. \$99 for 2003.

USEC's sales contracts are typically for multiple years at a set price. As market prices change over time, the average price of delivered SWU under these long-term contracts may be more or less than current market prices. Following privatization in 1998, market prices declined from \$100/SWU to \$80/SWU in 1999-2001. USEC made long term contracts at these lower prices. Since then prices have risen to around \$105/SWU. (See comments below on the Trade Cases.) USEC inherited high priced, long-term contracts in 1998 averaging over \$110/SWU. Those higher priced contracts are now expiring and the lower priced contracts made in 1999-2001 make up a larger % of the average price of sales, which is declining as a result. This average sales price should bottom out in 2005 and start rising, assuming market prices stay around \$105.

Current Market Price per SWU – approx. \$105.

Current supply and demand are more or less stable, which allowed U.S. market prices to rise in 2002-2003. Prices have risen and stabilized because Russian imports are capped at 5.5 million SWU/year for the time being; USEC production at Paducah has been near 5 million SWU for the last year, and European imports have also stabilized between 2-3 million SWU per year as the result of trade cases on subsidies and dumping filed against European government-controlled producers by USEC and PACE in late 2001. USEC halted production at the Portsmouth, OH plant in June 2001, which reduced capacity and production costs.

Production Level at Paducah Gaseous Diffusion Plant (GDP)

Paducah is operating near 5 million SWU/year with capacity of 6 million. Current average production costs at Paducah are between \$100-\$105/SWU. That is about even with current market prices, but it exceeds USEC's average sales price to customers. It is critical for Paducah to stay at or near break even to allow USEC to become sufficiently profitable to finance construction of a new plant. If production drops to 3.5-4.0 million SWU annually, unit costs at Paducah increase to \$115-\$120/SWU. That loss at Paducah will reduce profits on the sale of the Russian SWU imports and sales of natural uranium inventory. Any increase in imports from Russia or Europe will also displace production at Paducah, increase unit costs, and reduce profits. Approximately 60% of the production cost at Paducah is the cost of electricity to run the plant. USEC currently has favorable contracts for electricity. USEC can cut back production and electricity purchases in Summer if electricity rates rise too much with Summer demand. Other fixed costs, including labor, remain the same, however, so unit costs go up.

Profitable Russian Contract Starting in 2003 to 2013

USEC, as exclusive agent for the U.S., negotiated a new, market-based contract with the Russians to purchase the blended-down warhead uranium at a substantial discount from a rolling three-year average of market prices. This virtually assures USEC of a profit from the purchase and resale of these Russian imports. USEC also has exclusive control of the sale of these imports in the U.S. Approval of this arrangement by DOE and the Administration in June 2002, was the quid pro quo USEC received in return for promising to maintain production at Paducah at no less than 3.5 million SWU/year and building a replacement centrifuge enrichment plant by 2010. USEC also got control of the DOE technology for that new plant. This quid pro quo on the Russian contract provides USEC with the opportunity to become sufficiently profitable to maintain Paducah operations and build the new plant. Conversely, if USEC fails to meet either of its obligations, it stands to lose the Russian deal, and any chance it has for viability or profitability.

Russian and European Trade Cases Continue to Control Imports of Low-Enriched Uranium Fuel

In 1991, one of the predecessor unions of PACE (the Oil, Chemical and Atomic Workers International Union (OCAW), joined in an unfair trade case against the former Soviet Union for dumping natural uranium and low-enriched uranium fuel (LEU) in the U.S. Following the collapse of the Soviet Union the cases were continued against Russia and some other countries. Only Russia had the capability to enrich uranium, both for utility fuel and nuclear bombs, and currently has a lot of excess capacity to make commercial fuel (LEU). That case was suspended in 1993 with an agreement by the Russians to limit its imports into the U.S. The quotas for LEU have expired and no new quotas have been granted. PACE and USEC have worked to maintain this agreement since USEC was privatized. The agreement expires in March 2004. Reviews by the U.S. Department of Commerce may delay that expiration for up to one year. If that agreement is not extended or renegotiated in a favorable way, Russia could once again flood the U.S. market with very cheap LEU fuel.

In December 2001, USEC filed antidumping and subsidy cases against European producers of LEU from France, UK, Germany and the Netherlands. PACE joined as a petitioner in that case as well. These producers were proven to have oversupplied the market at unfair prices and duties were imposed. These imports were increasing at the same time the Russian imports from the HEU Agreement were peaking. This was a major cause of the decline in SWU prices from 1999 through 2001.

The European producers and several of the largest U.S. utilities appealed these duties to the U.S. Court of International Trade (CIT) on the basis that the production of enriched uranium was a service, not manufacture of a product or good. If uranium enrichment is deemed a service, the trade laws would not apply and both the Europeans and the Russians would be free to import as much LEU as they could make into the U.S. That would doom the Paducah enrichment operations and prohibit the construction of any new enrichment plants in the U.S. The U.S. would then become totally dependent on these foreign suppliers for fuel for over 20% of U.S. electricity supplies.

CIT sent the cases back to the Commerce Department to provide a better explanation of the legal and factual basis on which Commerce determined that LEU was a manufactured good under the unfair trade laws. Commerce has done so and sent the cases back to the CIT for review. PACE and USEC are strongly supporting the arguments of Commerce at the CIT and believe that the Department will be sustained by CIT. The European producers and U.S. utilities may appeal that decision as well.

