

BEFORE THE PANEL CONVENED PURSUANT)
TO CHAPTER 18 OF THE CANADA-UNITED STATES)
FREE TRADE AGREEMENT)

USA-93-1807-01

IN THE MATTER OF)
PUERTO RICO REGULATIONS ON)
THE IMPORT, DISTRIBUTION AND SALE)
OF U.H.T. MILK FROM QUEBEC)

FINAL REPORT OF THE PANEL

JUNE 3, 1993

Ivan Bernier
Bruce Gardner
Joseph Greenwald
Armand de Mestral (Chair)
Frank Petrie

TABLE OF CONTENTS

1. INTRODUCTION
2. TERMS OF REFERENCE
3. FACTUAL BACKGROUND
4. LEGAL ARGUMENTS OF THE PARTIES
 - (a) Submissions of Canada
 - (b) Submissions of the United States
5. ANSWERS TO THE TERMS OF REFERENCE
 - (a) General considerations
 - (b) FTA Article 407/GATT Article XI
 - (c) FTA Articles 501 and 502/GATT Article III
 - (d) FTA Article 703
 - (e) FTA Article 708,710, & Schedule 11 to Annex 708.1
 - (f) Nullification and Impairment
6. DETERMINATIONS
7. RECOMMENDATIONS

1. INTRODUCTION

1.1 On September 17, 1992, Canada's Minister for International Trade wrote to the United States Trade Representative requesting the establishment of a Panel pursuant to Article 1807.2 of the *Canada-U.S. Free Trade Agreement* (the "FTA") to decide certain questions relating to the importation, distribution and sale of UHT milk from Québec in Puerto Rico. The Governments of Canada and the United States reached agreement on the terms of reference of this panel on December 2, 1992.

1.2 Accordingly, a Panel was convened and, pursuant to Article 1807(3) of the FTA, the United States and Canadian Governments agreed on the individuals who would serve as panelists, namely, Professor Ivan Bernier, Professor Bruce Gardner, Joseph Greenwald, Esq., Professor Armand de Mestral (Chair)¹, and Frank Petrie, Esq.

1.3 On December 17, 1992, the parties agreed to a timetable. Canada made its initial submission on January 5, 1993. The United States requested an extension until February 1, 1993 for filing its counter-submission.

1.4 As a result of this delay, a new schedule for the Panel's review was set as follows:

¹ Professor Stephen Toope, Ms Lisa Yarmoshuk and Me Guy Lachapelle served as assistants to Armand de Mestral.

FTA CHAPTER 18 PANEL DISPUTE - UHT MILK

PANEL TIMETABLE

<u>Date</u>	<u>Event</u>
September 17, 1992	Panel requested
December 10, 1992	Panel selection completed
January 5, 1993	Canada files initial submission
February 1, 1993	USA files counter-submission
March 1, 1993	Oral Proceedings
March 10, 1993	Parties file supplementary submissions
April 13, 1993	Panel issues initial report
April 20, 1993	Parties file objections
April 30, 1993	Panel issues final report

In accordance with this agreed timetable, a hearing was held in Washington, D.C., on Monday, March 1, 1993. Counter-submissions, including responses to questions put at the hearing, were received on March 10, 1993. The Panel deliberated and, having requested an extension of the deadline, submitted its Initial Report on April 26, 1993. The Parties filed their Comments on May 10, 1993.

1.5 Having requested an extension, the Panel submitted its Final Report in English and an

unofficial version in French on June 3, 1993.

2. TERMS OF REFERENCE

The following terms of reference were agreed by the parties:

The Panel is asked:

(a) to consider:

(i) whether the prohibition, within the Commonwealth of Puerto Rico, on the importation, distribution and sale of UHT milk produced in Québec by the Lactel Group, made effective, in particular, by Puerto Rico Department of Agriculture Regulations 2 and 5, and Department of Health Regulation 138, is inconsistent with obligations of the United States under the FTA, including, in particular, Articles 407, 501, 502, 703, 708, 710 and Schedule 11 of Chapter Seven; and

(ii) whether such prohibition nullifies and impairs benefits Canada reasonably expected would accrue to it under the FTA; and

(b) in light of the determinations made by it under sub-paragraphs (a) (i) and (ii) above, to include in its report its recommendations, if any, for the resolution of the dispute between the Parties.

3. FACTUAL BACKGROUND

(a) The Product

3.1 Aseptically processed ultra-high temperature milk ("UHT milk") is produced by treating fluid milk to a high temperature for a specified period of time, such as at least 138 degrees Celsius for a minimum of two seconds. The milk is then cooled to room temperature and is aseptically packaged in hermetically sealed containers. The shelf life of properly processed and handled UHT milk is between six and twelve months at room temperature.

(b) Right of Entry into US

3.2 In the United States, UHT milk from Canada is subject to an import duty of 0.5 cents per litre. In accordance with the Canada-U.S. Free Trade Agreement Article 401.2, the United States

is under an obligation to eliminate the tariff on UHT milk over a ten-year period.

(c) History of Sales of UHT Milk by Lactel

i) Sales in Puerto Rico

3.3 During the period beginning September 1977 and ending on December 31, 1991, UHT milk from Québec was exported to, and sold to the general public in, Puerto Rico by the Lactel company. Prior to the entry of UHT milk from Québec into Puerto Rico, there was no UHT milk sold in the Puerto Rico market.

3.4 From 1977 through 1981, UHT milk from Québec produced by Lactel, and sold under the brand name "Grand Pré", occupied 100% of the Puerto Rico UHT milk market. During the years 1982 to 1985, the Québec UHT milk market share fluctuated between 25.3% and 88.4%. In 1986, INDULAC (the trade name for the "Puerto Rico Milk Industry Inc.") entered the market and the Québec UHT milk market share slowly declined from 66.5% to 24.59% in 1991 when its market access was closed.² UHT milk from Québec was also sold to the United States Army at Fort Buchanan, Catana, Puerto Rico on a monthly basis since September 1977. These sales to the United States Army continued until March 3, 1993. However, UHT milk has always been a very small part of the total milk consumed in Puerto Rico.

ii) Other Exports of UHT Milk from Québec

3.5 According to information supplied by Canada, UHT milk from Québec has been sold

²Groupe Lactel sales figures, 1977-1991. Sources: Internal marketing and Milk Industry Regulation Office of the Puerto-Rican Department of Agriculture (Canadian Exhibit A).

throughout the Caribbean since 1976. Prior to being excluded from Puerto Rico on January 1, 1992, Québec UHT milk was also shipped to St. Croix and St. Thomas in the U.S. Virgin Islands. There is also a history of sales to the public and U.S. Army in Panama and to Venezuela, Mexico, Africa and the Middle East. UHT milk from Québec is sold in both Newfoundland and the Northwest Territories in Canada.

(d) Regulations governing the Importation, Production, Processing and Inspection of Milk

i) U. S. Regulations Before 1991

3.6 Before 1991, UHT milk from Québec was exported to Puerto Rico on the basis of the Puerto Rico Secretary of Health's determination that it was produced and processed under conditions and standards that were "essentially equivalent" to those under *Health Regulation 133*, then in force.³ Officials from the Puerto Rico Department of Health based this determination on a review of the processing data for each shipment, as well as on a sampling of each production batch of the milk during a ten-day impoundment period upon arrival in Puerto Rico. In the 14 years of exports to Puerto Rico, no shipment of UHT milk from Québec was ever rejected as unsafe.

3.7 Until April 1989, Puerto Rico maintained a unique milk regulatory system. For two decades, Puerto Rico was repeatedly urged by the U.S. Food and Drug Administration ("FDA") to upgrade its milk regulatory system. The FDA criticized Puerto Rico's milk standards for inadequately protecting the public health. In an effort to meet this criticism the Puerto Rico Department of Health

³Article XVII of the Department of Health's Sanitary *Regulation 133*.

asked the FDA in 1983 to make a preliminary evaluation of Puerto Rico's milk. Over the next several years, both the Puerto Rico Department of Health and the Department of Agriculture took steps to improve the safety and quality of Puerto Rico milk.

3.8 The Puerto Rico authorities changed their milk regulations in 1983 and Lactel was advised that its milk fell under the definition of thermally processed, low-acid canned foods subject to the *Low-Acid Canned Food Regulations*⁴ of the FDA and that the product could no longer be sold. In order to return to the Puerto Rico market, Lactel modified its processing equipment in Québec, obtained the required approvals and was permitted to export to Puerto Rico until December 31, 1991.

ii) U.S. Regulations Post-1991

3.9 In 1987, the Puerto Rico Departments of Health and Agriculture entered into an interagency agreement to improve the quality of milk production, to join the National Conference on Interstate Milk Shipments ("NCIMS") and to adopt the *Pasteurized Milk Ordinance* ("PMO"). The U.S. milk program is based on prevention. It was designed to enforce strict milk industry adherence to safe sanitation standards and practices. The objective is to prevent milk from becoming contaminated or adulterated. The focus of milk regulation has been mainly on fresh milk.

3.10 The NCIMS, a voluntary organization of State and local milk control agencies and the governing body for U.S. interstate milk shipments, was created in 1950. All 50 states, and the District of Columbia are members. In May 1989, Puerto Rico was accepted as a full voting member

⁴ 21 C.F.R. 113.

of the NCIMS. The mission of the Conference is stated to be to "Promote the Best Possible Milk Supply for all the People"⁵. In a 1977 Memorandum of Understanding, the FDA and NCIMS agreed on measures to implement the Interstate Milk Shippers Program which governs the sale of milk in U.S. interstate commerce. The agreement is embodied in the *Procedures Governing the Cooperative Federal-State Program for Certification of Interstate Milk Shippers* ("Procedures").

3.11 The Procedures provide for a mandatory certification process, to ensure compliance with health and safety requirements. The certification standards are set out in *Methods of Making Sanitation Ratings of Milk Supplies*. Dairy processing plants that comply with the certification requirements are deemed to comply with the requirements of any member of the NCIMS, and thus may ship their milk and milk products to NCIMS member states.

3.12 The Interstate Milk Shippers Program relies upon the *Grade "A" Pasteurized Milk Ordinance* ("PMO"), the "model" regulation developed by the Public Health Service of the FDA establishing technical standards for fluid milk, milk products and UHT milk, and related technical documents referred to in the Procedures Manual for sanitary standards, requirements and procedures it follows to ensure the safety and wholesomeness of Grade "A" milk and milk products.⁶

3.13 The PMO is drafted in the form of an ordinance. It has been incorporated into the laws of the 50 U.S. states, the District of Columbia, and since 1991, Puerto Rico. As a result, it is

⁵Constitution of the National Conference on Interstate Milk Shipments, May 5, 1989, Article II, Section 1.

⁶Memorandum of Understanding Between the U.S. Food and Drug Administration and the National Conference of Interstate Milk Shipments.

recognized as the U.S. national standard for milk sanitation. Accordingly, two new regulations were subsequently adopted by Puerto Rico to incorporate the technical standards of the PMO into Puerto Rico law.

3.14 On December 21, 1990, the Puerto Rico Department of Health issued *Sanitation Regulation 138*. The Regulation became effective January 21, 1991. In October 1991, *Regulation 5* was issued by the Administrator of the Office of Milk Industry Regulation of the Puerto Rico Department of Agriculture. This Regulation became effective December 1, 1991. The PMO and the rating process referred to in the Procedures were thus incorporated into the Puerto Rico regulations.

3.15 Articles XIV:E and IV of Regulation 138 of the Department of Health (similar to the provisions of Sections 5 and 12 of Regulation 5 and Section 5 of Regulation 2 of the Department of Agriculture) provide the central provisions with respect to the import, distribution and sale of milk and milk products originating from outside the territory of Puerto Rico.

3.16 Article XIV:E of Regulation 138 and Section 12 of Regulation 5 state that:

The supply of milk and milk products for sale from areas outside territorial boundaries of Puerto Rico shall be accepted, without having to inspect the supply thereof, as long as it complies with the following requirements:

1. At the time the milk and raw milk products are received for pasteurization, these shall comply with the temperature, bacteriological and chemical requirements set in this Regulation.
2. The pasteurized and *ultra-pasteurized milk and milk products shall comply with the temperature, bacteriological and chemical requirements set in this Regulation.*
3. They have been elaborated and processed under *substantially similar regulations.*

4. That milk supply is under routine official supervision.

5. That the products and their sources, have been awarded a milk sanitation compliance and enforcement rating equal or higher than 90% by a Rating Officer, certified by the Food and Drug Administration.

6. All ratings are made on the basis of procedures outlined in the "Methods of Making Sanitation Ratings of Milk Supplies of the United States Public Health Service/Food and Drug Administration.

Shippers meeting these conditions are eligible for licenses authorising them to import, distribute and sell milk in Puerto Rico.

3.17 The United States informed the Panel that Puerto Rico's adoption of the PMO and the rating and inspection systems required by the NCIMS, together with its joining the NCIMS were the latest of a series of initiatives by the Puerto Rico Departments of Health and Agriculture to improve the safety and quality of milk production in the Commonwealth. Puerto Rico also desired to adhere to the NCIMS and PMO regulatory system and standards so that its milk could be sold to other U.S. states, major airlines, U.S. flag vessels, the large military bases located in Puerto Rico and other local purchasers of Grade A only milk.⁷

3.18 Section 11 of the PMO governs the entry of milk from outside the jurisdiction. Section 11 states that:

Milk and milk products from points beyond the limits of routine inspection of the...of ... or its jurisdiction, may be sold in ..., or its jurisdiction, provided they are produced and pasteurized, ultra-pasteurized or aseptically processed under *regulations which are substantially equivalent* to this Ordinance and have been awarded an acceptable milk sanitation compliance and enforcement rating made by a State milk sanitation rating officer certified by the Food and Drug Administration.⁸

⁷ United States First Submission, p. 10, para. 52.

⁸Grade "A" Pasteurized Milk Ordinance, 1989 Revision, U.S. Department of Human Services, pp 106-107.

(d) Regulation of Production of UHT Milk in Québec

3.19 UHT milk from Québec exported to Puerto Rico meets the FDA's definition of a low-acid canned food and is processed and packaged under a standard identical to the *Low-Acid Canned Food Regulations*⁹ of the U.S. Food and Drug Administration since 1983.

