An Escalating LNG Trade War?
U.S. Power and Gas Weekly

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Data Sources Used in This Publication
EIA
Department of Energy
Bloomberg

Restart to Trade Negotiations

When the Trump administration levied tariffs on Chinese imports two months ago, setting off a series of tit-for-tat retaliations, a rapid end to hostilities seemed unlikely. However, the United States and China have now agreed to lower-level negotiations, injecting hope that the gap between the two sides can be bridged. These exploratory negotiations at the end of August will be held at the undersecretary/vice minister level. The talks come before expected enforcement of U.S. tariffs on an additional $200 billion of Chinese goods and follow additional Chinese threats at the beginning of August to apply new tariffs on $60 billion worth of U.S. products, including liquefied natural gas. This analysis looks at the impact of tariffs on LNG for U.S. export projects and Chinese imports of natural gas.

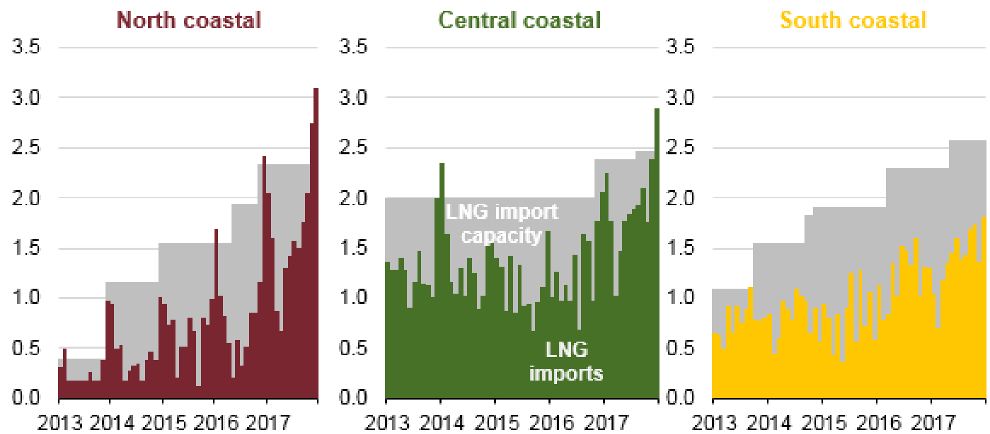
LNG in China

In 2017, China unseated South Korea as the second-largest importer of LNG, at around 5 billion cubic feet per day. According to the Energy Information Administration, Chinese LNG imports in 2017 grew by 1.6 bcf/d, a 46% increase year over year. This growth in natural gas demand can be attributed to two domestic changes. The first concerns stricter government regulations around air pollution encouraging a rapid transition from coal to natural gas-fired electricity generation. The second is government efforts to convert the residential sector from coal to natural gas-generated heat. Chinese demand for natural gas is expected to continue growing as the coal to gas transition progresses.

Chinese natural gas supply relies on a combination of domestic production and imports. Domestic production accounts for roughly 60% of the nation's supply, with pipeline imports from Central Asia and LNG representing the other 40%. Natural gas shortages in Northern China this past winter highlighted the limitations of the country's natural gas infrastructure, and overall LNG increased to represent more than half of the country's natural gas imports in 2017. As demand for natural gas grows, imports as well as domestic production are likely to increase.

China has 20 LNG import terminals with a capacity of a little over 8 bcf/d along its eastern coastline. In past years, capacity utilization at these facilities remained low (Exhibit 1). This past winter, however, utilization skyrocketed on colder temperatures in the north, leading to higher utilizations in the northern and central coastal regions. Along with the growth in natural gas demand, China's LNG import capacity is expected to grow to 11.2 Bcf/d by 2021. According to the EIA, this includes terminal expansions and new terminals under construction. As China's demand for natural gas increases, LNG will play an increasingly important role in meeting the country's needs.

