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COMMERCE COMMISSION

Final Determination

Final determination in the matter of applications for determinations of disputes under the Dairy Industry Restructuring Act 2001, involving:

**KAIMAI CHEESE COMPANY LIMITED; and (separately) THE
GRATE KIWI CHEESE COMPANY LIMITED
and
FONTERRA CO-OPERATIVE GROUP LIMITED**

The Commission: D R Bates QC, G Pickering and P J M Taylor

Summary of Application: Kaimai Cheese Company Limited (Kaimai) and The Grate Kiwi Cheese Company Limited (Grate Kiwi) have applied for determinations, under section 120 of the Dairy Industry Restructuring Act 2001, of disputes with Fonterra Co-operative Group Limited (Fonterra) about the interpretation and application of regulation 4(1) of the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Regulations).

Determination: The Commission's view is that Kaimai and Grate Kiwi are "independent processors" under the Regulations and are entitled to be supplied with regulated milk by Fonterra. The Commission is also of the view that the requirement that Fonterra "supply" milk "to" independent processors allows independent processors to require milk to be delivered to a nominated delivery address. Fonterra must therefore supply milk to Kaimai and Grate Kiwi on request in accordance with the Regulations, and must deliver that milk to the delivery addresses that Kaimai and Grate Kiwi nominate.

The Commission determines that Fonterra has breached the Regulations by not supplying Kaimai and Grate Kiwi with milk under the Regulations since 1 October 2008. The Commission therefore orders that Fonterra must pay compensation to Kaimai and Grate Kiwi to compensate them for the loss associated with the fact that they did not receive regulated milk from 1 October 2008, in light of the Commission's view that they were entitled to receive that milk.

Date of Determination: 5 June 2009

Confidential information in this Final Determination is contained in square brackets.

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EXECUTIVE SUMMARY¹

- E1. The Commerce Commission is empowered by the Dairy Industry Restructuring Act 2001 (the Act) to determine disputes between Fonterra Co-operative Group Limited (Fonterra) and independent processors about the application of subpart 5 of Part 2 of the Act or regulations made under section 115 of the Act.
- E2. On 26 June 2008 and 14 July 2008 respectively, Kaimai Cheese Company Limited (Kaimai) and The Grate Kiwi Cheese Company Limited (Grate Kiwi) applied to the Commission for determination of their disputes with Fonterra about the application of regulation 4(1) of the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Regulations). The Regulations provide that Fonterra must supply raw milk to “independent processors”, subject to certain volume limits (such as the cap on the entitlement of most individual independent processors of 50 million litres per season). The relevant part of the definition of “independent processor” in the Act is “... a processor of milk or milksolids or dairy products”.
- E3. Kaimai and Grate Kiwi had both applied to Fonterra to purchase milk from Fonterra under the Regulations, and both requested that the milk be delivered to Open Country Cheese Company Limited's (Open Country) premises. Open Country would undertake the first stage(s) of processing that milk on behalf of Kaimai and Grate Kiwi under toll-processing contracts. In the case of Kaimai, Open Country would process some of the milk into pasteurised milk for Kaimai to make into soft cheese, and further process the remainder into hard cheese on Kaimai's behalf. In the case of Grate Kiwi, Open Country would process all of the milk into cheese on Grate Kiwi's behalf. Fonterra did not supply Kaimai and Grate Kiwi with milk under the Regulations, on the basis that Fonterra did not consider that they were independent processors. The reason for Fonterra's view was that Kaimai and Grate Kiwi would not carry out the initial processing of the milk using their own plant, equipment and labour.
- E4. The resolution of the disputes turns on whether Kaimai and Grate Kiwi should be considered independent processors for the purposes of the Regulations. If Kaimai and Grate Kiwi are independent processors, the question then becomes whether Fonterra is obliged to supply them with all of the regulated milk that they have requested (subject to the 50 million litre cap) or only that part which they themselves physically process. A secondary issue is whether or not Fonterra is required to deliver milk supplied under the Regulations to a nominated delivery address that is not the address of the premises of the party requesting the milk.
- E5. The meaning of “independent processor”, and the requirement that Fonterra “supply” milk “to” independent processors, are matters of statutory interpretation. The Commission has therefore considered the ordinary meaning of the relevant provisions in their immediate and general legislative context and in light of their purpose. In determining the disputes, the Act requires that the Commission specifically consider the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

¹ This Executive Summary does not form part of the Commission's Determination.

- E6. The Commission considers that the most appropriate interpretation of “independent processor” is one that requires an independent processor to process all of the regulated milk at all stages of the production process, either by processing it itself in its own facility or by toll-processing. The Commission’s view is that this interpretation places the least constraints on entry into dairy markets. Entry is desirable because it stimulates competition, efficiency and innovation.
- E7. The Commission is also of the view that the most appropriate interpretation of the requirement that Fonterra “supply” milk “to” independent processors allows independent processors to require milk to be delivered to a nominated delivery address. That address may be the processor's own premises, or the premises of a toll-processor that will process the milk on behalf of the independent processor.
- E8. The Commission considers that the interpretations set out above best promote the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.
- E9. The Commission is of the view that Kaimai and Grate Kiwi are “independent processors” under the Regulations and are entitled to be supplied with regulated milk by Fonterra. Fonterra must therefore supply milk to Kaimai and Grate Kiwi on request in accordance with the Regulations, and must deliver that milk to the delivery addresses that Kaimai and Grate Kiwi nominate.
- E10. The Commission determines that Fonterra has breached the Regulations by not supplying Kaimai and Grate Kiwi with milk under the Regulations since 1 October 2008. The Commission therefore orders Fonterra to pay compensation to each of Kaimai and Grate Kiwi to compensate them for the loss associated with the fact that they did not receive regulated milk from 1 October 2008. The Commission orders that Kaimai and Fonterra, and Grate Kiwi and Fonterra, should use their best endeavours to agree on the appropriate amounts of compensation, taking into account:
- the amounts that would have been paid by Kaimai and Grate Kiwi to Fonterra for their forecast volumes of regulated milk, based on their October 2008 forecasts being repeated for each remaining month of the season (subject in Kaimai’s case to proof of Kaimai’s intention at a board level, in the form of internal documentation, to purchase such volumes);
 - the amounts that Kaimai and Grate Kiwi would have paid to toll-process the regulated milk into pasteurised milk and cheese (for Kaimai), and cheese (for Grate Kiwi);
 - the costs that Kaimai and Grate Kiwi actually incurred in purchasing milk and cheese (for Kaimai), and cheese (for Grate Kiwi);
 - for Kaimai, any changes in Kaimai’s volume of production that are directly attributable to its lack of receipt of raw milk at the regulated price from 1 October to 5 October 2008, and from 3 November 2008; and
 - any other factors that the parties consider bear on the appropriate amount of compensation.
- E11. In addition, the Commission orders Fonterra to pay Kaimai and Grate Kiwi interest (at the prevailing 90 day Bank Bill Rate) on the amount of compensation calculated. Interest should apply from the date of each payment for the relevant input products (or the date the loss was suffered) to the date of the actual payment of compensation.

E12. If the parties do not reach agreement on the amount of compensation, any party may apply to the Commission for a decision on the appropriate level of compensation. Any such application must be made within three months of the date of this Determination and must be accompanied by the information specified by the Commission in the Determination.

INTRODUCTION

1. The Commerce Commission (the Commission) is empowered by the Dairy Industry Restructuring Act 2001 (the Act), to determine disputes between Fonterra Co-operative Group Limited (Fonterra)¹ and independent processors about the application of subpart 5 of Part 2 of the Act or regulations made under section 115 of the Act.
2. On 26 February 2008 and 4 March 2008 respectively, Kaimai Cheese Company Limited (Kaimai) and The Grate Kiwi Cheese Company Limited (Grate Kiwi) applied to Fonterra for the supply of raw milk under the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Regulations) for the 2008/2009 season.
3. On 26 June 2008 and 14 July 2008 respectively, the Commission received applications from Kaimai and Grate Kiwi for determinations to resolve disputes under section 120 of the Act in relation to the application of the Regulations. On 30 July 2008 and 27 August 2008, respectively, the Commission decided to determine the disputes.² Given the similar nature of the disputes, the Commission has, in accordance with section 120(3) of the Act, considered the applications together.
4. Both Kaimai and Grate Kiwi are in dispute with Fonterra about the application of regulation 4(1) of the Regulations. This affects Kaimai and Grate Kiwi's eligibility to access raw milk under the Regulations. The disputes concern the definition of "independent processor" as outlined in the Act, and the ability of an independent processor to contract a third party to undertake the initial processing of the regulated milk.³
5. The Commission issued a Draft Determination on 16 October 2008, after earlier advising the parties and the industry of its preliminary views on 26 September 2008. The Commission's preliminary view in the Draft Determination was that Kaimai and Grate Kiwi are independent processors for the purposes of regulation 4(1), and that Fonterra must supply raw milk to Kaimai and Grate Kiwi on request (subject to regulations 5 to 15 of the Regulations). It was also the Commission's preliminary view that the Regulations contemplate delivery of the raw milk to a nominated address. Kaimai and Grate Kiwi could therefore request that Fonterra deliver Kaimai and Grate Kiwi's raw milk to the premises of Open Country Cheese Company Limited (Open Country).
6. Having reviewed the submissions on the Draft Determination, the Commission issued a Consultation Document on 19 March 2009. The Commission specifically sought feedback from all dairy manufacturers as well as any other interested parties.
7. In making this Determination, the Commission has considered submissions made by parties to the disputes at the time the applications for determination of the disputes were made; submissions received on the Draft Determination; other submissions received and information requested from the parties; and submissions and cross-submissions received in response to the Consultation Document.

¹ References in the Act and Regulations to "new co-op" have been replaced with [Fonterra] throughout this Determination.

² Commerce Commission, *Decision 646: Kaimai Cheese Company Limited / Fonterra Co-operative Group Limited* (30 July 2008); Commerce Commission, *Decision 647: The Grate Kiwi Cheese Company Limited / Fonterra Co-operative Group Limited* (27 August 2008).

³ References to "regulated milk" in this Determination refer to milk purchased and supplied under the Regulations.

8. This Determination sets out the issues in dispute, the legal framework, the Commission's analysis of which interpretation of the legislation would best promote the purpose (of the promotion of the efficient operation of dairy markets in New Zealand) and the principle (that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets) it is directed to consider by the Act,⁴ and the Commission's decision on the disputes.

THE PARTIES

Kaimai

9. Kaimai is a small cheese producer located in Waharoa in the Waikato. It sells a range of soft and hard cheeses. Kaimai opened for trading on 7 January 2008. It manufactures its soft cheese range (including camembert, brie, blue, washed rouge, and bocconcini) within its factory from pasteurised milk that it currently purchases from Open Country. Kaimai currently has Open Country produce its hard cheese range to Kaimai's specifications.

Grate Kiwi

10. Grate Kiwi was established under the name Oceanic Foods Limited in 1990. It specialises in providing large catering size packs of house brand grated cheese. It also produces house brand retail products. Grate Kiwi does not have the plant required to process raw milk into cheese. At present, Grate Kiwi buys cheese from both Fonterra and Open Country, and either grates and blends it, or cuts it into blocks, and then packages and sells it.

