Tariff War Would Have Hurt U.S. and Mexican Oil Industries

Repercussions worse for Gulf Coast refiners.

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Data Sources for This Publication
EIA
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Sener
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Near Miss

President Trump's indefinite suspension of threatened tariffs on Mexican imports Friday, following a last-minute deal on migrant flows, represents a near miss for U.S. refiners. They faced higher prices at best and shortages of preferred heavy crude feedstock at worst if the tariffs were implemented as planned today (Monday, Jun 10). If Mexico retaliated in kind on U.S. refined products to Mexico, the repercussions would have been considerably worse for Gulf Coast refiners and midstream infrastructure companies invested in Mexico's domestic market. As with much of Mexico's cross-border trade with the United States, the two countries' interdependence makes it hard to identify winners in a petroleum tariff war. As we describe in this note, a trade conflict with Mexico over oil and refined products would have left both sides suffering and consumers footing the bill.

Heavy Shortage

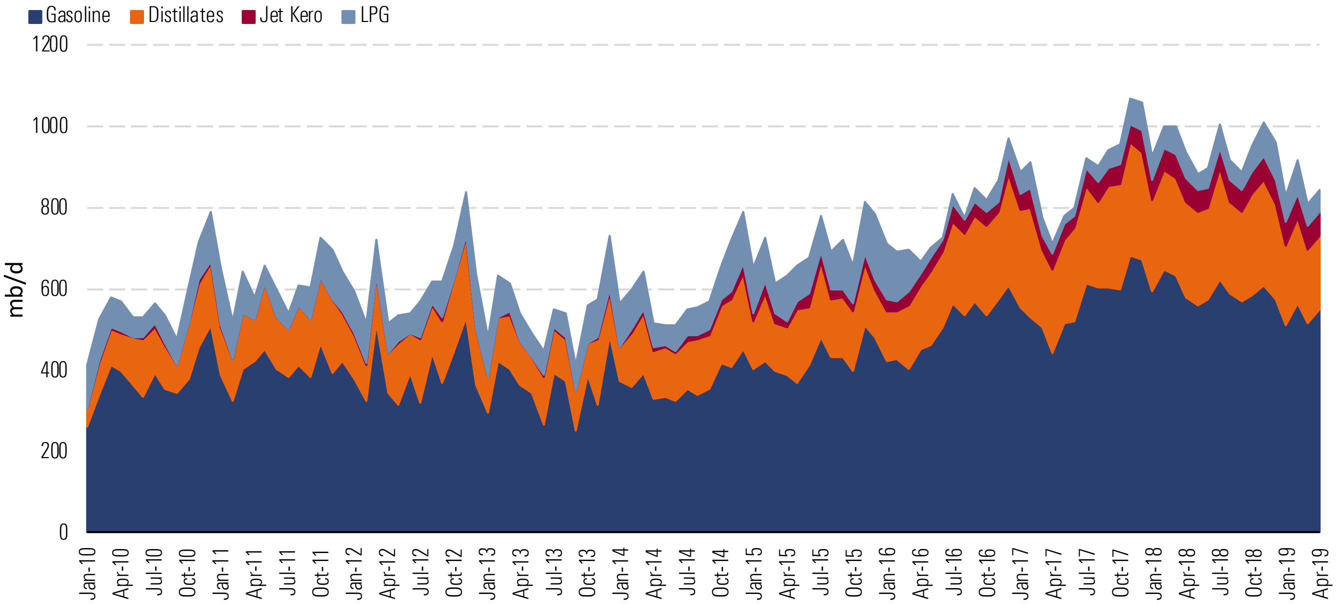
U.S. refiners' call on Mexican crude imports has fallen 42% in the past nine years from an average 1.15 million barrels/day in 2010 to 0.67 mmb/d in 2018, according to the Energy Information Administration. In part the decline is due to booming domestic shale production, but it also reflects falling Mexican crude output, down from 2.6 mmb/d in 2010 to 1.8 mmb/d in 2018, according to Sener. Most crude imports from Mexico are heavy sour Maya processed by Gulf Coast refineries. Replacing those barrels wouldn't normally be a challenge in a free market. However, in the current climate, Venezuelan and Iranian heavy crude production is diminished by sanctions, and OPEC, Russia, and the Canadian province of Alberta are curtailing production voluntarily, creating a shortage of heavy crude. Adding Mexico to the list of curtailed suppliers would add insult to injury for U.S. refineries configured to run on a staple of heavy crude. Latin American suppliers such as Colombia, Ecuador, and Brazil could make up some of the loss but have little spare capacity to expand output. Additional heavy crude shipments by Mideast OPEC suppliers like Saudi Arabia, Iraq, and Kuwait might have closed the gap but were unlikely to be sanctioned by OPEC partners. In any event, it seems certain that the resulting heavy crude shortage would have allowed Mexico to realize higher prices for its exports from other buyers outside the U.S.

