

**American Petroleum Institute**  
*Drawback / FTZ / Import Seminar*

**Crude Oil Imported from Canada**  
*Status of NAFTA Issues*

New Orleans, LA

March 26, 2012

Heavy crude oil / bitumen that requires blending with diluent to facilitate pipeline transportation presents potential costly and disruptive challenges to the Western Canada supply industry.

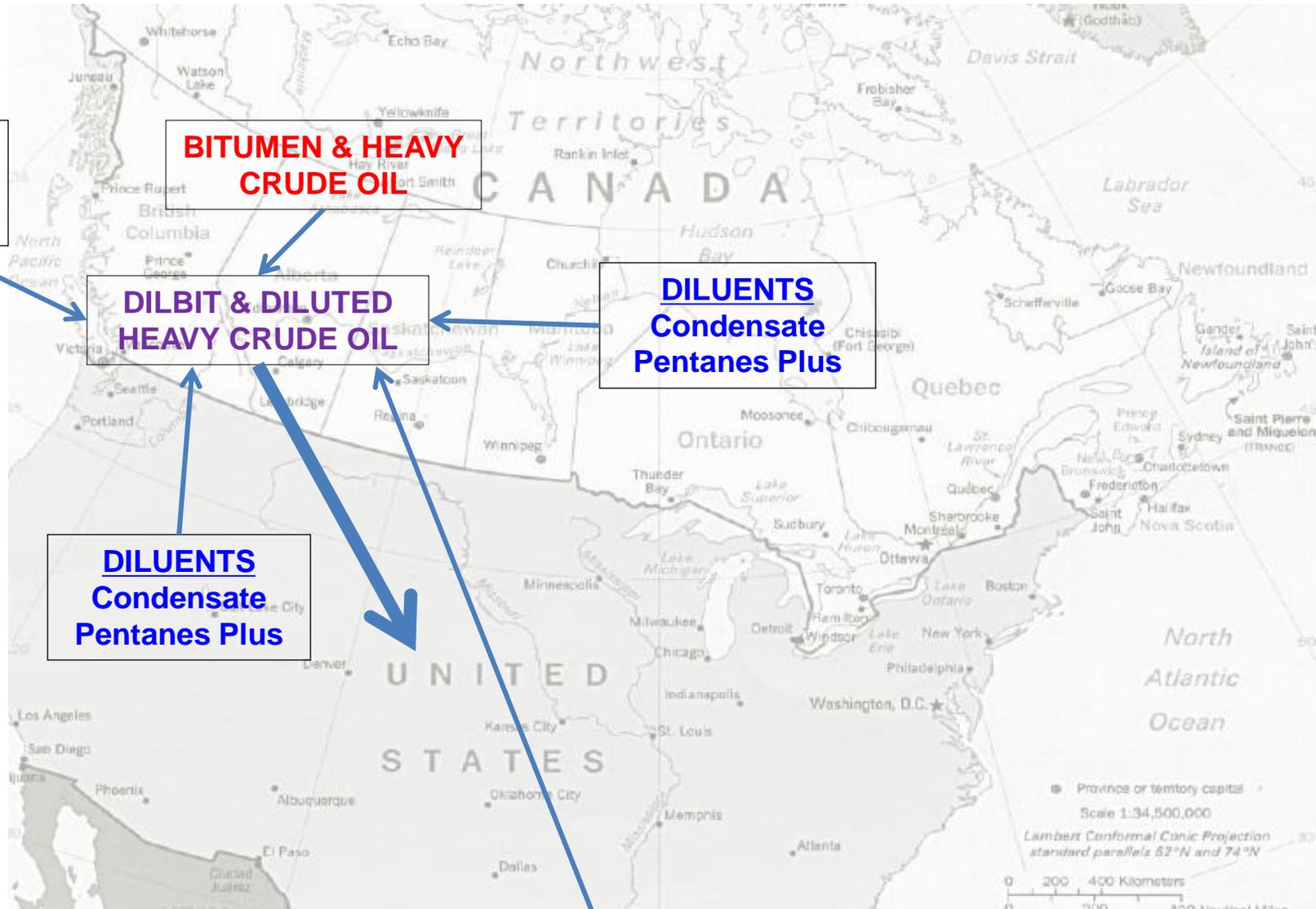
- Export to U.S. of Heavy Crude Oil in 2009 → **970,000 BPD**
- Export to U.S. of Light Crude Oil in 2009 → **300,000 BPD**
- If full U.S. duties were charged on both streams, annual cost to industry → **\$30,000,000!**
- Numbers are forecast to increase substantially.

