

STEEL IMPORTS – TARIFFS AND QUOTAS

In March, the Trump Administration initiated new imported steel and aluminum tariffs under the authority of Section 232 of the Trade Expansion Act of 1962. The scope of these tariffs affects American oil and natural gas producers. The implications are numerous. They include:

1. Higher prices for Oil Country Tubular Goods (OCTG) and Line Pipe (LP) due to both tariffs and increased domestic steel prices;
2. An excessively complicated and invasive product exclusion process for imported products that particularly burdens small businesses; and
3. The creation of alternative trade agreements potentially leading to import quotas that could cripple expansion of American oil and natural gas production.

Background

Section 232 of the Trade Expansion Act of 1962 provides the President authority to impose trade restrictions – tariffs and/or quotas – on imported products if necessary to protect national security. The Department of Commerce completed a Section 232 analysis concluding that the current level of steel and aluminum imports posed a threat to national security and recommended actions to increase production of domestic steel to 80 percent of its capacity. The President announced steel tariffs (25 percent) and aluminum tariffs (10 percent) that became effective on March 19, 2018.

American independent producers utilize OCTG and LP steel products to develop and produce oil and natural gas resources. These steel products include OCTG such as carbon steel casing and alloyed steel tubing that build and complete the wellbore and LP that is both carbon steel and alloyed steel used to move oil and natural gas on the surface of the well site and for transport off the well site to pipelines or storage. These products typically range from 10 to 20 percent of well development costs.

Over the past few years, domestic steel products have captured more than 50 percent of the OCTG and LP market. However, historically, imports have provided from 35 to 55 percent of OCTG, and many of the alloyed steel products are not produced in the United States and must be imported.

Issues

Recent development of unconventional American oil and natural gas production changed the fundamentals of American energy. After decades of severe dependency on foreign oil and facing a

future of rising imported liquefied natural gas, the United States now is realizing new production, generating not only new unconventional supplies to address critical national needs but the capability to export record volumes as well as a comprehensive product range of oil and natural gas. Increased American energy production enhances both domestic security of supply and the capacity to influence international affairs. However, for the past couple of years, low commodity prices have threatened the structure of the industry, particularly its small business component. Consequently, the impact of added costs and – more critically – limited products by quotas can seriously inhibit the economic recovery of American oil and natural gas producers.

Price Implications

When the Section 232 review process was initiated, independent oil and natural gas producers began to see domestic steel product prices increase, ranging from \$50/ton to \$130/ton depending on the product. With the initiation of the 25 percent steel tariffs, these prices continued to increase. Generally, domestic steel prices are now 5 to 10 percent higher than imported steel prices (including the 25 percent tariff).

The Process

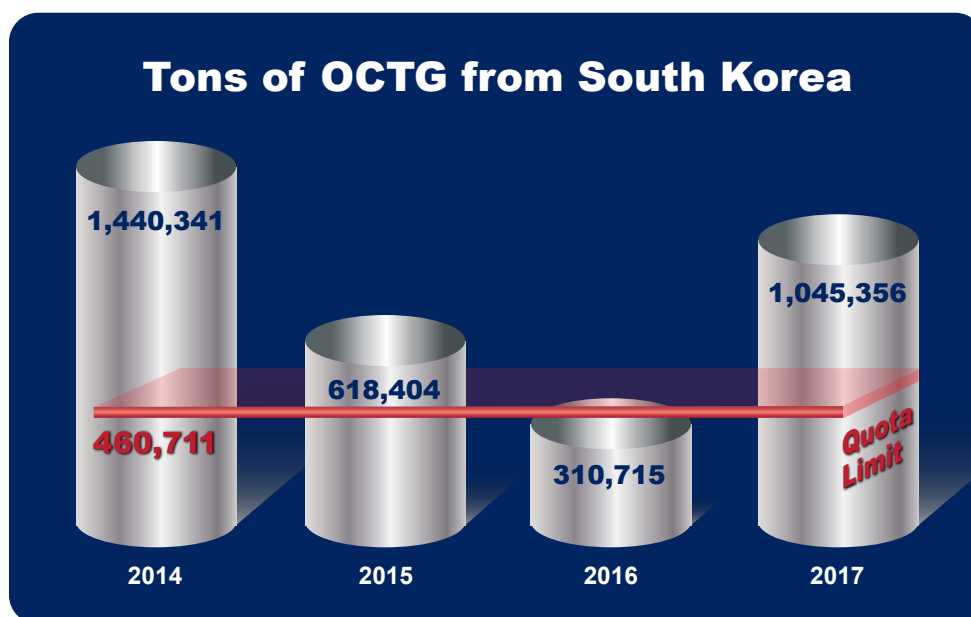
The current process to alleviate the impact of steel and aluminum tariffs involves two key components. The first constituted country exemptions. These were granted by the Administration. Initially, country exemptions were granted for Canada, Mexico, the European Union, Australia, Argentina, Brazil and South Korea. All of these country exemptions have been terminated except for Australia, Argentina, Brazil and South Korea. At the same time, bilateral agreements with South Korea, Argentina and Brazil have been announced. Other key OCTG producing countries such as Japan – which is the only source of many critical alloyed steel products – have not been granted exemptions. This process creates enormous uncertainty.