Fonterra

11. Fonterra is the company formed by the amalgamation of New Zealand Co-operative Dairy Company Limited, Kiwi Co-operative Dairies Limited, and the New Zealand Dairy Board. Fonterra operates multiple milk processing plants in various dairy regions throughout the country. Fonterra collects over 14 billion litres of milk from farmers annually and manufactures over two million tonnes of dairy products. It exports 95% of its production to 140 countries, and processes over 95% of New Zealand's raw milk.

Open Country

12. Open Country is not a party to these disputes. However, it is involved in these disputes as the proposed toll-processor of regulated milk on behalf of Kaimai and Grate Kiwi. Open Country is also based in Waharoa and manufactures a range of cheeses and milk powder products.⁵ Open Country is a 100%-owned subsidiary of Open Country Dairy Limited.

⁴ Section 125. Refer to paragraph 41 of this Determination.

⁵ Although it is not required to address the issue, the Commission considers that Open Country is an independent processor for the purposes of the Regulations because it is a processor of milk, milksolids, or dairy products, and is not an associated person of Fonterra.

Common Shareholding and Directors

13. Dairy Investment Fund Limited holds 28% of Kaimai's shares, 30% of Grate Kiwi's shares and 10% of Open Country's parent company's shares.
14. Mr Wyatt Creech is one of Kaimai's five directors, and one of Open Country's three directors. Mr Nigel Atherfold is one of Grate Kiwi's two directors. Mr Creech and Mr Atherfold are also two of Open Country's parent company's nine directors.

THE DISPUTES

15. The Regulations provide that Fonterra must supply raw milk to independent processors. This obligation is subject to certain volume limits, and (in the absence of agreement to the contrary) the price for the regulated milk⁶ is determined by a default milk price formula.⁷
16. Kaimai applied to purchase approximately 10 million litres of regulated milk from Fonterra for the 2008/2009 season. Kaimai does not have the capacity or capability to manufacture its entire product range itself at its own premises, so has entered into an arrangement with Open Country to undertake some of the processing steps. Kaimai requested that the regulated milk be delivered to Open Country's premises. Kaimai's original business plan provided that if the regulated milk were to be supplied, Open Country would pasteurise the milk and forward some of it to Kaimai to be processed into soft cheeses. The balance of the regulated milk purchased by Kaimai would be made by Open Country into hard and semi-hard cheeses to be marketed and sold by Kaimai.⁸
17. Grate Kiwi applied to purchase approximately 50 million litres of regulated milk from Fonterra for the 2008/2009 season. Grate Kiwi does not have the plant to process raw milk into cheese at its own premises. Therefore, it proposes to enter into a toll-manufacturing arrangement with Open Country whereby Open Country would manufacture the raw milk into cheese for Grate Kiwi. Grate Kiwi requested that the regulated milk be delivered to Open Country's premises. Once Open Country has manufactured the cheese, it is proposed that it be forwarded to Grate Kiwi for grating, blending, cutting and/or packaging. The end product is to be marketed and sold by Grate Kiwi.⁹
18. On 4 April 2008, Fonterra wrote to Kaimai and Grate Kiwi (separately) stating that if Fonterra is required to deliver raw milk to Open Country's (or any other independent processor's) facility, then Fonterra would count that milk as part of the regulated milk allocation of Open Country (or the other independent processor) as that processor would be processing the raw milk.¹⁰ Fonterra subsequently offered, after the release of the Draft Determination, to supply Kaimai and Grate Kiwi with raw milk in October at the regulated price on the basis that if either was found in the Final Determination not to be an independent processor, then the relevant company would

⁶ In this Determination, references to regulated milk requested from Fonterra are assumed to be within the 50 million litre individual processor cap. The cap is discussed at paragraph 31 of this Determination.

⁷ Details of the regulatory regime for raw milk are set out in the Legal Framework section of this Determination.

⁸ Kaimai's Application for Dispute Determination (25 June 2008).

⁹ Grate Kiwi's Application for Dispute Determination (14 July 2008).

¹⁰ Letter from Fonterra to Kaimai (4 April 2008); letter from Fonterra to Grate Kiwi (4 April 2008).

be required to pay the difference between the default milk price and a “fair and reasonable market price”, which was not specified.¹¹

19. The dispute concerns the definition of “independent processor” as outlined in the Act and the ability of an independent processor to contract a third party to undertake the initial processing of the regulated milk. The resolution of that issue turns on whether Kaimai and Grate Kiwi should be considered “independent processors” for the purposes of the Regulations; and if they are independent processors, whether they are entitled to require Fonterra to supply them with all of the regulated milk that they have requested from Fonterra, or only that part which they themselves physically process at the initial processing stage.
20. Fonterra submitted that because Kaimai and Grate Kiwi would not carry out the initial processing of the regulated milk using their own plant, equipment and labour, they are not “independent processors” for the purposes of the Regulations and therefore cannot require Fonterra to supply them with regulated milk.¹² Fonterra considers that, as a result of the proposed toll-processing arrangements, Open Country would evade the individual processor cap on the entitlement to regulated milk.¹³ Kaimai and Grate Kiwi submit that they are “independent processors” and are each accordingly entitled to purchase regulated milk.
21. A secondary issue is whether or not Fonterra is required to deliver the regulated milk to premises other than those of the party requesting the milk. Fonterra submitted that the Regulations only require supply “to” the independent processor who has ordered the regulated milk; and that that reinforces Fonterra’s primary submission that the Regulations are designed to make raw milk available to processors who are able to process it. Kaimai and Grate Kiwi submitted that Fonterra is obliged to supply them with regulated milk at their nominated delivery address.

THE LEGAL FRAMEWORK

Regulation of dairy markets and obligations of Fonterra

22. The Act authorised the creation of Fonterra, which resulted in the amalgamation of the two largest dairy co-operatives in New Zealand and the New Zealand Dairy Board. As a result of the merger, it was considered that Fonterra would have a dominant market position in a number of key domestic New Zealand dairy markets.¹⁴ The Act provides for a package of measures to mitigate the risks associated with that dominant position for the promotion of competition in dairy markets.
23. One of the purposes of the Act is “to promote the efficient operation of dairy markets in New Zealand by regulating the activities of [Fonterra] to ensure New Zealand markets for dairy goods and services are contestable”.¹⁵
24. Subpart 5 of Part 2 of the Act regulates dairy markets and imposes certain obligations on Fonterra. The purpose of the subpart is “to promote the efficient operation of dairy

¹¹ Kaimai’s submission on the Draft Determination (30 October 2008); Grate Kiwi’s submission on the Draft Determination (23 October 2008).

¹² Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 1.4.

¹³ Fonterra’s submission on the Draft Determination (31 October 2008), paragraphs 2.13, 2.15 and 2.17.

¹⁴ Facilitation of the Proposed Dairy Industry Merger: Paper One (9 April 2001), Hon Jim Sutton, Minister of Agriculture, paragraph 19.

¹⁵ Section 4(f).

markets in New Zealand” (section 70). The subpart promotes a number of principles, under section 71, including:¹⁶

- independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets;
 - Fonterra must accept applications by new entrants and shareholding farmers to supply it with milk, as shareholding farmers; and
 - Fonterra must not discriminate between new entrants and shareholding farmers whose circumstances are the same.
25. The Commission’s view is that the principles are directed towards the achievement of the purpose of the efficient operation of dairy markets.
 26. To that end, subpart 5 sets out various rules that govern the operation of dairy markets.¹⁷ Those include the open entry and exit regime (Fonterra’s obligation to accept applications to supply Fonterra with milk, and the right of shareholding farmers to cease or reduce the supply of milk); rules allowing shareholding farmers to supply 20% of their weekly production to independent processors; and rules ensuring that, at any time, at least 33% of the milksolids produced within a 160 kilometre radius of any point in New Zealand is supplied either under contracts with independent processors, or under contracts with Fonterra that expire (or may be terminated without penalty) at the end of the current season.
 27. Subpart 5 enables regulations to be made to impose supply obligations on Fonterra (under section 115). Such obligations may relate to the transportation, processing, and packaging of raw milk, milk components, and products derived from milk. The only regulations of that type that have been promulgated are the Regulations, which relate to the supply of raw milk by Fonterra to independent processors.
 28. Regulation 4 provides that Fonterra must supply raw milk to independent processors subject to regulations 5 to 15.
 29. Regulation 3(2) records that the term “independent processor” is defined in section 5 of the Act. That definition is as follows:
 - (a) ... a processor of milk or milksolids or dairy products who is not an associated person of [Fonterra]; and
 - (b) includes [Goodman Fielder]¹⁸ and any associated person of that company other than [Fonterra]¹⁹
 30. Regulations 5 to 15 set out the requirements to which Fonterra’s obligation to supply raw milk is subject.
 31. In particular, the supply obligation is subject to volume limits.²⁰ The total volume of raw milk that Fonterra must supply to independent processors is 600 million litres. The total volume of raw milk that Fonterra must supply to a single independent processor is limited to 50 million litres per season. That limit applies to all processors

¹⁶ Section 71(a) to (c).

¹⁷ The Commission’s power under subpart 5 of Part 2 to determine disputes is described in the following section.

¹⁸ References in the Act and Regulations to “New Zealand Dairy Foods Limited” have been replaced with [Goodman Fielder] throughout this Determination.

¹⁹ References in this Determination to a processor of, or the processing of, milk, milksolids or dairy products refer to a processor of, or the processing of, milk, milksolids or dairy products derived from regulated milk.

²⁰ Regulation 11.

except Goodman Fielder, whose limit is 250 million litres per season. The entitlement of a single processor to raw milk includes any interconnected bodies of that processor. That is, if two processors are interconnected bodies corporate then they are together entitled to 50 million litres (or 250 million litres for Goodman Fielder) between them, rather than 50 million litres each. In general, two corporate entities are interconnected where they are a parent company and its subsidiary; subsidiaries of the same parent company; and/or corporate entities that are interconnected with such subsidiaries or parent companies.²¹ A company Y is a subsidiary of company X if company X:

- controls the composition of company Y's board;
 - controls over half of the votes exercisable at a meeting of company Y;
 - holds more than half of company Y's issued shares; or
 - is entitled to more than half of every dividend paid by company Y.
32. The definition of "independent processor" specifically excludes persons associated with Fonterra. In general, a body corporate is associated with Fonterra if it has substantially the same shareholders; either it or Fonterra has the power to control voting rights attached to 25% or more of the other's shares; one is a director of the other; or either of them is able to exert a substantial degree of influence over the other.²²
33. It follows that if two bodies corporate are not interconnected in terms of the above definition, then their entitlements to raw milk are separate. Even if two bodies corporate are associated persons as defined by the Act,²³ their entitlements to raw milk are separate. Drafters of the Act and the Regulations were aware of the different legal tests that apply under interconnection and association. If it had been considered important not to allow associated independent processors separate entitlements to regulated milk, that would have been specifically provided for in the Regulations. As no such provision has been included, the Commission can conclude that the Regulations do not prevent independent processors that are associated, but not interconnected with one another, from being separately entitled to 50 million litres of regulated milk.
34. The Regulations also provide for the price payable by an independent processor for regulated milk. Fonterra and an independent processor may agree a price for the supply of raw milk, but if there is no such agreement, an independent processor may require Fonterra to supply the regulated milk at the default milk price.²⁴
35. There are some limits on the volume of milk that an independent processor can purchase under the Regulations during certain parts of the season. The effect is to limit the volume of regulated milk able to be required by an independent processor in the months other than October from August to April to 10% above the volume of milk required in October.²⁵ This is colloquially known as the "October Rule".