Canadian suppliers and U.S. importers require more certainty in their NAFTA programs – ability to rely on certifications is key – varying levels of chaos over the past few years.

- NAFTA Good: The item that is being shipped from one NAFTA territory into another under a claim for NAFTA trade benefits.
  - May be wholly obtained or produced in a NAFTA territory or produced from materials.
- NAFTA Material: An item that is used in the production of a NAFTA good.
  - May or may not be NAFTA-originating.
- NAFTA-Originating: Refers to a good or material that satisfies the applicable NAFTA Rules of Origin to qualify the good or material for NAFTA preferential tariff treatment.
  - Three primary NAFTA Rules of Origin.
- NAFTA-Non-Originating: Refers to a good or material that does not satisfy the NAFTA Rules of Origin for purposes of NAFTA preferential tariff treatment.

- Bitumen / Crude Oil: The NAFTA-originating material that is taken from the ground (recovered) in Canada.
  - Bitumen and Heavy Crude Oil (API < 20° ) require blending with a moderate amount of a thinning agent – diluent – in order to produce flow for pipeline transportation.
- Diluent: Lighter hydrocarbon mixture blended with Bitumen (producing “Dilbit”) and Heavy Crude Oil to allow pipeline flow.
  - Despite physical similarities, there are **DIFFERENT TYPES** of Diluent for purposes of NAFTA!
  - Condensate: A type of diluent – obtained through recovery (versus processing with hydrocarbon separation by heat)
  - Pentanes Plus: A type of diluent – obtained through processing - fractionation - includes natural gasoline, plant condensate and isopentane.
  - Naphtha: A type of diluent – obtained through processing of crude oil, usually at a refinery – distillation.

# The Flow



**DILUENTS**  
Condensate  
Pentanes Plus

**BITUMEN & HEAVY**  
**CRUDE OIL**

**DILBIT & DILUTED**  
**HEAVY CRUDE OIL**

**DILUENTS**  
Condensate  
Pentanes Plus

**DILUENTS**  
Condensate  
Pentanes Plus

**DILUENTS**  
Condensate  
Pentanes Plus

- Oil Sands Bitumen and Heavy Crude Oil are too thick and viscous to allow pipeline flow.
  - Classifiable under HTSUS heading 2709, which covers crude oil and natural gas condensate.
- Must be blended with a lighter hydrocarbon material, “diluent,” in a minority percentage to thin the material and enable flow.
  - May be classifiable under either HTSUS heading 2709 (e.g., condensate) or HTSUS heading 2710, which covers petroleum products (e.g., naphtha, natural gasoline, pentanes plus).
  - Typical diluent content is in the range of 20-25%.
- **Customs has ruled that the blending of 2709 crude oil material with minority percentage of 2710 diluent results in a blend classifiable under 2709.**
  - **See HQ Ruling No. 016802, issued November 19, 2008.**

