



US Duty On Canadian Heavy Crude Exports

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The presentation should not be relied on as a basis for any particular company's customs filings, or any government compliance documentation. It is only intended to provide an overview of a very complex subject.



Introduction

- Over the past few years, Country of Origin of diluent imports into Canada have created questions about the duty status of Canadian heavy crude blends that are entering the US
- Lack of clarity on the issue has led to:
 - ▶ Some companies deciding to pay duty on all the heavy blends they import into the US
 - ▶ US Customs deciding recently to collect data so they can understand how the industry is complying with US import regulations



Introduction cont'd

- The intent of this presentation was originally to use it as a forum to disseminate expected ruling information that had been issued by US Customs
- Since US Customs has not issued any of the relevant rulings, this presentation is now being used to provide an overview of the issues and some of the directions that are being pursued by the industry



Background

- Under NAFTA, crude oil that originates in North America can move from Canada to the US without duty
- Appropriate import paperwork must be filed to demonstrate the origin of the crude
- Under NAFTA, importers must also identify the COUNTRY OF ORIGIN of their blend components as Country of Origin is defined in the NAFTA regulations



Background

- Traditionally Canadian heavy blends have been considered to be a commodity with all components originating in North America
- As diluent imports into Canada have increased, the NAFTA status of Canadian heavy blends have been questioned
- To answer these questions, consideration must be given to how diluent is classified within the NAFTA regulatory framework

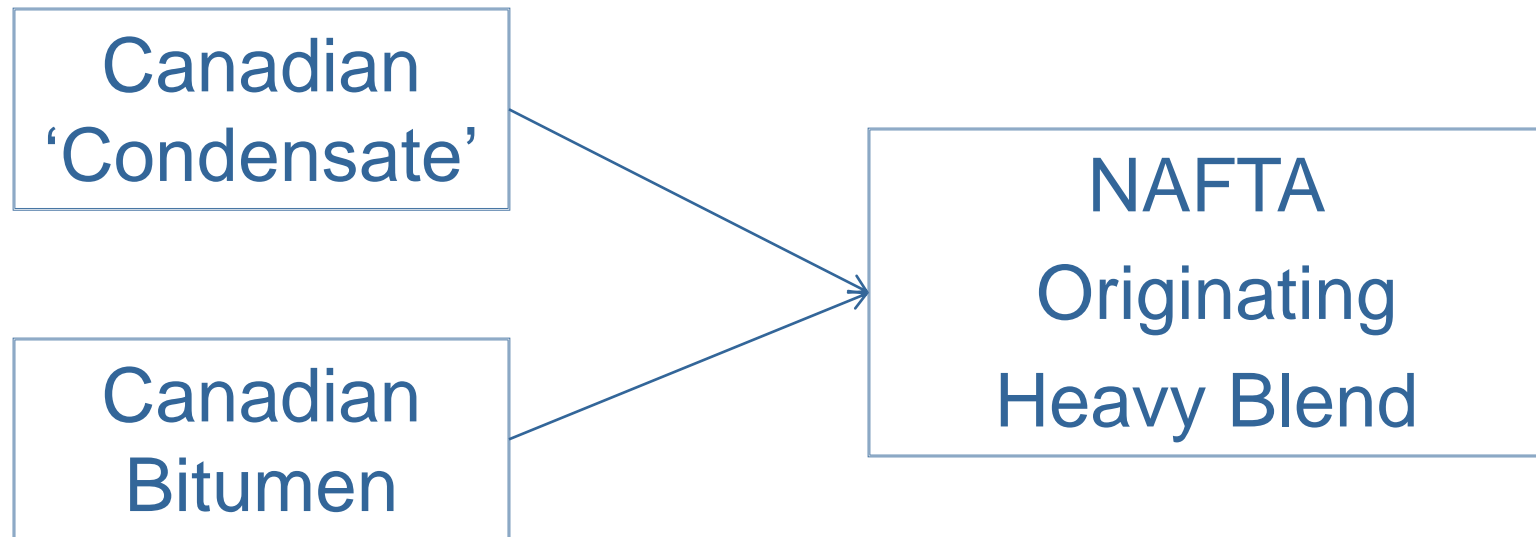


Terminology

- **Diluent:**
 - ▶ a hydrocarbon which is added to heavy crude to reduce its viscosity and density to meet pipeline specifications
- **Condensate:**
 - ▶ A defined term in customs regulations that only includes the liquids that drop out immediately after production of natural gas
- **Naphtha/Processed material:**
 - ▶ Defined terms in customs regulations for liquids that have been subjected to some processing