²¹ Regulation 3(2) records that the term "interconnected body corporate" is defined in section 5 of the Act. That definition imports the definition of "interconnected bodies corporate" from section 2(7) of the Commerce Act 1986.

²² Section 5(2).

²³ Section 5(2).

²⁴ Regulation 8(1) and (2).

²⁵ Regulation 8(3).

36. For raw milk supplied to an independent processor in a season, the default milk price is the wholesale milk price for that season plus the reasonable cost of transporting the raw milk to the independent processor.²⁶
37. Fonterra may require an independent processor to estimate the quantity of raw milk to be supplied to it, up to three months, and up to one week, before that supply is to occur.²⁷
38. Subpart 5 of Part 2 of the Act will expire, and the Regulations will be revoked, once certain triggers specified in the Act are met. The supply of regulated milk will then cease. The triggers are based on the aggregate quantities of raw milk collected from farmers by independent processors.²⁸
39. Some amendments to the Regulations took effect on 1 June 2009.²⁹ The main effect of the amendments is to provide for a rationing mechanism if the estimated total demand for raw milk in a season by independent processors is likely to exceed the quantity that Fonterra must supply in a season.
40. The Ministry of Agriculture and Forestry (MAF) submitted in response to the Consultation Document that the Government is intending to allocate regulated milk through an auction system in the future, to address the issues it has identified with the current regime (including that the default price for regulated milk is perceived to be lower than its market value). However, issues with the current regime, proposed changes that are not yet the subject of promulgated legislation, and the effect of this Determination on MAF's policy development and recommendations, are not matters that the Commission is able to consider in making this Determination. The Commission is required to determine the disputes under the current law.

The Commission's role in determining disputes

41. In making a determination on the disputes, the Commission is directed by the Act to consider the purpose in section 70 (which, as mentioned, is to promote the efficient operation of dairy markets in New Zealand).³⁰ The Commission is also directed to consider whether the determination would promote the principles specified in section 71.³¹ The relevant principle in the context of the current disputes is the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.³²
42. Once it has decided to make a determination, the Commission must complete a determination as soon as practicable.³³

²⁶ Regulation 8(5) and (6).

²⁷ Regulations 5 and 6.

²⁸ Sections 147 and 148 of the Act provide that subpart 5 of Part 2, and the Regulations, will cease to apply once independent processors collect 12.5% of the milksolids collected from farmers in the North Island in a season; and at least 65 million kilograms of milksolids from farmers in the South Island in a season (with one processor collecting at least 25 million kilograms of milksolids from outside of the boundaries of the Westland Regional Council).

²⁹ See the Dairy Industry Restructuring (Raw Milk) Amendment Regulations 2008.

³⁰ Section 125(a).

³¹ Section 125(b).

³² Section 71(a).

³³ Section 124.

43. A determination by the Commission must:³⁴
- state the Commission’s decision on the matters in dispute;
 - state clearly whether a breach of subpart 5 of Part 2 or the Regulations has occurred;
 - include the reasons for the determination;
 - include the terms and conditions on which the determination is made; and
 - specify the actions that a party to the determination must do or refrain from doing, which may include (without limitation) payment of compensation by one party to the other;

and the Commission may also specify an expiry date for the determination.

44. The Commission is not bound by technicalities, legal forms, or rules of evidence in reaching a determination. The Commission may inform itself of any matter relevant to the determination in any way that it thinks appropriate.³⁵ The Act is otherwise silent on the procedure to be followed for determinations.

Approach to statutory interpretation

45. The resolution of the disputes depends on the statutory interpretation of the terms “independent processor”, and “supply”, in regulation 4(1).
46. The meaning of an enactment must be ascertained from its text and in light of its purpose.³⁶ With this in mind, the Supreme Court has recently confirmed the approach to statutory interpretation:³⁷

It is necessary to bear in mind that s 5 of the Interpretation Act 1999 makes text and purpose the key drivers of statutory interpretation. The meaning of an enactment must be ascertained from its text and in light of its purpose. Even if the meaning of the text may appear plain in isolation of purpose, that meaning should always be cross checked against purpose in order to observe the dual requirements of s 5. In determining purpose the court must obviously have regard to both the immediate and the general legislative context. Of relevance too may be the social, commercial or other objective of the enactment.

47. The Commission sets out its consideration of the ordinary meaning, legislative context, and purpose in relation to “independent processor” and “supply” in the next section of this Determination.
48. The Commission considers that the purpose of promoting the efficient operation of dairy markets in New Zealand is the primary purpose that it must consider in determining the appropriate interpretation of those terms.³⁸ The other elements of purpose that the Commission must consider are:
- the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets;³⁹ and

³⁴ Section 126.

³⁵ Section 127.

³⁶ Interpretation Act 1999, section 5(1).

³⁷ *Commerce Commission v Fonterra Co-operative Group Limited* [2007] 3 NZLR 767, paragraph 22, which was recently reiterated and endorsed by the Supreme Court in *Greenpeace New Zealand Inc v Genesis Power Ltd* [2009] 3 NZLR 51.

³⁸ Section 70.

³⁹ Section 71(a).

- the overall purposes set out in the Act, the relevant one being to promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra to ensure New Zealand markets for dairy goods and services are contestable.⁴⁰
49. In the ordinary course, text and purpose are key drivers of interpretation, but in this case the importance of purpose is even greater given the statutory direction that the Commission specifically consider it in determining disputes, as discussed in paragraph 41.⁴¹
50. The Supreme Court has described some of the key purposes of the Act and the Regulations in a recent decision in the following terms:⁴²
- The 2001 Act expressly authorised the making of regulations requiring Fonterra to supply milk, prescribing the terms of supply and specifying the methodology for determining the prices to be paid. This authorising provision reflects the general statutory purpose of promoting the efficient operation of local markets for dairy goods by regulating Fonterra’s activities in order to ensure contestability. This expression of legislative purpose is reiterated in the statements of purpose and principles in subpart 5 of the Act, which deals generally with dairy market regulation and Fonterra’s obligations in that regard. *These provisions are all plainly directed towards creating a level playing field for all processors in relation to their raw milk costs.* They form an important part of the legislative context in which the Raw Milk Regulations were made and against which the crucial provisions in those regulations must be interpreted. [Emphasis added]
51. The meaning of “independent processor” was not at issue in that decision.
52. The Commission has also considered the legislative history in order to identify the historical concerns that the Act and Regulations were intended to address. The Explanatory Note to the Act, when it was first introduced to Parliament as a Bill, stated that:
- the public policy objectives of the regulatory and structural reforms included:
 - maximising the economic performance of the dairy industry by allowing the structure of the industry to evolve in response to changes in the domestic and global dairy industry;
 - facilitating the emergence of new competition and new strategies in the dairy industry; and
 - limiting the potential for dairy farmers, New Zealand consumers and other firms or co-operatives in the dairy industry to be adversely affected by the use of monopoly power by the newly formed company; and
 - the proposed merger (that is, the creation of Fonterra) had detriments, including:
 - the continued loss of innovation, including the evolution of new and higher value products, through insufficient diversity and competition in the production, marketing and exporting of New Zealand dairy products; and
 - the creation of a large monopoly that, without an effective regulatory regime, may use its dominant position to reduce the overall level of contestability in both the domestic consumer product and raw milk markets. This might reduce pressure on the industry to be efficient in its processing of raw milk. If so, it

⁴⁰ Section 4(f).

⁴¹ Section 125(a).

⁴² *Commerce Commission v Fonterra Co-operative Group Limited* [2007] 3 NZLR 767, paragraph 2.

would, over time, result in losses of income to farmers and price increases for consumers.

53. A Cabinet paper of April 2001, which outlined in general terms how the legislative package would look, stated that there would be an access obligation on Fonterra with respect to the supply of raw milk “to anyone who asks”.⁴³

ANALYSIS

Independent Processor

54. Whether or not Kaimai and Grate Kiwi are entitled to receive regulated milk turns on whether they can be considered independent processors under the Regulations. The relevant part of the definition of “independent processor” is the words “... a processor of milk or milksolids or dairy products who is not an associated person of [Fonterra]”. It is not disputed that Kaimai and Grate Kiwi are not associated persons of Fonterra, and therefore meet the “independence” requirement.
55. The following analysis therefore focuses on the interpretation of the words “a processor of milk or milksolids or dairy products”. The discussion below considers the various interpretations in terms of the plain or ordinary meaning of those words, their context, how the interpretations give effect to the purpose (of the promotion of the efficient operation of dairy markets in New Zealand) and the principle (that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets) that the Commission is specifically directed to consider, and finally assesses whether the Commission’s preferred interpretation is consistent with the legislative history.
56. The central issue is the extent to which an independent processor may process regulated milk, and products derived from regulated milk, by way of toll-processing. In other words, in order to be an independent processor:
- does a person have to do some processing itself in its own facility?
 - if so, does all of the regulated milk, or only some of it, have to be processed by that person itself?
 - as Fonterra suggests, must that person carry out the initial processing of the raw milk?

The four options

57. The Commission has considered four possible interpretations of the term “independent processor”, labelled options 1 to 4 below. All of the possibilities permit an independent processor to process regulated milk through toll-processing arrangements to a greater or lesser degree. None of the options allow, under normal circumstances, for the on-sale of raw milk.⁴⁴ Option 4 permits all of the processing to be done through toll-processing arrangements (but would also include a party that did any level of processing in its own facility). The distinction between Option 4, and options 1-3, is the extent to which the latter mandate some degree of processing through a processor’s own facility.

⁴³ Cabinet Paper: Dairy Industry Merger Proposal: Paper Two: Regulatory Package and Tax Provisions (9 April 2001), Office of the Minister of Agriculture, Annex 1: Detailed Regulatory Package, page 3, paragraph 27.

⁴⁴ Refer to paragraphs 134 to 137 of this Determination.

- **Option 1:** an independent processor must, at a minimum, physically process in its own facility all of the regulated raw milk at the initial stage of processing.⁴⁵ The balance of the processing may be done through toll-processing arrangements.

Under this option, neither Kaimai nor Grate Kiwi would be independent processors.

- **Option 2:** an independent processor must, at a minimum, physically process in its own facility all of the regulated milk at some stage in the production process. The balance of the processing may be done through toll-processing arrangements.

Under this option, the Commission considers that Grate Kiwi would be an independent processor (given the Commission's view, set out below, that what Grate Kiwi does to the cheese made by Open Country from Grate Kiwi's regulated milk entitlement constitutes a processing step).