3.20 The legislative and administrative framework for regulation of the dairy industry in Québec subjects producers and processors to federal, provincial and municipal regulation which regulate many aspects of dairying. The relevant Acts and Regulations are:

Dairy Products and Dairy Products Substitutes Act, R.S.Q., c. P-30
Regulation Respecting the Pasteurization of Dairy Products; c. P-30, r.8
Regulation Respecting the Quality of Dairy Products, O.C. 183-188, 10 February 1988
Regulation Respecting Microbiological and Cleanliness Standards for Dairy Products, c. P-30, r.5
Regulation Respecting the Transportation of Milk and Cream from Producers, c. P-30, r.17
The Canada Agricultural Products Act, R.S. 1985, c. 20 (4th Supp.)
Regulations Respecting the Registration of Establishments, the Operation and Maintenance of Registered Establishments, the Grading, Inspection, Packing and Labelling of Dairy Products and International and Interprovincial Trade in Dairy Products: The Dairy Products Regulations; SOR/79-840 and amendments
Dairy Plant Inspection Manual, Agriculture Canada, Food Protection Inspection Branch
Animal Disease and Protection Act, R.S. 1985, c. A-11
Regulations Respecting Reportable Diseases SOR/91/2
Health of Animals Act, S.C. 1990, c. 21
The Food and Drugs Act, R.S. 1985, c. F-27

(e) Effect of Adoption of Pasteurized Milk Ordinance

3.21 In January 1990, Puerto Rico notified representatives of Lactel that Puerto Rico had joined the NCIMS and would consequently need to adopt regulations in accordance with the PMO.¹⁰

⁹21 C.F.R. 113.

¹⁰ Letter from Delia M. Olivo Rivera, Director, Puerto Rico Milk Hygiene Program to Charles Petty, Jr., Hopkins & Sutter dated January 31, 1990 (United States First Submission, Attachment 20).

In December 1990, Puerto Rico authorities had provided Lactel representatives with a complete copy of the new regulations.¹¹ United States FDA officials noted that Québec was not a member of the NCIMS and thus did not implement either the PMO or the *Procedures*.¹²

3.22 In January 1991, Lactel represented to FDA authorities that UHT milk from Québec qualified for entry into Puerto Rico under Section 11 of the PMO, which authorizes the sale of milk outside "routine official supervision" if it is processed under conditions "substantially equivalent" to the PMO. Lactel submitted that the technical standards under which UHT milk was produced in Québec were at least equivalent to the PMO.¹³

3.23 On February 19, 1991, the local distributor of Québec UHT milk was advised that its import, sales and distribution licence, issued by the Puerto Rico Department of Agriculture, would be cancelled effective July 1, 1991 because of "non-compliance" with Department of Health *Regulation 138*¹⁴.

3.24 On June 20, 1991, the Puerto Rico Department of Agriculture extended Lactel's

¹¹Letter from Delia M. Olivo Rivera, Director Puerto Rico Milk Hygiene Program to Joaquin Marquez, Hopkins & Sutter dated December 13, 1990 (United States First Submission, Attachment 21).

¹²Letter from Johnnie G. Nichols, Chief Milk Safety Branch, Center for Food Safety and Applied Nutrition, FDA to Charles Petty, Jr., Hopkins & Sutter dated January 9, 1991 (United States Attachment 24).

¹³Letter from Charles Petty, Jr. to L. Robert Lake, Director, Office of Compliance, FDA, Center for Food Safety and Applied Nutrition, Milk Safety Branch dated January 2, 1991 (United States First Submission, Attachment 22)

¹⁴Letter from Getulio Rodriguez Gonzalez, Puerto Rico Department of Agriculture to Carlos Matos Jordan, Marketing & Brokerage Specialists, Inc. dated February 19, 1991 (Canadian Exhibit G).

licence until December 31, 1991. On July 1, 1991, the Puerto Rico Department of Health informed Lactel that Québec UHT milk was not made under the conditions of the PMO and therefore did not meet the requirements for sale in Puerto Rico. Lactel's agent was thereby notified that its pasteurized milk agent's licence would be revoked within thirty days of receipt of the letter of notification.¹⁵

3.25 On August 12, 1991, the Puerto Rico Secretary of Health extended the import, sales and distribution licence for 150 days to allow time to resolve the deficiencies identified by the agency. He stated that if the deficiencies were not solved during the extension period, the licence would then be suspended.¹⁶

3.26 On December 16, 1991, the Québec UHT milk distributor learned that the import, sales, and distribution licence extended by the Department of Agriculture would not be extended a second time.¹⁷

3.27 On December 31, 1991, the Governor of Puerto Rico rejected a request made by the Government of Canada on behalf of Lactel that the waiver be extended. He wrote:

...
This year Puerto Rico became a member of National Conference on Interstate Milk Shipments (NCIMS) and has agreed to follow all Conference procedures. On January 21, 1991 Puerto Rico adopted the Grade A Pasteurized Milk Ordinance (PMO) through promulgation of Puerto Rico Health Department Regulation

¹⁵Letter from José E. Soler Zapata, M.D., Secretary of Health, Puerto Rico, to Carlos Matos, Marketing & Brokerage Specialist, Inc. dated July 1, 1991 (Canadian Exhibit H).

¹⁶Letter from José E. Soler Zapata, M.D., Secretary of Health, Puerto Rico, to Jorge Luis Cordova, Bufete Rivera, Tulla & Ferrer dated August 12, 1991 (Canadian Exhibit I).

¹⁷Letter from Agro. Getulio Rodriguez Gonzalez, Administrator, Puerto Rico Department of Agriculture, dated December 16, 1991 (Canadian Exhibit J).

No. 138. As you are aware, Grand Pré does not comply with the PMO nor with Regulation 138.

We believe that the Government of the Commonwealth of Puerto Rico has, in good faith, made an effort to create an environment conducive to an amicable resolution of our differences. Ample advance warning was provided of Puerto Rico's plans to join the NCIMS. A draft copy of Regulation 138 was made available to the firm Hopkins & Sutter, representing Interl Marketing, Inc., as early as December 1990.

Both Canadian government officials and private sector representatives were invited to participate at the NCIMS biennial meeting held in April 1991. Puerto Rico's participants at the conference planned to bring up for discussion [sic] Grand Pré's access to Puerto Rico. Although this conference could have provided a forum to resolve this issue, no Canadian public or private sector representative was present and consequently the subject was not discussed.

Finally, Puerto Rico provided the Canadian company with a six month reprieve, extending Grand Pré's required licenses to the end of 1991. In short, the Government of the Commonwealth of Puerto Rico has done everything possible - by providing ample warning, a potential forum for resolution of the problem, and additional time - short of exempting Grand Pré from Regulation 138 on an extended basis.

Unfortunately, I must take issue with your statement that the NCIMS has agreed to wait until 1993 and that Puerto Rico's continued importation of Grand Pré will not jeopardize our membership in the Conference. In a letter to me dated November 14, 1991 Mr. Alfred R. Place, Chairman of the NCIMS, stated that he is "unable to provide... assurance" that Puerto Rico's status in the Conference would not be jeopardized if it continued to import UHT milk from Canada. He reiterated his position just this week during conversations with Puerto Rico government representatives in Washington, DC.

We understand that this matter is politically sensitive for the Government of Canada. We would like to stress, however, that we, too, are under considerable pressure by our milk producers, who have made substantial investments in order to comply fully with the NCIMS and the PMO. In the interest of our NCIMS membership and long-term public health safety, as well as elementary fair play, we simply can not continue to apply less strict standards to an imported product than we apply to domestic products. The fact that Puerto Rico's UHT milk producers are denied access to the Canadian market makes the request for an exemption from Regulation 138 even more politically impalatable.

Your representation notwithstanding, the Government of the Commonwealth of Puerto Rico is not convinced that a meaningful equivalency exercise, resulting in expanded two-way trade in fluid milk, will be completed by late 1992. Officials from the U.S. Food and Drug Administration stated at the meeting held in Washington, DC on October 2, 1991 that they would not participate in an equivalency exercise if the only purpose was one company's one-way market access.

The Government of the Commonwealth of Puerto Rico wholeheartedly supports free trade in general and the U.S. - Canada Free Trade Agreement specifically. After consulting your request with the pertinent Instrumentalities [sic] of the Department of Health and the Department of Agriculture of the Commonwealth of Puerto Rico, we lament not being able to grant your request at this time and we look forward to continue working toward the harmonization of dairy sanitation regulations as well as achieving two-way market access in fluid milk products.¹⁸

Since December 31, 1991, UHT milk produced in Québec has been excluded from the Puerto

¹⁸Letter from the Honourable Rafael Hernandez Colon, Governor of Puerto Rico to Michael H. Wilson, Canadian Minister for International Trade dated December 31, 1991 (Canadian Exhibit T).

Rico market.

3.28 On October 29, 1992, a Puerto Rico Administrative Tribunal found that the refusal to renew the distributor's licence was justified on the grounds that the milk did not comply with Section 12 of Regulation 5 and, in particular, the failure to demonstrate that the milk had been rated by an FDA-certified Rating Officer. The distributor filed a motion for reconsideration of the decision, which was rejected on December 17, 1992.¹⁹

3.29 An administrative review before the Department of Health scheduled for January 14, 1992 was adjourned *sine die* pending the outcome of the hearing before the Department of Agriculture. As a result of that adjournment, the importation, sale, and distribution licence issued by the Department of Health continued in force until October 1992. The refusal to renew the Department of Agriculture licence remained the basis for the import prohibition that has continued to date.²⁰

(f) Search for a Test to Determine Equivalence

3.30 In accordance with Section 11 of the PMO, Lactel with the assistance of the governments of Canada and Québec sought to establish the equivalency of the Québec and Puerto Rico UHT milk regulatory systems and to agree upon a *modus operandi* for rating the Québec UHT milk in the future.

¹⁹Decision of Lcda. Carmen Aulet Martinez, Office of Milk Industry Regulation of Puerto Rico (ORIL) dated October 29, 1992, in the matter of Carlos F. Matos Jordan, Marketing & Brokerage Specialists (English translation), (Canadian Exhibit K).

²⁰ Canada's First Submission, p. 7, para. 18.

3.31 In a letter to the FDA, dated January 2, 1991, Lactel's counsel asked that Québec UHT milk be admitted into Puerto Rico under Section 11 of the PMO.²¹ The FDA responded on January 9, 1991, that they were not familiar with the Québec Grade A system and that they "had repeatedly invited Canada and/or any of their Provinces [sic] to join the NCIMS". The FDA further stated that:

... We have, and will continue to encourage Québec's participation [in NCIMS], as a full partner, providing for unrestricted, reciprocal free trade of all Grade A dairy products between Québec, all fifty U.S. states, Washington, D.C., and Puerto Rico. FDA could certainly certify Québec's milk regulatory officials, laboratories, sample surveillance officers, etc., just as we do for Puerto Rico and each state.

FDA has never fully addressed in depth the question of Agrinove's [Lactel] compliance with all U.S. health and safety regulations. Although the firm believes they are in compliance with the U.S. PMO, we have no knowledge of their operations, nor has the government of Québec documented their compliance with the PMO.

The NCIMS program requires that certification of a milk sanitation official to conduct ratings of milk supplies can only be done if that official is an employee of that government agency. If the Canadian Federal Government, or by separate agreement with a provincial government, has a desire to participate in the NCIMS program, we stand ready to assist in the implementation of these "Procedures" and certification processes. However, due to budgetary constraints, we will not be able to standardize/certify Canadian government officials, unless they are working toward full participation in the NCIMS. This would be a major expenditure of FDA resources which we could only justify if it were used to solve a broad problem between governments. We would not be able to justify this large expense at the present time to afford relief to only one Canadian firm.²²

3.32 In the same letter, the FDA asserted that the decision to allow the entry of imported milk rested with Puerto Rico since the PMO is enforced exclusively by state authority. Consequently, the FDA could not rule on "substantial equivalency" under Section 11 of the PMO; the decision was for Puerto Rico to make.²³

²¹Letter from Charles Petty, Jr., Hopkins & Sutter, to L. Robert Lake, Director, Office of Compliance, FDA, Center for Food Safety and Applied Nutrition, Milk Safety Branch, dated January 2, 1991 (United States Attachment 22).

²²Letter from Johnnie G. Nichols, Chief Milk Safety Branch, FDA to Charles W. Petty, Jr., Hopkins & Sutter dated January 9, 1991.(United States Attachment 24).

²³Letter from Johnnie G. Nichols, Chief Milk Safety Branch, FDA to Charles W. Petty, Jr. dated January 9, 1991 (United States Attachment 24).

3.33 On February 27, 1991, the Canadian Ambassador to the United States wrote to the FDA Commissioner to propose that the FDA certify Canadian officials pursuant to FTA Article 708 to conduct inspections to certify Lactel's compliance with the PMO and the Procedures:

...

I am writing to propose, pursuant to Article 708 of the Canada-United States Free Trade Agreement, that Canadian milk sanitation inspectors be approved by the FDA to certify Canadian milk intended for export as meeting the requirements of the Pasteurized Milk Ordinance (PMO). Such certification would permit a Canadian company to maintain access for its ultra-high pasteurized (UHT) milk to the Puerto Rican market.

... This traditional market will be closed to Interl in the next three to six months if Puerto Rico proceeds in its intention to promulgate the PMO, a regulation that is technically administered by the FDA.

The long-term solution is recognition of equivalence in our countries' technical regulatory requirements pursuant to FTA Article 708.1.a. Canada will request, therefore, that the FTA working group on dairy, fruit, vegetable and egg inspection determine the equivalence of Québec's milk standards and the PMO.

...

Before this recognition is established, however, the only practical way to avoid a serious disruption in our long-standing trade with Puerto Rico may be to have the Canadian milk certified as meeting the requirements of the PMO. I understand that Section 11 of the PMO permits inspection of milk products from points beyond the limits of routine state inspection on the condition that the milk sanitation rating officer be certified by the FDA. Such inspection in Canada would conform to the guiding principle of Article 708.d of the FTA - the use of the other country's personnel for testing and inspection of agricultural products, where appropriate.

