400 North Columbus Street, Suite 201
Alexandria, VA 22314
p 703.684.5574
f 703.836.8503
www.ilma.org
ilma@ilma.org

October 9, 2017

Hon. Robert E. Lighthizer
United States Trade Representative
600 17th Street, N.W.
Washington, D.C. 20508

Re: NAFTA Renegotiation and Group III Base Stocks

Dear Ambassador Lighthizer:

As the Administration renegotiates the North American Free Trade Agreement ("NAFTA"), the Independent Lubricant Manufacturers Association ("ILMA") understands that efforts are being made to address "rules of origin" issues. NAFTA already has the strictest rules of origin of any major U.S. trade agreement, and the existing, tougher regulations on content requirements for a growing segment of our members' businesses is putting them at a distinct competitive disadvantage with their Canadian and Mexican competitors.

Since NAFTA originally took effect, engine, transmission and drivetrain technologies for motor vehicles have dramatically changed, largely to meet governmental mileage and emissions standards. To meet these regulatory mandates, which are becoming more and more stringent, the automakers are specifying lower viscosity, higher-quality lubricants, including engine oils and transmission fluids, causing ILMA members to shift to higher-grade base oils, such as Group III base stocks, to meet the specifications and market demand. The trend for the foreseeable future is for the increasing volumes of Group III base oils.

In the past ten years, Group III base stock production has nearly quadrupled to 162,000 barrels per day. The problem is that 99 percent of the Group III base oils used in the U.S. today are produced outside of North America. Because Group III base stocks cannot be used by themselves in an engine oil or transmission fluid, ILMA members must add additives, chemicals and detergents to meet the increasingly demanding automakers' specifications. ILMA members transform the Group III base oils into a different article in commerce at a significantly higher value that is in increasing demand and that is essential to the automotive industry.

Current NAFTA rules of origin do not distinguish between Group III base stocks and finished products, such as engine oils, in the tariff classification 2710.19. Because there is no tariff shift, ILMA members cannot confer U.S. origin on their finished products. Further, because of the overwhelming dependence on Group III base oils from non-NAFTA sources, ILMA members' finished products are subject to an import duty when sold into Canada or Mexico.

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As part of the Administration's renegotiation of NAFTA, ILMA requests that the rules of origin rules be modified to eliminate the tariff shift requirement for Group III base oils by including a 100 percent exemption for non-originating Group III base stocks.

Introduction of ILMA

ILMA is a national trade association founded in 1948. Its 350 members represent every aspect of the lubricants industry. The Association's 155 manufacturing members account for over 30 percent of the automotive lubricants sold in the U.S. and over 75 percent of the metalworking fluids used. Our economy simply does not function without the products made and sold by ILMA's members.

What makes ILMA's manufacturing members "independent" is that they are neither owned nor controlled by refiners, re-refiners or major chemical companies. These manufacturing members buy their raw materials from the suppliers they compete against in the marketplace. ILMA members succeed in the marketplace, in part, because of their proximity and added value to their customers.

ILMA members typically qualify as "small businesses" under the Small Business Administration's size standards. ILMA estimates that there are at least 11,525 people directly employed by its manufacturing members and that employment in the overall lubricants industry exceeds 40,000 individuals. The overwhelming majority of ILMA members export finished products from the U.S. and many report that their largest export markets are Canada and Mexico.

Background on Group III Base Stocks and Demand

The American Petroleum Institute ("API") has created five broad categories of base stocks – Group I through Group V – to create base oil interchange guidelines for its licensing program[1] for engine oils. Group I through Group II base oils are produced from mineral oils (*i.e.*, crude oil). As one moves from Group I to Group III base stocks, the viscosity index ("VI") of the product increases.[2]

VI measures an oil's resistance to viscosity changes as temperatures change. The higher the VI, the more stable the viscosity remains over a wider range of temperature changes. For example, a higher VI oil will thicken less as temperatures get colder and will thin less as temperatures get hotter. This characteristic is important for today's multi-grade oils used in vehicle engines that are smaller, more efficient, and operate at higher temperatures and with tighter tolerances.

Over the past decade, more stringent vehicle emission requirements have caused a dramatic shift in the U.S. base oils market. Many ILMA members have replaced Group I base stocks with Group II and Group III base oils.[3] Advantages from using higher-quality Group II and Group III

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[1] Engine Oil Licensing and Certification Program.

[2] Group II+, while not an API base oil category, is used in the lubricants industry to describe Group II base stocks with and higher VI and lower volatility than other Group II base oils.

[3] The purity and oxidation of the higher quality Group II and Group III base stocks also has resulted in base oil substitution for industrial oils (*e.g.,* hydraulic fluids).

base stocks include greater purity to meet automakers' specifications, higher fuel economy, lower evaporative emissions, extended drain intervals, better cold temperature performance, and lower formulating costs.

Most automakers are moving to lower viscosity lubricants for fuel economy, driving up the demand for Group III base stocks. According to the May 3, 2017 issue of the industry newsletter, *Lube Report,* North America is the largest consuming region for Group III base oils, currently using between 1.1 and 1.2 million metric tons of Group III base stocks. Using *Lubes'N'Greases* "Guide to Base Oil Refining," this translates to approximately 17 percent of global Group III refining capacity.