Under this option, Kaimai would only be an independent processor to the extent that it undertakes a processing step on the products into which the regulated milk is made, which would mean it is only entitled to regulated milk for its soft cheese products, but not its hard cheese products (which are entirely toll-manufactured by Open Country).

- **Option 3:** an independent processor must, at a minimum, physically process in its own facility some portion of the regulated milk at some stage in the production process. The balance of the processing at that stage, and for all of the regulated milk at all other stages, may be done through toll-processing arrangements.

Under this option, both Kaimai and Grate Kiwi would be independent processors.

- **Option 4:** an independent processor must process all of the regulated milk at all stages of the production process, either in its own facility, or by toll-processing. This option would allow all of the processing to be done through toll-processing arrangements.

Again, under this option, both Kaimai and Grate Kiwi would be independent processors.

58. The Commission considers that all of the above definitions of “independent processor” are arguably available under the legislation, and each interpretation can be viewed as promoting competition in dairy markets. However, the Act requires the promotion of the efficient operation of the relevant markets. The reference to efficiency indicates that it is necessary to consider which interpretation *best* promotes the efficient operation of dairy markets in New Zealand, and *best* promotes the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.⁴⁶
59. The Commission's objective in consulting on the four options was to find out more about the implications of each option for the dairy industry, and most importantly, which interpretation would best give effect to the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that

⁴⁵ Option 1 was expressed in the Consultation Document in a way that equated the initial processing stage with pasteurisation, but the Commission acknowledges that pasteurisation may not always be the initial processing stage. Another possible initial processing stage is the extraction of proteins for pharmaceutical purposes.

⁴⁶ This approach is also supported by the approach of the majority of the Supreme Court in *Greenpeace New Zealand Inc v Genesis Power Ltd* [2009] 3 NZLR 51, paragraph 56.

independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

60. Submissions received on the Consultation Document made it clear that there is a need for flexibility in defining what is required of a person in order for that person to be considered an independent processor. In determining the current disputes, the Commission does not need to, nor does it intend to, definitively set out the minimum requirements for qualification as an independent processor.
61. The Commission has analysed the meaning of “independent processor” in terms of the text, context and purpose. The first consideration is the text and its ordinary meaning.⁴⁷

Ordinary meaning

62. The first step in determining the meaning of “a processor of milk or milksolids or dairy products” is to consider the plain meaning, or ordinary meaning, of the words in their immediate legislative context.
63. The Commission’s preliminary view, as set out in the Draft Determination, was that the plain meaning of the words “independent processor” supported the view that they include a party that does not carry out all the processing of the raw milk at its own premises, but contracts a third party to carry out some of that processing.⁴⁸ The Commission acknowledged in the subsequent Consultation Document that different interpretations are possible; there is no one ordinary meaning of the words “a processor of milk or milksolids or dairy products”.
64. There are three aspects to the meaning of those words:
- the first aspect is what it means to process something; in other words, how much a person needs to do to a product before that person can be said to have processed it (the “substantive” aspect);
 - the second aspect is whether it is consistent with the ordinary meaning that a processor may be a person who contracts for the processing to be done, or whether the ordinary meaning requires that the processor be a person who carries out the actual processing themselves (the “agency” aspect); and
 - the third aspect relates to whether the relevant processing ceases at the point the relevant product changes from milk, milksolids or dairy products (e.g. milk powder) to some other product (e.g. chocolate) (the “product” aspect), or whether the relevant words can include a person that processes milk, milksolids or dairy products into another product outside those categories.
65. It is necessary for the Commission to reach a view on the first two aspects of the meaning of “independent processor” in order to make a determination on the current disputes. Although submissions raised questions as to the appropriate meaning of the “product” aspect, it is not necessary to decide those questions to determine the current disputes.⁴⁹

⁴⁷ Interpretation Act 1999, section 5(1).

⁴⁸ The Draft Determination was not explicit about whether an independent processor could only do some, or could do all of the processing, through toll-processing arrangements. The Consultation Document was issued to clarify the exact boundaries around toll-processing and the implications of those boundaries.

⁴⁹ For completeness, the Commission records here that its preliminary view is that, in circumstances where an independent processor intends to process a product by toll-processing, it favours an interpretation requiring that

66. The immediate legislative context does not provide any explicit guidance as to either the “substantive” or the “agency” aspects of the meaning of the relevant words.
67. As mentioned in the Draft Determination, the dictionary⁵⁰ defines “process” as:
 a series of actions or steps towards achieving a particular end; a natural series of changes.
68. In relation to the “substantive” aspect, the dictionary definition may suggest a broad meaning, to the effect that in order to be said to “process” something, a person need only carry out one action or step that forms part of a series of actions or steps toward the creation of the end product. That may indicate that the threshold for what constitutes a processing step is fairly low.
69. In relation to the “agency” aspect, the dictionary definition does not assist.
70. Fonterra submitted that the words “processor of milk, milksolids or dairy products” have no plain meaning. It submitted that the industry understanding of the Regulations has been that they only apply to processors of raw milk.⁵¹ However, Fonterra did not submit that the words have an accepted and well-understood meaning within the industry. In addition, any industry understanding, by itself, would not assist in determining the application of the Regulations to the current disputes. Enactments apply to the circumstances as they arise, and the historic situation is not necessarily illustrative of an understanding that the Regulations would not apply to a new business structure.
71. Fonterra also submitted that the recent review of the Regulations by MAF proceeded on the basis that independent processors are those who process raw milk themselves.⁵² However, as Fonterra itself noted, the breadth of the meaning of “independent processor” was not at issue in the review.
72. Kaimai submitted that “[c]ontracting out is not unusual in the dairy industry. Fonterra has had much publicity in relation to outsourcing some of its corporate functions and its coolstore requirements. Some processors obtain energy or effluent disposal services from another operator. Some contract a range of technical support, administrative and marketing services. The reality is that, as with other commercial activities, processors contract out some parts of their activities – that is normal.”⁵³
73. Contracting out aspects of business operations is a generic business practice. That indicates that the ordinary meaning of “process” may include a person that processes by contracting another person to carry out the processing. However, it is also possible to argue that the ordinary meaning of “process” implies a step carried out by the relevant person themselves.
74. Although there are some indicators as to what the plain or ordinary meaning may be, none point clearly one way or the other on either aspect. Contrary to its position in the Draft Determination, the Commission is now of the view that different

the end product of the relevant part of the production process must be milk, milksolids, or dairy products (such as one that would fall within the Australian and New Zealand Standard Industrial Classification dairy product class). However, this is the Commission’s preliminary view only. Whatever the appropriate scope of the “product” aspect of the definition may be found to be, the Commission considers that the relevant products of Kaimai and Grate Kiwi clearly fall within the meaning of “milk, milksolids or dairy products” and does not therefore discuss this aspect further in this Determination.

⁵⁰ As taken from the *Concise Oxford English Dictionary* (11th edition), Oxford University Press, Oxford, 2006.

⁵¹ Fonterra’s submission on the Draft Determination (31 October 2008), paragraph 1.2(a).

⁵² Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.7(b).

⁵³ Kaimai’s Application for Dispute Determination (25 June 2008), paragraph 54.

interpretations are possible of the ordinary meaning of the words “a processor of milk or milksolids or dairy products”, in the definition of the term “independent processor”. The ordinary meaning is silent as to whether the processor can process solely by toll-processing arrangements, or must do some of the processing itself; and as to what constitutes a processing step.

75. Since the plain or ordinary meaning of the words “a processor of milk or milksolids or dairy products” is silent on both the substantive aspect and the agency aspect of the definition, context and purpose are essential guides to meaning⁵⁴ in this case.

Context

76. The second step is to consider the meaning of the words “a processor of milk or milksolids or dairy products” in light of their more general legislative context.
77. The starting point is that the meaning of the term “independent processor” in the Regulations is the same as the meaning in the Act,⁵⁵ unless the context otherwise requires.⁵⁶

Whether definition should be limited to processors of raw milk

78. Fonterra submitted that the only feasible interpretation of “independent processor” under the Regulations is that it refers to a commercial processor that takes the initial processing step on the regulated milk using its own plant, equipment and labour.⁵⁷ Fonterra stated that its view is supported by the fact that the Regulations only concern raw milk, and argued that the term must be given an interpretation consistent with that ambit. Fonterra referred to section 115(a) of the Act, which, as mentioned, allows regulations to be made in relation to a range of matters relating to milk, components of milk, and products derived from milk.⁵⁸
79. Fonterra submitted that a broad concept of “independent processor” was necessary in the Act to match the broad range of products and services that could potentially be regulated under section 115. The only regulation that has been made, under section 115(a), refers to the supply and transportation of raw milk. Fonterra argues that the relevant Minister has “clearly chosen not to regulate other dairy products, or other dairy processes at this time. Accordingly, the Regulations should be given an interpretation consistent with their ambit. That is, references to an “independent processor” in the Raw Milk Regulations should be limited to independent processors that physically process raw milk themselves and who seek raw milk for that purpose.”⁵⁹
80. The question is whether the narrower interpretation of the term proposed by Fonterra is appropriate in the context of the Regulations.
81. The definition of “independent processor” adopted by the Regulations from the Act is a broad definition. It is sufficient to be a processor of either milk, or milksolids,⁶⁰ or dairy products. There is no definition of “dairy products” in the Act, but by

⁵⁴ *Commerce Commission v Fonterra Co-operative Group Limited* [2007] 3 NZLR 767, paragraph 24.

⁵⁵ Section 34 of the Interpretation Act 1999 provides that “A word or expression used in a regulation... has the same meaning as it has in the enactment under which it is made.”

⁵⁶ Section 5(1) provides that the definitions listed in that section apply “unless the context otherwise requires”.

⁵⁷ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 1.4.

⁵⁸ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.7(c).

⁵⁹ Fonterra’s supplementary submission (27 August 2008), paragraphs 21-22.

⁶⁰ An independent processor also includes a processor of raw milk derivatives based on the further definition of “milksolids” in the Act.

implication, the dairy products listed in Schedules 5 and 5A of the Act, including butter, various cheeses, prepared edible fats and milk powder, may be included. Dairy products are likely to also include products made in New Zealand from milk produced by dairy cows, for example, evaporated milk, cream, yoghurt, and ice cream.

82. The Commission's view is that if the Minister had intended "independent processor" in the context of the Regulations to mean a processor of raw milk, then the Minister would have recommended defining "independent processor" more narrowly in the Regulations as a processor of raw milk (using the definition of "raw milk" in regulation 3(1)). The Minister did not however recommend such a definition. The Regulations adopt the broader definition from the Act. The Commission considers that the reference to the definition in the Act must have a practical effect. The Commission is not persuaded that anything in the context of the Regulations or the Act requires a definition that is limited to processors of raw milk.
83. The Commission now turns to consider the contextual indications in the legislation in relation to the "agency" and "substantive" aspects of the meaning of "a processor of milk or milksolids or dairy products", as referred to in paragraph 64.

