Will the trade war impair the "second wave" of U.S. LNG?

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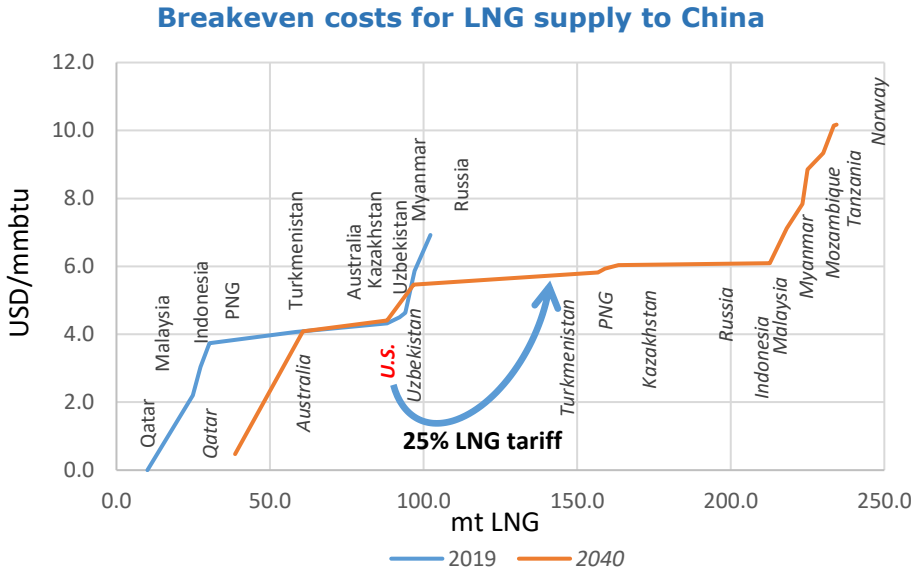
Alexander Apokin, Energy Economics Analyst, Energy Economics and Forecasting Department (EEFD)

US-China trade tensions have escalated this summer, with two rounds of bilateral tariff hikes prompting both sides to affirm they are in a state of a full-fledged trade war. Despite numerous high-level meetings and ongoing talks, both the U.S. and China have raised the trade barriers, with currently 75 bn USD of U.S. exports to China and 550 bn USD of Chinese exports to the U.S. targeted by tariffs.

From Sep 1, a new volley of trade tariffs kicked in from both sides. For the first time, China targeted U.S. crude oil (5% tariff) that added to existing tariffs on propane (increased to 30%), MEG/methanol (25%), and LNG (25%).

According to the GECF Global Gas Outlook, if there were no barriers to the U.S.-China LNG trade, by 2040 the U.S. would supply 11% of Chinese imports and 21% of its LNG imports, while China would account for 16% of the U.S. LNG exports. "Second wave" U.S. LNG projects, especially from the West Coast, are well-positioned to enter the growing Chinese market with breakeven prices above 6-6.5 USD/mmbtu. However, the prolonged trade tensions might have a grave impact on this as the U.S. LNG tariffs that have been in place since June come at a particular moment of an investment boom in the U.S. LNG industry. They have the potential to strand a blooming industry that over the last three years has expanded to a 40 mtpa nameplate capacity in operation and has about 46.5 mtpa of capacity under construction.



Note: The average total LNG costs are inclusive of liquids credit. For Australia, Indonesia, Malaysia, Russia, and the U.S. costs are averaged over the supply sources.

Source: GECF Secretariat based on data from the GECF GGM

There are currently two direct U.S. contracts with China: the 1.2 mtpa Cheniere-PetroChina contract and the 2.2 mtpa Total (acquired from Toshiba) tolling contract for Freeport LNG from 2020. The former is reported to be serviced through cargo swap agreements, with U.S. LNG effectively entering China in very rare occasions.

More of the 69.7 mtpa that is currently contracted from U.S. capacity by Asian companies might end up in China through swaps. However, as imports grow, this channel will soon be exhausted. Even in 2018, Chinese imports accounted for 22.8% of total Asian imports and 73.8% of flexible-destination LNG contracts in Asia not bound for China already. Assuming most LNG capacity additions in the next several years will be in the U.S., and most import demand growth will come from China, cargo diversions via swap and portfolio trades could potentially provide up to 10-15 mtpa replaced by the U.S. LNG elsewhere in Asia, and the rest could only be achieved via reloadings.

Thus, apart from it being more costly than direct shipments, and cargo parameters possibly not fully matching, the volume of Chinese imports will increasingly prevent using LNG swaps to circumvent the 25% tariff. For U.S. LNG reloadings to be efficient, the cost (estimated at 0.6-0.8 USD/mmbtu) must be lower than the tariff cost (25% of the price). This is achieved at prices north of 3.2 USD/mmbtu, i.e. at any level above the shut-in price for U.S. LNG facilities. Still, it is more profitable for U.S. exporters to go after the Latin American market. In 2019 Argentina, Brazil, Chile, and Colombia are the primary markets for the U.S. LNG on record.

Given the ongoing escalation of the trade war, it is unlikely China will lift the LNG tariffs until after U.S. presidential elections (effectively until 2021). By end-2020, Chinese LNG imports are expected to grow by at least 25 mt or 18.75% of the 2018 global imports and by 2030, imports are expected to add extra 50 mt. Tariffs would prevent most of the new U.S. LNG from taking that niche, despite 42.5 mtpa of new LNG capacity currently under construction is expected to go online by 202. On top of that, an extra 70 mtpa might be there by 2030. The increase in other Asia Pacific LNG imports is projected to be much less, at 5 mt in 2019-2020, as demand from Japan and Korea is stagnant. Thus, most of the new U.S. capacity will compete with new projects from Australia and Russia at a disadvantage of either paying swap costs or reloading.

In case the new U.S. administration in 2021 will continue on the course of a trade war, Chinese LNG tariffs will stay in place for longer - even as the trade talks go on. If this scenario materializes, there are certain long-term implications for the global LNG market, as the potential for LNG swaps and reloadings will be exhausted even if China will not crack down on the practice.

Firstly, changing margins will lead to the geographical redistribution of LNG and upstream investment. Coupled with the impending oversupply, it could put on hold FIDs on some of the 70 mtpa planned U.S. LNG projects (so far, difficulties reported for Driftwood LNG, Rio Grande LNG, and Magnolia LNG). For supplies to China, investment in Russian, Canadian, Mexican and Mozambique, projects will be prioritized.

Secondly, the intermittent nature of the tariffs and the need for using swaps and reloads to overcome them, will at the same time disincentivize long-term contracts with Chinese buyers, and speed up the development of spot markets, especially in the Asia-Pacific. This, in turn,

will stimulate investment in Asian LNG trading and transport infrastructure, and drive the emergence of trading hubs outside mainland China that are slowly forming in the Asia-Pacific.

Thirdly, in case U.S. export facilities will be rescheduled and (or) suspended, the new price collapse in the U.S. shale gas markets will become imminent. It will stall investment in domestic pipeline infrastructure, keep the pipeline bottlenecks in place, and reduce the amount of feed gas that could be exported in the future, as well as profitability of oil projects that are mandated to dispose of the associated gas.

Contact: Alexander.Apokin@gecf.org