- How are goods determined to “originate in the territory of a NAFTA party”?
  - (1) They are “wholly obtained or produced entirely” in the territory of U.S., Canada or Mexico (*e.g.*, crude oil, bitumen, mineral goods);
  - (2) They are “transformed” in a NAFTA territory such that**
    - **Any non-NAFTA-originating materials undergo a prescribed change in tariff classification (*e.g.*, diluent blended with bitumen or heavy crude), or**
    - Goods otherwise satisfy the NAFTA rules (*e.g.*, regional value-content); or
  - (3) They are produced entirely in a NAFTA territory exclusively from originating materials.
- NAFTA-Originating status must be supported by a current, valid NAFTA Certificate of Origin (“C/O” or “CoO”).
  - CBP generally considers the NAFTA C/O to be the “claim.”
  - NAFTA declaration can be made up to one year after importation.
  - Importer must possess C/O at time of making NAFTA declaration.

# NAFTA Tariff Shift Rule Prior to Oct. 2, 2009 “Track 2”

- **U.S. Tariff General Note 12(t) - Change in Tariff Classification Rules:**  
**(3) A change to headings 2705 through 2709 from any other chapter.**
- Crude oil and bitumen = HTSUS chapter 27, heading 2709
- Diluent = HTSUS chapter 27, heading 2709 (condensate) or heading 2710 (naphtha, pentanes plus, etc.) – small amounts in Chapter 29
- DilBit and other Blended Heavy Crude = HTSUS chapter 27, heading 2709
- The Tariff Chapter under which the Diluent is classified does **not** change when it is blended with Bitumen or Heavy Crude Oil.
  - Required tariff shift does not occur (with minor exceptions)
- **RESULT: Blended Heavy Crude Oil and DilBit made with non-NAFTA-originating Diluent are NOT NAFTA-originating goods.**

- NAFTA Eligibility of Canadian-Sourced Blended Heavy Crude / DilBit prior to October 2, 2009:

**NAFTA-ORIGINATING  
DILUENT**

**NON-NAFTA ORIGINATING  
DILUENT**

**DILUENTS - FO**  
Condensate  
Pentanes Plus

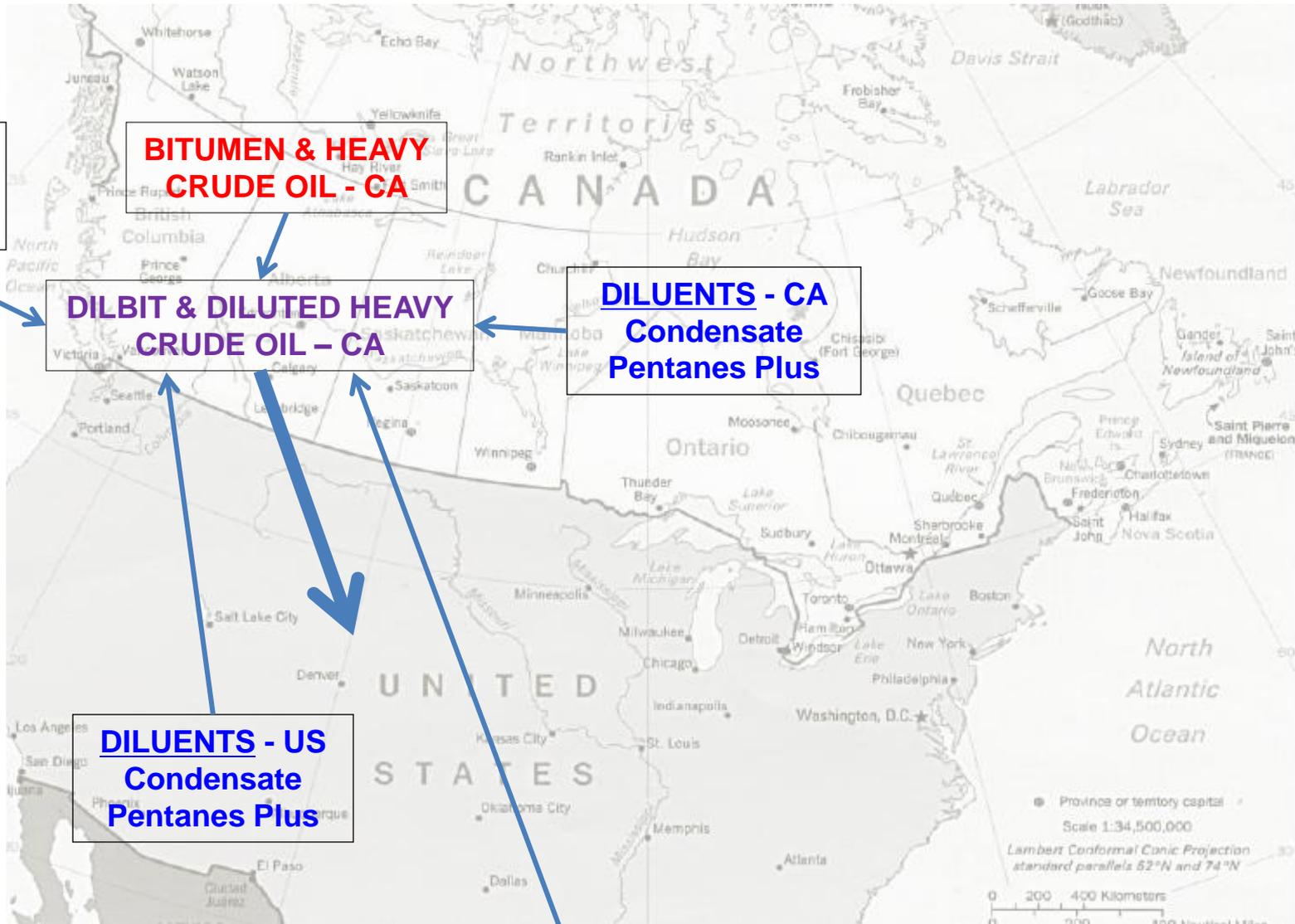
**BITUMEN & HEAVY**  
**CRUDE OIL - CA**