Exhibit 1 Chinese LNG Imports and Import Capacity by Region (bcf/d)

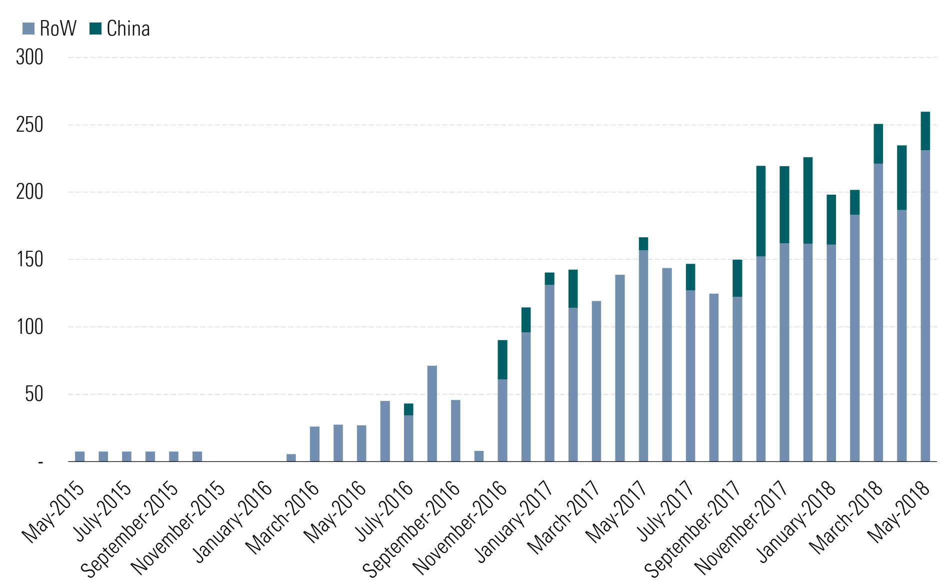


Source: EIA

U.S. LNG Exports to China

In 2017, China was the third-largest importer of U.S. LNG, taking around 283 million cubic feet per day, which represented roughly 15% of U.S. LNG exports (Exhibit 2). According to the U.S. Department of Energy, 2018 exports (January-May) to China are on pace to exceed levels seen last year, currently sitting around 391 mmcf/d, a 38% increase. U.S. LNG accounts for roughly 5% of China's LNG imports and represents one of the most promising destinations for U.S. natural gas. The fact that Chinese demand for natural gas is set to grow at a time when U.S. export capacity is expanding rapidly highlights the potential for deeper economic ties between the two countries. The current trade tensions make this difficult if neither side intends to de-escalate them.

Exhibit 2 U.S. LNG Exports (mmcf/d)



Source: U.S. Department of Energy

Next Chapter of the Trade War

In an ever-escalating trade war between the world's two largest economies, no product is immune from potential tariffs. If China imposes a 25% import tariff on U.S. LNG, its appetite for LNG is unlikely to change, but the impact on U.S. producers and exporters will be more direct. This threat comes at a time when the Trump administration has stated its commitment to prioritize and fast-track the government approval process for fossil-related projects including LNG export terminals. At the moment, 8 bcf/d of export capacity is under construction with in-service dates starting in 2019, and another 7 bcf/d of projects are approved but waiting to put steel in the ground.

In February, Cheniere signed the first long-term supply contract with a Chinese entity, a 25-year deal with China National Petroleum Corp. This deal begins delivery in 2023 and facilitated the final investment decision for a new production train at Corpus Christi. Several other approved LNG terminal projects waiting for final investment decisions require long-term contracts similar to those signed between Cheniere and CNPC. A more aggressive stance on trade increases the risk that these projects will see delays. In a direct response to the trade conflict, PetroChina has said it may temporarily halt purchases of spot U.S. LNG, which means competitor supplier countries are likely to benefit.