However, according to the same sources, only three percent of the global Group III base stock production occurs in North America. Petro-Canada's Mississauga, Ontario refinery can produce some 195,000 metric tons of Group III base oils per year. A re-refiner, Avista Oil, says it can make 8,000 metric tons per year of Group III base stocks at its plant in Peachtree, Georgia. Calumet Refining started producing one grade of Group III base oils at its Shreveport, Louisiana refinery earlier this year, and a re-refinery is scheduled to open next year in Tampa, Florida that is slated to produce about 1,170 metric tons annually of Group III base oils.[4]

Based on the foregoing, about 99 percent of the Group III base stocks used today in the U.S. are imported from Korea and the Middle East. It also is important to note that all Group III base oils are not interchangeable and, therefore, do not meet automakers' performance requirements.

Group III base stock variations largely occur because of differences in feedstocks and refining technologies.[5]

Lubricants industry analysts, such as Kline & Co. and Freedonia, estimate that the pace of the automakers' shift to lower viscosity oils is expected to increase in North America over the next 10 years, leading to greater demand for Group III base oils. While some U.S. refiners can upgrade some of their Group II capacity to make Group III base stocks, it is expected that most of the demand for Group III base stocks will continue to be served by imports from non-NAFTA sources.

The NAFTA Tariff Classification Issue

Because of the low volumes of Group III base oils on a percentage basis when NAFTA was originally ratified, the Agreement's rules of origin requirements were not a significant issue. This has now changed and a significant problem exists and will get worse for ILMA's members.

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[4] ILMA believes that a significant portion of Petro-Canada and Calumet's base oil production is consumed internally by those companies for their finished lubricants, so the actual amount of Group III base stocks available to ILMA's manufacturing members is appreciably less. Some large oil companies, such as Shell, Phillips 66, Chevron, BP Castrol, also are dependent on Group III base oils produced outside North America and are affected by NAFTA's rules of origin.

[5] Because of the trends in lubricant manufacturing, ILMA anticipates that there will be increased research and development in the U.S. on Group III base oils and testing for interchangeability.

Rules of origin stipulate the percentage of input components allowed from non-NAFTA countries in order to qualify for the Agreement's duty-free benefits. General Note 12 (NAFTA) of the US Harmonized Tariff Schedule, Section (t), Change in Tariff Classification Rules, Chapter 27, heading 2710, rule 4C states:

> Production of any good of heading 2710 as the result of direct blending, provided that (1) the non-originating material is classified in chapter 27, (2) no component of that non-originating material is classified under heading 2207, and (3) the non-originating material constitutes no more than 25 percent by volume of the good [results in a NAFTA-qualified good].

Based on this provision, any engine oils manufactured by ILMA members or others in the U.S. and containing more than 25 percent by volume of non-NAFTA origin Group III base stocks is subject to import duty when the product crosses into Canada or Mexico. Because many of today's engine oils may contain up to 90 percent by volume of Group III base stocks from Korea or the Middle East, the 25 percent "cap" on foreign material creates a real trade barrier for ILMA members and a significant cost disparity with their Canadian and Mexican competitors.

As ILMA understands NAFTA's rules of origin requirements, the tariff classification for engine oils – 2710.19 – is the same subheading for Group III base oils, resulting in no tariff shift when the ILMA members manufacture a distinctly different product by combining the Group III base stocks with the additives, chemicals and detergents. From a specification standpoint, there are distinct differences between the Group III base stock and the finished lubricant.

The transformation of a Group III base oil into a high-quality engine oil also includes a significant value add. Group III base stocks in the U.S. cost between $2.00 and $3.00 per gallon; however, after manufacture and including the cost of the other components, the finished engine oil sells for more than $20.00 per gallon. Because the new, finished engine oil is a distinctly different product in commerce after its manufacture, and because the added value is essential to product's functional use, a significant transformation has occurred and a tariff shift should take place.

<u>NAFTA Should Include a Carve-Out or Exclusion from the Classification of Base Oils</u>

The current NAFTA negotiations are an opportunity to address inefficiencies and reflect procedures adopted or proposed in subsequent free-trade agreements, such as the one with Korea ("KORUS"). ILMA believes that rules of origin under NAFTA should be clear, simple, and transparent to reduce transactional time and costs. At a minimum, the NAFTA negotiation should allow for mitigation provisions if the rules of origin disadvantage a particular product. Here, the deliberate and controlled mixing or blending of materials, including non-NAFTA Group III base stocks, to predetermined specifications that are relevant to the finished lubricant should confer origin when done in the NAFTA territories.

NAFTA's rules of origin should be modified to eliminate the tariff shift requirement for Group III base oils by including a 100 percent exemption for non-originating Group III base stocks, given that the volume of Group III base oils necessary to meet the automakers' specifications

and market demand are not produced in sufficient quantities in the NAFTA territories. ILMA members will continue to rely on non-NAFTA sources for Group III base stocks, so without the tariff shift they will increasingly face competitive issues in the North American market.

We are happy to meet with you and your staff to discuss this important issue.

Sincerely,

Holly Alfano
CEO

cc: ILMA Board of Directors
Jason Bernstein, USTR
Justin Hoffman, DOC/ITA
David Olsen, DOC/ITA
Dean Wilson, Valvoline