**DILBIT & DILUTED HEAVY**  
**CRUDE OIL - CA**

**DILUENTS - CA**  
Condensate  
Pentanes Plus

**DILUENTS - US**  
Condensate  
Pentanes Plus

**DILUENTS - FO**  
Condensate  
Pentanes Plus



# Addressing CBP Challenges to NAFTA Origin

- PROBLEM: Commingling of materials (*e.g.*, diluent) and goods (*e.g.*, DilBit) in storage and in transit can create inability to track cargoes from source to border.
  - If non-NAFTA diluent enters the system, how to account for it?
- NAFTA rules allow use of “Inventory Management Method” to track origin on a constructive basis (*e.g.*, FIFO).
- Commingled goods and materials must be *fungible* for NAFTA purposes in order to apply an Inventory Method and permit a finding of NAFTA-originating status.
- But multiple shippers and multiple goods/materials of varying (and sometimes indeterminate) NAFTA status – how can one shipper account?

- Encana had imported cargoes of Peruvian (non-NAFTA) condensate into Canada for use as a diluent for blending with bitumen and heavy crude oil.
- Encana was unable to identify its specific use of the imported diluent due to **commingling** – unable to allocate the Peruvian material to goods on a physical (*i.e.*, “molecular”) basis.
- CBP began assuming that Encana’s material (and, perhaps, similar non-NAFTA diluent) had “*infected*” the Canadian industry, jeopardizing the NAFTA-originating status of *all* blended heavy crude oil and DilBit from Canada.
  - Brought NAFTA programs to a virtual standstill for heavy crude oil - *and frequently light crude oil* - imported from Canada.