US Import Considerations

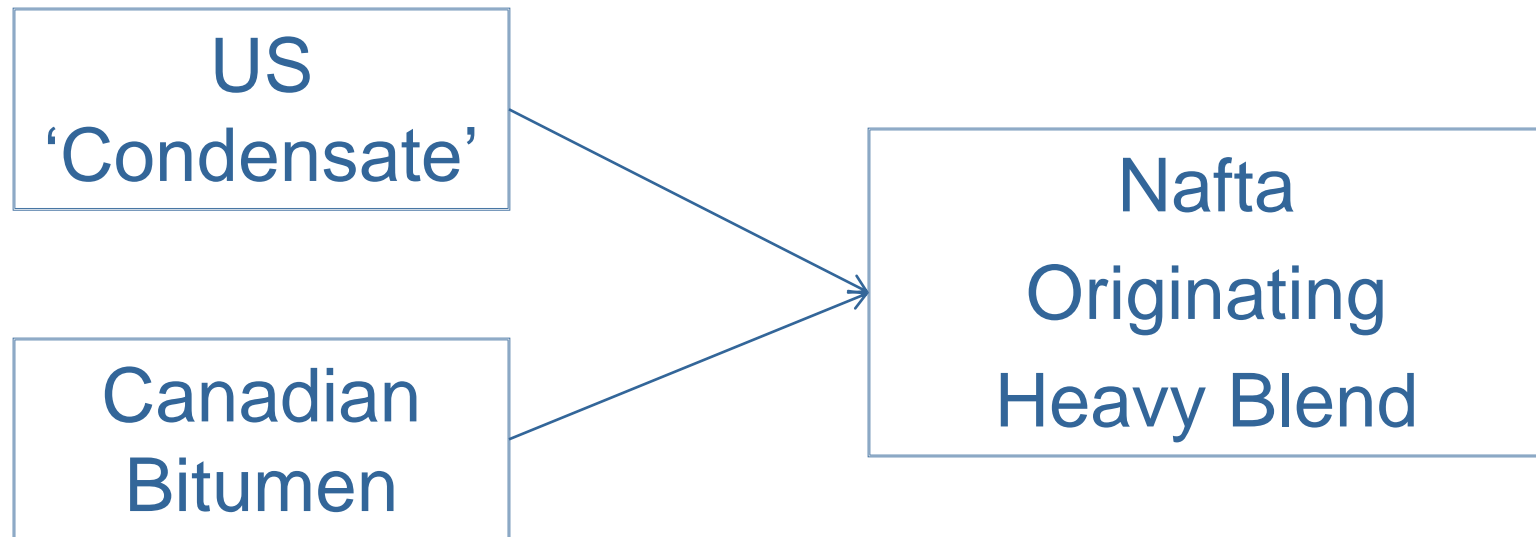
Traditional Assumption of Market



No duty issues because everything originates in Canada

US Import Considerations

With US Supplied Diluent



No duty issues because everything originates in NAFTA zone

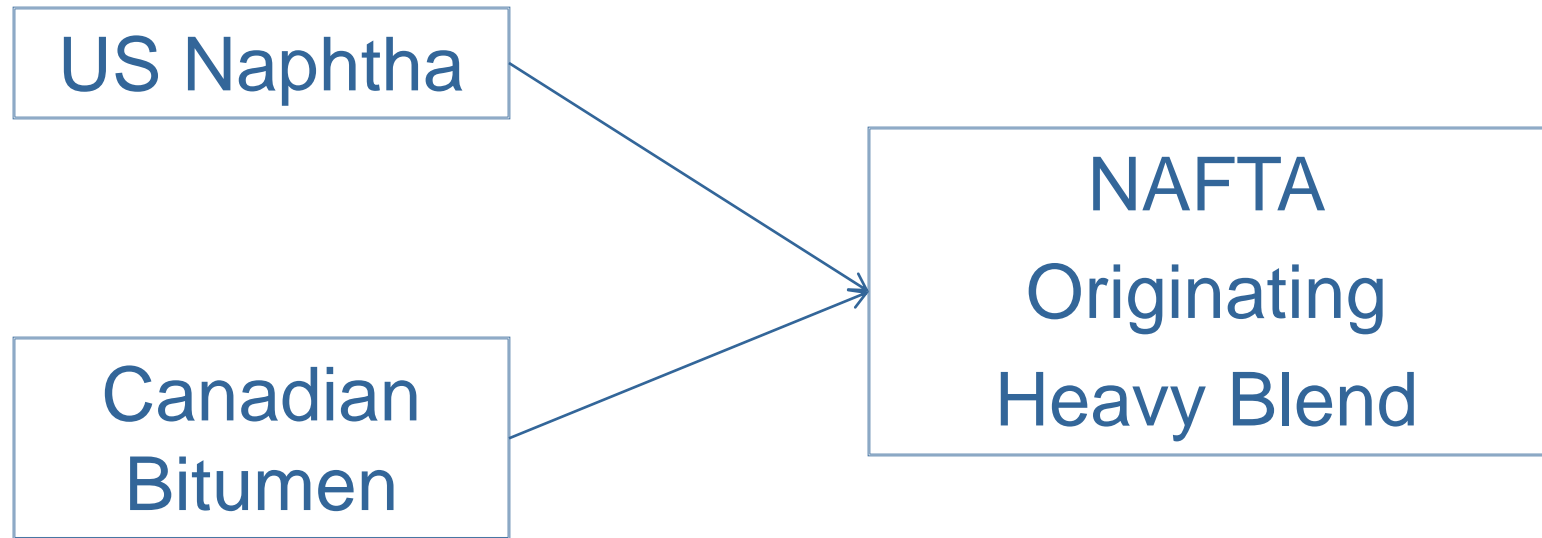


US Import Considerations

- For Customs purposes, the commodities are designated by their World Customs Organization codes
- Crude and Condensate are classified as:
 - ▶ *2709 – Petroleum oils and oils obtained from bituminous minerals, crude*
- In the previous examples all of the commodities would be classified as 2709

