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JAMA

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GENERAL DIRECTOR

NHTSA-2001-11419-6

DEPT. OF TRANSPORTATION DOCKETS
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April 22,2002

Docket Management
Room PL-401
400 Seventh Street, S.W.
Washington, D.C. 20590

Re: Docket No NHTSA-2002-11419 -- National Academy of Sciences Study and Future Fuel Economy Improvements, Model Years 2005-2010

Dear Sir or Madame:

The Japan Automobile Manufacturers Association (JAMA) is pleased to respond to NHTSA's "Request for Comments on the National Academy of Sciences Study and Future Fuel Economy Improvements, Model Years 2005-2010," as published in the *Federal Register* of February 7,2002.

This comment particularly responds to Question 12 of NHTSA's Request for Comments, which is found on page 5772 of the *Federal Register.* Question 12 requests comment on the effect that elimination of the "two-fleet'' or "fleet split" rule would have on manufacturers, consumers, employment, the U.S. marketplace and on the automotive industry in general.

JAMA is the trade association of Japan's motor vehicle manufacturers, representing a significant number of the companies directly affected by the Corporate Average Fuel Economy (CAFE) standards, and in particular by the CAFE two-fleet or fleet split rule. The CAFE fleet split rule requires separate compliance for domestic and import passenger autos.

JAMA has long taken the position that the CAFE fleet split rule represents a regulatory burden on auto manufacturers that can be eliminated without adversely affecting the goal of fuel efficiency, and should be eliminated.

JAMA notes that in the National Academy of Sciences study entitled, "Effectiveness and Impact of Corporate Average Fuel Economy Standards," the study's Finding **3** stated: "The committee could find no evidence that the 'two-fleet rule' distinguishing between domestic and foreign content has had any perceptible effect on total employment in the U.S. automotive industry."

Accordingly, the study recommended as follows (Recommendation **4):** "Under any system of fuel economy targets, the two-fleet rule for domestic and foreign content should be eliminated." JAMA concurs with this recommendation.

In March 2000, JAMA submitted a paper on the fleet split issue to the National Highway Traffic Safety Administration. Since this paper provides substantial detail and analysis supporting JAMA's position on eliminating the fleet split rule, it is attached as part of JAMA's comment.

JAMA appreciates the opportunity to comment on this important issue. Should you have any questions or need additional information, please contact me or our Director of Government Affairs, Ron Bookbinder, at 202-296-8537 or email us at (wd@jama.org) and (rbookbinder@jama.org).

Thank you.

Sincerely,

William C. Duncan, Ph.D.
General Director

Attachment: CAFE Fleet Split Requirement: The Need for Deregulation

ATTACHMENT

CORPORATE AVERAGE FUEL ECONOMY FLEET SPLIT REQUIREMENT:

THE NEED FOR DEREGULATION

JAPAN AUTOMOBILE MANUFACTURERS ASSOCIATION

MARCH 2000

Introduction

On June 19, 1997 the Governments of Japan and the United States agreed to an Enhanced Initiative on Deregulation and Competition Policy. The Enhanced Initiative is a dialogue intended to address regulatory measures which have the effect of unnecessarily distorting trade, raising costs and limiting choices for consumers. The ultimate objective of the Enhanced Initiative is the removal of sectional and structural impediments to expanded international trade and investment flows.

At its inception, the Enhanced Initiative recognized that the United States and Japan are part of an *increasingly integrated world economy.* Nowhere is this fact more evident than in the automotive industry, which is at the forefront of globalization, and is made up of multinational competitors with manufacturing operations throughout the world. Aspects of the Corporate Average Fuel Economy ("CAFE") regime exist in stark contrast to this reality, imposing restrictions and requirements that cut against the grain of a global automotive industry.

Specific provisions of the CAFE law and regulations are preoccupied with what is "domestic" and what is "foreign," an increasingly irrelevant distinction in light of the automotive industry's development over the last twenty years, and particularly over the last two years. Unfortunately the distinction as imposed under CAFE is not trivial in terms of its burden on trade costs, and consumer choice, which is why the regulatory scheme is an appropriate topic of discussion under the Enhanced Initiative.

Simply put, the CAFE "fleet split" rule imposes artificial bureaucratic restrictions that increase costs, do not serve any useful purpose, distort normal market-based decisions by multinational companies, and undermine other, equally desirable goals of **U.S.** policy. The "fleet split" should be eliminated.