...

... If it appears, however, that trade will be affected, Canada would expect notification of this and an opportunity for consultations in keeping with FTA Article 708.2.c.²⁴

3.34 The FDA responded to the letter of February 27, 1991 on June 20, 1991. The FDA did not address the Canadian request for an equivalency study and rejected the request for certification of Québec milk inspectors. The letter referred to discussions that had taken place at the March 4, 1991 meeting of the Dairy, Fruit, Vegetable, and Egg Inspection Technical Working Group (the "Technical Working Group"), established under the U.S.-Canada Free Trade Agreement. The FDA stated that the purpose of the meeting had been to explore the short, medium and long term

²⁴Letter from the Canadian Ambassador to the United States D.H. Burney to Dr. David A. Kessler, Commissioner, FDA, dated February 27, 1991 (Canadian Exhibit N).

alternatives that would respond to the specific problem referred to in the Canadian Ambassador's letter.²⁵

3.35 During this meeting of the Technical Working Group on March 4, 1991, FDA representatives present stated that the Canadian Ambassador's short-term proposal for FDA certification of Canadian inspectors would not solve Lactel's problem, since "substantial equivalency" under Section 11 of the PMO did not mean a one-time inspection. Rather, it required a system of preventative standards, oversight and verification that complied with the PMO and Procedures. They went on to say that Section 11 required implementation of the PMO, including the adoption of an oversight and verification system under the Procedures, with routine official supervision and FDA-certified state oversight through check ratings.²⁶

3.36 At the March 4, 1991 Technical Working Group meeting two alternative short-term solutions had been suggested to address Lactel's concerns. The FDA proposed these solutions to the Canadian Ambassador in the June 20, 1991 letter. First, it was suggested that Lactel request a waiver from Puerto Rico of the requirement that the milk be from a NCIMS processing state. Second, the FDA suggested that Lactel contract with a U.S. regulatory agency near the Québec border (such as New York or Vermont) to have the authorized inspectors, certified laboratory officials, and certified

²⁵Letter from John E. Kvenberg, Director, Division of Cooperative Programs, Center for Food Safety and Applied Nutrition, FDA to Canadian Ambassador D.H. Burney, dated June 20, 1991 (Canadian Exhibit O).

²⁶U.S. First Submission, p. 13, para. 65. (See United States Submissions Attachment 34, FDA Minutes of the meeting of the Working Group, March 4, 1991.) Seven Canadian representatives, from Agriculture Canada, the Québec Ministère de l'Agriculture, Direction des pêcheries et des légumes, and the Canadian Embassy, and five United States representatives, from the United States Department of Agriculture and Food and Drug Administration, were present at the meeting.

ratings officers carry out the inspections and ratings required under the PMO and Procedures. The FDA noted that this avenue would have to be approved by the Puerto Rico Department of Health.²⁷

3.37 The second short-term solution became known as the "Vermont option" and involved Québec approaching a northern U.S. state, to determine if it would be willing to have its authorized inspectors, certified laboratory officials, and certified ratings officers carry out the inspections and ratings required under the PMO and Procedures. Lactel, and the governments of Québec and Canada rejected this proposal. The "Vermont option" was rejected as unacceptable because, on Canada's understanding, it did not allow for the use of Québec milk in the UHT testing process.²⁸ Furthermore, it felt that it was based on the assumption that the Québec regime was not equivalent to that of the PMO, an assumption that Canada denies.

3.38 At the same March 4, 1991 meeting, a medium term solution involving direct interaction between the Canadian government and the NCIMS was also identified. The FDA encouraged Canada and Québec to attend the April 22-26, 1991 NCIMS conference. The Conference was scheduled to review a proposal by Puerto Rico to change the by-laws of the NCIMS and establish "criteria that should be met by foreign countries that wish to be part of the IMS

²⁷ *Infra*, notes 30 and 31.

²⁸ Canada's First Submission, p. 15, para. 36 and Canada's Supplementary Submission para. 9-13. Neither Canada nor the United States provided official documents regarding this matter. See FDA Minutes of March 4, 1991 meeting of the Working Group, United States First Submission, Attachment 34. However, the record of Canadian participants at the March 4, 1991 Technical Working Group meeting, Canadian Supplementary Exhibit 15, set out on Page 2, Paragraph 2 of a telex, dated March 7, 1991, from Mr. John McNab, Counsellor Commercial of the Canadian Embassy in Washington, states that:

It became clear, however, that feasibility of Vermont option for FDA rested on use of USA milk from supplier listed in National Conference of Interstate Milk Shipments (NCIMS). Use of Québec milk would require certification of farms by Vermont or another state and FDA presented host of reasons why this could not/not be done easily. Option was thus less attractive to CDA since interests of fifty supplying farms would not/not be protected. FDA agreed that inspection and certification in CDA could theoretically be done by PR.

program".²⁹

3.39 It was further suggested at the Technical Working Group meeting on March 4, 1991 that the long term solution was for Canada to develop "a parallel system to the NCIMS and work, with FDA assistance, for reciprocal acceptance of both systems". It was urged by the FDA that any review of the equivalence of the two systems be reciprocal, covering both the U.S. and Canadian systems.³⁰

3.40 At the August 18, 1991 meeting of the Canada-U.S. Trade Commission, the Canadian Minister of International Trade requested that the Technical Working Group give the issue of equivalence top priority. He also sought assurances that the Puerto Rico market would remain open until an equivalency study had been completed.³¹

3.41 A UHT Sub-committee was established to work toward a determination of equivalency of the Puerto Rico and Québec milk regulatory systems. The UHT Sub-committee met on three occasions -March 5, 1991, July 15-16, 1991 and October 1-2, 1991 - to continue its review of "equivalence" under Section 11 of Annex 708.1 of the FTA. Copies of United States and

²⁹ United States First Submission, Attachment 26. Canada did not respond favourably to this suggestion which it believed would submit its milk production regulations to an American organization and compromise its milk marketing system. Letter dated June 20, 1991, *supra*, and Minutes of Working Group meeting, *supra*. See also: Record of Canadian participants at the March 4, 1991 meeting of the UHT Sub-committee of the Technical Working Group, telex dated March 7, 1991, from Mr. John McNab, Counsellor Commercial of the Canadian Embassy in Washington (Canadian Supplementary Exhibit 15).

³⁰ Letter from John E. Kvenberg, Department of Health & Human Services, FDA to Canadian Ambassador Burney, June 20, 1991. (Exhibit O). See also: Record of Canadian participants at the March 4, 1991 meeting, telex dated March 7, 1991, from Mr. John McNab Counsellor Commercial of the Canadian Embassy in Washington (Canadian Supplementary Exhibit 15).

³¹ Canada's First Submission, p. 12, para. 13. There is no official document in the record to support this assertion.

Canadian/Québec regulations and standards governing milk and milk products were exchanged.³²

3.42 On November 8, 1991, following the initial request for an equivalency study by Canadian Ambassador Burney on February 19, 1991 and the three UHT Sub-committee meetings, Agriculture Canada (the Canadian Federal Department of Agriculture) proposed a detailed timetable for evaluation of the equivalence of the two systems. The proposal suggested that an equivalency study, limited to UHT milk, be undertaken and completed by December 31, 1992.³³

3.43 In a letter to the Governor of Puerto Rico dated November 26, 1991, the Canadian Minister for International Trade requested that Puerto Rico extend the waiver to December 1992.³⁴ As noted in 3.27, this request was rejected by the Governor of Puerto Rico and the Puerto Rico market was subsequently closed to Québec UHT milk.³⁵

3.44 In a letter dated July 9, 1992, the Canadian Minister of International Trade wrote:

The Canadian Government's overriding objective continues to be the restoration of the Puerto Rican

³²United States First Submission, p. 15, para. 77. Canada's First Submission, pp. 12-13. There are no official documents of these meetings in the records.

³³ Canada submitted that the proposal was conditional on the willingness of Puerto Rico to guarantee continued access for Québec UHT milk while the equivalency evaluation exercise was under way. Letter from P.J. Brackenridge, Director, Food Production and Inspection Branch, Agriculture Canada, to Dr. Kenneth C. Clayton, Deputy Administrator, Marketing Programs, U.S. Department of Agriculture, dated November 8, 1991 (Canadian Exhibit R). Canada also said that there was no U.S. response to this proposal (Canada's First Submission, p. 13).

³⁴Letter from the Canadian Minister of International Trade to the Governor of Puerto Rico, dated November 26, 1991 (Canadian Exhibit S).

³⁵Letter from the Governor of Puerto Rico to the Canadian Minister of International Trade, dated December 31, 1991 (Canadian Exhibit T).

market for Grand Pré UHT milk. Since Puerto Rican laws required imported UHT milk to be produced in accordance with standards that are substantially equivalent to Puerto Rico's, we are prepared to demonstrate that equivalency. Unfortunately, our previous attempts to do so have been frustrated.

...

At the meeting of the Trade Commission, you indicated that it would still be possible to reach an expedited and conclusive determination of equivalency for UHT milk from Quebec. The Canadian Government would be prepared to give favourable consideration to any proposal to that effect. Beyond the issue of equivalency, however, we would want assurances that any other possible barriers arising from Puerto Rico's membership in the NCIMS would also be removed. If market access were thus assured, FTA Chapter 18 panel proceedings on this issue would obviously become pointless.³⁶

3.45 On August 24, 1992, Acting United States Trade Representative ("Acting USTR") Katz wrote to the Canadian Minister for International Trade presenting an FDA proposal for a three part equivalency study of the Québec/Canadian regulation and inspection system for UHT milk, which could be completed by January 1993. Acting USTR Katz wrote:

At the June 9, 1992 Trade Commission meeting, I committed to examine the possibility of conducting an expedited and conclusive determination of the equivalency of the Québec/Canadian and Puerto Rico/United States systems for the regulation and inspection of UHT milk, in an effort to avoid referring the issue to a dispute settlement panel before every possible means of resolving the matter had been explored. This letter responds to your letter of July 9, 1992 requesting that we provide a proposal that would allow Canada the opportunity to demonstrate equivalency.

Since the Trade Commission meeting, the Food and Drug Administration (FDA) has developed a proposal to conduct a three-part equivalency evaluation study of the Québec/Canadian regulation and inspection system for UHT milk which could be completed by January 1993.

...

I have been advised by the FDA that the Québec/Canadian system, as it is currently understood, does not include the federal oversight and verification elements that are essential components of the U. S. system as outlined in the Pasteurized Milk Ordinance (PMO) and related documents. The oversight and verification elements are part of the checks and balances in the U.S. system that are essential to ensuring the safety of the milk supply. At a minimum, therefore, any conclusions from the proposed equivalency study are likely to include recommendations for changes to the Québec/Canadian system to provide for equivalent checks and balances.

The FDA has expressed to us their readiness to proceed with a review to provide the Government of Canada with the opportunity to present evidence that the Québec/Canadian system is equivalent in effect to the Puerto Rico/United States system despite the fact that the Québec/Canadian system, as it is currently understood, does not include the federal oversight and verification elements that are essential components of the U.S. system....³⁷

³⁶Letter from the Canadian Minister of International Trade to the United States Trade Representative, dated July 9, 1992 (Canadian Exhibit U).

³⁷Letter from Acting USTR Julius L. Katz to the Canadian Minister for International Trade, dated August 24, 1991 (Canadian Exhibit V).

3.46 On September 16, 1992, the Canadian Minister for International Trade responded by rejecting the U.S. proposal. He wrote:

As indicated in my letter of July 9, 1992, Canada has been attempting to establish the equivalency of our two systems for some time. In March 1991, at the first meeting of the UHT Sub-committee of the FTA Article 708 Working Group, we provided a side-by-side comparison of the sanitary conditions of the Quebec/Canadian system and the Pasteurized Milk Ordinance. In addition, a representative of the Quebec government addressed this issue at the October 1991 UHT Sub-Committee meeting. Canada also provided a proposal for an equivalency study in November 1991. We have never received any response to either the documentation or our proposal.

...

Ambassador Katz's proposal also covers federal oversight and verification elements. As you are aware, Canada's position is that the Quebec/Canadian regulatory and inspection system for UHT milk is equivalent in effect to the U.S. Pasteurized Milk Ordinance (PMO). Accordingly, we see no need to adopt the U.S. system in Canada.

The Canadian Government's overriding objective continues to be the restoration of the Puerto Rican market for Grand Pré milk and therefore, beyond the issue of equivalency, I had sought assurances that any other possible barriers arising from Puerto Rico's membership in the NCIMS would also be removed. The response provided by Ambassador Katz -- i.e., that market access is the responsibility of the Puerto Rican Government and the United States could only work to obtain support for the outcome of the study -- indicates that a determination of equivalency may not be sufficient to re-open the market.

...³⁸

3.47 On September 17, 1992, the Canadian Minister for International Trade wrote to the United States Trade Representative requesting the establishment of a panel pursuant to Article 1807.2 FTA, and proposing a timetable and terms of reference.³⁹

3.48 On September 25, 1992, Acting USTR Katz wrote to the Canadian Minister of International Trade to clarify that the United States was not insisting that Canada or Québec implement an identical system to the PMO. Acting USTR Katz wrote that:

³⁸Letter from the Canadian Minister for International Trade to the United States Trade Representative, dated September 16, 1992 (Canadian Exhibit W).

³⁹Letter from the Canadian Minister for International Trade to the United States Trade Representative, dated September 17, 1992 (Canadian Exhibit X).

In your letter of September 16, you imply that because our proposed equivalency evaluation raises the issue of federal oversight and verification, we are necessarily insisting that Canada and Québec adopt a milk inspection system identical to the Pasteurized Milk Ordinance (PMO). Quite to the contrary, my letter of August 24 clearly expresses our readiness to proceed with a three-part equivalency evaluation to present evidence that the Québec/Canadian system is equivalent in effect despite the lack of federal oversight and verification. If you are confident of your ability to demonstrate the equivalence in effect of the Québec/Canadian system, our proposal provides a more expeditious means of resolving the issue than referring the matter to a panel.

