We Have a Deal
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Data Sources Used in This Publication
NOAA
U.S. Energy Information Administration
PointLogic Energy
U.S. Department of Energy

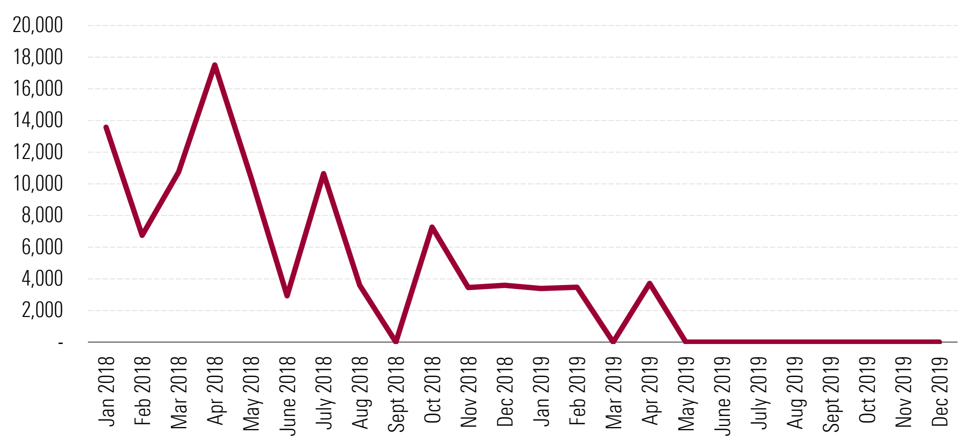
Phase 1 Deal

On Jan. 15, the United States and China agreed to a truce in their ongoing trade war by signing a so-called Phase 1 deal. As a part of this agreement, China pledged to purchase $200 billion in U.S. goods and services, while the U.S. agreed to ratchet down tariffs. Within the bundle of $200 billion U.S. exports bound for China, $52 billion will come from energy. Given growth in U.S. natural gas production and increased export capacity for liquefied natural gas, the sector should benefit from this agreement on paper. Yet while the administration chalks up the agreement squarely in the win column, the details that have emerged show a more nuanced reality. This note looks at near-term prospects for LNG growth and how the trade deal is likely to affect the sector.

The Impact of Tariffs

For the last few years, U.S. LNG exports have grown significantly. New export facilities, primarily in the U.S. Gulf, have contributed to this growth. LNG exports grew 53% versus 2017 during 2018 and another 30% during 2019. U.S. exports to China, however, have declined year over year. In 2017, LNG exports to China accounted for 15% of the U.S. total but have since decreased with each passing year (Exhibit 1). In 2018 and 2019, the share of U.S. exports finding a home in China fell to 8% and less than 1%, respectively. The last shipment that made its way directly to China was in April 2019, right before it announced 25% tariffs on U.S. LNG.

