

Tariffs on the Mexican Border Avoided for Now

U.S. Power and Gas Weekly

Morningstar Commodities Research
June 12, 2019

Matthew Hong
Director of Research, Power and Gas
+1 312 244-7649
matthew.hong@morningstar.com

Data Sources Used in This Publication
EIA
PointLogic Energy

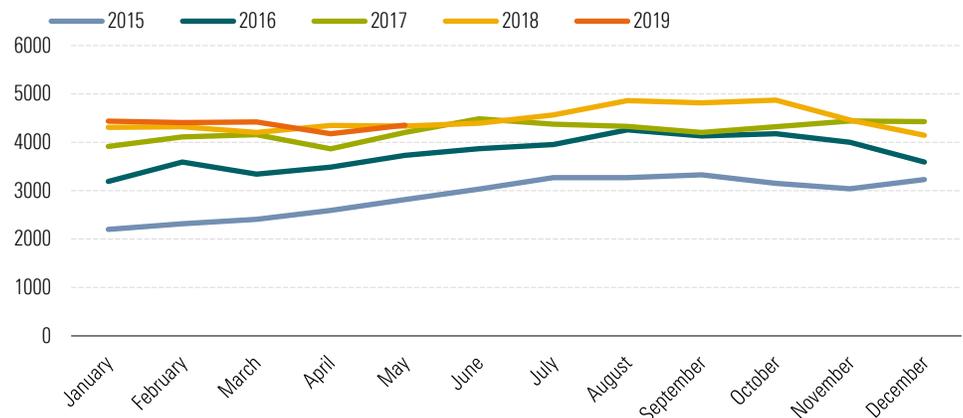
The Prospect for Tariffs

The Trump administration has recently lifted the threat of a 5% tariff on all Mexican goods entering the United States. While much of the coverage related to the impact of this unilateral action centered around increased prices for American consumers, the impact to the natural gas sector received less attention. While Friday's deal between the two governments de-escalates another front in the U.S. administration's war on trade, the Trump administration is anything but predictable. This note considers how tariffs could impact U.S. natural gas in the event the threat is levied again soon.

Increased Trade

Over the past few years, natural gas exports to Mexico from the U.S. have steadily increased, from an average 2.8 Bcf/d in 2015 to an average 4.4 Bcf/d in 2018 with another slight increase year to date (Exhibit 1). Decreased domestic production in Mexico and plans to increase pipeline infrastructure to meet growing demand made investing in the Mexican energy sector a bright spot over the past few years and most market participants see additional growth for years to come.

Exhibit 1 Pipeline Exports to Mexico (MMcf/d)



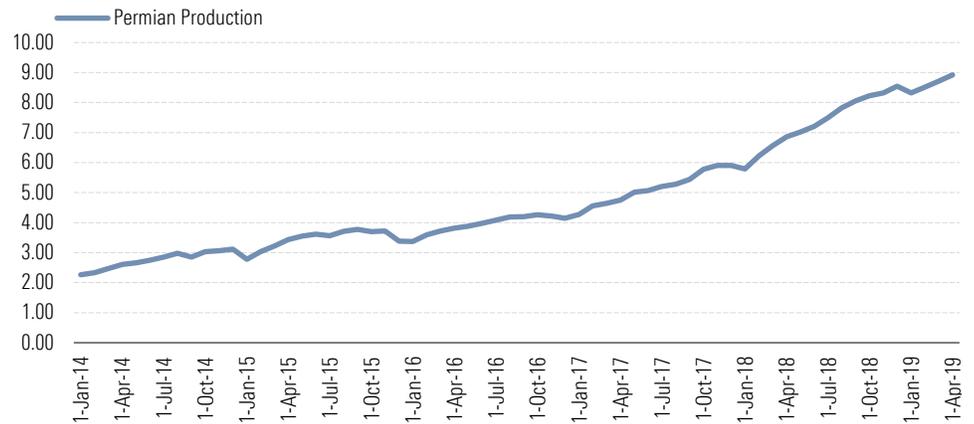
Source: PointLogic Energy

Permian Production Growth

Since 2017, natural gas production in the Permian basin has seen explosive growth. In January 2014, production averaged 2.2 Bcf/d leaping to an estimated 8.9 Bcf/d by April 2019 (Exhibit 2). Year to April

output is already above the same period last year by 36%. While Texas and the surrounding region continue to expand natural gas consumption through new natural gas plants and LNG, growth in pipeline exports to Mexico are also expected to grow as connecting infrastructure expands. Most of this export demand will be supplied by the Permian basin, making the region particularly susceptible to trade barriers.