...⁴⁰

3.49 Acting USTR Katz's letter reiterated the offer of an equivalency study as an alternative to a Panel.⁴¹ On October 15, 1992, the Canadian Minister for International Trade responded by suggesting that an expedited six-week equivalency study be commenced. He proposed that the Panel timetable be modified to accommodate the equivalency process. He also requested assurances that if the study concluded that the two systems were substantially equivalent, the United States would ensure that all necessary measures be taken in order to give effect to those conclusions.⁴²

3.50 On November 9, 1992, the United States Trade Representative replied that it would be too costly and time-consuming to conduct an equivalency study and pursue a dispute settlement case simultaneously. With respect to assurances for full effect to be given to the results of such an equivalency study, she stated that the decision to reopen the Puerto Rico market to Québec UHT milk rested with the Government of Puerto Rico. However, she gave assurances that the United States

⁴⁰Letter from Acting USTR Julius L. Katz to the Canadian Minister of International Trade, dated September 25, 1992 (Canadian Exhibit Y).

⁴¹*Ibid.*

⁴²Letter from the Canadian Minister for International Trade to the United States Trade Representative, dated October 15, 1992 (Canadian Exhibit Z).

would work with the NCIMS and Puerto Rico during the equivalency study to ensure that its conclusions were implemented.⁴³

4. **ARGUMENTS OF THE PARTIES**

4.1 The United States and Canada agreed that the FTA applies to the Commonwealth of Puerto Rico.

4.2 The United States and Canada also agreed that the provisions of the FTA acknowledge the right of the Parties to adopt new technical standards. At the same time, the FTA provisions recognize the danger of governments raising new trade barriers under the guise of health or other technical standards.⁴⁴

(a) Submissions of Canada

4.3 Canada argued that the Puerto Rico licensing requirements governing the import, sale and distribution of milk (Department of Health Regulation 138 and Department of Agriculture Regulation 5) constituted a prohibition or quantitative limitation upon importation, breaching Article XI of the GATT which is incorporated into the FTA under Articles 407 and 710. It was submitted

⁴³Letter from the United States Trade Representative to the Canadian Minister for International Trade, dated November 9, 1992 (Canadian Exhibit AA).

⁴⁴Canada's First Submission, p. 18, para. 44 and United States First Submission, p. 19, paras. 100-101.

that the licensing requirements as they affected imports could be distinguished from their effects upon domestic sale and distribution. For imported milk, the license requirements would take effect before the product could enter the market.⁴⁵

4.4 Canada argued that import licenses are generally prohibited by GATT Article XI:1 unless their imposition is otherwise justified under exceptions appearing later in Article XI or elsewhere in the GATT. The Puerto Rico measures meet all of the criteria set out in GATT Article XI:I: (1) they operate to restrict completely the quantity of UHT milk from Québec entering Puerto Rico; (2) they are made effective through licences; and (3) they apply on the importation of the UHT -- the licence required is conditional on the importer complying with specific Puerto Rico requirements. Moreover, measures expressly covered by GATT Article XI do not become internal measures by virtue of the operation of the interpretive note ad GATT Article III.⁴⁶

4.5 If Puerto Rico Regulations 138 and 5 were interpreted and applied in a fair manner, however, Québec UHT milk would meet all requirements and Puerto Rico would not find reason to deny the import, sale and distribution licenses. Puerto Rico has interpreted and applied the regulations in a manner which has created conditions for compliance which cannot be met⁴⁷. Essentially, Puerto Rico would require Canada to join the National Conference on Interstate Milk

⁴⁵Canada's First Submission, pp 19-21.

⁴⁶Canada's First Submission, p.22 and Canada's Supplementary Submission, pp 16-17.

⁴⁷Canada's Supplementary Submission, p. 16.

Shipments (NCIMS) and to adopt the U.S. Pasteurized Milk Ordinance (PMO). The Regulations therefore operate as a prohibition on importation.⁴⁸

4.6 Alternatively, Canada argued that the Puerto Rico licensing requirements breach GATT Article III as incorporated into the FTA under Articles 501 and 502. Even though the required license affects Québec UHT milk at the border, it also applies to the internal sale and distribution of the product. As such, under the terms of GATT Article III:4, the principle of national treatment must be applied. It is not permitted to treat an imported product less favourably than a like domestic product. Underlying this rule is the goal of providing equal opportunity of market access to imported and domestic products.⁴⁹ The precise manner in which the national treatment principle has been violated lies in Puerto Rico's interpretation and application of Regulations governing the production, sale, distribution and import of milk. Puerto Rico has chosen to interpret the condition that milk from outside Puerto Rico be "elaborated and processed under substantially similar regulations"⁵⁰ as meaning that the PMO standards must be employed. This interpretation is not consistent with the definition of "equivalent" under Article 711 of the FTA and therefore denies the fundamental principle of national treatment.⁵¹

⁴⁸Canada's First Submission, pp 20-21.

⁴⁹Canada's First Submission, pp 22-25.

⁵⁰Section 11, Grade 'A' Pasteurized Milk Ordinance, 1989 Revision, U.S. Department of Human Services, pp 106-107.

⁵¹Canada's Supplementary Submission, pp 15-16.

4.7 Canada further argued that even though *prima facie* the Puerto Rico Regulations apply equally to domestic and imported milk, this *de jure* equality masks *de facto* discrimination because it is simply impossible for the imported Québec UHT milk to meet the requirements which can be routinely met by like U.S. products. The reason for the inability to meet the requirements is the inflexible interpretation accorded the Regulations by Puerto Rico authorities and their refusal to adopt measures which would allow the Québec producer to demonstrate the equivalence of Québec and Puerto Rico health and safety standards for the production of milk.⁵²

4.8 Canada submitted that the denial of sales and distribution licenses to Québec UHT milk further breaches GATT Article III:1 by affording protection to domestic production. By interpreting and applying the Regulations so as to exclude from the Puerto Rico UHT milk market the largest non-Puerto Rico UHT producer, the authorities have afforded protection to domestic producers. While, on their face, the Puerto Rico regulations appear to apply the same standards to domestic and imported products alike, in fact, they are being interpreted and applied in a manner that affords protection to domestic UHT production.⁵³

4.9 Canada argued that (i) by requiring an FDA-certified inspection but refusing to certify Canadian or Québec inspectors to carry out such inspections, (ii) by requiring that the regime established for the production of UHT milk from Québec be identical to that of the PMO, and (iii) by requiring that Canada adopt a U.S. system of verification and oversight and join the NCIMS, the

⁵²Canada's First Submission, p. 24.

⁵³Canada's First Submission, p. 25.

United States imposed conditions that neither Canada nor the producer of the UHT milk from Québec could meet.⁵⁴

4.10 Canada also submitted that the Puerto Rico Regulations as interpreted and applied breached Article 703 of the FTA which requires the parties to "facilitate trade in agricultural products" by working together "to improve access to each other's markets through the elimination or reduction of import barriers". Because the Puerto Rico Regulations were applied to create a new import barrier to Québec UHT milk, where none had existed before, Article 703 was violated. In addition, the failure of Puerto Rico to agree to an expeditious equivalency study before the exclusion of the UHT milk from the market was itself a violation of the obligation to "work together" to improve market access.⁵⁵

4.11 Canada argued that the Puerto Rico measures should be treated as technical regulations and inspection procedures subject to a requirement under FTA Article 708.1(a) to make such measures equivalent in Canada and the USA. Article 708.1 recognises the legitimacy of technical regulations and standards "to protect human, animal and plant life" but goes on to state that "the Parties shall seek an open border policy with respect to trade in agricultural, food, beverage and certain related goods". In implementing that policy, the parties are to be guided by "principles" including the duty to "make equivalent their respective technical regulatory requirements and

⁵⁴Canada's First Submission, para. 69.

⁵⁵Canada's First Submission, p. 26.

inspection procedures" where full "harmonisation" is not feasible.⁵⁶

4.12 Canada also submitted that in refusing to carry out a timely equivalency study to assess whether the Québec production standards for UHT milk are equivalent to Puerto Rico's standards, the United States breached Article 708.1(a). Equivalency should be measured according to the definition of "equivalent" found in Article 711 of the FTA, that is, "having the same effect".⁵⁷

4.13 Furthermore, under Article 708.1(c), the Parties to the FTA agree "to establish equivalent accreditation procedures for inspection systems and inspectors". Puerto Rico's insistence that only FDA-certified inspectors could be employed to evaluate the Québec UHT milk failed to meet the requirements of Article 708.1(c).⁵⁸

4.14 Canada further submitted that the Puerto Rico measures failed to comply with FTA Article 708.2(a) which imposes binding obligations upon Canada and the United States:

The Parties shall, with respect to agricultural, food, beverage and certain related goods:

a) work towards the elimination of technical regulations and standards that constitute, and prevent the introduction of technical regulations and government standards that would constitute, an arbitrary, unjustifiable or disguised restriction on bilateral trade;

...

This provision contains two separate elements: to work towards the elimination of existing technical regulations and standards which constitute "an arbitrary, unjustifiable or disguised restriction on

⁵⁶Canada's First Submission, p. 27.

⁵⁷Canada's First Submission, p. 28.

⁵⁸Canada's First Submission, p. 28.

bilateral trade"; and to prevent the introduction of any such new regulations. The Puerto Rico Regulations were adopted after the ratification of the FTA and therefore constitute new technical regulations or standards. The result of the interpretation and application of those Regulations is the arbitrary and unjustifiable exclusion from the Puerto Rico market of Québec UHT milk which had been imported and distributed in Puerto Rico for some 14 years.⁵⁹ To introduce new standards the United States would have to justify its action with more than a mere assertion that the standards are necessary for reasons of health and milk quality.⁶⁰

4.15 Canada submitted that UHT milk from Québec already met the standards of the U.S. *Low-Acid Canned Food Regulations*⁶¹; as these regulations were merely incorporated into the PMO (Part II, Section I:N1), no material change in aseptic processing was required under the new Puerto Rico Regulations. The new Regulations would not provide greater protection for public health, but amounted merely to technical regulations which had the effect of excluding Québec UHT milk from the Puerto Rico market.⁶² The Puerto Rico measures are also unjustifiable because there are other less trade restrictive measures which could have been taken to achieve the desired result of protection of public health.⁶³

4.16 The obligation contained in Article 708.2 must be interpreted in good faith as required

⁵⁹Canada's First Submission, p. 29.

⁶⁰Canada's Supplementary Submission, p. 19.

⁶¹21 CFR 113.

⁶²Canada's Supplementary Submission, p. 9.

⁶³Canada's First Submission, p. 29.

by Article 31 of the *Vienna Convention on the Law of Treaties*, and in the light of the principles set out in Article 708.1. A reasonable interpretation of Article 708.2 would require that once a party has made out a *prima facie* case that the introduction of new standards was arbitrary, unjustifiable or a disguised restriction on trade, the burden of proof would shift to the party which has introduced the standard to justify its existence.⁶⁴ Furthermore, a commonsensical interpretation of Article 708.2 would demand that the United States cannot determine equivalence with sole reference to its domestic law when the applicable standard has been set out expressly in a binding international treaty, Article 710 of the FTA. Nor can the United States defer to the interpretation of equivalence offered by Puerto Rico, even if that determination is constitutionally valid under domestic law. Article 27 of the *Vienna Convention* provides that "[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."⁶⁵

4.17 Canada submitted that the Puerto Rico denial of an import, sales and distribution license to Québec UHT milk could not be justified under GATT Article XX(b), the exception relating to the protection of health. That exception must be strictly construed. Moreover, the burden of proof under Article XX lies on the party seeking to invoke the exception. In any event, Article XX(b) is inapplicable on the facts because even though the Puerto Rico Regulations are *prima facie* related to health protection, the manner in which they are being interpreted and applied suggests that they are actually disguised restrictions upon trade. This interpretation is bolstered by the fact that the regulations are not necessary to achieve the health protection objective. Other avenues were and are

⁶⁴Canada's Supplementary Submission, p. 19.

⁶⁵Canada's Supplementary Submission, p. 18.

available to guarantee the purity of an imported UHT milk supply. Such measures had indeed been employed by Puerto Rico authorities for 14 years, during which time no complaint had ever been lodged against the purity of Québec UHT milk. Article XX requires that when less trade restrictive measures are available to meet legitimate policy goals, those measures must be pursued.⁶⁶

4.18 Canada further argued in the alternative that even if the Puerto Rico measures were found to be consistent with U.S. obligations under the FTA, the application of the measures nullifies and impairs the benefits Canada could reasonably have expected to achieve under the FTA. Nullification and impairment, as defined by FTA Article 2011, should be measured in the light of GATT practice which requires that the parties have negotiated a tariff concession, that one party has subsequently introduced a government measure which has upset the competitive relationship between like imported and domestic products, and that this measure could not reasonably have been anticipated at the time of the negotiation of the tariff concession. Canada submitted that on the facts, all three conditions had been met in the present case.⁶⁷

4.19 Finally, Canada argued that the Québec UHT milk should be allowed to re-enter the Puerto Rico market pending the completion of any equivalency study. The Québec milk is safe and healthy, and only this approach could ensure that the Québec producer does not permanently lose its market share.⁶⁸

⁶⁶Canada's First Submission, pp 30-31.

⁶⁷Canada's First Submission, p. 33.

⁶⁸Canada's Supplementary Submission, p. 21.

b. Submissions of the United States

4.20 The United States argued from the agreed proposition that FTA Article 708.1 explicitly affirms the right of the parties to promulgate technical regulations and standards to protect human, animal and plant life. Accompanying this right is the further right to upgrade such health standards in the light of improvements in scientific and public health knowledge. It falls upon the producer to tailor its product to the market, including the legitimate health regulations applicable within the market.⁶⁹

4.21 The burden of proof in the case rests upon Canada, as it is the party alleging a breach of treaty obligations.⁷⁰

4.22 The United States submitted that GATT Article XI has no application to the situation of Québec UHT milk in Puerto Rico. The license requirements imposed by Puerto Rico do not amount to an import prohibition or restriction, but are entirely internal measures applicable to all producers of milk, domestic or foreign. Even though the license requirements apply at the border for imported products, the requirements do not single out imported products, but relate to all milk products, no matter their origin.⁷¹ Puerto Rico applies a single licensing requirement for the import,

⁶⁹United States First Submission, pp 19-20.