Exhibit 1 U.S. Exports to China per Month
Million cubic feet

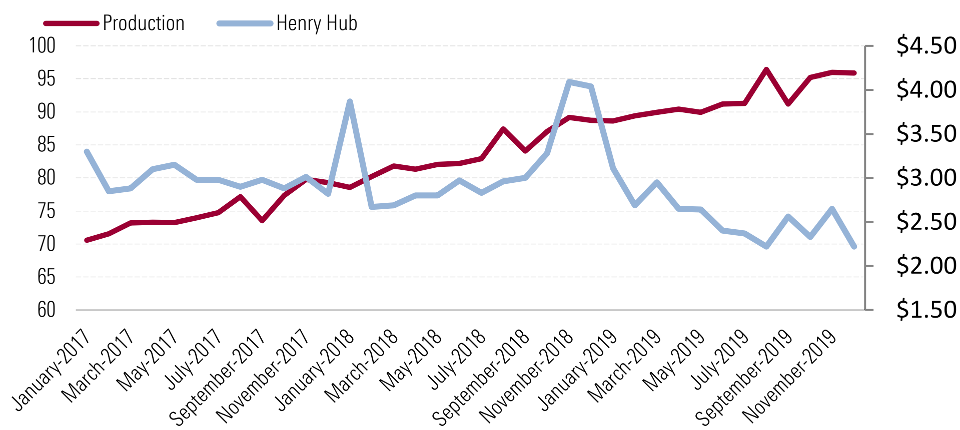


Source: U.S. Department of Energy

Rise in Shale Production

U.S. LNG export growth has resulted from significant expansion of domestic production and low prices during the shale era. Domestic dry production of natural gas grew by 30% between 2010 and 2017, according to the Energy Information Administration, and by another 36% from 70 billion cubic feet per day in 2017 to around 96 bcf/d in 2019 (Exhibit 2). Hand in hand with this growth in supply, natural gas prices fell and have stayed relatively range-bound, with the exception of a few seasonal changes during that time. Plentiful cheap U.S. natural gas coupled with China's evolution away from coal and subsequent increased demand, as well as rising Asian demand, all helped create an environment where U.S. LNG has become the swing supply into the seaborne market.

Exhibit 2 U.S. Dry Production (Bcf/d) and Henry Hub Spot Prices



Source: Energy Information Administration, PointLogic Energy

The U.S. was an importer of LNG only a few years ago but now supplies over 8 bcf/d of natural gas to LNG export terminals. According to the EIA, liquefaction capacity is expected to continue growing, with current estimates showing around 10 bcf/d by 2021. Most of that growth is predicated on rising Asian demand, particularly from China.

Growing demand for natural gas in China is driven by domestic incentives to increase local production and environmental pressure for coal to gas switching in the power sector. Imports (pipeline and LNG) account for roughly 45% of Chinese natural gas supply, and it is the world's largest market for LNG. Rising U.S. LNG export capacity is well positioned to capture part of that market share.

Trade Barriers

The implementation of tariffs on LNG imports rapidly disrupted what had been a relatively smooth U.S. and China trade relationship. While in theory January's Phase 1 deal between the U.S. and China offers respite in the form of a pledge to buy $52 billion in energy exports, the commitment level of those purchases is up for debate. As part of the agreement, China agreed to purchase "no less than $18.5 billion above the 2017 baseline amount" of energy products in 2020. China's vice premier, however, highlighted that it would purchase based on market demand, inserting another level of vagueness to a deal that is generally light on details. In addition to vague commitments, the "Expanding Trade" chapter of the Phase 1 agreement fails to address consequences for noncompliance other than consultation if conflicts arise.

While news of the trade deal had a generally positive impact on sentiment, the jury remains out on whether China will significantly increase LNG imports over the short term. The Chinese import tariff of 25% remains on U.S. LNG, leaving the latter disadvantaged to regional competitors in Asia. Falling natural gas prices in Asia that suggest oversupply, as well as the recent coronavirus impact on Chinese demand also diminish prospects for resumed growth in U.S. LNG exports to China.

Trade treaty or no, it's difficult to envision short-term growth in U.S. LNG exports to China this year. For one thing, rival Asian suppliers such as Australia stepped in to replace U.S. supplies as tariff escalation threatened during 2018 and 2019 and will be hard to budge until China lifts import tariffs on U.S. supplies. We believe the greatest impact will be continued investor commitment to expand LNG export capacity at the U.S. Gulf Coast. These projects will find it easier to secure firm commitments as the trade war truce pans out.

Conclusion

While news of a trade deal between the U.S. and China is bullish for the LNG sector, the short-term impact from the agreement is difficult to evaluate. While the Chinese have agreed to purchase more energy products from the U.S., the deal lacks details and penalties. In addition, tariffs remain on U.S. LNG, rendering it uncompetitive with regional rivals. The recent coronavirus wrench to trade threatens to reduce economic activity and demand for energy imports further. While the U.S. gas sector welcomes the recent deal, the changing situation on the ground in China might make any bullishness temporary.

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