Exhibit 2 Permian Production Growth (Bcf/d)



Source: EIA

Retaliatory Tariffs Averted

The U.S. is a net energy exporter to Mexico and had the tariffs gone into effect, the sector would have been a natural target for retaliation. Increased tensions with a new Mexican administration, lukewarm to the energy liberalization pursued by its predecessor, would have created the perfect storm for U.S. natural gas producers.

Permian producers would have been directly impacted by an escalating trade war with Mexico given that the basin's lack of markets for surging gas supply has already weakened prices in West Texas to negative levels in the past year and flaring is at record levels. Absent demand for more molecules south of the border Texas producers would rely increasingly on the LNG export market where they compete with other domestic basins as far north as Appalachia. Meanwhile Mexico could see a slowdown in much needed energy infrastructure investment without access to cheap U.S. supply.

The impact of an escalating trade war on price would be inevitable. Henry Hub futures and basis prices at Waha in West Texas would face additional downward pressure. With Mexican exports accounting for roughly 5% of natural gas demand for the Lower 48, a curtailment in trade would force volume back into the domestic stack, pushing down futures and basis markets.

Conclusion

The threat of tariffs on goods entering the U.S. from Mexico has been lifted for now, but the possibility of a similar threat in the future cannot be ignored. The supply chain integration seen over the past

decade between the U.S. and Mexico has extended to the energy sector and the implementation of tariffs would clearly impact supply and demand fundamentals. In the short-term, tariffs would keep more Permian production in the U.S., further depressing prices. In the long term, an escalating trade war would force companies to reconsider investment strategies and Mexico to reconsider which of the previous government's energy reform policies to keep in place. Any trade war between the U. S. and Mexico is likely to hurt both, but with the administration willing to use trade as a weapon against unrelated matters, the possibility of tariffs in the future cannot be discounted. ■■

About Morningstar® Commodities Research™

Morningstar Commodities Research provides independent, fundamental research differentiated by a consistent focus on the competitive dynamics in worldwide commodities markets. This joint effort between Morningstar's Research and Commodities & Energy groups leverages the expertise of Morningstar's 23 energy, utilities, basic materials, and commodities analysts as well as Morningstar's extensive data platform. Morningstar Commodities Research initially will focus on North American power and natural gas markets with plans to expand coverage of other markets worldwide.

Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individuals, financial advisors, and institutions. Morningstar's Commodities & Energy group provides superior quality market data and analytical products for energy data management systems, financial and agricultural data management, historical analysis, trading, risk management, and forecasting.

For More Information

+1 800 546-9646 North America

+44 20 3194 1455 Europe

commoditydata-sales@morningstar.com



22 West Washington Street
Chicago, IL 60602 USA

©2019 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. The information, data, analyses, and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete, or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions or their use. References to "Morningstar Credit Ratings" refer to ratings issued by Morningstar Credit Ratings, LLC, a credit rating agency registered with the Securities and Exchange Commission as a nationally recognized statistical rating organization ("NRSRO"). Under its NRSRO registration, Morningstar Credit Ratings issues credit ratings on financial institutions (e.g., banks), corporate issuers, and asset-backed securities. While Morningstar Credit Ratings issues credit ratings on insurance companies, those ratings are not issued under its NRSRO registration. All Morningstar credit ratings and related analysis are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Morningstar credit ratings and related analysis should not be considered without an understanding and review of our methodologies, disclaimers, disclosures, and other important information found at <https://ratingagency.morningstar.com>. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. To license the research, call +1 312 696-6869.