⁷⁰United States First Submission, p. 20.

⁷¹United States First Submission, p. 21.

sale and distribution of milk.⁷²

4.23 A construction of Article XI which would bar any import restrictions, even when identical to domestic standards, would undermine the sovereign power of states to set appropriate health and safety standards to protect their respective populations.⁷³

4.24 The relevant GATT provision is Article III, incorporated into the FTA through Articles 501 and 710, which governs "laws, regulations and requirements affecting the internal sale, offering for sale, [and] distribution" of products, including milk. The Puerto Rico Regulations are purely internal requirements because they apply equally to domestic and imported milk. This interpretation is supported by the Interpretive Note Ad Article III which states that "any law, regulation, or requirement...which applies to an imported product and the like domestic product and is...enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal...law, regulation, or requirement...and is accordingly subject to the provisions of Article III". Consistent GATT and FTA practice also supports this view of the relative scope of Articles XI and III.⁷⁴

4.25 The United States further argued that the denial of Puerto Rico licenses to Québec UHT milk was fully consistent with GATT Article III:4 which imposes a "national treatment"

⁷²United States Supplemental Submission, p. 12.

⁷³United States First Submission, p. 24.

⁷⁴United States First Submission, pp 22-23.

standard. The Puerto Rico Regulations apply equally to imported and domestically produced milk; imported milk is treated "no less favorably" than the like domestic product. In every case, the relevant standard is the Pasteurized Milk Ordinance (PMO), which is incorporated into Puerto Rico law through Regulations 5 and 138. The Québec UHT milk simply did not meet that universally applicable standard.⁷⁵

4.26 To meet the PMO standard, the Québec milk producer would have had to demonstrate that its UHT milk was produced and pasteurized under regulations that are "substantially equivalent" to the PMO. "Substantial equivalence" under PMO Section 11 has been interpreted by the National Conference on Interstate Milk Shipment (NCIMS) to mean that an equivalent system must be identical to or stricter than the requirements of the PMO. This interpretation applies to all milk producers, and is the appropriate interpretation in the present case.⁷⁶

4.27 The Québec producer was not able to demonstrate the required equivalence, and should not be exempted from the application of a requirement which applies to all of its competitors.⁷⁷ The United States position is that Lactel milk exported to Puerto Rico must meet PMO standards, unless Puerto Rico has determined that the government of Québec's standards are equivalent to the PMO.⁷⁸

⁷⁵United States First Submission, pp 24-25.

⁷⁶ United States First Submission, p. 27 and United States Supplemental Submission, p. 10.

⁷⁷United States First Submission, p. 28.

⁷⁸United States Supplemental Submission, p. 10, fn 16.

4.28 In any event, border inspections of individual shipments of milk could not have amounted to substantial equivalence with the PMO because that system is rooted in production standards and prevention to protect the public health. Border inspections would provide an inadequate level of protection because they do not enforce strict industry standards, but simply assess whether any given shipment of milk is contaminated. Moreover, given the huge volume of transborder shipments of food and agricultural products, border inspection of all shipments is impractical, particularly where, as in the case of UHT milk, the product is in sealed boxes.⁷⁹ Neither the FTA nor the GATT create obligations to provide special procedures outside the standard regulatory regime to give more favourable treatment to a Canadian producer than that accorded to Puerto Rico or U.S. milk producers.⁸⁰ In any event, border inspection procedures cannot assure equivalent levels of safety or quality. Canada itself does not permit border inspections in administering its own dairy safety programme and imposes process and inspection requirements directly analogous to those of Puerto Rico.⁸¹

4.29 Whatever legal standard of equivalency should be applied, the Panel cannot conduct its own equivalency assessment, comparing Puerto Rico and Québec standards for the production of UHT milk. Any such assessment would fall outside the scope of the Panel's Terms of Reference, and

⁷⁹United States Supplemental Submission, pp 15-16, paras. 48-51.

⁸⁰United States First Submission, p. 27.

⁸¹United States Supplemental Submission, pp 9-11 and para. 36.

would be fraught with risk of error.⁸² The final decision concerning equivalency rests in the discretion of Puerto Rico authorities. Nothing in the FTA dislodges this exercise of sovereignty. Article 708.3 provides that a party is required to accept certification by the other party only after "the Parties have harmonized or accepted the equivalence of each other's inspection systems, certification procedures, or testing requirements".⁸³

4.30 The United States argued that Article 703 of the FTA is hortatory, simply requiring the Parties to "work together" toward an ultimate goal of reciprocal market access. The Article imposes no binding obligation immediately to eliminate all import barriers, nor does it relate to technical standards. The Working Groups set up under Article 703 in which the United States participates, more than satisfy its obligations.⁸⁴

4.31 The United States also submitted that Article 708 should be interpreted to create only a "best efforts" obligation to work to integrate technical standards. The Preamble to the FTA emphasises the need to preserve "the Parties' flexibility to safeguard the public welfare." This emphasis serves to aid in the appropriate contextual and purposive interpretation of Article 708 as a whole.⁸⁵ The Article is cast in facilitative, not mandatory, terms: the parties agree to "seek", to be "guided by", and to apply "principles".

⁸²United States Supplemental Submission, p. 7.

⁸³United States First Submission, p. 32 and United States Supplemental Submission, p. 7, para. 22.

⁸⁴United States First Submission, pp 32-33.

⁸⁵United States Supplemental Submission, p. 3.

4.32 More particularly, the "principles" set out in Article 708.1, including the principle of prospective equivalency of technical standards, do not constitute obligations, but long-term *desiderata*. Therefore, they are not justiciable, and do not properly fall to be applied by a dispute settlement panel.⁸⁶ Working Groups are now seeking to further the concept of equivalency, but this merely underscores the non-binding character of Article 708.1. The Parties to the FTA retained ultimate authority to determine equivalency of technical standards. The United States more than met its obligations under Article 708.1 by offering to conduct an expedited equivalency study.⁸⁷

4.33 The United States also discussed Article 708.2(a) which provides that the Parties shall prevent the introduction of new technical standards that would amount to an arbitrary, unjustifiable or disguised restriction on trade. It was argued that this provision does not prevent a Party from upgrading its health standards. The mere fact that an enhanced standard results in the exclusion of sub-standard products does not render the new standard arbitrary or unjustifiable.⁸⁸ To show that the new Regulations were not arbitrary, unjustifiable or adopted or applied for the purpose of restricting trade, the United States has related the Regulations to a legitimate policy objective, the safety and quality of the milk supply.⁸⁹

4.34 The United States also noted that it had suggested various reasonable short-term

⁸⁶United States First Submission, p. 34.

⁸⁷United States Supplemental Submissions, pp 7-8, paras. 22, 23, 27.

⁸⁸United States First Submission, p. 35.

⁸⁹United States Supplemental Submission, p. 4.

options by which the Québec producer could demonstrate compliance with the Puerto Rico measures, pending a full equivalency study. These options had not been taken up. Canada itself requires that imported milk be processed under technical and inspection requirements "at least equivalent" to the Canadian regulations. Canada is not in a position to argue that a similar approach adopted by Puerto Rico is arbitrary or unjustifiable.⁹⁰

4.35 As an alternative submission, the United States submitted that if it had breached any provision of the FTA, the *prima facie* breach should be treated as a legitimate exception under GATT Article XX which allows states to adopt measures "necessary to protect human, animal or plant life or health", as long as such measures are not "arbitrary or unjustifiable discrimination between countries where the same conditions prevail". To be "necessary", a regulation relating to public health need not be the least trade restrictive measure available.⁹¹

4.36 The United States argued that Canada suffered no nullification or impairment of its benefits under the FTA because Canada could not reasonably have assumed that Puerto Rico would never upgrade its milk import, sale and distribution regulations. Because Article 708 of the FTA implicitly allows Parties to modify their technical standards, the Puerto Rico decision to implement the PMO could not have been a surprise to Canada, particularly as this standard applies in all fifty U.S. states. This interpretation is supported by the reference in a 1990 document of the bilateral Working Group on Dairy Trade that the U.S. and Canada believed that there was "no trade expected"

⁹⁰United States Supplemental Submission, pp 11-12.

⁹¹United States First Submission, p. 37.

in sterilised milk.⁹²

4.37 Finally, the United States argued that the Québec milk should not be permitted access to the Puerto Rico market until after the successful completion of an equivalency study. There is no evidence, apart from the mere assertion by Canada, that Québec production standards are equivalent to the Puerto Rico standards. Puerto Rico must be able to prevent access to its market until it is satisfied that Québec UHT milk is produced under equivalent standards. Any other approach would place trade considerations ahead of legitimate public health concerns.⁹³

5. ANSWERS TO THE TERMS OF REFERENCE

(a) General Considerations

5.1 This dispute relates to the manner in which a new health regulation, relating generally to milk production, was applied to UHT milk from Québec. Both Parties have urged upon the Panel the potential significance of a recommendation in this, the first dispute under the FTA dealing with standards. While the Panel is conscious of its responsibilities in this regard, it wishes to make a few cautionary remarks, by way of introduction, with respect to its understanding of the nature of this dispute.

5.2 Standard-setting is a significant prerogative of States. The issues posed by standards are all the more important as the public becomes aware of the need to protect public health through

⁹²United States First Submission, pp 38-39.

⁹³United States Supplemental Submission, p. 13-14.

wise standards, governing products and production processes. It is also clear to the Panel that standards have an effect upon imported goods which cannot be ignored. In a global economy and *a fortiori* in the special context of the Canada-U.S. Free Trade Agreement, cooperation and mutual consideration must be present if the imperatives of free trade are to be reconciled with the imperatives of public health.

5.3 The terms of reference direct the Panel to determine whether the prohibition within the Commonwealth of Puerto Rico, since December 31, 1991, on the importation, distribution, and sale of UHT milk produced in Québec is inconsistent with the obligations of the United States under the FTA, including, in particular, Articles 407, 501, 502, 703, 708, 710 Schedule 11 of Chapter 7 and Article 2011. The governing legal principles are to be found in the FTA and related principles of the GATT. In other words, this is a dispute as to international obligations and not with respect to the legality under domestic law of enhanced standards.

5.4 The Panel wishes to make three specific points with respect to this dispute. In the first place, the dispute relates not to the validity of the PMO or related Regulations adopted by the Commonwealth of Puerto Rico. There is no question as to the right of the United States and Puerto Rico to adopt these standards. Secondly, the dispute relates to UHT milk. It does not relate to fresh milk or other aspects of milk marketing in Puerto Rico. Thirdly, the dispute relates to the manner in which the authorities of the United States and Puerto Rico responded to requests by Canada that UHT milk from Québec might continue to be marketed in Puerto Rico after the adoption of the PMO and related Puerto-Rico regulations. In other words, this dispute turns upon the interpretation and

application of the PMO and related Puerto-Rico regulations in relation to UHT milk imported from Québec and not upon the legitimacy of the standards themselves.

5.5 Finally, in the view of the Panel, the central issue of this dispute turns upon the question of equivalency, the manner of determining equivalency, and the appropriate standard by which equivalency is to be judged with respect to agricultural products under the FTA.

(b) FTA Articles 407, 710/GATT Article XI

5.6 In its written and oral submissions, Canada argued that the refusal of the Puerto Rico Departments of Health and Agriculture to renew the permit which would authorize Lactel to import UHT milk into Puerto Rico after December 31, 1991, constituted a violation of Articles 407 and 710 of the FTA and Article XI:1 of the GATT. Canada argued at paragraph 61 of its Submission that "by refusing to certify an officer to rate the Québec UHT and by not offering other reasonable alternatives (such as inspection of the milk at the border), the United States and Puerto Rico are preventing Québec from complying with Regulations 138 and 5... As such, they (Regulations 138 and 5) operate as a prohibition on the import into Puerto Rico of the Québec UHT and are inconsistent with GATT Article XI:1." The United States, on the other hand, denied the proposition that these measures or their implementation could be characterized as quantitative restrictions. In the view of the United States the only applicable rules were Articles 501 and 502 of the FTA and the comparable Article III of the GATT dealing with national treatment of a domestic measure.

5.7 As the division of opinion within the earlier FTA Panel *In the Matter of Lobsters from Canada*⁹⁴ reveals, the distinction between a quota or a measure having the effect of a quota and a domestic measure enforced at the border is not always an easy one to make. In the *Lobster* Panel report, the majority characterized the U.S. rule prohibiting the importation of lobsters under a minimum size requirement as a domestic measure, while the minority considered it to be a quantitative restriction. Certain recent GATT decisions reveal that Article XI violations can arise out of what begin as essentially domestic measures. Thus, certain aspects of Canadian provincial liquor monopoly practices with respect to imported wine and spirits were deemed to violate Article XI.⁹⁵ The recent case involving a complaint by Mexico against the prohibition on the importation of tuna in the United States not certified to have been caught in a manner compatible with United States regulations, also involved a finding that the U. S. measures violated Article XI of the GATT.⁹⁶ However, in this case, the Panel is not convinced that the Puerto Rico regulations and their implementation can be characterized as quantitative restrictions.

5.8 The Panel has carefully studied the submissions of both Parties and supporting documents concerning the nature of the license to import, distribute and sell milk in Puerto Rico pursuant to Puerto Rico Regulations and the PMO. At the oral hearing, the Panel asked for further clarification as to whether there was in fact a separate import licence required by these Regulations

⁹⁴ Final report of the Panel, May 25, 1990, USA-89-1807-01

⁹⁵ Panel on Import, Distribution and Sale of Alcoholic Drinks by Canadian Provincial Marketing Agencies, February 5, 1988, GATT, BISD 35S/37.