US Import Considerations

With US Naphtha



- No duty issues because everything originates in NAFTA zone

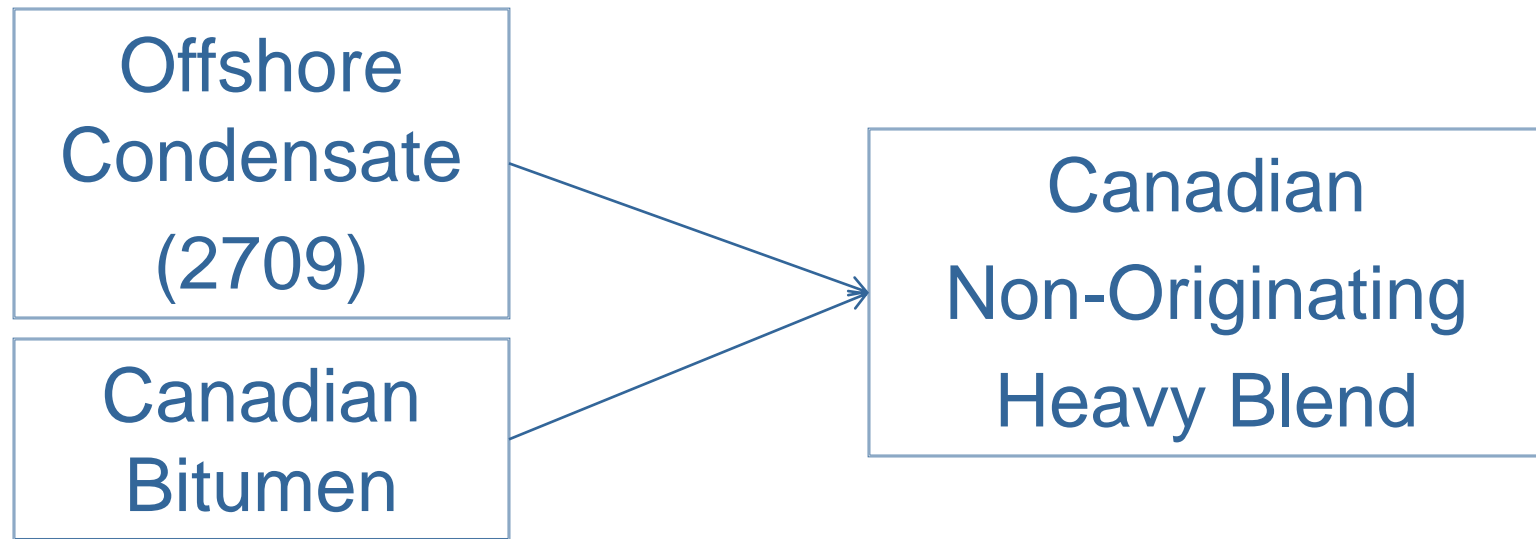


US Import Considerations

- Crude and Condensate are classified as:
 - ▶ *2709 – Petroleum oils and oils obtained from bituminous minerals, crude*
 - ▶ *2710 – Petroleum oils and oils obtained from bituminous materials other than crude...*
- In the refinery naphtha example:
 - ▶ Bitumen – 2709
 - ▶ Refinery Naphtha - 2710
 - ▶ Heavy Blend - 2709 because the majority of the blend is bitumen

US Import Considerations

Offshore Condensate



- Mostly Canadian but non-Canadian material disqualifies the blend under NAFTA regulations - Duty is payable