- Customs HQ made 3 important findings (HQ Ruling No. 012415, issued August 3, 2010)
  - Not only resolved Encana’s specific issue but set valuable industry precedent going forward:
    - (1) Fungibility: Encana’s Canadian diluent/condensate and commingled foreign diluent/condensate were “fungible” for NAFTA purposes = commercially identical and interchangeable.
    - (2) Inventory Management Method: Because the diluent was held fungible, CBP allowed Encana to use an “Average Method” of inventory accounting, constructively segregating NAFTA and non-NAFTA diluent, and, consequently, NAFTA and non-NAFTA blends.
    - (3) Title Separation: Encana’s use of non-NAFTA diluent did not affect the NAFTA eligibility of other shippers’ products or materials.

**RESULT: Encana ruling established the framework for determining Track 2 NAFTA-originating status for blended heavy crude oil.**

- **In addition to Encana other volumes of foreign diluent entered the Canadian system during the Track 2 period.**
  - Relatively small volumes; 2<sup>nd</sup> half 2008; low dollar impact (~\$65K)
- Must account for these NAFTA-disqualifying volumes in order to validate NAFTA status of other crude shipped to US
  - Required extensive industry cooperation
  - Volumes tracked through several channels to receipt by 3 wholly unsuspecting producers
  - Producers able to track usage into crude delivered to US importers; conservative in production factors and in applying all volumes to US shipments (i.e., none to Canadian shipments)
  - **Prior disclosures** submitted in early December 2011; pending
- Issuance and support of NAFTA C/Os still in limbo.

- Prior Disclosures filed with CBP in Chicago, as port of entry of affected crudes, and subsequently transferred to CBP in Pembina – greater familiarity with the issues; HQ involved.
- Resolution of the Prior Disclosures affects not only status and effect of Track 2 NAFTA C/O's and dutiability of entries made there under, **but also Track 3 C/O's and entries.**
- **Essentially requesting that CBP rule as follows:**
  - **Presumption that all crude oil and bitumen base stock originates in Canada, with perhaps small volumes crossing in from U.S., such that all is NAFTA-originating.**
  - **Accept industry's use of Stats Canada import data to identify all potentially NAFTA-disqualifying diluents on an ongoing basis –**
    - **Tariff classification – complete and correct**
    - **Canadian point of entry – no East-to-West diluent transport in Canada**

# NAFTA Tariff Shift Rule - Oct. 2, 2009 to Present “Track 3”

- *On and after October 2, 2009: “Track 3” = A tariff shift to HS heading 2709 from any other heading qualifies the good as NAFTA-originating.*
- Crude oil and bitumen = HTSUS heading 2709
- Diluent = HTSUS heading 2709 (condensate) or heading 2710 (naphtha, pentanes plus, etc.) – minor amounts under heading 2901
- DilBit and other Blended Heavy Crude = HTSUS heading 2709
- **RESULT: Only non-originating diluent classifiable under HTSUS heading 2709 fails to undergo an approved tariff shift and so disqualifies the NAFTA origin of the resulting DilBit or blend. All other diluent qualifies for NAFTA.**

- NAFTA Eligibility of Canadian-Sourced DilBit from October 2, 2009 forward:

<b>NAFTA-ORIGINATING DILUENT HS 2709</b>	<b>NAFTA-ORIGINATING DILUENT HS 2710</b>
<b>NON-NAFTA- ORIGINATING DILUENT HS 2709</b>	<b>NON-NAFTA- ORIGINATING DILUENT HS 2710</b>