⁹⁶ United States restrictions on Import of Tuna, GATT Doc. DS21/R September 3, 1991. This Panel Report has not been adopted by the GATT Council.

or whether there was a single licence which dealt with every aspect of the importation, sale, and the distribution of milk in Puerto Rico, pursuant to these Regulations. Analysis of the Regulations, of the response of the Parties during the Hearing and subsequent additional material furnished in response to the Panel's questions make it clear that the Puerto Rico regulations do not involve a separate import licence but rather involve a general licence which permits the licence holder to import, distribute and sell milk which conforms to the standard of the Regulations and the PMO. In the view of the Panel, this scheme is more properly characterized as a domestic measure than as a quantitative restriction. For this reason the Panel is of the view that there has been no violation of FTA Article 407 or GATT XI by the United States.

(c) FTA Articles 501 and 502/GATT Article III

5.9 Canada alleges that the United States has violated Articles 501 and 502 of the Free Trade Agreement and thereby Articles III:1 and III:4 of the GATT in its interpretation and implementation of the PMO and Puerto Rico Regulations 5 and 138. The United States has answered this claim by asserting that its application of the relevant regulations has been entirely in conformity with the relevant articles of the FTA and GATT.

5.10 Canada alleges that by denying Lactel the opportunity to prove that its UHT milk was produced under regulations having the same effect as the PMO, the Puerto Rico Regulations 5 and 138 were interpreted and applied in a way which denied national treatment to Québec UHT milk and in a manner which afforded protection for milk produced in Puerto Rico and elsewhere in the United

States.

5.11 GATT Article III involves two important dimensions. Article III:4 of the GATT requires that the products of the territory of any contracting party imported into the territory of another contracting party shall be accorded national treatment with respect to "all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use." In paragraph III.1, it is to be found the requirement that "domestic laws, regulations and requirements affecting the internal sale... should not be applied to imported or domestic products so as to afford protection to domestic production." The submissions and counter-submissions of the Parties and their oral arguments before the Panel turned on these two dimensions of Article III.

5.12 Given its approach to the application of GATT Article XI in this context, the Panel has no difficulty with the proposition that the PMO and Puerto Rico Regulations 5 and 138 constitute internal measures. This view is reinforced by the Interpretative Note ad GATT Article III. In the view of the Panel the measures in question are such as are contemplated in the Interpretative Note ad GATT Article III. The Panel therefore considers it appropriate to consider the Parties' arguments under GATT Article III.

(i) GATT Article III:4

5.13 Canada alleges that UHT milk from Québec was afforded less favourable treatment than UHT milk produced in the United States. The United States responds that it has never required anything more of UHT milk from Québec than compliance with the production and quality standards of the PMO and the implementing Puerto Rico regulations and thus has always approached this matter on the basis of strict equality.

5.14 The application of Article III to standards designed to protect public health, such as the PMO and Puerto Rico Regulations 5 and 138, is a matter of considerable sensitivity and difficulty. The Panel believes that the starting point of any analysis must be the principles of non-protection and sovereignty which lie at the heart of Article III. In the view of the Panel, Article III affords broad discretion in the setting of health standards applicable to imported products. The only qualification on the sovereign right of States to impose such standards upon imported products is that these standards must apply equally to domestic and to imported products and, secondly, that they should not be applied in a manner calculated to afford protection to domestic production.

5.15 The application of the concept of equality in a given context is always a matter of considerable difficulty and debate. However, since the time of Aristotle, at least two principles have been widely recognized with respect to the definition of equality. Firstly, equal treatment involves according the same treatment to the same facts. Secondly, equal treatment of dissimilar facts will not produce

equality.⁹⁷ The interpretation of the GATT has reflected both these propositions.⁹⁸

5.16 The standard of treatment required by Article III.4 of the GATT has been commented upon by a number of Panels. The classic description is to be found in the Panel report on *Italian Discrimination Against Imported Agricultural Machinery*⁹⁹. It states that "the intent of the drafters was to provide equal conditions of competition once goods had been cleared through customs". More recently, a Panel report¹⁰⁰ described national treatment as "a requirement to accord imported products competitive opportunities no less favourable than those accorded to domestic products." In 1992, a GATT Panel stated that "[t]he Article III.4 requirement is one addressed to relative competitive opportunities created by the government in the market..."¹⁰¹ Another pertinent discussion of the standard of treatment of imported products required by Article III.4, and III.1 is to be found in *EEC - Measures on Animal Feed Proteins*.¹⁰²

5.17. Has there been denial of equality of treatment in the application of the PMO as required by Article III:4 in the circumstances of the case? The difficulty in answering this question

⁹⁷ Aristotle, *Nicomachean Ethics*, Book 5, lines 1131a 21 -30 trans T. Irwin, 1985, Hackett Publishing Co; *Politics*, Book 3, Ch.9, lines 1280a ff.

⁹⁸ See Section 337 of the U.S. Tariff Act GATT BISD 36S/345 at para. 5.10.

⁹⁹ GATT BISD 7S/60 (1959) at para 13.

¹⁰⁰ Canada - Import Distribution and Sale of certain Alcoholic Drinks by Provincial Marketing Agencies, Report of the Panel October 16, 1991 at para.5.6.

¹⁰¹ United States - Measures Affecting Alcoholic and Malt Beverages, Report of the Panel GATT Doc DS23/R, March 16, 1992, at para. 5.31 (This Panel report has not been adopted by the GATT Council).

¹⁰² GATT, BISD 25S/49 at paras 4.1 - 4.12.

lies not so much in the applicable general principles, which the Panel believes to have been well enunciated, as in their application to the specific context of product standards. This would seem to be a question best addressed in the context of the FTA. Standards in general and agricultural product standards in particular are dealt with in the FTA Chapters 6 & 7. In these circumstances, the Panel considers that it is preferable to base its determinations in this case upon the more specific provisions of the FTA rather than upon the general principles of the GATT.

5.18 The Panel therefore abstains from making any determination based upon GATT Article III:4.

(ii) Article III.1

5.19 Canada also argues that the interpretation and application of the PMO and Regulations 5 and 138 by Puerto Rico authorities is a violation of Article III:1. Article III:1 provides that domestic laws and regulations should not be applied in a manner designed to favour domestic production. Canada submits that Puerto Rico authorities have interpreted and applied the PMO and the implementing regulations in a manner which has had the effect of promoting the production of UHT milk by INDULAC, a local state supported company in Puerto Rico and by other American producers from other states.

5.20 Surprisingly, for so central an article, Article III:1 has been examined by only four GATT

panels, one of them very early in the history of the GATT and two very recently.¹⁰³ The paragraph requires that domestic measures "...should not be applied to imported or domestic products so as to afford protection to domestic production." This language is broad enough on its face to encompass both measures specifically designed to afford protection and those which have that effect. But no panel has been faced with the application of this paragraph to new production standards and for the reasons set out above this Panel finds it preferable to make its determinations on the basis of the specific provisions of the FTA, rather than upon the basis of more abstract general principle.¹⁰⁴

5.21 For this reason the Panel abstains from making any determination based upon GATT Article III:1.

5.22 The decision not to make a determination regarding GATT Article III does not, of course, mean that the national treatment principle does not apply to technical standards.

(d) FTA Article 703

5.23 Canada argues that the Puerto Rico measures are inconsistent with FTA Article 703.

¹⁰³ Uruguayan Recourse to Article XXIII, GATT, BISD 11S/95; EEC - Measures on Animal Feed Proteins, GATT, BISD 25S/49; Canada-Import, Distribution and Sale of Alcoholic Drinks by Canadian Provincial Marketing Agencies, GATT, BISD 35S/37; US - Measures Affecting Alcoholic and Malt Beverages, GATT Doc DS23/R, 16 March 1992 (Not yet adopted by the GATT Council).

¹⁰⁴ One Panelist dissociates himself from the interpretation of GATT Article III:1 in the third sentence of this paragraph and the reference to "new production standards" in the fourth sentence. In his view, they are not directly related to the findings of the Panel.

This Article states, in very general terms, the overall objective of Canada and the United States insofar as market access for agricultural goods is concerned. Article 703 reads as follows:

"In order to facilitate trade in agricultural goods, the Parties shall work together to improve access to each other's markets through the elimination or reduction of import barriers".

There is clearly no hard obligation involved in the language of this provision; it does not require that any specific action be taken by one or other of the Parties. Indeed, by stating that "they shall work together", it implies that the obligation involved is one that requires joint action by the two Parties. It is, in essence, a "best efforts" type of obligation, the observance of which is fundamentally a matter of acting in good faith. It is more than a general declaration of goals in a preamble, but less than a strict duty to do something specific. Unless a Party deliberately and systematically acts so as to block further progress in the elimination or reduction of import barriers - in bad faith in other words - it should not be found acting contrary to such a duty for the sole reason that it refuses an undertaking unsatisfactory to itself.¹⁰⁵

5.24 Canada does not suggest that the United States has acted in bad faith. Canada stated that the Puerto Rico regulations, "by effectively creating a new import barrier to Québec UHT milk where none existed before, run directly contrary to the obligations imposed by Article 703". This is an interpretation of the obligation involved in that provision that clearly goes beyond a "best efforts" undertaking. On the basis of this interpretation, Canada concludes that there exists a specific obligation regarding health and safety regulations in food and agricultural goods, a proposition that is all the more surprising as such questions are specifically dealt with in Article 708. The Panel,

¹⁰⁵ *Tacna-Arica Arbitration*, 2 R.I.I.A., 921 at 929-930.

therefore, cannot accept Canada's argument based on Article 703 of the FTA.

(e) FTA Articles 708 and 710.

5.25 Canada further argues that the Puerto Rico measures are inconsistent with Articles 708.1, 708.2 and Schedule 11 of Annex 708.1 of the FTA. These provisions of Chapter 7, which deal with health and safety regulations in the agricultural and food sectors, build upon what Article 710 describes as the rights and obligations retained by the Parties "with respect to agricultural, food, beverage and certain related goods under the GATT and agreements negotiated under the GATT". Apart from such provisions of the General Agreement as Articles III and XI, whose bearing on the subject has been examined above, the only other rights and obligations Canada and the United States have commonly assumed insofar as concerns health and safety regulations in the agricultural and food sectors are those of the GATT Code on Technical Barriers to Trade (the Standards Code).¹⁰⁶ Since neither Canada nor the United States have made specific reference to the Standards Code in their briefs¹⁰⁷ the Panel will abstain from looking at the compatibility of the Puerto Rico regulations with the Standards Code.

5.26 In dealing with Article 708 of the FTA, the Panel will consider separately paragraph 1, paragraph 2 and Schedule 11 to Annex 708.1. Paragraph 1 of Article 708 is concerned with the

¹⁰⁶ GATT BISD 26S/205

¹⁰⁷ In answer to a question regarding the relationship between the GATT Code on Technical Barriers to Trade and the FTA, Canada, in its oral presentation, suggested that the provisions of Chapter 7 of the FTA, relating to standards, were more precise and went further than the Standards Code, particularly with regard to the definition of equivalence.

general process of implementing an open border policy with respect to trade in agricultural and food goods and addresses the harmonization of norms and recognition of equivalence. Paragraph 2 of Article 708 deals with other aspects of that process, the most important one being the elimination of regulations and standards that constitute or would constitute "an arbitrary, unjustifiable or disguised restriction on bilateral trade". Schedule 11 to Annex 708.1 finally deals with two particular aspects of trade in dairy products, that is inspection systems and laboratory systems.

(i) Article 708.1

5.27 The first paragraph of Article 708, as both Canada and the United States recognize, attempts to balance the legitimate need for technical regulations and standards to protect human, animal and plant life with the need to facilitate commerce between the Parties.¹⁰⁸ It states that the Parties "shall seek an open border policy with respect to trade in agricultural, food, beverage and certain related goods and shall be guided in the regulation of such goods and in the implementation of Article 708 and the Schedules contained in Annex 708.1" by a set of five principles which it then sets out. Two of these principles are particularly pertinent in the present case, those set out in subparagraphs (a) and (c)¹⁰⁹. The first principle is as follows:

a) to harmonize their respective technical regulatory requirements and inspection procedures, taking into account appropriate international standards, or, where harmonization is not feasible, to make equivalent their respective technical regulatory requirements and inspection procedures.

The second principle is:

c) to establish equivalent accreditation procedures for inspection systems and inspectors

¹⁰⁸Canada's First Submission, p. 28 and United States' First Submission, p. 33.

¹⁰⁹ The other principles deal with quarantine restrictions, the establishment of reciprocal training programs and the use, where possible, of common data and information requirements.

Where they speak of the Parties making "equivalent their respective technical regulatory requirements and inspection procedures" and establishing "equivalent accreditation procedures", such guiding principles are to be interpreted in the light of the definition of "equivalent" given in Article 711 ("equivalent means having the same effect"). The interpretation and application of the principles must be consistent with the definition of equivalent.

5.28 The language of Article 708.1 makes it clear that the undertaking to seek an open border policy is not to be interpreted as an obligation of result. The use of words such as "shall seek" indicates that an effort in good faith to attain the objective in question is all that is required. No time limit is involved. If the Parties had wanted to go beyond such a "best efforts" obligation, they could easily have used other words such as "shall realize" coupled with some time limit or "shall maintain", or they could have formulated the principles in terms of strict obligations. However, this "best efforts" undertaking does not mean that the Parties are free to do whatever they want under Article 708.1. They have a duty to act in good faith, which is generally interpreted in international law to mean that no actions should be taken that would make the achievement of the undertaking impossible.

5.29 In order for the Panel to find a violation of Article 708.1, therefore, Canada must demonstrate that the United States has acted in such a way as to make the fulfilment of the "best efforts" undertaking of Article 708.1 impossible. Canada argues that the refusal of the authorities of Puerto Rico and the United States to carry out, in a timely fashion, an equivalency study to confirm that Québec's standards respecting the production process and final product of UHT are "substantially

equivalent" to those set out in the PMO and to those in Regulations 5 and 138, violated FTA Article 708.1(a)¹¹⁰. If this argument is intended to mean that the United States has acted in a manner inconsistent with Article 708.1 because it did not carry out in time the equivalence study in question, the Panel has no choice but to reject it. To accept this argument would mean that Article 708.1 goes further than simply setting up a process for the gradual realization of an open border policy, but that it incorporates an obligation of result within a given period of time. For the reasons set out above, this is an interpretation of Article 708.1(a) that the Panel cannot accept.