Significance of the 50 million litre cap

84. In relation to the "agency" aspect, the Commission has considered how the 50 million litre cap (on the entitlement of individual independent processors to regulated milk) might affect the interpretation it considers most appropriate.
85. The starting point in considering the parties' entitlements to regulated milk is that none of Kaimai, Grate Kiwi, and Open Country are interconnected bodies corporate. It has not been suggested that any of them are interconnected, and Kaimai and Grate Kiwi have submitted that they are not interconnected with Open Country.⁶¹ Neither the shareholdings held by Dairy Investment Fund Limited in Kaimai and Grate Kiwi and Open Country's parent company, nor the common directorships set out at paragraph 14, make any two of them interconnected in terms of the definition discussed at paragraph 31 above. The Commission is not aware of any other arrangements that would suggest that any two of them are interconnected. The Commission determines that none of Kaimai, Grate Kiwi, and Open Country are interconnected bodies corporate, and therefore if Kaimai, Grate Kiwi, and Open Country are all independent processors, they are all separately entitled to up to 50 million litres of regulated milk.
86. Fonterra has submitted that the cap would have no practical effect under interpretations wider than the one it has proposed.⁶² Fonterra submitted that the Regulations are deliberately designed to limit how much regulated milk each processor receives so that, consistent with the overall goal of the regulatory regime, processors must develop their own supply of raw milk. Fonterra argues that the purpose would be frustrated by an interpretation that allows the toll-processing of raw milk, because those in possession of raw milk processing plant would be able to access arbitrarily large quantities of regulated milk (subject only to the overall cap, and rationing rules). Fonterra submitted that the Commission must not interpret "independent processor" in a way which allows the cap to be avoided.

⁶¹ Kaimai's Application for Dispute Determination (25 June 2008), paragraph 8; Grate Kiwi Application for Dispute Determination (14 July 2008), page 5, paragraph 1.6.

⁶² Fonterra's submission on the Consultation Document (17 April 2009), paragraph 2.9(b).

87. The Commission does not agree with Fonterra's assessment of the overall goal of the regime. The overall goal of the regime relates to the regulation of the activities of Fonterra in order to promote efficiency and competition in dairy markets.
88. Fonterra submitted that under Kaimai's and Grate Kiwi's arrangements with Open Country, Open Country will be able to process more regulated raw milk than the amount to which it is entitled. Fonterra asserts that the approach taken by the Commission in the Draft Determination has the effect of allowing Open Country to avoid the 50 million litre cap.⁶³
89. The Commission remains of the view expressed in the Draft Determination that, given that Kaimai, Grate Kiwi, and Open Country are not interconnected bodies corporate, requiring Fonterra to supply each of them with up to 50 million litres of raw milk per season cannot have the effect of allowing Open Country to avoid the cap.
90. The regulated milk, and products made from the regulated milk, will not be owned by Open Country, but by Kaimai and Grate Kiwi. It is Kaimai and Grate Kiwi who will order and pay for a certain volume of regulated milk and take the risks associated with the marketing and sales of the end products.
91. It is not therefore a question of Open Country avoiding the cap. Rather, Open Country is making available to Kaimai and Grate Kiwi a portion of its processing capacity under toll-processing arrangements.
92. The Commission has researched the legislative history of the Act and Regulations for an indication of the purpose underlying the 50 million litre cap. There is virtually no guidance as to its purpose in the legislative history. It appears that the level of the cap may not have been based on any particular aspect of dairy processing. It did not necessarily correlate with the processing capacity of any processing facility that was operating at the time the Regulations were made.
93. The Commission sought the views of interested parties in the Consultation Document as to whether each of the interpretations set out in that document would be consistent with the 50 million litre cap. Fonterra's view, as mentioned, was that any interpretation of "independent processor" wider than the one it proposes (a processor that takes the initial processing step on the regulated milk using its own plant, equipment and labour) would be inconsistent with the cap.
94. Apart from Fonterra, submitters did not comment on the cap in any detail. The Commission considers that that may indicate that the 50 million litre cap is not considered by industry players to be one of the most significant features of the Regulations.
95. New Zealand Dairies Limited (NZDL) submitted that only Option 1 was consistent with the cap, and that contract manufacturing would allow circumvention of the cap. Options 2, 3, and 4 would, in its submission, allow the concentration of regulated milk in a small number of third party toll-processors.⁶⁴ Kaimai submitted that the cap did not make any difference to which interpretation best promotes the efficient operation of dairy markets; and that all of the options were "not inconsistent" with the cap.⁶⁵ Grate Kiwi submitted that all the options were consistent with the cap, and that both

⁶³ Fonterra's submission on the Draft Determination (31 October 2008), paragraphs 2.13, 2.15, and 2.17.

⁶⁴ NZDL's submission on the Consultation Document (15 April 2009), responses to questions 3(c) and 6.

⁶⁵ Kaimai's submission on the Consultation Document (16 April 2009), paragraphs 52 to 55.

the cap and the finite term of the Regulations encourage farm gate competition.⁶⁶ Westland Co-operative Dairy Company Ltd submitted that the cap was consistent with all options to an equal degree.⁶⁷

96. The Commission concludes, in relation to the purpose underlying the cap, that it was intended to result in the purchase of regulated milk by a number of separate processors. This is consistent with the cap being placed on the entitlement to regulated milk by a processor, rather than a processing facility. The fact that the word “processor” was used in the context of rationing regulated milk, rather than limiting the supply to a “processing facility” is a significant factor in analysing the purpose underlying the cap. The words “factory” and “facility” were used in section 95 of the Act,⁶⁸ which suggests that the choice of the word “processor” in framing the cap was deliberate.
97. The 50 million litre cap allows new entrants to enter the market with some certainty of supply, and allows them to expand to a certain level of production before obtaining their own sources of supply. The cap, together with the fact that the Regulations will be revoked on the expiry of subpart 5 of Part 2,⁶⁹ indicates that the development of an own-supply network of farmers by independent processors was considered to be an important element in promoting the efficient operation of dairy markets.
98. The cap may also indicate that there was a desire for new independent processing capacity that would endure after the revocation of the Regulations, as it ensures access to raw milk by multiple processors. The likelihood of processing capacity enduring beyond the Regulations is increased if a range of sizes of processors and facilities become established. However, the emphasis must be on the number of processors, as opposed to the number of facilities, since as mentioned the cap attaches to the processor and not the facility.
99. On that basis, the Commission considers that none of the options for interpretation it has considered would be inconsistent with the cap. The proposed arrangements that Kaimai and Grate Kiwi have with Open Country are not circumventing the cap. The cap applies to the processor, not the processing facility. The raw milk that Open Country will process on Kaimai’s and Grate Kiwi’s behalf belongs to Kaimai and Grate Kiwi, not Open Country. Therefore Open Country would not be purchasing regulated milk to a greater extent than it is entitled to under the Regulations; it is simply selling contestable processing services to Kaimai and Grate Kiwi for their regulated milk. Further arrangements for toll-processing would appear to promote the development of contestable services. In the Commission’s view, arrangements for toll-processing are not inconsistent with the underlying goal of the receipt of regulated milk by a number of separate processors.
100. Fonterra’s submission on the Consultation Document referred to an example that would be permitted under options 2, 3, or 4, that it considers is inconsistent with the cap.

⁶⁶ Grate Kiwi’s submission on the Consultation Document, response to question 3(c).

⁶⁷ Westland’s submission on the Consultation Document (16 April 2009), response to question 3(c).

⁶⁸ Section 95 uses the words “factory” and “facility” in the context of providing for Fonterra to reject an application from a new entrant if the cost of transporting the milk of the new entrant exceeds the highest cost of transporting another shareholding farmer’s milk.

⁶⁹ Section 149(3).

101. The example⁷⁰ is of a full-range dairy processing company that has a factory with the capacity to process at least 300 million litres of milk. It sets up five wholly-owned subsidiaries, and transfers some of its downstream processing equipment to each, so that each carries out a downstream processing step on all of the milk (and derivative products) passing through the factory. The parent company enters into long-term toll-processing arrangements with each subsidiary under which the parent company toll-processes raw milk on behalf of each subsidiary. The parent company then sells 51% of the shares in each subsidiary to various third parties and accordingly ceases to be the parent company. Each of the companies it created, in which it now has a 49% shareholding, is then separately entitled to regulated milk. The former parent company's plant could then process up to 300 million litres of regulated milk (50 million litres on behalf of each of the five former subsidiaries, and 50 million litres of its own entitlement), and can capture a share of the economic benefit from it, all without any investment in new processing assets. Fonterra submitted that the former parent company in this example would completely avoid the intent of the cap.
102. The Commission has also considered whether the following examples, which it accepts are somewhat extreme, are inconsistent with the cap (assuming that the shareholders are not interconnected bodies corporate):
- six equal shareholders in a company that produces cheese each purchase 50 million litres of regulated milk. Each shareholder contracts with the company to process the raw milk into cheese, which the shareholders then separately market and sell; and
 - six equal shareholders in a company that produces cheese each purchase 50 million litres of regulated milk. Each shareholder contracts with the company to process the raw milk into cheese, which the shareholders sell to the company. The company then markets and sells the cheese.
103. The Commission does not consider that the examples set out in paragraphs 101 and 102 are inconsistent with the cap. The Regulations prohibit interconnected persons from being separately entitled to regulated milk, but not associated persons. Their entitlements are not affected if they are associated with one another, as long as they are not associated with Fonterra. As long as each of the companies in Fonterra's example are not interconnected bodies corporate, they are each separately entitled to 50 million litres of regulated milk. As mentioned, the cap applies to the processor, not to the facility.
104. Submissions referred to various options giving rise to the potential for gaming of the Regulations. The Commission considers that under any interpretation, market participants will have incentives to structure their arrangements to take advantage of the entitlement to regulated milk. This, of itself, is not something that the Commission considers it can or should try to prevent, as long as participants are acting within the law – and in this case, consistently with the purpose of the Act and Regulations. Whether participants are so acting has to be assessed on a case-by-case basis.

⁷⁰ Fonterra's submission on the Consultation Document (17 April 2009), paragraph 4.10(d).

Significance of overall cap

105. Another aspect of the legislative context considered by the Commission, in relation to the “agency” aspect, is the overall cap of 600 million litres on the entitlement of independent processors to raw milk from Fonterra.
106. Fonterra submitted that the 600 million litre overall cap is likely to be reached in the near future and that expanding entitlements to regulated milk can only increase pressure on the cap. It submitted that this would swamp niche processors and deter genuine new entrants.⁷¹ It further submitted that there is a real prospect of demand for regulated milk exceeding supply.
107. Kaimai submitted that “the nature of the industry is that all serious players own equipment”⁷² and that “only serious players in the industry will have the capability of organising the making and marketing of the products” (made from regulated milk).⁷³
108. The Commission acknowledges that if Grate Kiwi and Kaimai have access to regulated milk, then pressure on the cap may increase. However, the demand for regulated milk is approaching the overall cap at present even if the amounts that Grate Kiwi and Kaimai have requested are excluded. The fact that the cap is almost met does not of itself bear on this Determination. In addition, the Commission considers that pressure on the cap is likely to increase competition between processors at the farm gate to purchase raw milk directly from farmers. As discussed at paragraph 143 below, the encouragement of farm gate competition is one of the goals of the regulatory regime.
109. The issue of how milk will be allocated if demand exceeds the cap is addressed by the 1 June 2009 amendments to the Regulations, which provide for rationing. As discussed further below, the Commission is of the view that allowing parties such as Grate Kiwi and Kaimai access to regulated milk will enhance the likelihood of new entry into dairy markets. The Commission concludes that the issue of increasing pressure on the overall cap does not assist it in identifying the most appropriate interpretation of “independent processor”.