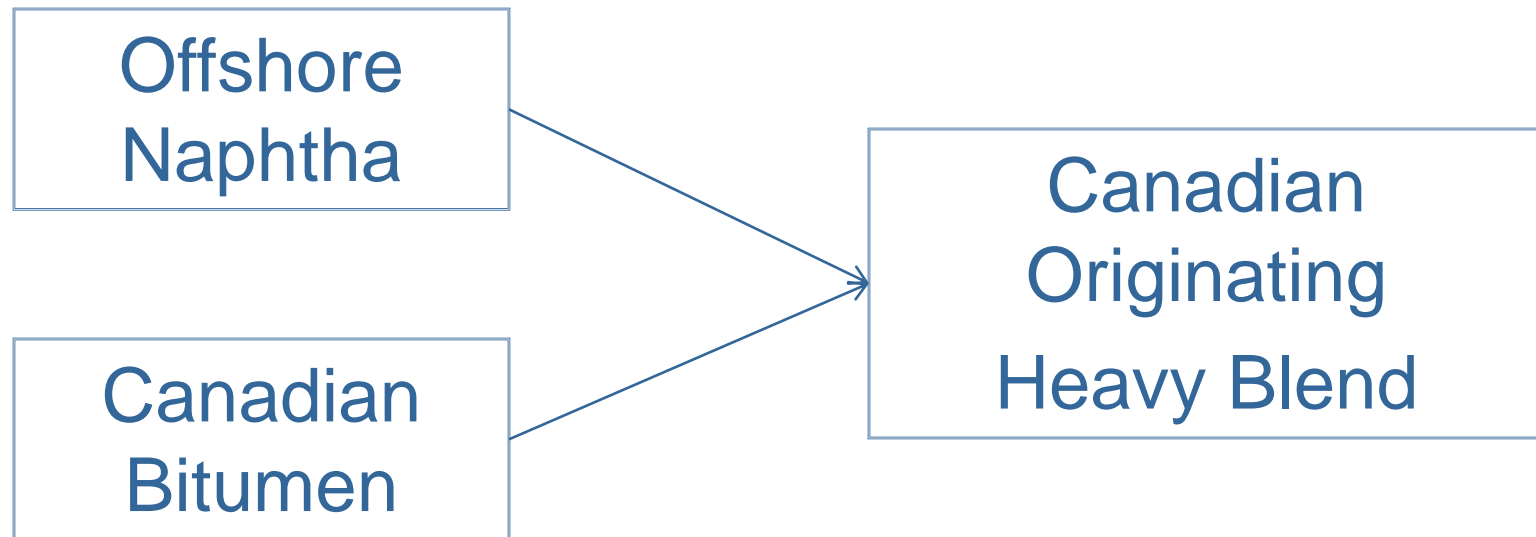


US Heavy Blend Imports

- Condensate (2709) was imported to Canada from Venezuela in 2008, possibly for diluent use
- US Gulf Coast storage facilities CAN comingle foreign and domestic material?
 - ▶ Some foreign may arrive in Canada this way but it is normally documented as US sourced 2709 condensate – Country of Origin?

US Import Considerations

Offshore Naphtha



- Allowed under NAFTA rules since Oct. 2009
- No duty is payable

US Import Considerations

- In October 2009, NAFTA Track 3 changes were enacted that defined the customs treatment of blends of 2710 processed petroleum streams and 2709 crude petroleum streams
 - ▶ Resulting blend takes the designation and Country of Origin of the dominant component, in our case, Bitumen
- Before October 2009, the rules were the same for these blends as for bitumen condensate blends



Summary

- Where does this leave us as an industry?
 - ▶ Canadian and US (and Mexican) domestic diluent is good
 - ▶ Offshore condensate (2709) is a problem
 - ▶ Offshore naphtha (2710) should be manageable
- With these facts we can look at the real Canadian diluent system, its constraints and future options



Diluent Facts

- In first 11 months of 2009
 - ▶ Overall W Cdn diluent pool: ~209,000 BPD
 - ▶ Cdn C5+ and Condensate ~134,000 BPD
 - ▶ Naphtha from Processing ~18,000 BPD
 - ▶ Imported Condensate ~39,000 BPD
 - ▶ Imported Naphtha ~18,000 BPD
- CRW throughput, the most public part of the diluent system ~101,000 BPD

Diluent Facts cont'd

- The approximately 20% of the diluent pool that is imported condensate cause the potential problems
 - ▶ Within this 20% a significant proportion is US originating and is NAFTA eligible
 - ▶ There is less certainty about potentially undefined US Gulf Coast condensate and the infrequent direct receipts into Canada of offshore condensate