Relevant Statute

As part of the U.S. response to the fuel shortages of the early 1970's, Congress enacted the Energy Policy and Conservation Act of 1975 requiring manufacturers of passenger cars and light trucks to meet specific fuel-efficiency (miles-per-gallon) standards that would be set by the federal government, through NHTSA. The Environmental Protection Agency ("EPA") also has a role in the testing and verification of fuel efficiency for vehicles. These Corporate Average Fuel Economy ("CAFE") standards were ostensibly designed to require the auto industry to produce increasingly more fuel-efficient vehicles in order to conserve energy.

The Act set a CAFE standard for passenger cars that has increased several times. Since Model Year 1986, the standard has been **27.5** miles per gallon for cars. The current standard for "light trucks," a category which includes sport utility vehicles ("SUVs"), mini-vans, and pickup trucks is **20.7** miles per gallon. These standards are applied on a fleet-wide basis for each manufacturer, requiring the numerical average of the fuel economy ratings for a manufacturer's entire line of vehicles to equal or exceed the appropriate standard for its category.

NHTSA is authorized to raise or lower the truck standard for a particular model year to achieve the "maximum feasible average fuel economy," taking into account technological feasibility, economic feasibility, the effect upon fuel economy of other federal motor vehicle standards, and the need of the nation to conserve energy. For the last several years, Congress has amended DOT appropriations acts to prohibit NHTSA from preparing, proposing, or promulgating any new fuel-economy requirement. Under the Act, a manufacturer that fails to meet the CAFE standard is liable for a monetary penalty. However, a manufacturer may offset its shortfall in meeting the CAFE standard one year with credits it has earned by exceeding the standard in other years.

A manufacturer's passenger car fleet must be divided into two parts for CAFE purposes, depending on content: its "domestic" fleet consisting of vehicles with **75** percent or more U.S./Canadian content; and its "import" fleet of vehicles with less than **75** percent U.S./Canadian content. If a manufacturer produces both domestic and import fleets, each fleet must separately comply with the CAFE standard. The term "fleet split" has been applied to this arrangement. No such requirement exists with respect to light trucks, where the import and domestic fleets are combined.

The North American Free Trade Agreement ("NAFTA") Implementation Act of 1993 provided that the value added to a passenger automobile in Mexico will be considered to be domestic value as of January 1, 2004 and in all subsequent model years. This provision is being implemented in phases, with certain manufacturers currently permitted to elect the model year for which Mexican content in their automobiles will be treated as domestic content.

Artificial Bureaucratic Restrictions

The regulatory structure established to implement the CAFE fleet split is cumbersome. It does not reflect the actual conditions in the auto industry, nor is it sufficiently flexible to allow for changes in those conditions. Moreover, substantial record of questions and agency responses has grown up around these regulations. In short, the United States Government, through NHTSA, has become a "micro-manager" in the economic decisions of **U.S.** and foreign automakers involving where production and procurement are to be located.

How Fleet Split Works

The rules governing the separation of domestic and foreign passenger car fleets for CAFE purposes, found at 40 C.F.R. § 600.511-80, establish the following requirements.

A manufacturer that produces passenger cars with both domestic and imported content is required to divide its fleet into two content-based sections. For CAFE purposes also, the U.S. and Canada have been treated as one country and cars with 75 percent or more U.S./Canadian content are considered "domestics." Cars with less than 75 percent "domestic content" are classified as "imports." Each of the two parts of this "split fleet" must comply separately with the CAFE standard.

Pursuant to NAFTA, cars produced in Mexico are now becoming "domestic" for CAFE calculations when at least 75 percent of the cost to the manufacturer of the vehicle can be attributed to value added in NAFTA. This new requirement will be completely phased in by January 1, 2004, although manufacturers already assembling cars in Mexico may elect to be included sooner.

Under CAFE, an automobile is considered to be domestically manufactured if at least 75 percent or more of the cost to the manufacturer is attributable to value added in the **U.S.,** Canada, or Mexico (if the manufacturer has already elected coverage for vehicle assembly there), ***inclusive*** of labor and other overhead costs such as advertising and depreciation on plant and equipment.

Where content levels are close to the 75 percent threshold, the regulations require manufacturers to trace individual components to their raw material sources to attain an accurate measure.