Absent alternate heavy supplies, U.S. refineries could switch to abundant domestic light shale crude. However, this reduces processing throughput in refineries configured for heavy crude, since light components overwhelm the distillation tower and there's less residual fuel to feed downstream units. The resulting hit to refinery economics doesn't always justify the switch, although blending more light crude with heavy can help stretch supplies. A more likely result would be higher prices for heavy crude versus light as the market absorbs increased tariffs and Mexico's competitors raised their prices accordingly. This narrowing of the heavy/sweet price spread has already occurred this year in the face of Iranian and Venezuelan sanctions, OPEC production cuts, and Canadian output curbs (see our April note, East Coast Refiners Lose Canadian Heavy Card). The resulting slowdown in heavy crude processing threatens product shortages this summer. It could also distort the impact of upcoming tighter International Maritime Organization bunker specifications by limiting the supply of distillate product needed to blend very-low-sulfur fuel oil (see our March note, Heavy Sour Crude Shortage Disrupts IMO 2020 Response). Higher refined product prices are almost certain to result.

Retaliation

Imposing tariffs on Mexico's crude exports to the U.S. would likely have invoked reciprocal action. The obvious target would be U.S. exports of refined products to Mexico. EIA data show that, including liquid petroleum gases (propane and butane, some of which comes from processing natural gas), total U.S. exports of refined products to Mexico in the first quarter averaged 1.1 mmb/d, a higher volume than Mexico's crude imports of 0.6 mmb/d. Over the past nine years, U.S. refined product exports to Mexico have increased consistently (Exhibit 1). Gasoline exports grew 262% from an average 214 thousand barrels/day in 2010 to 560 mb/d in the first quarter of 2019. Over the same period, diesel exports increased threefold from 94 mb/d to 279 mb/d and LPG exports grew fourfold from 38 mb/d to 153 mb/d. These booming shipments represent a significant chunk of overall U.S. exports that are a mainstay of refinery profitability in the Gulf Coast region. Based on EIA data for the first quarter of 2019, 55% of U.S. gasoline exports, 23% of diesel, 26% of jet kerosene, 20% of fuel oil, and 11% of LPG went to Mexico. As such, Mexican tariffs restricting refined product exports would cause greater pain to Gulf Coast refiners than higher crude oil tariffs. Absent U.S. imports, Mexican consumers would face higher gasoline and diesel prices with replacements probably coming from European refineries, which may struggle to meet demand.

Exhibit 1 U.S. Refined Product Exports to Mexico



Source: EIA, Morningstar.

With reliance on U.S refined products has come infrastructure investment in Mexico to improve supply logistics (see our May 2017 note, Mexican Downstream Opportunity for U.S. Refiners). This investment came as part of the country's energy market reforms begun in 2013, which encouraged outside investment. As part of that process, Mexico's downstream transport fuel infrastructure was opened to outside competition, and U.S. refiners and midstream operators invested down to the retail gas station level, including ExxonMobil (see our March 2018 note, Exxon Bets on Downstream U.S. Returns) and Marathon (see our May 2018 note, Has Marathon's Refining Empire Hit the Wall?). Plans have also been developed for smaller refineries in Texas to sell refined product into the Mexican market (see Can Small Refineries Succeed in North Dakota and Texas?). However, last July's election of Andrés Manuel López Obrador—known universally as AMLO—as Mexico's president threw the progress of energy market reforms into question.