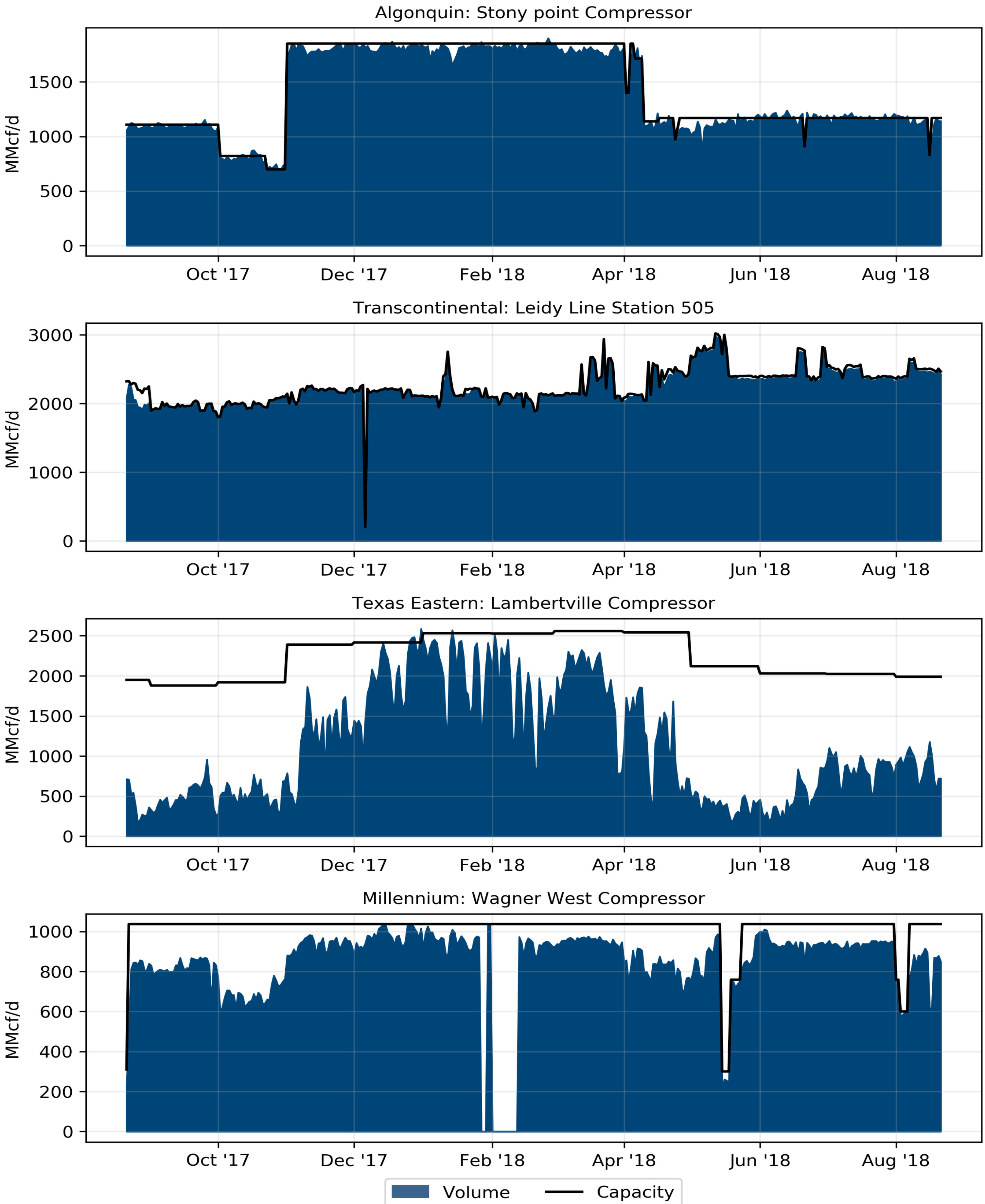
A prolonged trade war with China will affect U.S. producers and exporters. In the short term, U.S. cargoes headed for the second-largest LNG market with the highest growth potential may decline or stop. An additional 25% cost on U.S. suppliers will help Australian, Qatari, or Southeast Asian sellers compete. Chinese buyers with agreements in place to purchase U.S. LNG may swap their contracts with other counterparties to avoid paying additional fees or outright cancel them. In these circumstances, U.S. natural gas destined for the international market could find its way back into the domestic pipeline system, adding to an already oversupplied market.

Over the long term, a prolonged disagreement could delay the second wave of U.S. LNG projects from receiving final investment decisions. Each of these projects requires some level of base contracting, and this is especially true for projects that depend heavily on third-party financing. While a delay by itself would not kill a specific project, it could prevent developers contracting with potential shippers during the early stages of what is expected to be bull market for LNG over the next two years.