Light trucks are not subject to the fleet split requirement.

Why CAFE Fleet Split Does Not Match Real World Conditions

Requiring the creation of two car fleets, on the basis of a legalistic, bureaucratically-applied formula, is neither realistic nor practicable.

CAFE fleet split requirements disrupt and distort market-based decisions by auto manufacturers. The automobile industry is global. Auto companies need to be able to meet consumer demand, increase productivity, and keep costs low to succeed in a highly competitive climate where there is pressure to maintain price stability. They need to be free to make market-based choices about sourcing of parts and components and the selection of the most appropriate location of assembly. The benefits of globalization and flexibility are passed on to the consumer, in the form of lower costs and a wider variety of makes and models. Under the CAFE fleet split requirements, however, auto manufacturers must constantly balance potential CAFE penalties for their imported and domestic fleets against their desire to meet consumer preferences and keep costs down.

The original intent behind the twenty-five year old fleet split requirement was to preserve small car production in the United States, not to enhance fuel efficiency of automobiles sold in the United States, since that could be accomplished without separating the import and domestic fleets. At the time of implementation, the fear was that, absent such restrictions, Ford, General Motors and Chrysler would move small car production off-shore. Yet there is simply no evidence to substantiate that fear in today's setting. Indeed, as the chart on the next page indicates, there is significant small car production in North America (and particularly in the United States) now. Moreover, it is unlikely that the billions of dollars invested in small car production and parts facilities in the North America by Japanese **and** U.S. automakers would simply walk away if the fleet split requirement were removed.

NORTH AMERICAN PRODUCTION OF SMALL CARS 1998

Model by Segment	United States	Canada	Mexico	Total
Lower Small				
Geo Metro	0	21,136	0	21,136
Suzuki Swift	0	2,481	0	2,481
Subtotal	**0**	**23,617**	**0**	**23,617**
Upper Small				
Chevrolet Cavalier	233,806	0	78,376	312,182
Chrysler Neon	203,101	0	55,630	258,731
Ford Escort	198,679	0	136,744	335,423
Geo Prizm	45,284	0	0	45,284
Mercury Tracer	27,760	0	1,872	29,632
Nissan Sentra	54,358	0	62,239	116,597
Pontiac Sunfire	96,851	0	7,212	104,063
Saturn	244,101	0	0	244,101
Toyota Corolla	158,180	150,413	0	308,593
VW Golf	0	0	60,066	60,066
VW Beetle	0	0	106,627	106,627
VW Jetta	0	0	123,037	123,037
Subtotal	**1,262,120**	**150,413**	**631,803**	**2,044,336**
Specialty Small				
Eagle Talon	295	0	0	295
Mitsubishi Eclipse	50,715	0	0	50,715
Nissan 200sx	6,102	0	0	6,102
Subtotal	**57,112**	**0**	**0**	**57,112**
Total Small	**1,319,232**	**174,030**	**631,803**	**2,125,065**

Source: Ward's Automotive Yearbook 1999. Segmentation based on Ward's sales segmentation.

Light Truck Exception

Whereas manufacturers of passenger cars have long suffered from the CAFE fleet split requirement, there is no comparable restriction for light trucks. While a provision within the **CAFE** regulations does require the separation of "captive imports," its impact is no longer of any significance. Like the fleet split requirement for passenger cars, the "captive imports" provision was first and foremost intended to prevent Ford, General Motors and Chrysler from shifting auto production (in this case light truck production) overseas. **It** served to curtail a 1980's trend by **U.S.** manufacturers to import trucks produced by foreign manufacturers and "re-badge" the imports under their own nameplates.

There is no logical reason for maintaining a fleet split requirement for passenger cars while applying no such distinction for light trucks. The fact that CAFE has served its purpose with respect to light trucks by enhancing fuel efficiency in those vehicles in the absence of any fleet split requirement is ample evidence that the requirement is unnecessary for passenger cars.

Renault-AMC and Volkswagen Exceptions

The United States Congress, twenty years ago, confirmed just how artificial and counterproductive the CAFE fleet split rule was (and still is) when it compromised the rule to serve the needs of AMC, which had just merged with Renault, and Volkswagen. AMC sought to import small-fuel efficient Renault models, but the rule prevented AMC from combining those imports with its domestic models to help it comply with CAFE standards. Volkswagen had established manufacturing facilities in Pennsylvania to make VW Rabbits. As VW increased its **U.S.** procurement, and the U.S. content of those Rabbits approached 75 percent, VW risked having its fleet split between "imported," lower mileage Porsches and Audis that did not meet CAFE standards, and "domestic," high-mileage Rabbits that did.