Muddle Through or Perfect Storm?

Muddle Through

USEC currently pays \$45 million in dividends per year and around \$36 million in interest on the \$500 million in debt, with no amortization. USEC guidance on earnings for 2003 is in the range of \$9 to \$11 million after accounting for increased expenditures on the R&D for the American Centrifuge project. PACE supports that additional spending on the centrifuge project, but net profits are still too low to reduce debt and save enough for equity to finance the \$1.5 billion cost of the new centrifuge plant. USEC intends to spend \$150 million on R&D between June 2002 and 2007. USEC will need another \$150 to \$450 million in equity to finance the \$1.5 billion cost of the new plant. Profits should increase somewhat after 2005 as low-priced SWU contracts are replaced by newer contracts that reflect the higher market prices of 2002-2003. USEC now has the opportunity to increase its profitability with the Russian agreement in hand and a new collective bargaining agreement with its PACE workers. That alone may not be enough to succeed.

USEC management has indicated it is considering various forms of partnership or joint ventures with other companies to help build the new plant. Public statements that equity could be as low as 10% or around \$150 million for construction would still be challenging for USEC to achieve under the current business plan. The current guidelines by NRC for licensing construction of a new plant are 30% equity and at least five years of contract commitments from customers to cover the costs of financing and operating the new plant. USEC has suggested different criteria for its plant, but that will not be resolved before next year when USEC files its application with NRC.

PACE continues to believe that USEC must do more to reduce debt and increase savings in order to meet its obligations to maintain operations at Paducah and build the new centrifuge plant within the time frame set out in the June 2002 Agreement with DOE. It appears that USEC will require some help, either from other companies or the Federal Government, if it continues on its current course. USEC can try to muddle through, but the outcome is uncertain. PACE believes USEC can either maintain operations at Paducah, or save enough to do R&D and build a new plant, but it will be difficult to do both under the current business plan.

The Perfect Storm

USEC must maintain operations at Paducah near 5.0 million SWU/year to break even based on average unit cost equaling the market price of SWU. Currently, each is approximately \$105/SWU. This will maximize profits from the Russian agreement and the sale of natural uranium inventory over the next few years. Those are the sole source of USEC's positive cash flow and profits.

In order to manage Paducah's costs, USEC must maintain favorable electricity rates to run the plant. If rates go up, Paducah does not break even. Also, if production levels at Paducah are cut back

from 4.5 to 5.0 million SWU/year to the 3.5 million SWU minimum, Paducah's average unit costs will rise to \$115 to \$120 per SWU, and Paducah cannot break even.

On the other side of the equation, SWU prices must stay in the \$105 range. That is a function of the level and price of imports. The Russian imports under the HEU Agreement are capped currently at 5.5 million SWU/year. Paducah production and imports from Europe currently fill the rest of U.S. demand. USEC sells around 3.0 million SWU per year to Asian and other overseas customers. Paducah production has to stay in the 4.5 to 5.0 million SWU range. If there is any significant increase in imports, they will displace and lower Paducah production.

If the trade cases against the European producers are not maintained, or the Suspension Agreement restricting Russian commercial LEU imports is not renewed by the end of 2004, imports of LEU could increase significantly. If the European producers and U.S. utilities convince the Courts that enrichment of uranium is a service rather than manufacture of a product, there will be no restraints on imports from Europe or Russia. In that event, SWU prices will drop and Paducah production will be displaced by the amount of the imports. That will increase unit costs at the same time SWU prices are dropping. USEC's losses on Paducah production could consume most of the profits on the Russian HEU Agreement.

Under the "perfect storm" scenario, USEC would be forced to halt operations at Paducah, and would be unable to finance construction of a new plant in the face of a flood of cheap imports. USEC would fail to meet its obligations under the MOA with DOE, and would probably lose control of the Russian HEU deal. Direct sales by the Russians would drive prices even lower.

The U.S. could maintain energy security for 20% of its electricity production then only if the government took back the Paducah plant operations or subsidized USEC's losses. There would still be virtually no incentive for investors to finance the new plant, and the U.S. government would most likely have to guarantee or underwrite that construction as well. While this is the worst case scenario, it can be triggered by an adverse outcome in either or both trade cases.

PACE International Union

PACE represents 320,000 workers in paper, chemical, oil, atomic energy, auto parts, grain milling and industrial materials industries. PACE is concerned about the ability of USEC Inc. to continue uranium enrichment operations at the only remaining enrichment plant in Paducah, KY and replace it with a new centrifuge plant at either the Portsmouth, OH enrichment site or the Paducah site by 2010. These are two primary issues for PACE workers at the two plant sites, and addressing these issues is actually required under a Memorandum of Agreement (MOA) with the Department of Energy (DOE) dated June 17, 2002. PACE Local 5-550 at Paducah and USEC have recently concluded a long-term labor agreement for eight years, which is intended to cover the remaining years of operation of the Paducah plant. This will provide a stable labor environment and costs that will allow USEC to focus on its future.

For further information, contact Phil Potter at (202) 626-0550 and see www.usec-watch.org.