**DILUENTS - FO**  
Condensate (2709)  
Pentanes Plus (2710)

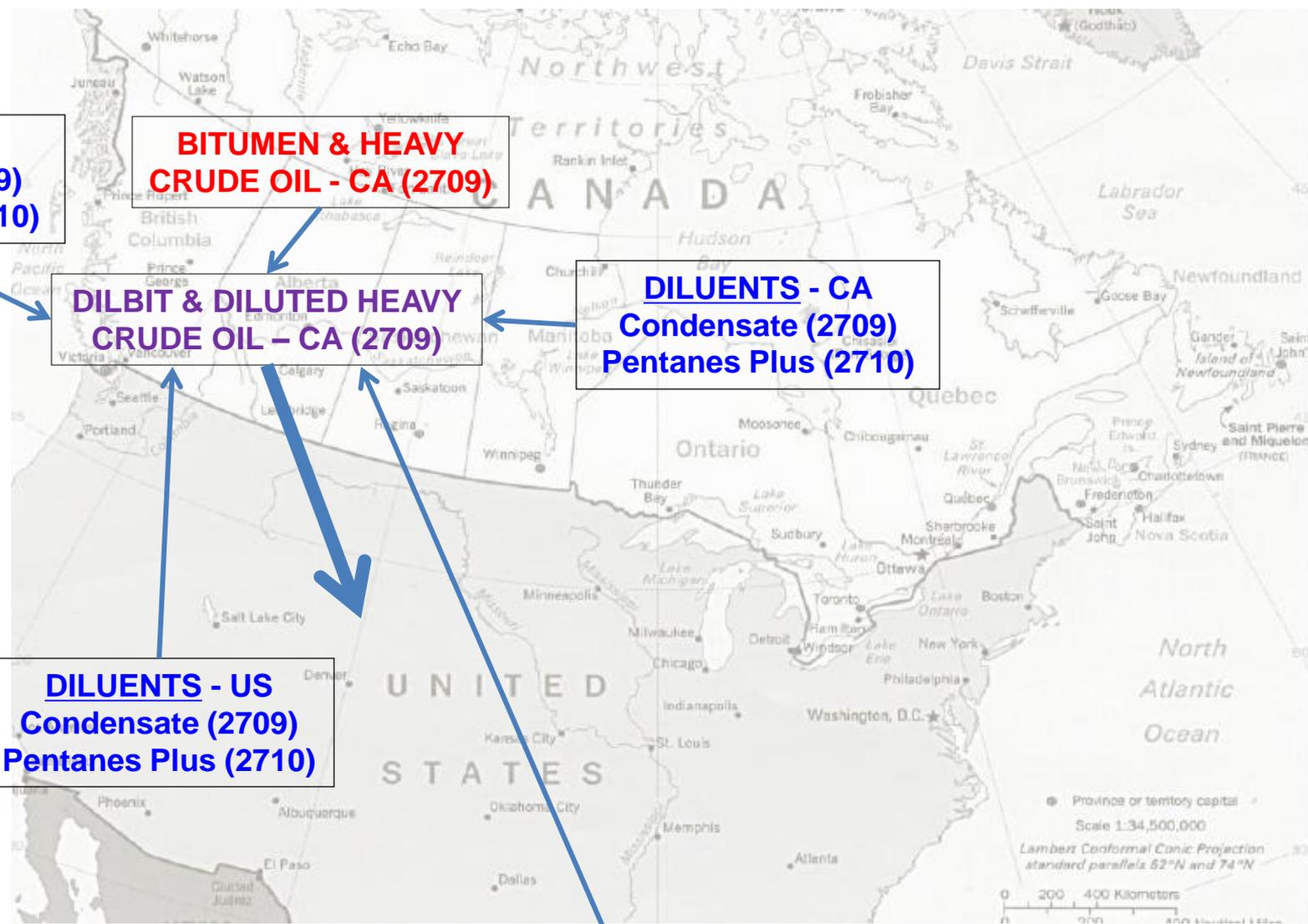
**BITUMEN & HEAVY  
CRUDE OIL - CA (2709)**

**DILBIT & DILUTED HEAVY  
CRUDE OIL - CA (2709)**

**DILUENTS - CA**  
Condensate (2709)  
Pentanes Plus (2710)

**DILUENTS - US**  
Condensate (2709)  
Pentanes Plus (2710)

**DILUENTS - FO**  
Condensate (2709)  
Pentanes Plus (2710)



# Different Rules Apply for Different Diluents

## NAFTA-Originating Diluent (HTSUS 2709 or 2710)

- Per EnCana, can be tracked to qualifying use in blend production of NAFTA-originating dilbit / heavy crude oil.
- Establish fungibility, apply Inventory Management Method.