AMC and Volkswagen requested special exemptions from the CAFE fleet split, and Congress granted them. Both were allowed to combine their fleets, with limits placed on the level of foreign content and volume of imports permitted..

At time Congress and the President agreed to this exemption, the justification was the need to encourage new investment and small car production in the United States. Twenty years later, the exception has now proven to be the rule. Many manufacturers have now established plants in the United States to build fuel-efficient cars. Yet the fleet split, long ago compromised solely to encourage such investment, remains in place. What was an unnecessary disincentive to U.S. procurement and investment then is even more so today. Certainly the VW and AMC Renault exceptions indicate there has been no defensible policy justification for this rule for many years.

<u>Distortion of Normal Market-Based Decisions</u>

The CAFE fleet split creates artificial conditions that influence auto manufacturing. The global auto industry has changed radically since this regulatory scheme was imposed, but CAFE has not changed in any substantial way. Under the CAFE fleet split, as noted above, decisions which should be made on practical economic considerations such as productivity, costs, access to suppliers, consumer demand, and profitability are being compromised to avoid the adverse regulatory consequences of CAFE penalties.

Non-Market Impact on Parts Sourcing

The CAFE fleet split requirements distort the normal market-based decisions of global auto manufacturers. Because auto manufacturers must meet separate fuel efficiency requirements for their imported and domestic fleets, their sourcing flexibility is limited and strongly influenced by the threat of CAFE penalties. In some instances, the sourcing practices of automakers in the U.S. market amount to a kind of CAFE shell game. For example, in a well-documented case Ford shifted the "citizenship" of its least fuel-efficient cars (at that time the Crown Victoria and the Grand Marquis) to stay ahead of the fleet split curve by simply switching out rear axles. This move saved Ford over a million dollars in CAFE penalties without changing the fuel economy of the cars at issue.

Even more important for JAMA member companies and other foreign manufacturers is the fact that the CAFE fleet split can penalize those companies when they seek to increase their procurement of U.S.-made parts. Since **1986,** production of Japanese nameplate vehicles in the **U.S.** has increased almost **300%** from **617,000** units in **1986** to **2.38** million units in **1998.** JAMA member companies have for two decades made significant and sustained efforts to procure auto parts for these U.S.-built vehicles from U.S. suppliers. As a result, JAMA member companies have increased their procurement of U.S. auto parts from **$2.09** billion in **1986** to **$24.57** billion in **1998.**