Since taking office in December, AMLO has questioned outside investment and placed emphasis on state monopoly Pemex to increase crude production and fix the country's deteriorating refining system, currently running at 35% of capacity. This month, AMLO initiated a $7.7 billion project to build a new refinery at Dos Bocas in Tabasco state to help reverse the decline in refined product output. To date, the AMLO regime has successfully reduced the fuel theft that was crippling Pemex, but the state company's record on refinery investment is poor.

So, while U.S. investment in Mexican energy infrastructure continues, the slower pace of reform and preference for domestic investment has reduced the appeal. Disrupting the flow of crude and refined products across the border through tariffs would further worsen investor sentiment. This helps justify AMLO's policy of reducing overseas investment and encouraging energy self-sufficiency—at the expense of U.S refiners. Although not the topic of this note, there would be a similar impact on the equally significant U.S.-Mexico natural gas trade. Ultimately, this stifling of trade and investment would hurt Mexican consumers through higher refined product prices.

FTZ Immunity?

Since the tariff threat was raised at the end of May, commentators have highlighted the potential immunity of Gulf Coast refiners to Mexican crude tariffs because of their location in foreign-trade zones. If an oil refiner in a foreign-trade zone imports crude, then it avoids or defers tariffs as long as it exports the resulting refined products. Most Gulf Coast refineries export refined products and therefore have acquired designated FTZ status to avoid customs. If the FTZ designation overrides the imposition of tariffs on Mexican imports, then these refineries would be immune to rising tariffs on Mexican imports. If this were true, then the impact of tariffs would be marginal. EIA crude import data since 2015 show that Mexico's exports have predominantly been shipped to the Gulf Coast region (Exhibit 2). The latest numbers for the first quarter of 2019 show that 92% went to Gulf Coast refineries, up from an average 89% in 2018. A small but growing volume of imports went to refineries on the West Coast—mostly in California—over the past three years along with a trickle to the East Coast and Marathon's Detroit refinery in the Midwest. These refineries are unlikely to be exporting equivalent volumes of refined products, so they can't avoid the tariffs but can probably replace Mexican crude more easily, given the lower volumes.

Exhibit 2 Mexican Crude Imports by U.S. Refining Region

Region	2015	2016	2017	2018	2019 Q1
Gulf Coast	558	628	556	589	574
Midwest	0	1	0	13	11
West Coast	0	0	37	49	38
East Coast	16	9	5	8	0
Total	574	638	597	659	624

Source: EIA, Morningstar.

While FTZ-designated Gulf Coast refineries are immune to tariffs (assuming the administration upholds the rules), they could find themselves penalized if Mexico imposes high enough tariffs on U.S. refined products. If such tariffs price U.S. products out of the Mexican market, then refiners may struggle to find alternative markets for their exports. In that case, reduced refined product exports will reduce their ability to import crude without tariffs. In general, any threat to U.S. refined product export volumes increases overhead for Gulf Coast refiners as they lower throughput. There could be wider repercussions on the refining complex if U.S. inventories build in the face of lower exports. The recent negative market price reaction to a record increase in crude and product stocks reported in the EIA Petroleum Supply report (for the week ended May 31) provided an indication of what could happen in that case.

Damage

In summary, the threat to U.S. refiners of the now suspended tariff war with Mexico would have been greater than the threat to Mexico's crude exports, but such a conflict would damage both countries' oil industries as well as consumers' pocketbooks. Since neither country has much to gain from this dispute, we hope the threat has been removed by Friday's last-minute deal. Future renewal of the tariff threat in response to political differences threatens to reverse years-long benefits of interdependency that has provided cheaper energy for consumers. M

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