## HTSUS 2710 Diluent (Non-NAFTA)

- Qualifies for use in blend production of NAFTA-originating dilbit / heavy crude oil.
- Cannot be tracked by Inventory Management Method – material classified based upon what it is.

## HTSUS 2709 Diluent (Non-NAFTA)

- Does not qualify for use in blend production of NAFTA-originating dilbit / heavy crude oil.
- Same analysis if origin and type of diluent are unknown.
- **Double-Shift: Non-NAFTA 2709 diluent could *shift* to 2710 when blended with 2710 diluent, and then *shift back* to 2709 when blended as minority component with bitumen or heavy crude oil.**

- Work to *maximize* diluent classification under HTSUS heading 2710, rendering it eligible for NAFTA-qualifying tariff shift to HTSUS heading 2709 when blended with bitumen and heavy crude oil, regardless of origin.
  - 2710 *valid* for naphtha, pentanes plus, natural gasoline, plant condensate, and other “processed” petroleum products and NGLs.
    - CBSA advance rulings re natural gasoline and other natural gas liquids.
  - 2710 *not valid* for lease condensate or light crude oil that is “collected” or “recovered” rather than “processed” = 2709.
  - **Commingling** of fungible materials remains an issue.  
Recent CBSA advance rulings: Per HTSUS General Rule of Interpretation 3(c), “mixtures” of diluents classifiable under heading 2709 and 2710 are classifiable under heading 2710 because that heading appears last in numerical order.
    - NOTE: Does not define minimum amount of 2710 diluent needed.
  - ***Still requires 2709 versus 2710 distinction at point of input.***

- **Trade data in the United States and Canada support a finding that NO foreign, non-NAFTA 2709 diluent has been imported since start of 2009.**
  - And only small series of disqualifying diluent imports (by one importer) unaccounted for over the past 5 years – occurred in 2<sup>nd</sup> half of 2008 – duty exposure for the industry < \$65,000!
- Enbridge Southern Lights Pipeline “NAFTA Practice” prescribes only NAFTA-originating or 2710 diluent.
- Still, must be prepared with a methodology to account for such material in the event market conditions change.
- Effective system of compliance begins with understanding what you are receiving.
  - NAFTA-originating or not? 2709 or 2710?
- Concerns grow sharply if/when Keystone XL approved.

Given the complexities of the crude oil and diluent storage and transportation systems in Western Canada, industry-wide NAFTA success with CBP may rest upon the following under Tracks 2 and 3:

- **Presumption** that all crude oil and bitumen shipped from Western Canada to U.S. originated in Canada, or in some cases U.S., and is a NAFTA-originating material = low risk verification concern
- Allow industry to use **Stats Canada** import data to establish type and volume of diluents imported for use in Western Canada - “tracking the exceptions” -
  - **Tariff Classification**: We have targeted all possible tariff provisions under which potentially NAFTA-disqualifying diluent might be classified
  - **Logistics**: By tracking imports only into the 4 westernmost provinces of Canada – British Columbia, Alberta, Saskatchewan and Manitoba – we have accounted for all receipts – diluent does not move from Eastern CA to western CA
  - **Commingling**: Under Track 3 the presence of 2710 diluent mixed with 2709 diluent creates a 2710 product – no substantive NAFTA concern

- Proposed “Track 4” – two alternatives proposed:
  - “A change to heading 27.09 from within that heading or any other heading;” or
  - “A change to a good of heading 27.09 from any other good of that heading or any other heading.”
- Would authorize NAFTA-originating status for virtually all crude oil from Canada, so long as presence of heading 27.09 diluent remains < 50%.
- Mexico now is a firm NO, ongoing but senior dialogue
- Track 5, anyone?