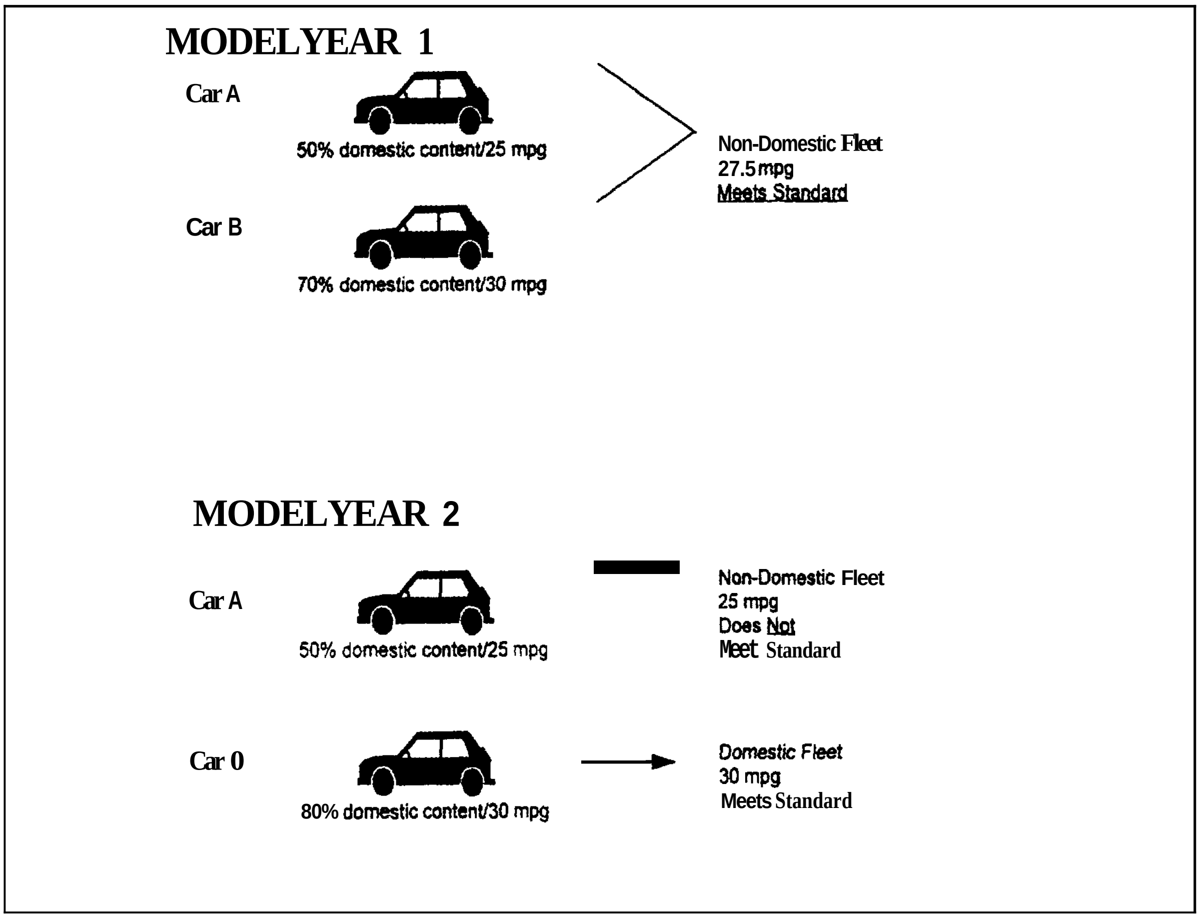
Ironically, however, the CAFE fleet split works against this effort and the benefits its creates. Japanese auto companies (and other foreign-based manufacturers) producing cars in the United States are forced by the CAFE fleet split to make a potentially uneconomic choice. They can increase local procurement at their U.S. plants and exceed the 75 percent content criterion for the cars they build in the **U.S.,** so that they shift the mix of their "import" fleet, and risk paying CAFE penalties. Or, they can source parts from overseas to keep U.S.-built cars in their "import" fleet and avoid CAFE penalties.

This negative effect thus keeps foreign auto companies from increasing their U.S. parts purchases to avoid the possible shift in classification from "import" to "domestic." Such a change would limit their ability to import the larger cars that are in growing demand from U.S. consumers, but for which the volume of sales will not support a U.S. production facility.

The CAFE fleet split has the opposite effect on manufacturers with U.S.-produced fleets with content exceeding 75 percent. They have an added incentive to increase their foreign purchasing when it is to their advantage to have certain U.S.-produced cars reclassified from "domestics" to "imports" for CAFE purposes.

The diagram below generally illustrates this non-market impact on parts sourcing.

HOW CAFE FLEET SPLIT IMPACTS PARTS SOURCING



In this diagram, assume that all of these cars are being built in the United States. In Model Year 1, since Car **A** and Car B both do not meet the CAFE content requirement of 75 percent, the entire fleet is considered "imported," and meets the 27.5 mpg standard. In Model Year 2, the manufacturer has increased **U.S.** procurement for Car B, but Car A has retained its 50 percent content. **As** a result, the manufacturer's **U.S.** production ***of the same vehicles*** has now been split into two fleets, and the import fleet no longer meets the CAFE standards. No fuel economy benefits have been achieved, and the manufacturer is now exposed to CAFE penalties, all because it sought to buy more U.S. parts.

What these facts indicate is that the CAFE fleet split has encouraged, rather than eliminated or curtailed, the off-shore sourcing patterns of multinational auto companies operating in the United States. The "Big **3**" source off-shore because they can, and the other companies do so because they must. When these sourcing decisions are driven by such CAFE considerations, they undercut the goal of increasing **U.S.** parts purchases.