Other contextual considerations

110. Fonterra submitted that the wider interpretations of “independent processor” would necessitate an extensive monitoring and compliance regime to ensure that processors took the relevant own-processing and toll-processing steps on the physical derivatives of the regulated milk. The fact that there is no such regime provided for in the Regulations, in Fonterra’s submission, indicates that a wider interpretation is not appropriate.⁷⁴
111. In the Consultation Document, the Commission noted that under options 1, 2 or 3, Fonterra may be entitled to be satisfied before supplying the milk that the milk would be processed in the way that each option required, and to investigate after the milk had been supplied whether it had been so processed.
112. However, upon reflection, the Commission considers that all of the options potentially lead to a need for some sort of monitoring. No matter how “independent processor” is interpreted, Fonterra may be entitled to reasonably satisfy itself that the person

⁷¹ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.9(c).

⁷² Kaimai’s cross-submission on the Consultation Document (28 April 2009), paragraph 17.

⁷³ Kaimai’s submission on the Draft Determination (30 October 2008), paragraph 8.

⁷⁴ Fonterra’s submission on the Consultation Document (17 April 2009), paragraphs 2.10 to 2.15.

requesting the regulated milk was entitled to request it. That is simply a consequence of the fact that regulated milk is only available to a certain class of person. The Commission recognises that monitoring may be more difficult under options 2, 3, and 4, compared with Option 1, but the difference is not so material as to assist in determining which is the most appropriate interpretation.

113. In relation to the “agency” aspect, Fonterra also submitted that there are various contextual indications in the Regulations that the meaning of “independent processor” was intended to be limited to processors who process raw milk themselves. In the Commission’s view, all of the provisions referred to by Fonterra can be read consistently with the proposition that the meaning of “independent processor” may include processing through toll-processing arrangements. Fonterra referred to:
- the explanatory note to the Regulations, which describes Fonterra’s obligations as being to supply milk “to *milk processors* that are independent of Fonterra” (Fonterra’s emphasis).⁷⁵ The Commission considers that clear contextual indications would need to be present in order for the Commission to depart from the words used in the definition. The indication in the explanatory note is not a sufficiently clear indication that the meaning was intended to be limited in the way Fonterra suggests. Also, the explanatory note is clearly paraphrasing and summarising the Regulations rather than setting out the requirements in full. The Commission does not therefore consider that Fonterra’s argument is persuasive;
 - regulation 4(1) refers to Fonterra’s obligation to “supply raw milk to independent processors” (Fonterra’s emphasis).⁷⁶ The Commission considers that this submission relates more to the “supply” obligation, and it is discussed later in this Determination in relation to that issue;
 - regulation 8(5) provides that an element of the raw milk price is the “reasonable cost of transporting the raw milk to the independent processor”, and this would make little sense if the milk was not to be transported to the independent processor.⁷⁷ The Commission considers that this provision can be read consistently with the transport of milk to the nominated address of an independent processor rather than the independent processor’s own premises. Again, this submission relates more to the “supply” obligation and is discussed later in this Determination; and
 - regulation 10(4) states that “[Fonterra] may require an independent processor ... to notify [Fonterra] of its actual requirement for raw milk by noon on the day before the raw milk is to be supplied”.⁷⁸ Fonterra submitted that again, that requirement would make little sense if it was not the independent processor that was to make use of the raw milk on the day of supply. However, the Commission considers that this requirement can be read consistently in relation to either a processor that does not undertake the initial processing of raw milk itself, or one that does. Both processors have a requirement for raw milk, and for practical purposes both would need to notify Fonterra of their actual requirement.

⁷⁵ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.7(d)(i).

⁷⁶ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.7(d)(ii).

⁷⁷ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.7(d)(iii).

⁷⁸ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.7(d)(iv).

114. In summary, none of the provisions referred to by Fonterra are sufficient to persuade the Commission that a definition other than the one adopted in the Regulations from the Act is appropriate. A departure from the statutory definition is not justified.
115. The Commission has considered whether any statutory definitions outside the Act of “process”, “processing”, “processor” or “processed” assist in interpreting any aspect of the meaning of “independent processor”. There are definitions of those terms in the Animal Products Act 1999, the Chemical Weapons (Prohibition) Act 1996, the Fisheries Act 1996, the Meat Act 1981 (now repealed), and the New Zealand Horticulture Export Authority Act 1987. The definitions in those statutes are not a useful aid to interpretation in this case. In addition to the uncertainty about precisely what the various definitions imply about the meaning of “process”, those statutes have different purposes to those of the Act and Regulations in question in these disputes. The fact that the definitions vary amongst the different statutes is an important indicator that the meaning of the word can vary according to the context.

Conclusion – contextual considerations

116. The Commission concludes that contextual considerations do not significantly assist it in identifying the most appropriate meaning of “independent processor” in terms of the “substantive” aspect and the “agency” aspect.
117. The question then arises as to which interpretation, in relation to both aspects, best promotes the purpose and the principle.

Purpose and principle

118. As mentioned, the Commission must, in determining the interpretation of “independent processor” and therefore the disputes, consider the two matters set out in section 125 of the Act:
- the purpose of promoting the efficient operation of dairy markets (section 70); and
 - promoting the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets (section 71(a)).
119. In the ordinary course, purpose is a key driver of interpretation when the ordinary meaning and context do not clearly indicate what the appropriate interpretation is. In this case, the importance of purpose is even greater, given the statutory direction that the Commission specifically consider it in determining disputes.
120. One of the overall purposes of the Act is also relevant, which is to promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra to ensure New Zealand markets for dairy goods and services are contestable (section 4(f)).
121. The Act and the Regulations are concerned with *promoting* efficiency and competition (emphasis added). One of the ways in which they do so is by ensuring access to raw milk, which is an input into the manufacture of products that are eventually supplied to dairy markets by independent processors.
122. The Commission has evaluated the four options, as set out in paragraph 57, in terms of which of those options best promotes the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets. That analysis is set out in the following sections.

Efficient operation of dairy markets

123. The Commission has considered which of the competing interpretations of “independent processor” would best promote the efficient operation of dairy markets. This section describes what the Commission considers the concept of the efficient operation of dairy markets means in practical terms; in other words, what is the purpose that the Commission is working towards in making a determination on the disputes.
124. There are three types of efficiency – allocative, productive, and dynamic. A market is allocatively efficient if it is producing the right goods for the right people at a price that reflects marginal cost of production. A productively efficient market is one in which each firm in the industry carries out its activities at minimum cost, and in which activities are distributed between firms such that industry-wide costs are minimised. Finally, a dynamically efficient market is one that embraces new, more efficient, production processes, and new, innovative product offerings, as they are developed. Dynamic efficiency is likely to be promoted where entry is relatively unimpeded,⁷⁹ as entrants often bring new ideas with them. A dynamically efficient market will, to the extent allowed by technological possibilities within the industry, produce an innovative product mix that offers diversity in supply and choice for consumers.
125. The Commission considers that the efficient operation of dairy markets is both a short-term and a long-term objective. The purpose statement in section 70 will, of course, expire once the triggers for the expiry of subpart 5 of Part 2 are met, but it will be survived by the overall purpose of the Act in section 4(f), which also refers to efficiency. Nonetheless, the Commission’s analysis places more weight on the medium-term and long-term implications, since entry occurs by definition in the long-term,⁸⁰ and it is important that competition is sustainable over the long-term. In the long-term, the dairy industry will be best served by a range of producers operating in contestable markets that promote the various dimensions of economic efficiency.
126. It was considered that entry into dairy markets following the formation of Fonterra was not likely to be easy without regulatory assistance. Fonterra controlled about 95% of the total supply of raw milk, was responsible for nearly all of the country’s exports of dairy products, and was one of only two major suppliers to the domestic market. In addition, entry was difficult for various other reasons: the economies of scale (large plants are lower cost); the economies of scope (ability to process by-products); the vertically integrated nature of production, where entry at more than one stage has tended to be the industry practice; the sunk costs of such investments, which adds to the risks, especially over multiple stages; the “chicken and egg” difficulty of securing raw milk supplies without a plant, and of building a plant without having secured milk supplies; and dairy farmers’ adherence to the co-operative principle.
127. Hence, the Act and Regulations can be seen as providing a “stepping stone” for entrants, overcoming their main difficulty by providing access to supplies of raw

⁷⁹ The reference to barriers to entry or entry conditions in this Determination takes account of recent discussion by the High Court in *Commerce Commission v New Zealand Bus Ltd* (2006) 3 NZCCLR 111, *Air New Zealand v Commerce Commission* (No 6) (2004) 11 TCLR 347, and *Southern Cross Medical Care Society v Commerce Commission* (2001) 10 TCLR 25.

⁸⁰ While the decision to enter by a new entrant is a short-term decision, based on current market conditions, the inclusion of the firm’s capacity in the market alters the amount of capacity available in the market and therefore has long-term implications.

milk. Initially, provision was made for 150 million litres of default milk to be made available to entrants over and above the 250 million litres for the incumbent domestic competitor to Fonterra (the successor company is Goodman Fielder). This was subject to a cap of 50 million litres per operator, implying that the aim was to ensure that at least three entrants would appear to compete against Fonterra, rather than allowing one entrant to claim all 150 million litres. The latter would be a risky policy for the legislators because (a) the single entrant could turn out to be unsuccessful, and (b) one additional competitor might not be enough to ensure competition, at least across the range of dairy products.

128. The aim, then, is to encourage new firms to enter to compete against Fonterra, both for the acquisition of raw milk, and also in the downstream markets for dairy products. This competition is expected to generate allocative, productive and dynamic efficiencies. A mix of entry has occurred, from large-scale milk powder manufacturers producing for export, to small, niche cheese-makers aiming at the domestic market. Given the costs and risks, some firms may enter only at one vertical level, at least initially. This means that they are reliant on other firms to take their by-products, or to undertake other processing stages, at least initially. Such is not uncommon in the dairy industry, with the established operators often trading intermediate products.
129. When resolving disputes, the Commission must consider what incentives to actual or potential market participants are appropriate to bring about contestable markets. The Commission has therefore analysed the incentives that would be provided to market participants under each of the four options to ensure that the term is interpreted in a way that best promotes the efficient operation of dairy markets.

Toll-processing

130. Toll-processing is a potential feature of the production process of products derived from regulated milk under all of the options for interpretation identified by the Commission.
131. A company will be incentivised to have a product toll-processed if the cost of doing so is less than the cost of producing it in its own facility. It may also establish toll-processing arrangements where specialised labour or equipment is required, which if brought into the person's own facility would raise the cost of production in its own facility.
132. The cost of toll-processing may be lower than the cost of own-processing when there is a processing facility with spare capacity, as a toll-processor may be willing to offer toll-processing at a marginal cost, benefitting both parties.
133. A firm facing high start-up costs for its own production facility may enter an industry by toll-processing and then graduate to own-processing. This may occur once the firm increases its through-put to the stage where the cost of toll-processing becomes higher than the cost of own-processing.