5.30 If, however, the Canadian argument is that the United States, by systematically refusing to adopt the interpretation of equivalence given in Article 711, has placed itself in a situation where it could not claim to be guided by the principles of Article 708.1(a), then a different situation arises. For such a line of argument to succeed, Canada would have to prove that the United States has acted in bad faith. In the present instance, however, the United States has recognized in the Katz's letters, and repeated in its submissions, before this Panel, that it "recognizes that the concept of "equivalence" as defined in Article 711 encompasses situations where Canada's standards and/or inspection regime, while not 'identical' to the PMO, have the "same effect"¹¹¹. Even if this explicit recognition of the pertinence of Article 711 in the present matter came at a relatively late stage, the Panel cannot accept that the United States has acted in bad faith. Taking into consideration the fact that Article 708.1(a) essentially sets up a process of harmonization of health and safety regulations, or of recognition of equivalence - a process whose duration is not defined and which obviously

¹¹⁰Canada's First Submission, para. 81.

¹¹¹United States Supplemental Submission, para. 5.

involves negotiation between the Parties - and taking into consideration also the position of the United States reflected in the Katz's letters, the Panel finds that the United States has not acted in a manner inconsistent with its obligations under Article 708.1(a).¹¹²

5.31 Canada also argues that under Article 708.1(c), "the Parties are entitled to establish and maintain their own accreditation procedures and that each Party would recognize the validity of the other's accreditation procedures"¹¹³. In view of Puerto Rico's insistence that only FDA-certified inspectors be used to rate UHT milk from Québec, Canada concludes that such behaviour is inconsistent with the principle in FTA Article 708.1(c). This argument is a reformulation, in a slightly different way and different context, of the previous argument concerning Article 708.1(a). Canada argues that the insistence on using FDA-certified inspectors was fundamentally incompatible with the acceptance of the principle set out in Article 708.1(c), and constituted therefore a violation of the "best efforts" undertaking of the United States under Article 708.1. Since this article also involves a "best efforts" obligation, the Panel cannot accept this argument. For the same reasons as were given with regard to Article 708.1(a), the Panel does not find that the United States has acted in a manner that is inconsistent with its obligation under Article 708.1(c).

¹¹²While concurring on the finding of para. 5.30 that the United States has not acted in a manner inconsistent with its obligations under FTA Article 708.1(a), one Panelist does not agree with the hypothetical discussion which appears to raise the definition of equivalence and the principles above the level of "best efforts" which characterizes the substantive provisions.

¹¹³ Canada's First Submission, para. 81.

(ii) Article 708.2

5.32 FTA Article 708.2 (a) requires the Parties *inter alia*, to prevent the introduction of new technical regulations that constitute an arbitrary, unjustifiable or disguised restriction on Canada-U.S. bilateral trade. It provides as follows:

The Parties shall, with respect to agricultural, food, beverage and certain related goods:

- a) work towards the elimination of technical regulations and standards that constitute, and prevent the introduction of technical regulations and government standards that would constitute, an arbitrary, unjustifiable, or disguised restriction on bilateral trade.

The language used in sub-paragraph (a) indicates a level of obligation that goes beyond a "best efforts" obligation. However, the French version of this provision reads somewhat differently. Sub-paragraph a) provides as follows:

- a) s'attacheront à éliminer les règlements techniques et les normes qui constituent une restriction arbitraire, injustifiée ou déguisée au commerce bilatéral et à empêcher l'adoption de règlements techniques et de normes gouvernementales qui constitueraient une telle restriction;...

In this French version, the use of the expression "s'attacheront" to cover both existing and future technical regulations and standards appears to suggest in the case of future technical regulations and standards a level of obligation that is less imperative than is the case in the English version.

5.33 In answer to a written question from the Panel on that discrepancy, the United States argued that this "supports the U.S. interpretation of Article 708 as imposing essentially a 'best efforts' obligation"¹¹⁴. Canada, for its part, has answered that "[T]he French text mirrors the English in the

¹¹⁴United States Supplemental Submission, p. 20.

mandatory nature of the obligation agreed to by the Parties"¹¹⁵. This conflicting view on the level of obligation involved in Article 708.2 is a preliminary question that must be clarified by the Panel.

5.34 The Panel is aware that the negotiations leading to the FTA were conducted exclusively in English and that the text eventually adopted was originally written in English. But confronted with two equally authentic versions of the text, the Panel considers that this is not a sufficient reason to conclude as to the superiority of one version over the other. Such a solution was explicitly rejected by the International Law Commission in its preparatory work for the Vienna Convention on the Law of Treaties. Article 33 of the Vienna Convention on the Law of Treaties, which follows the conclusions of the International Law Commission on the subject of the interpretation of multilingual treaties, states:

"when a comparison of the authentic texts discloses a difference of meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted".

Article 31 states that the starting point of interpretation should be the "ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". In the present instance, the distinction that is made in the English version between the "best efforts" obligation to eliminate existing arbitrary, unjustifiable or disguised restrictions and the imperative duty to prevent the introduction of such restrictions in the future appears in line with a technique commonly used in trade agreements, and repeatedly used in the FTA itself, whereby certain actions are prohibited in the future but are the subject of a "best efforts" obligation if they have already taken place. The French version, on the other hand, leads to a situation where the Parties undertake to work towards the non-

¹¹⁵Canada's Supplementary Submission, p.8.

introduction of arbitrary, unjustifiable or disguised restrictions on bilateral trade, an undertaking which makes little sense and would certainly be a step back when compared to the prescription of Article XX of GATT or to the commitments made in the GATT Code on Technical Barriers to Trade. For these reasons, the Panel considers that the English version must prevail and that Article 708.2(a) does indeed prohibit the introduction of arbitrary, unjustifiable or disguised restrictions on bilateral trade.¹¹⁶

5.35 Canada argues that the Puerto Rico measures were adopted after the FTA came into force and are hence new technical regulations and governmental standards. Canada attacks not the PMO and the implementing regulations but the manner in which they were interpreted and applied. Canada alleges that the manner of their interpretation and application was inconsistent with Article 708.2 because this led to a situation where a product was excluded for health and safety reasons, without any explanation and without offering Lactel a genuine opportunity of demonstrating that its UHT milk was produced under standards having the same effect as the PMO. This, according to Canada, constitutes an arbitrary and unjustifiable restriction on bilateral trade. The United States responds to this argument by pointing out that nothing in the FTA prevents a government from upgrading its standards and that if the Canadian products do not meet these new standards, this does not mean that they are arbitrary or unjustifiable or a disguised restriction on bilateral trade¹¹⁷.

¹¹⁶One Panelist dissents from the interpretation in para. 5.34 that FTA Article 708.2(a) constitutes more than a "best efforts" obligation regarding the introduction of regulations and standards. While there is a lack of clarity in the drafting and some apparent confusion between the English and French versions, the Panel did not in the view of this panelist, have enough evidence from the material before it to determine the intent of the parties. In view of the ambiguity of the article 708.2(a) language and the lack of evidence about the intent of the Parties, he cannot support the majority conclusion that the Article "does indeed prohibit the introduction of arbitrary, unjustifiable or disguised restrictions on bilateral trade".

¹¹⁷United States First Submission, paras. 169-170.

5.36 In its Supplementary Submission, Canada argues that the United States has an obligation in good faith to justify its interpretation and application of the PMO, given the prima facie case it has made that UHT milk from Québec is safe and is produced under conditions at least as stringent as those contained in the Puerto Rico regulations themselves. According to Canada, a "reasonable, good faith interpretation of Article 708.2 would require that once the complaining party has made a *prima facie* case that the introduction of the new measure constitutes an arbitrary, unjustifiable or disguised restriction on trade, the Party that has introduced the measure must justify its action"¹¹⁸. In its Supplemental Submission, the United States points out that Canadian legislation requires that imported products from the United States and other foreign sources meet highly specific process and inspection requirements which are directly analogous to those imposed by Puerto Rico, and that in consequence it could hardly be deemed arbitrary or unjustifiable for Puerto Rico to require that UHT milk from Québec be rated under a system paralleling Québec's own inspection and enforcement system¹¹⁹.

5.37 Canada points out that UHT milk from Québec was imported and distributed in Puerto Rico for 14 years (to which was later added the fact that it was still being imported in Puerto Rico by the U.S. Army up to March 2, 1993). These facts are by and large admitted by the United States. The real problem has to do with their legal significance. In the view of the Panel, they cannot in themselves justify a conclusion that Puerto Rico's introduction of the PMO as such arbitrarily and

¹¹⁸Canada's Supplementary Submission, para. 36.

¹¹⁹United States Supplemental Submission, para. 37.

unjustifiably restricted bilateral trade, but they do justify a fuller examination of the introduction, interpretation and application of these regulations.

5.38 Canada alleges that Puerto Rico's interpretation of the PMO was such as to make it impossible for Lactel to comply with the requirement that its UHT milk be rated by an FDA-certified Rating Officer as being produced under "substantially similar" regulations. The evidence on record indicates that shortly after Puerto Rico introduced the new regulations in January 1991, Lactel's local distributor was advised that Québec UHT milk did not meet the requirements of these regulations and that, as a consequence, its license would be cancelled effective July 1, 1991.

5.39 In January 1991, Lactel's attorney's sought guidance from the FDA, representing that Québec UHT milk qualified for entry into Puerto Rico under Section 11 of the PMO, which authorizes the sale of milk produced outside "routine official supervision" if it is processed under conditions "substantially equivalent". In its response dated January 9, 1991, the FDA stated that the decision to allow the entry of imported milk rested with Puerto Rico; accordingly, the FDA could not rule on "substantial equivalency" under Section 11 of the PMO, since the decision was Puerto Rico's.¹²⁰ On February 27, 1991, Canadian Ambassador Burney wrote to FDA Commissioner Kessler to propose that the FDA certify Canadian officials to conduct inspections to certify Lactel's compliance with the PMO and Procedures.¹²¹

¹²⁰Canada's First Submission, Canadian Exhibit "M": United States First Submission, para. 61.

¹²¹United States First Submission, para. 63.

5.40 On March 4, 1991, a meeting of the FTA Technical Working Group explored solutions that would allow Lactel to retain its license to sell UHT milk in Puerto Rico. One suggestion was for Canada or Québec in effect to join the NCIMS and implement the PMO and Procedures. Another suggestion was that Lactel request a waiver from Puerto Rico of the requirement that the milk be from a NCIMS processing state. There was a further suggestion that Canada or Québec approach a northern U.S. state to have its certified personnel carry out the inspections and ratings required under the PMO procedures, under what became known as the "Vermont Option". On June 20, 1991, the FDA formally responded to the letter of Ambassador Burney of February 1991. It did not address the Canadian request for an equivalency study and rejected the request for certification of Québec milk inspectors.

5.41 On July 1, 1991, the Puerto Rico Department of Health informed Lactel that Québec UHT milk was not produced under the conditions of the PMO and therefore did not meet the requirements for sale in Puerto Rico. But Lactel's license was extended for six months to December 31, 1991, to provide time for a way to be found to meet Puerto Rico's requirements.

5.42 The issue of equivalency of the Puerto Rico and Québec milk regulatory systems was discussed at the FTA Technical Working Group Meeting of March 4, 1991, and a UHT Subcommittee of this group met on March 5, July 15-16, and October 1-2, 1991 to work toward an equivalency determination. These efforts did not progress to such a determination, not even to agreement on the terms of reference for an equivalency study, by the time the six-month extension expired.

5.43 In his letter of December 31, 1991, the Governor of Puerto Rico rejected a request made by the Government of Canada on behalf of Lactel that the waiver it had granted be extended. His letter expresses the view that opportunities had been provided for finding a way by which Lactel's UHT milk could comply with Puerto Rico's regulations, in particular in April 1991, which Canada had not taken up. The Governor also stated that the Government of the Commonwealth of Puerto Rico was not convinced that a meaningful equivalency exercise resulting in expanded two-way trade in fluid milk could be completed by late 1992. Since December 31, 1991, Lactel's UHT milk has been excluded from Puerto Rico.

5.44 Following Puerto Rico's exclusion of imports at the end of 1991, the Panel has no information on bilateral discussion of an equivalency determination or other means of reopening the Puerto Rico market until July 1992, except for Canada, Québec and Lactel's efforts to have the Puerto Rico market reopened by the findings of an Administrative Hearing. During July-September 1992, correspondence between the Canadian Trade Minister and the Acting U.S. Trade Representative indicated scope for a possibly mutually acceptable equivalency study. However, Canada's lack of confidence in an expeditious equivalency determination that would re-open the Puerto Rico UHT milk market to Lactel (even if the determinations were favourable to Canada) led to the convening of this Panel.

5.45 The central issue in these events with respect to U.S. obligations under 708.2(a) is whether, with Puerto Rico's closing of its market to Lactel since December 31, 1991, the United States failed to prevent the introduction of a government standard that constituted an arbitrary,

unjustifiable or disguised restriction on trade. Exclusion from the market obviously restricts trade, so the question is whether the exclusion is arbitrary, unjustifiable, or disguised. The exclusion is not disguised. Nor, in view of the extended discussions and proceedings during 1991, the explanations offered in the U.S. letters, and the six-month extension of Lactel's license between July 1 and December 31, 1991, can the exclusion be viewed as arbitrary. The issue remaining is whether the exclusion is justifiable.

5.46 Canada alleges that the Puerto Rico measures were unjustifiable because there were several other less trade-restrictive means of attaining the same objective such as sending FDA inspectors to Québec to rate Lactel's UHT milk, certifying Canadians to carry out the ratings, agreeing to an equivalence study or inspecting each shipment. That other less trade-restrictive means existed is clear to the Panel. What is less clear again is the significance to be attached to this fact. In the absence of an equivalency study, the choice of any one of these other means does not necessarily offer the same level of protection as the PMO. Thus, it appears to the Panel that the existence of less trade-restrictive means cannot be used to support the argument that the Puerto Rico measures are unjustifiable until an equivalency study has taken place. Unfortunately, the terms of reference for such an equivalency study, much less the study itself, were never agreed upon.