GATT-Illegal

In 1993-94, a GATT dispute settlement panel examined the CAFE fleet split rule, determining that it could not withstand scrutiny under Article III:4 (National Treatment) analysis. In summary, the panel concluded that the fleet split rule could not be justified simply because it balanced less favorable treatment of imported cars in some instances against less favorable treatment of domestic cars in other instances:

> *"In this case, less favorable treatment **of** large foreign cars (because they could not be averaged with small domestic cars, as large domestic cars could) would be balanced by less favorable treatment **of** large domestic cars (because they could not be averaged with small foreign cars, as large foreign cars could). The Panel noted that under Article III:4 a contracting party cannot justify less favorable treatment to an individual product by showing that other products receive more favorable treatment . . . and concluded that the separate foreign fleet accounting accorded less favorable conditions **of** competition to cars and car parts of foreign origin than those accorded to like domestic products, and thus was inconsistent with Article III:4."*
>
> *Report **of** the Panel on <u>United States - Taxes on Automobiles</u>, 29 September 1994 DS31/R.*

As the GATT panel found, the CAFE fleet split requirement distorts trade and alters the competitive environment in which automobiles are manufactured and sold in the United States. This result is unwarranted and unnecessary in meeting the stated intent of the law.

Counterproductive

As this paper has demonstrated the **CAFE** fleet split regulatory scheme is a burden on both manufacturers and consumers. It neither enhances efficiency nor reduces cost, but can have the opposite effect, and thereby serves to restrict competition in the industry and deprive consumers of the benefits such competition would produce--more of the vehicles they want at lower costs. In short, it inhibits both the productivity of the industry and the marketplace with no offsetting benefit.

By restricting the sourcing decisions of auto manufacturers, the **CAFE** fleet split requirement necessarily drives up manufacturing costs by preventing selection of the most cost-effective means of auto production. These costs are passed on to the consumer. In many cases, U.S. parts suppliers are unable to supply U.S. auto operations where the parts supplied could tip the balance between whether a car line is deemed domestic or foreign and therefore trigger **CAFE** problems. The opportunity costs that these suppliers lose are incalculable, but surely reach millions of dollars in lost sales for U.S. companies, lost investment by multinational companies that might otherwise locate or expand plants in the U.S., and many jobs for **U.S.** workers.

The **CAFE** fleet split requirement does more to foster gamesmanship in the calculation of "domestic" and "foreign" fleet fuel efficiency ratings than to encourage actual gains in fuel efficiency. Parts allocation has become a function of knowing how far or close an auto manufacturer is to meeting its "domestic" and "foreign" fleet requirements. Where an auto manufacturer's "domestic" or "foreign" fleet is below the **CAFE** standard, it is more likely to turn to creative parts sourcing or move car lines between the two classifications, rather than actually seek to increase the fuel efficiency of the car in question, to gain a competitive edge or avoid penalties.

CAFE standards would be more effective if they allowed fuel efficiency gains to be achieved through combining overall fleets in a global manufacturing context.

Conclusion

The **CAFE** fleet split is counterproductive, inefficient and unjustifiable in the new global manufacturing setting. It fails to achieve its stated intent of promoting fuel efficiency and preserving U.S. small car production. Instead, it works against those objectives by limiting any real incentive to enhance fuel efficiency or improve the environment. No ***legitimate*** U.S. interest is served by such an outcome.

This regulation creates burdens that adversely affect auto manufacturers, with a substantial burden falling on non-U.S. manufacturers with significant investments in the United States that support U.S. jobs and U.S. manufacturing. Because of the unjustified burdens this regulation creates, it should be repealed.

Enhancing fuel efficiency in automobiles is a worthy objective. However, the fleet split requirement is not a fuel efficiency issue. It is a burdensome, outdated and counterproductive regulation for which there is no practical justification. This is particularly true today, when ownership and investment changes have made the distinction between a "domestic" and a "foreign" car virtually irrelevant. Companies operating in the **U.S.,** like companies operating in any national economy, need to be free of regulations like the CAFE fleet split, which act as a drag on new investment and responsiveness to the consumer. Eliminating the fleet split will have no detrimental effect on auto companies' efforts to achieve new efficiency levels in their fleets. Eliminating the fleet split will almost certainly result in more sourcing of parts and assembly in the **U.S.,** since it would no longer be necessary or desirable to make overseas production or sourcing decisions primarily to allow adjustment of content for CAFE purposes.