Next Steps

- The first step has been to try to clarify the rules
 - ▶ Obtain confirmation of the difference between 2709 Condensate and 2710 naphtha/processed material
 - ◆ Confirm gas plants produce a processed material
 - ▶ Clarify what mechanisms would be considered acceptable for managing blends of 2709 and 2710 diluent
 - ◆ What aspects of title separation and inventory tracking will provide adequate documentation to demonstrate compliance with NAFTA Track 3 blending rules?



Next Steps cont'd

- US Customs is examining the second issue carefully and they have not provided any response even though it has been 3 years
- Timing is unknown but it is important to the industry because it might have an impact on how Southern Lights volumes are classified



Next Steps cont'd

- Get clarification of 2709/2710 classification
- Disseminate the results of that clarification to ensure that imports are properly classified
- Develop ways to ensure that any duty issues are limited to heavy blends that are using diluent that is not eligible for NAFTA certification
 - ▶ Needs to be done in a way that minimizes disruption to existing business practices



The Cost

- Heavy blend exports are ~1,000,000 BPD
- If duty is applied to all shipments, cost would be
 - ▶ \$20,000,000 per year plus administration fees
 - ▶ Cost will increase as heavy blend volumes increase
- To date, no one has identified any impact on the value of Canadian heavy blend as a result of this issue
 - ▶ Are there any future impacts?



For a Heavy Blend Producer

- At this time there is little certainty but
 - ▶ Keeping track of diluent supply sources is important
 - ◆ Know your supplier
 - ◆ Is their documentation adequate and reasonable?
 - ▶ US Customs has an extensive list of expectations under their informed compliance program