The on-sale of regulated milk in its raw state

134. Although it is not at issue in the disputes, the Commission stated in the Consultation Document that it did not consider that it was open, on the language of the legislation, to adopt an interpretation that would allow an independent processor to on-sell all or some of the regulated milk purchased under the Regulations in its raw state.

135. First, an independent processor could not be considered to be processing milk that it had not altered (either itself, or by contracting a toll-processor) in any manner. In other words, if a person is on-selling milk in its raw state, then the person would not have processed it in the substantive sense.
136. Second, the Commission considers such an interpretation to be inconsistent with the purpose of the legislation, in that one of the principles in section 71(a), as mentioned, is that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets. If any of the milk is on-sold in its raw state, the independent processor is not using it to compete in dairy markets.
137. MAF submitted that there are instances in which it considers the on-sale of regulated milk is consistent with the Regulations.⁸¹ Those include “distressed milk” where independent processors had the intention and capacity to process the milk but for unforeseeable reasons, such as a factory breakdown, were unable to process it. MAF considers the ability to on-sell distressed milk is an important risk management tool for independent processors. The Commission agrees that the on-sale of raw milk in such circumstances is not inconsistent with the purpose of the Regulations. However, as mentioned, the Commission is not required to determine this issue in the context of the disputes.

Should raw milk be supplied only if it is “necessary to compete”?

138. Before discussing which interpretation best gives effect to the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets, it is essential to first clarify how the Commission intends to apply that principle.
139. Fonterra submitted that its interpretation is supported by the principle that processors be able to obtain raw milk and other goods and services that are necessary for them to compete.⁸² Fonterra suggests that where it is not “necessary” for a processor to obtain raw milk in order to compete, then the Regulations do not apply. It further submitted that there is no evidence that Kaimai and Grate Kiwi have experienced difficulty with obtaining input product; and that if a processor does not use raw milk, then it is not sensible to suggest that it is necessary for them to obtain it in order to be able to compete. Fonterra submitted that “necessary” in section 71(a) cannot be read as “desirable”.
140. The Commission does not agree with Fonterra’s interpretation. There is no qualification on the regulation 4(1) requirement on Fonterra to supply raw milk to independent processors that relates to the milk being “necessary” in order for the independent processors to compete. The principle cannot have the effect of requiring independent processors to show that they need access to raw milk to compete and that they cannot obtain raw milk from any other source.
141. The Regulations are based on the premise that access to raw milk, and other dairy goods and services, is necessary to allow competition in dairy markets. That necessity underscores the requirement that Fonterra supply independent processors with raw milk. If the Minister had intended that independent processors are only

⁸¹ MAF’s submission on the Consultation Document, paragraphs 21 and 22.

⁸² Fonterra’s submission on the Consultation Document (17 April 2009), paragraphs 2.18 to 2.20.

entitled to raw milk if they cannot obtain it elsewhere, or if they could demonstrate a genuine need for it, then that would have been made explicit in the Regulations.

How the four options promote the purpose and the principle

142. There was no consensus amongst submissions on the Consultation Document as to which option best promotes the purpose of the efficient operation of dairy markets in New Zealand, or as to which option best promotes the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets. Different submissions identified options 1, 2, and 4 as being the most consistent with the purpose and the principle. No submitter expressed a preference for Option 3.
143. There was also a range of views as to which of the considerations listed in the Consultation Document should be the most important to the Commission's analysis, including:
- the promotion of competition at the farm gate – in other words, the promotion of competition between Fonterra and other processors for access to raw milk directly from farmers. This goal can be inferred from the fact that the Regulations will expire once the triggers in the Act, which relate to the collection of milksolids by independent processors directly from farmers, are met. Although the Commission considers that that is a goal of the regime, it is also required by the relevant purpose (of the promotion of the efficient operation of dairy markets in New Zealand), and the principle (that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets) to consider all dairy markets;
 - the establishment of new independent processing capacity that will endure after the Regulations expire. The Regulations can be seen as a stepping-stone to a sustainable competitive industry, under which independent processors can use regulated milk to gain a foot-hold in the market. They can then develop their own alternative sources of milk over time. However, the Commission is also of the view that the fact that the Regulations are likely to be revoked in the medium-term, combined with the uncertainty of access to regulated milk (given the cap and the rationing mechanism⁸³) means that the effect of any of the four options on decisions to establish new processing facilities is relatively limited at this point; and
 - leaving the markets to determine how independent processors can operate most efficiently so that dairy products produced by them compete effectively with Fonterra in downstream markets. It is consistent with the concept of efficiency that toll-processing services are contestable. Independent processors can choose which raw milk processor to use, or to process it themselves.
144. Bearing in mind the description of the efficient operation of dairy markets set out earlier in this Determination, the following analysis assesses the extent to which each interpretation would best promote the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

⁸³ See the Dairy Industry Restructuring (Raw Milk) Amendment Regulations 2008.

Which interpretation of the “substantive” aspect would best promote the purpose and principle?

145. In relation to the “substantive” aspect of the meaning of “independent processor”, the Commission considers that a broad interpretation best gives effect to the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets, as it minimises barriers to entry.
146. The Commission considers that to “process” a product should simply be interpreted as carrying out any step that changes the product and as a result adds value to it. To add value to a product is to change it in some way, so that some users and consumers value it more than they would have if the product had not been changed in that way. The change may be chemical or physical. In relation to cheese, processing would therefore include grating, cutting, and packaging. Grated cheese, for example, may be valued more highly than block cheese because it may be a blend of different cheese varieties and it saves the user or consumer the time it would have otherwise taken to grate cheese itself.
147. Fonterra argues that grating does not constitute own-processing “in any sense relevant to the purpose” of the Act and the Regulations.⁸⁴ The Commission considers that grating cheese *is* a processing step. It changes the form of the cheese, and adds value to it.
148. For the avoidance of doubt, the Commission does not consider that transporting a product (or another logistical function) constitutes a processing step. Such functions do not involve a change to the product, and would depart from the ordinary meaning of “process” in a way that is not justified in light of the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

Which interpretation of the “agency” aspect would best promote the purpose and principle?

149. This section analyses the extent to which each of the four options for interpretation gives effect to the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets. The following analysis is independent of the contextual considerations identified earlier in this Determination.

Option 1

150. Under Option 1, an independent processor must, at a minimum, physically process in its own facility all of the regulated raw milk at the initial stage of processing. The balance of the processing may be done through toll-processing arrangements. Under this option, neither Kaimai nor Grate Kiwi would be independent processors.
151. From an efficiency perspective, an advantage of this option is that it would promote competition in the market for the acquisition of raw milk at the farm gate. Option 1 would make it more likely than the other options that an independent processor would engage its own supply of milk, since engaging own-supply is facilitated by having

⁸⁴ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 4.13((b)(i).

- one's own facility in which to process the milk instead of relying on a third party being available to process it.
152. Option 1 would also be likely to encourage the development of a secondary market for pasteurised milk or raw milk, as there would be more parties in dairy markets collecting milk directly from farmers, and therefore a choice of suppliers for smaller independent processors without their own farmer supply or first-stage processing facilities.
 153. In addition, Option 1 may (because the timeframe is fairly short), be likely to promote the establishment of new processing capability that would endure after the Regulations are revoked, as it would require investment in first-stage processing facilities in order to access regulated milk.
 154. However, the Commission is required to consider the effect of the interpretation on dairy markets generally in terms of whether it would promote efficiency. As explained below, the Commission does not consider that the effect of Option 1 on other dairy markets is conducive to efficient outcomes.
 155. Option 1 would limit the ability of market participants to focus on those stages of the production process in which they have a comparative advantage. The Commission considers that a new entrant should be free to focus on the particular stage(s) of processing where it can be most efficient and competitive. That will not necessarily be the initial processing stage.
 156. The incentives offered by Option 1 are likely to limit the amount of entry into dairy markets due to the capital cost involved for a new entrant in establishing a first-stage processing facility.
 157. Grate Kiwi submitted that the capital cost of a processing facility is in the order of \$90 million to \$100 million, and notes that all recent entrants to dairy markets who have established plants have built plants with 200 million litres of capacity.⁸⁵ In contrast, Kaimai submitted that establishing pasteurisation capability is not a significant cost.⁸⁶
 158. The Commission understands that Grate Kiwi was referring to a plant that could process raw milk into powder or cheese, whereas Kaimai was referring to the establishment of pasteurisation facilities only. For Kaimai, or other parties who use pasteurised milk for their downstream products, the establishment of pasteurisation capabilities in addition to their existing plant may not be a significant cost. However, for the likes of Grate Kiwi, who would need to process from the raw milk stage through to cheese, the cost of such a plant may be prohibitive.
 159. The Commission considers that the cost of a specialist processing facility, which involves a sunk cost, represents a barrier to entry. That means that under Option 1, the number of competitors in dairy markets may be relatively limited. Option 1 would in turn potentially limit the variety and breadth of products available in dairy markets.
 160. In terms of the principle that the Commission is required to consider (that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets), because Option 1 encourages the

⁸⁵ Grate Kiwi's submission on the Consultation Document, response to question 2.

⁸⁶ Kaimai's submission on the Consultation Document, page 8, paragraph 34.

development of a secondary market for pasteurised milk, access to dairy goods (other than raw milk) by independent processors (who then use them to compete in dairy markets) is promoted.

161. NZDL submitted that independent processors who do not physically process raw milk do not require access to raw milk. Rather, they require access to dairy products in a semi-processed state for further processing. NZDL submitted that there would be alternative suppliers of those products if investment in raw milk processing assets is encouraged.⁸⁷ The Commission agrees with that assessment. However, because of the restriction Option 1 places on access to raw milk, the Commission is of the view that this option does not generally promote the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.
162. Because Option 1 involves a potentially significant barrier to entry, and the number of competitors in dairy markets would be relatively limited, Option 1 would be less likely than the other options to promote workable competition and is not consistent with the promotion of efficiency.
163. The Commission therefore considers that an interpretation requiring that an independent processor be limited to a person that undertakes the initial processing step on the regulated milk themselves, using its own plant, equipment, and labour, is not the interpretation that best gives effect to the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets. There are insufficient contextual and purposive indicators to justify a departure from the words used in the definition, which includes processors of milk, milksolids or dairy products, not just raw milk.