The second key component is the product exclusion process. It applies in countries subject to the tariffs. However, the product exclusion process is complex. Each user of the product must file for an exclusion. Each product must be addressed; for example, each diameter of tubular goods would appear to need a separate exclusion. The Bureau of Industry and Security (BIS) makes initial decisions on an exclusion but then posts the decision for 30 days when objections can be raised. Detailed information on projected product use is required, but Confidential Business Information (CBI) protections are limited. The complexity of the process raises significant potential challenges for small businesses. It would seem appropriate that, once BIS approves and sustains a determination that a specific product should be granted an exclusion, the exclusion should be available for all users without each needing to apply. However, neither BIS nor the Department of Commerce has indicated it would adopt this approach. While the Department of Commerce has indicated that rebates would be made for products where the tariff is paid and an exclusion is subsequently granted, this position has not been codified. The process is not working well; BIS has received over 20,000 applications and has completed less than 10 percent of them.

The Trade Agreement Alternative

The Presidential Proclamation that established the specific country exemptions also presented the option of negotiating agreements to address the import concerns. Most likely, these would be bilateral trade agreements.

The first of these is an announced framework with South Korea. In this instance, it includes a voluntary limitation by South Korea on its exports of steel products to the United States. Specifically, it would cap each steel product at 70 percent of its average tonnage based on the 2015-2017 period. For OCTG and LP, this time period produces a lower effective cap because of the lower import volumes in 2015 and 2016 when commodity price weakness limited American drilling activity. South Korea has been the largest exporter of OCTG and LP to the United States.



In fact, using the information in the preceding graph, South Korean OCTG imports would be limited to approximately 460,700 tons (70 percent of a 2015-2017 average of 658,000 tons). However, this amount is 44 percent of 2017 imports and 32 percent of 2014 imports – the last year with robust oil and natural gas production. While some of this lost volume can be replaced with domestic carbon steel OCTG products, domestic production of high alloyed specialty steel products is much more limited. In August, the Administration moved to address a significant quota related problem allowing products that would qualify for a product exclusion to be imported despite the quota limits.

Anecdotal reports indicate that much of the quota has already been imported – since the quota’s effective date was January 2018. Not only have costs increased, but the loss of steel products that cannot be produced domestically or cannot be produced domestically in sufficient quantities is forcing independent producers to seek products elsewhere. However, other countries are already at capacity and cannot supply America’s needs for many months. In addition, the onset of growing infrastructure limitations for both oil and natural gas regarding pipeline take-away capacity in key producing basins around the country (especially the Permian and Delaware Basins) further exacerbate the potential threat posed by limited availability of LP required for pipeline expansions particularly over the next two years.

Among the issues that must be considered in these actions is the ability of domestic steel producers to increase their output. The Section 232 analysis recommended actions to move domestic steel production from 74 percent of its listed capacity to 80 percent based on tonnage of output. However, “working” steel capacity can differ from listed capacity. For example, in the OCTG area, a significant part of the listed capacity is based on production of offshore products. These are generally of larger diameter and heavier steel than onshore tubular goods. Since the primary growth in American oil and natural gas production is in onshore unconventional development, domestic steel production will need to be increasing for these products. Because onshore OCTG are of smaller diameter and lighter steel, a mill producing the same linear footage of onshore tubular goods as it did for offshore tubular goods would produce fewer tons of product. Consequently, using listed capacity as a basis for determining success of the Section 232 initiative for oil and natural gas production steel demand would be inaccurate. Correspondingly, building a steel tariff/quota system that does not recognize these realities could result in adverse, unintended consequences to American oil and natural gas production.

Conclusions

Revival of American oil and natural gas production created a strong national economic force, a new capacity for American exports into the world marketplace, and a major factor in international energy policies – the inherent framework of the Trump Administration’s energy dominance initiatives. Steel and aluminum tariffs and – more potentially critical – quotas could undermine these successes and the national security benefits that they provide.

As the Administration’s steel and aluminum production policies continue to evolve, the Administration needs to understand and address unintended consequences. Among these are:

1. Understanding the magnitude of cost increases for oil and natural gas production development and the implications for continued strong American production;
2. Assuring that negotiated trade agreements recognize the limits of domestic steel production capacity;
3. Revising the quota structure to address the adverse consequences on OCTG and LP steel products because of the 2015-2017 baseline; and,
4. Structuring a product exclusion process that is straightforward, that allows for easy submission and protects CBI, and that includes blanket exclusions for everyone once a product qualifies.