Intelligence MEMOS

From: Jon Johnson

To: Auto Industry Watchers

Date: January 23, 2023

Re: **How the US Lost the Fight Over Automotive Rules of Origin**

The panel in the recently released decision in *United States – Automotive Rules of Origin* tackled content requirements for cars and light trucks, which have the most complex origin rules in the Canada-United States Mexico Agreement (CUSMA.)

Each major "part" (engine, transmission, body and chassis, axle, suspension system, steering system, electric vehicle battery) of a light-duty vehicle identified in the CUSMA rules must qualify as "originating" for the entire vehicle to qualify. The rules set out multiple methods for making these content calculations.

The new panel decision, formally issued two weeks ago, addressed the practice of "roll-up" that became a significant issue during the brief (1989 through 1993) period that the original Canada-US Free Trade Agreement was in effect before its replacement by NAFTA.

Whether a material used to produce a good was originating depended on its compliance with the specific CUFTA rule of origin that applied to it.

Consider a "material" such as a spark ignition reciprocating engine – found in most light vehicles – classified under heading 84.07 of the Harmonized System used by both Canada and the US. The CUFTA "originating" rule required a change in tariff classification from another heading. Engine parts are classified under heading 84.09, so incorporating a part into the engine resulted in a heading change (84.09 to 84.07) and satisfied this part of the rule. However, the rule also requires that the value of materials originating in Canada or the US plus the direct cost of processing in either country, must equal no less that 50 percent of the value of the engine when exported to the other country.

Under the CUFTA value content requirement, the value of non-originating materials used in the production of a good counted against the producer. Materials that qualified as "originating" did not count against the producer, even though some of the sub-materials could be non-originating (such as by being imported). The value of such non-originating sub-materials was "rolled-up" into the value of the qualifying material, and not counted against the producer. Consider our engine rule. With the 50 percent requirement only, there was sufficient latitude in the rule for the engine to contain some clearly non-originating components (such as Japanese piston heads) and nonetheless satisfy the rule and qualify as originating.

GM, Ford and Chrysler considered that roll-up was being abused by the newly established Toyota and Honda North American operations, and insisted the NAFTA rules for light-duty vehicles be based on a system of tracing materials back to the point at which they were imported into a NAFTA country. The tracing regime was cumbersome and Toyota and Honda, with simpler supply chains and extensive North American supply networks, did not have difficulty complying.

The Trump administration negotiators disliked the NAFTA tracing regime and, with a few exceptions, tracing was not carried forward into CUSMA, which expressly recognizes the practice of "roll-up" in Article 4.5(4) as follows:

> "Each Party shall provide that the value of non-originating materials used by the producer in the production of a good shall not, for the purposes of calculating the regional value content of the good under paragraph 2 or 3, include the value of non-originating materials used to produce originating materials subsequently used in the production of the good." [my emphasis]

Roll-up applicability is further reinforced by the Uniform Regulations, to which all three nations agreed.

A *quid pro quo* for roll-up recognition was a significant increase in percentage requirements for a vehicle to qualify as originating. The 62.5 percent NAFTA requirement will end up at 75 percent next July as CUSMA takes full effect.

The US argued that the CUSMA roll-up provisions do not apply to the calculation of the regional value content of the major light-duty vehicle "parts" and so the value of any non-originating materials contained in those parts should count against the producer.

The panel rejected this argument in its 38-page decision and held that the roll-up provisions do apply.

The decision noted an email from the lead US negotiator to the lead Canadian shortly before CUSMA came into effect recognizing that roll-up did indeed apply. This communication was irrelevant, the US argued, but the panel disagreed and found it relevant as a "supplementary" means of interpretation.

The panel's reasoning and conclusions are compelling. Disputes over the interpretation of rules of origin respecting automotive goods can be extremely costly and disruptive, given the sheer volume of the trade in automotive goods among the CUSMA countries and the integration of their industries.

US manufacturers, with their extensive interests in the Canadian and Mexican automotive industries, should urge the US government to fully comply with the panel's decision.

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