5.47 Did the United States fail in its obligation by permitting Québec's UHT milk to be excluded from sale in Puerto Rico before an equivalency study had been completed? Closing the market in the midst of an equivalency study, or of discussion of the terms of reference for such a study, is disturbing because one party could, by delaying a refusal to agree to terms of reference,

exclude imports from the other party indefinitely. On the other hand, if Article 708.2(a) were taken as requiring that imports be permitted until an equivalency study had been concluded, then the exporting party could, by delaying or refusing to agree on terms of reference, retain access to the market indefinitely without having to meet the new standard or establish equivalency.

5.48 Whether the United States met its obligations must then turn on the facts of the case. Did the United States follow a path that would expeditiously lead to an equivalency determination? The documents available to the Panel raise questions about the behaviour of the United States in this respect. Puerto Rico and United States officials on several occasions stated seemingly non-negotiable positions that would not permit establishment of equivalency in the sense of "having the same effect" that the FTA calls for. FDA and Puerto Rico officials raised objections to an equivalency study on grounds of cost and applicability to only one company in Canada - United States (as opposed to two-way) trade that are irrelevant to 708.2(a) obligations. Most troubling is that these considerations were cited many months after bilateral discussions on equivalency had begun, indeed in the letter of December 31, 1991 in which the Governor of Puerto Rico excluded importation of UHT milk from Québec.

5.49 On the other hand, the Panel is aware of difficulties caused by the fact that Puerto Rico's genuine health and safety concerns had to be reconciled with obligations under the FTA in a most complicated and unprecedented fashion. United States and Puerto Rico officials made statements that indicated a willingness to find ways for Lactel to retain its license to sell UHT milk in Puerto Rico. Bilateral discussions of equivalency in fact occurred on three separate occasions in

1991, beginning on March 6, 1991. The documentation reveals that these meetings and other exchanges between Canadian, United States and Puerto Rico officials were protracted, incoherent and nonproductive; the Panel does not have evidence, nor did Canada allege, that the unproductive nature of the discussions was due to bad faith on the part of the United States.

5.50 In the circumstances, while the United States' handling of this matter was far from exemplary for the reasons given in paragraph 5.48, the Panel cannot find that the United States' exclusion of UHT milk from Québec is a clear violation of Article 708.2(a). In reaching this conclusion, the Panel is mindful of the fact that the determination of the terms of reference and the conduct of an equivalency study is inherently a consensual process which can neither be imposed nor conducted unilaterally. Under the FTA the Parties must cooperate and work together.¹²²

(iii) Schedule 11 of Annex 708.1

5.51 Canada has raised a last argument based on Article 708. It argues that the requirements by Puerto Rico that ratings be carried out by an FDA-certified officer runs counter to the FTA obligation "to work towards equivalent inspections systems for dairy products" found in Schedule 11 of Annex 708.1. The Panel considers that this provision, like Article 708.1, does not

¹²² Following his view, expressed in note 116 that there is not a hard, binding obligation in article 708.2(a), one Panelist does not agree with the argumentation in paragraphs 5.37 - 5.50. While accepting the conclusion that there is no clear violation of article 708.2(a) by the United States, this Panelist considers the discussion regarding an arbitrary, unjustifiable or disguised restriction on bilateral trade not applicable. If the evidence were clearer regarding the intent of the Parties with respect to the obligation involved in the second part of Article 708.2(a) a different analysis of measures "...that would constitute an arbitrary unjustifiable or disguised restriction on bilateral trade" would, in this Panelist's view, be required.

go beyond a "best efforts" obligation. It stresses the importance of developing equivalent inspection systems but does not fix a time limit for doing so. What is involved is essentially a process that the Parties accept to set in motion. An essential part of this process was the recognition by the United States of the applicability of the definition of equivalence of Article 711. However, considering the nature of the obligation assumed by the Parties in Schedule 11 and the facts of the present case, the Panel is not ready to say that the United States has acted in a manner inconsistent with Schedule 11 of Annex 708.1.

(f) Non-violation Nullification and Impairment

5.52 The Panel was asked in the terms of reference to consider:

- (ii) whether such prohibition nullifies and impairs benefits Canada reasonably expected would accrue to it under the FTA;

The Panel has carefully considered this matter and is of the view that this is indeed the case.

5.53 Canada argues that, if the Panel does not find violations of the GATT or the FTA, there has nevertheless been non-violation nullification and impairment of the benefits which it could legitimately expect in respect of UHT milk sales in the Puerto Rico market under the FTA and the GATT. Canada alleges that the exclusion of UHT milk from Québec, as a result of the interpretation of the PMO, has nullified and impaired Canada's reasonable expectations under the FTA.

5.54 The applicable provisions of the FTA are Articles 1801:1 and 2011. These Articles state:

1801:1....the provisions of this Chapter shall apply with respect to the avoidance or settlement of all disputes regarding the interpretation or application of this Agreement or whenever a Party considers that an actual or proposed measure of the other Party is or would be inconsistent with the obligations of this Agreement or cause nullification or impairment in the sense of Article 2011....

2011:1 If a Party considers that the application of any measure, whether or not such a measure conflicts with the provisions of this Agreement, causes nullification or impairment of any benefit reasonably expected to accrue to that Party, directly or indirectly under the provisions of this Agreement, that Party may, with a view to satisfactory resolution of the matter, invoke the consultation provisions of Article 1804 and, if it considers it appropriate, proceed to dispute settlement pursuant to Articles 1805 and 1807....

5.55 Both Parties trace the concept of "non-violation" nullification and impairment to Article XXIII:1 of the GATT, an article which has been invoked in a number of important GATT disputes.¹²³

5.56 It is clear that the origin of Article 2011 of the FTA is to be found in GATT Article XXIII. However, there are two differences from the other instances in the FTA which reaffirm or incorporate by reference the GATT. In the first case, Article 2011 does not specifically mention the GATT. Secondly, Article 2011 explicitly links nullification and impairment with the reasonable expectations of the parties under the FTA. The absence of a specific reference to the GATT does not seem to be significant, since the GATT so permeates the structure of the FTA. However, the Panel is of the view that the reference to "...any benefit reasonably expected to accrue..." appears to give special importance to that criterion or condition. GATT panel reports have suggested other

¹²³ GATT, BISD 37S/86; see also The Australian Subsidy on Ammonium Sulphate, Report of the Panel, GATT/CP.4/39, April 3, 1950 (GATT BISD vol.2 188); Japan - Trade in Semi-Conductors, GATT BISD 35S/116; U.S.A. Restrictions on the Importation of Sugar and Sugar-Containing Products Applied Under the 1955 Waiver, GATT BISD 37S/228; or Japan - Nullification or Impairment of the Benefits Accruing to the EEC Under the General Agreement and Impediment to the Attainment of GATT Objectives, GATT doc. L/5479 (1983); Uruguayan Recourse to Article XXIII, GATT BISD 11S/95; Treatment by Germany of Imports of Sardines, BISD 1S/53; and EEC Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region, Report of the Panel, L/5778, paras 4.21 & 4.22

conditions for nullification and impairment, but the specific reference to the reasonable expectations of the parties in the language of Article 2011 gives that test a special place in the context of the FTA.

5.57 The Panel therefore considered whether any benefit Canada could reasonably have expected to enjoy under the FTA was nullified and impaired. The United States asserted that Canada must have been aware that Puerto Rico would eventually adopt the PMO as part of a general move to upgrade the standard of milk production in its territory. With respect to the adoption of the PMO itself, the Panel is in full agreement with the United States' position. Given the place of the PMO in the regulation of milk production throughout the United States, it was virtually inevitable that Puerto Rico would seek to align itself to the general American standard at some point.

5.58 The issue, however, relates not so much to the adoption of the PMO itself, as to the manner of its application and interpretation in Puerto Rico with respect to UHT milk from Québec. In this regard the Panel considers that Canada's reasonable expectations under the FTA were indeed upset and to this extent, Canada has suffered nullification and impairment of the benefits which it could reasonably expect. These expectations flow from both the history of the product and from the FTA.

5.59 The Panel makes no judgment of the product but notes the following facts. Québec UHT milk is a product which is consumed in Québec and elsewhere in Canada and in the world; it was consumed in Puerto Rico for 14 years; the UHT process followed under Québec law is regulated by

measures which mirror the *U.S. Low-Acid Canned Food Regulations*.¹²⁴ Finally, UHT milk from Québec has been purchased by the U.S. Army for consumption in military bases in Puerto Rico over a long period of time up to March 2, 1993.

5.60 In the view of the Panel, consideration of the issue of non-violation nullification and impairment should take into account the general expectations to which the FTA gives rise. The FTA is a wide-ranging free trade agreement which governs virtually all of the trade between the United States and Canada. It subjects this trade to new rules which go further than the already extensive rules of the GATT. It deals with matters, including standards, which are not specifically dealt with by the GATT, and subjects them to new and more effective forms of discipline, including dispute resolution. The FTA contains a general chapter on standards and also contains more specific provisions on standards for agricultural products in Chapter 7. It specifically provides for the definition of "equivalence" of agricultural product standards in Article 711 as "having the same effect". In light of these provisions, the Panel is of the view that Canada had a reasonable expectation that a product like UHT milk would not be excluded from the market in the United States, as a result of the adoption of a new standard, if it could be shown that the product was being produced in Canada under standards having the same effect as the new United States' standard.

5.61 The provisions of the FTA on standards reflect a carefully negotiated compromise which respects the sovereign prerogatives of both states with respect to agricultural standards, but

¹²⁴ 21 CFR 113.

which tempers the exercise of these prerogatives with rules and procedures designed to avoid and resolve disagreements and facilitate trade. Previous Panels have reasoned that the FTA should receive a broad interpretation which takes into account the economic purposes of the Agreement¹²⁵ - in the words of a recent Extraordinary Challenge Committee, "entailing integration of two separate trading communities."¹²⁶ In the view of the Panel, Canada could reasonably expect the USA not to close the market during the course of negotiations on the matter of equivalency, in the circumstances that prevailed with respect to UHT milk from Québec. Nor would it be appropriate to lay responsibility at the door of Puerto Rico alone. Under the FTA the actions of the Puerto Rico authorities are imputable to the United States. In the view of the Panel, the decision to close the market during the course of negotiations concerning the equivalency of standards governing the production of UHT milk in Québec with the PMO, nullified and impaired benefits which Canada could reasonably expect under the FTA. This is not to say that a Party to the FTA is automatically obliged to conduct an equivalency study prior to applying a new agricultural standard to a product of the other Party. It may well be that in many cases the facts will speak for themselves and justify the immediate application of the new standard. However, in the present case, the facts on equivalency were far from clear and therefore bilateral discussions should have continued in order to reach the appropriate determination.

5.62 In these circumstances, the Panel believes that Canada did have a reasonable

¹²⁵ In the Matter of: Article 304 the Definition of Direct Cost of Processing, Final Report of the Panel, June 8, 1992, USA-92-1807-01, paras 80,81,82; In the Matter of: The Interpretation of and Canada's Compliance with Article 701.3 with respect to Durum Wheat Sales, Final Report of the Panel, February 8, 1993, CDA-92-1807-01, para. 18.

¹²⁶ Extraordinary Challenge Committee -In the Matter of :Live Swine from Canada, Decision of April 8, 1993, EEC-93-1904-01 USA, p.8

expectation that an equivalency study would be undertaken, and that, in the midst of a difficult negotiation concerned with reaching an acceptable method of determining the equivalence of Québec's UHT milk production standards to those of the PMO, the authorities of Puerto Rico would not unilaterally close their market to UHT milk from Québec before the issue had been resolved between the Parties on the basis of the FTA.

5.63 For these reasons, the Panel is of the view that the United States has nullified and impaired the benefits which Canada could reasonably expect to derive from the FTA.

DETERMINATIONS

6. Accordingly, the Panel DETERMINES that:
- a) The United States has not violated Article XI of the GATT.
 - b) It will abstain from making a determination on the argument that the United States has violated Article III:1 of the GATT.
 - c) It will abstain from making a determination on the argument that the United States has violated Article III:4 of the GATT.
 - d) The United States has not violated Article 703 of the FTA.
 - e) The United States has not violated Article 708.1 of the FTA.
 - f) The United States has not violated Schedule 11 to Annex 708.1.
 - g) The United States has not violated Article 708.2 of the FTA.
 - h) The United States has nullified and impaired benefits that Canada could reasonably expect to derive from the FTA by closing the market in Puerto Rico to UHT milk from Québec while negotiations were underway on the matter of equivalency.

RECOMMENDATIONS

The Panel makes the following recommendations:

7.1. In view of the fact that Canada suffered nullification and impairment of benefits as a result of the decision by Puerto Rico to close its market while negotiations were still continuing, an expeditious and conclusive equivalency study, as proposed in the Katz letter of September 25, 1992, should be conducted without delay in order to determine as rapidly as possible whether UHT milk is produced in Québec under conditions having the same effect as those set out in the PMO. All elements of the study should be completed within a reasonable time, within two months if possible. If the Canadian standards are found to have the same effect as the PMO, UHT milk from Québec should be re-admitted forthwith and permitted to be sold in the market in Puerto Rico.

7.2. In order to ensure that commercial relations between Canada and United States with respect to the sale of UHT milk produced in Québec and sold in Puerto Rico be placed upon a stable basis in the long term, it is recommended that procedures for the continued applicability of the conclusions of the equivalency study recommended in para. 7.1, be adopted by the Parties in a reasonable and timely fashion. The Panel recommends that the Parties begin preparation of these procedures as soon as the results of the equivalency study are known.

7.3. The costs of the equivalency study and of the implementation of the procedures should

be borne by both Parties. The costs of work undertaken in the United States, should be borne by the United States. The costs of the work undertaken in Canada should be borne by Canada.

SIGNED IN THE ORIGINAL BY:

June 3, 1993

Date

ARMAND DE MESTRAL

ARMAND DE MESTRAL

June 3, 1993

Date

BRUCE GARDNER

BRUCE GARDNER

June 3, 1993

Date

IVAN BERNIER

IVAN BERNIER

June 3, 1993

Date

JOSEPH GREENWALD

JOSEPH GREENWALD

June 3, 1993

Date

FRANK PETRIE

FRANK PETRIE