Tariffs on the Mexican Border Avoided for Now
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Data Sources Used in This Publication
EIA
PointLogic Energy

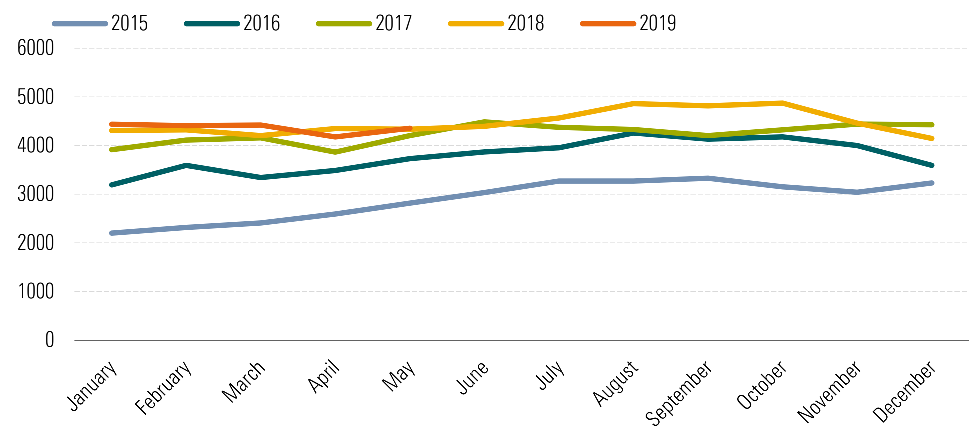
The Prospect for Tariffs

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)

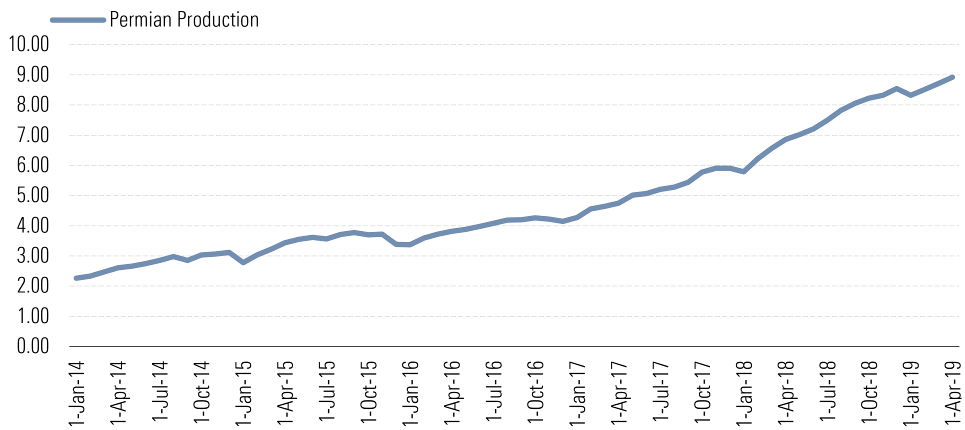


Source: PointLogic Energy

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.

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