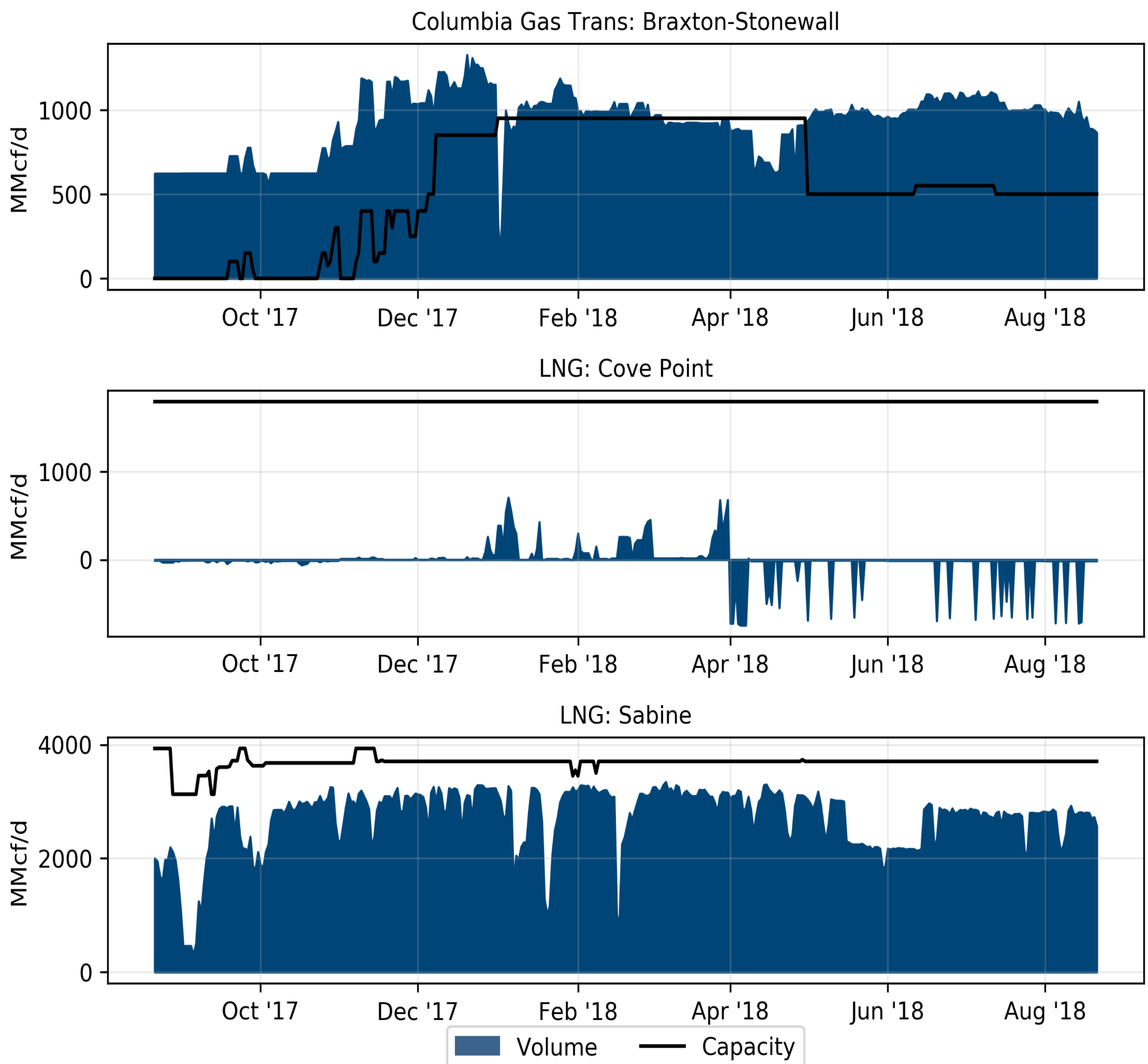
Conclusion

If negotiations between U.S. and Chinese trade representatives in Washington, D.C., on Aug. 22-23 fail to navigate a stalemate, U.S. natural gas producers and exporters will be the next victims in the administration's war on trade. In the short term, U.S. producers and exporters may be shut out of the second-largest market for LNG, especially going into the high-demand winter months. In the long term, a prolonged conflict could delay final investment decisions on second-wave LNG projects, forcing U.S. suppliers to miss out on what is expected to be a tighter market in 2020. In an ideal world, cooler heads would prevail and both parties would agree to suspend the escalating trade war, but recent history has shown the conventional outcome is the less likely.

Natural Gas Important Points



Source: Pointlogic Energy



Source: Pointlogic Energy

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