Oil Market Report: August 2018

In an otherwise quiet holiday month, the major energy talking point for those left in the office, was the introduction by China of a 25% tariff on American LNG – this as part of the burgeoning trade war between the 2 countries. Liquified Natural Gas (LNG) is simply natural gas, condensed and super-cooled to liquified form, so that it can be transported around the world. Of course transporting liquified gas is not cheap (a “conventional” LNG vessel would cost around $175m to build and the operational costs are much higher than a normal oil tanker), but the great advantage of LNG is that does not rely on traditional pipelines to reach its market destination. This makes the global reach of LNG much greater than conventional natural gas, the latter requiring an existing infrastructure of gas pipelines.

The question then is whether a tariff on seaborne US LNG will have its desired effect and damage the US economy? More specifically, will the US gas industry be impaired just at a time when Trump is pushing energy exports as part of his “energy dominance” agenda. The probable answer on both counts is no, because export volumes to China are not yet material enough to be significant. The Chinese currently buy about 15% of US LNG exports (circa 8m cubic metres per day), making them the 3rd largest buyer of US LNG globally – behind Mexico (11m m3 / day) and South Korea (10m m3 / day). To lose such volume would certainly be painful for US producers, but should not be critical for their ongoing operations. Having said that, the investors behind the 4 new LNG export facilities currently being built in Texas (x2), Georgia and Louisiana (with the aim of quadrupling US LNG export capacity), may beg to differ…

This is probably because losing market share is one thing, but losing a trading relationship can be much more harmful and US exporters will be wary of China simply walking away and finding new long-term LNG partners. Such is China’s insatiable demand for gas, that the US is far from being a pivotal supplier to the Chinese market and its LNG only accounts for a mere 6% of total Chinese imports (the total figure being 50bn cubic metres per annum). Even President Trump wouldn’t make the claim that American gas is any better than gas from elsewhere in the world and lots of other countries have very significant reserves. The likes of Australia, Qatar and Iran (free from sanctions in relation to China) have huge gas deposits, are heavily investing in LNG export facilities and perhaps most significantly, are all located much closer to China than America.

Despite these risks however, the prognosis for US LNG still looks positive. The fact remains that LNG is currently the biggest growth market in the oil and gas sector and although far from dominant, the US is still the largest exporter in the world. Therefore, US producers should have little trouble in finding alternative markets. You only need look to the brewing storm around Nordstream II (the gas pipeline from Russia that intensifies EU reliance on Russian gas and a situation that led Trump to declare that “Germany is totally controlled by Russia”) to know that European buyers are extremely keen to diversify their gas mix, both for political and economic reasons.

In addition, the nature of commodity trading is that exports are a result of global, rather than regional demand. If US LNG can no longer reach Chinese shores, then it will end-up in other markets - perhaps those markets hitherto supplied by the likes of Australia and Qatar, who will now find themselves the suppliers of choice to China. So ultimately demand for LNG will not disappear, it will simply be re-organised around revised supply-chains. And there is also every possibility that US producers will sell to international commodity houses, who in turn will simply trade back “into the market”, meaning that US LNG may end up in China anyway, but via a non-US intermediary. Either way, as long as LNG demand continues to increase, US producers will be able to find a home for their product. Yes, there may be short-term market dislocations, as regional shortages generate circuitous supply-chains and subsequent price arbitrages (ie, geographic differences in price). But in the end, if there is a market for LNG, the product - whether American or not - will find its way to supply that demand.

It may be giving President Trump too much credit to suggest that he has worked all of this out. The implementation of tariffs is an easy policy to deliver via the Twittersphere and also lends itself to his strong-arm form of governing. But if a major trade war is to kick-off between the US and China, it won’t take long for the more thoughtful men and women of Washington to work out that Chinese tariffs on LNG should not cause too much pain for the USA.