Option 2

164. Under Option 2, an independent processor must, at a minimum, physically process in its own facility all of the regulated milk at some stage in the production process. The balance of the processing may be done through toll-processing arrangements. Under this option, the Commission considers that Grate Kiwi would be an independent processor (given the Commission's view that cutting or grating cheese constitutes a processing step). Under this option, Kaimai would only be an independent processor to the extent that it undertakes a processing step on the products into which the regulated milk is made, which would mean it is only entitled to regulated milk for its soft cheese products and not its hard cheese products (which are entirely toll-manufactured by Open Country).
165. Given the Commission's conclusion that the "substantive" aspect of the meaning of "processor" is simply adding value to a product, the threshold that a processor would have to meet to qualify as an independent processor under Option 2 is fairly low. Provided that the independent processor does something itself to add value to all of the raw milk, milksolids or dairy products in at least one processing stage, then the remainder of the processing could be done through toll-processing arrangements.
166. Submissions and cross-submissions received on the Consultation Document argued that in order to meet the requirement that *all* of the milk, milksolids or dairy products

⁸⁷ NZDL's submission on the Consultation Document (15 April 2009), response to question 1(c).

be processed, an independent processor would have to take and process any by-products that are created in the production process (for example, whey, which is created in the cheese-making process). Those submissions highlighted that the requirement that *all* of the milk be own-processed at some stage is too prescriptive. Option 2 was only intended to require that all of some component of the regulated milk be processed by the independent processor itself at some stage.

167. Fonterra submitted that if an independent processor under Option 2 is not required to take and process any by-products, like whey, then the independent processor “could not be said to own-process all the milk and there would be a further ability to undermine the regulations.”⁸⁸ Fonterra suggested that a manufacturer of biofuel or vodka could arrange for the fat, protein and lactose components of raw milk to be separated by a toll-processor. The manufacturer could then own-process the lactose into biofuel or vodka and on-sell the fat and protein content of the milk. The Commission considers that such a company may be excluded from the definition of “independent processor” by defining the product aspect of the interpretation, as referred to in paragraph 64. However, as previously stated, the product aspect is not at issue in this Determination.
168. Option 2 may be likely to result in the establishment of new processing capacity that would endure after the Regulations are revoked, since it requires investment in processing assets for use in at least one stage of production.
169. Compared with Option 1, Option 2 may not promote competition at the farm gate to the same extent. Option 2 requires investment in processing assets for use in at least one stage of production, but because those assets are not necessarily the assets required for the initial processing stage, processors may still need to rely on third parties to toll-process the milk at the initial stage. That means independent processors may be less likely to engage their own supply when compared with Option 1 because their ability to process the milk may be dependent on the spare capacity of third-party processors being available. On the other hand, the Commission considers that overall demand for raw milk would be likely to increase if Option 2 was adopted, and to the extent that demand for regulated milk exceeds supply, that may ultimately lead to an increase in competition at the farm gate.
170. Option 2 imposes a barrier to entry to the extent that it requires some investment in specialist processing assets, which involve sunk costs, for use in at least one stage of production (though that barrier is not as significant as under Option 1). As a result, the number of competitors in dairy markets may be slightly fewer than under Option 1, and Option 2 may in turn potentially limit the breadth and variety of products available in dairy markets. Again, that effect may not be as marked as under Option 1, as a step as minimal as packaging could qualify a party for regulated milk under this interpretation.
171. In terms of the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets, Option 2 may promote access to dairy goods other than raw milk by independent processors who then use them to compete in dairy markets. However, because Option 2 still places some restriction on access to raw milk, the Commission is of the view that Option 2 is not the interpretation that best promotes the principle that independent

⁸⁸ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.9(a)(iv).

processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

172. Because Option 2 involves a barrier to entry, and the number of competitors would accordingly be limited, Option 2 would be less likely than an option with fewer barriers to entry to promote workable competition and is not consistent with the promotion of efficiency.
173. The Commission considers that an interpretation that requires that the processor processes all of the milk itself at some point is not the interpretation that best gives effect to the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

Option 3

174. Under Option 3, an independent processor must, at a minimum, physically process in its own facility some portion of the regulated milk at some stage in the production process. The balance of the processing at that stage, and for all of the regulated milk at all other stages, may be done through toll-processing arrangements. Under this option, both Kaimai and Grate Kiwi would be independent processors.
175. Given the Commission's conclusion that the "substantive" aspect of the meaning of "processor" is simply adding value to a product, then the threshold that a processor would have to meet to qualify as an independent processor under Option 3 is low. Provided that the independent processor does something itself to add value to even a small proportion of the raw milk, milksolids or dairy products, then the remainder of the processing could be done through toll-processing arrangements.
176. Option 3 may result in the establishment of new processing capacity that would endure after the Regulations expire, but the potential for this to occur appears to be fairly limited. It only requires investment in processing assets for use in at least one stage of production for only some of the milk, milksolids or dairy products, which could be a very small proportion of the regulated milk or the products derived from it.
177. Option 3 would not be likely to promote competition at the farm gate to the same extent as the options already discussed. Because the assets in which investment is required may relate only to one stage of production (and not necessarily the initial processing stage), and possibly to only some of the milk, independent processors may be less likely to engage their own supply of milk. The ability of independent processors to process the milk may be dependent on the spare capacity of third-party processors being available, more so than under Option 2. On the other hand, the Commission considers that overall demand for raw milk would be likely to increase if Option 3 was adopted, and to the extent that demand for regulated milk exceeds the supply, that may ultimately lead to an increase in competition at the farm gate.
178. Option 3 does not impose a significant barrier to entry because it only requires some investment in processing assets for use in at least one stage of production. Therefore, even if those assets are specialist in nature and their associated costs are sunk costs, any barrier to entry is minimal. As a result, Option 3 is likely to result in a greater number of competitors in dairy markets than options 1 or 2. It is therefore likely to result in more workably competitive markets than options 1 or 2 and is consistent with the promotion of efficiency.

179. Option 3 also leaves markets to determine how independent processors can operate most efficiently, to a greater extent than under options 1 and 2, so that milk, milksolids or dairy products produced by independent processors compete effectively with Fonterra in downstream markets. It leaves independent processors free to focus on the particular stage(s) of processing where they have the greatest competitive advantage, and can therefore be most efficient and competitive.
180. Fonterra submitted that it thought there was no real difference between selling raw milk to a third party, who would process it and sell it, and having a third party toll-process the raw milk and sell it. It submits that it is difficult to see how the milk is being used to compete in dairy markets in either scenario.⁸⁹ In the Commission's view, the difference is in who takes the risk on the purchase of the raw milk and the sale of the final products. Once raw milk is on-sold, the risk passes from the vendor. If an independent processor is paying another party to toll-process milk for it, then that independent processor will still take the risk on the sale of the end-products into the dairy markets in which it competes, as the independent processor would maintain ownership of that milk until the final product is sold.
181. In terms of the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary to compete in dairy markets, Option 3 may promote access to dairy goods other than raw milk by independent processors who then use them to compete in dairy markets. However, because Option 3 still places some restriction on access to raw milk (though to a lesser extent than the options already discussed), the Commission is of the view that Option 3 is not the interpretation that best promotes the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.
182. The Commission considers that an interpretation that requires that the processor processes some of the milk itself at some point is not the interpretation that best gives effect to the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

Option 4

183. Under Option 4, an independent processor must process all of the regulated milk at all stages of the production process, either in its own facility, or by toll-processing. This option would allow all of the processing to be done through toll-processing arrangements. Again, under this option, both Kaimai and Grate Kiwi would be independent processors.
184. Option 4 is likely to result in the greatest possible number of competitors in dairy markets, as it imposes the lowest barriers to entry in that, at the extreme, it does not require investment in any processing plant. It is therefore the option that is most likely to result in workably competitive markets and is most consistent with the promotion of efficiency.
185. Option 4 is the least likely of the four options to directly encourage farm gate competition. However, Option 4 would ultimately promote competition at the farm gate. As Option 4 has the lowest barriers to entry of all the options, it should thereby

⁸⁹ Fonterra's submission on the Consultation Document (17 April 2009), paragraph 4.16.

encourage entry into dairy markets, which may in turn encourage farm gate competition.

186. Fonterra suggests that Option 4 would lead to a swamping of demand for regulated milk. The Commission agrees that any new entry will increase the overall demand for regulated milk and put pressure on the overall cap. This is caused not by the interpretation of what is meant by “independent processor”, but by the existence of the cap. Any of the options could see pressure on the cap at some point. The cap, together with the fact that the Regulations will be revoked, is likely to encourage independent processors to develop own-supply arrangements, resulting in competition at the farm gate. Independent processors have to consider from where they would purchase raw milk when Fonterra’s obligation to supply regulated milk ceases. This may mean that they look for their own farmer suppliers, or may mean that they purchase milk or derived products from other independent processors, who would then need to source more milk directly from farmers to supply those parties. Either way, competition at the farm gate will be promoted.
187. The Commission considers that the number of new entrants who could rely on toll-processing arrangements for all steps in the production process will be limited by the spare capacity in the industry. Kaimai’s submission suggested that there is not a significant amount of spare processing capacity in the industry at present.⁹⁰ The Commission considers that potential new entrants who currently intend to establish new processing capability are unlikely to change their plans and rely on toll-processing as a result of this Determination. Because the Regulations are likely to be revoked in the medium-term, the effect of any of the options on decisions to establish new processing facilities is relatively limited.
188. There is an argument that Option 4 will not necessarily encourage the establishment of new processing capability that will endure beyond the Regulations. There is a counter-argument, however, that if independent processors who process by toll-processing arrangements lead to a demand for more processing services, then the establishment of new processing facilities may be encouraged.
189. NZDL submitted that the adoption of Option 4 would allow Fonterra, through entering into toll-processing arrangements with other parties, to secure access to some or all of the regulated milk available, in direct contradiction with the purpose of the Act and Regulations. NZDL submitted that if Fonterra acted as a third-party processor, that has the potential to undermine competition and place Fonterra in a position of greater dominance in the dairy industry.⁹¹
190. NZDL also submitted that under Option 4, NZDL could restructure its relationships with customers in New Zealand and overseas who currently purchase downstream products so that it would toll-process regulated milk for them into the downstream products that they currently purchase.
191. Fonterra similarly argued that Option 4 would not promote new entry, but would encourage the reconfiguration of existing contractual supply arrangements in order to take advantage of the price of regulated milk.⁹² Such arrangements would mean that

⁹⁰ Kaimai’s submission on the Consultation Document (16 April 2009), paragraph 64.

⁹¹ NZDL’s submission on the Consultation Document (15 April 2009), paragraph 6(ii) and response to question 6; NZDL’s submission on the Draft Determination (31 October 2008), paragraph 2(ii) under “Submission”.

⁹² Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.27(c).

the customers were “independent processors” as they would have milk, milksolids, or dairy products processed through toll-processing arrangements.

192. The Commission considers that it is possible that such restructuring could take place. The purchasers of downstream products would only be incentivised to do so if the regulated price of milk plus the cost of toll-processing is less than the price at which they currently purchase products. That has more to do with the level at which the regulated price is set, which is beyond the scope of this Determination, than the scope of the definition of “independent processor” and accordingly the entitlement to regulated milk, with which this Determination is concerned.
193. The Commission is aware that some consider that there is an arbitrage opportunity at the moment in that the price of regulated milk is regarded by some to be below the market price for raw milk. However, if that is the case, the Commission might have expected to see at least some instances of this being used to advantage by parties on-selling the regulated milk in its raw state. MAF submitted that it is not aware of this occurring, other than in relation to distressed milk.⁹³
194. If Fonterra is the lowest-cost toll-processor, then having it carry out processing that it can do more efficiently than other market participants must contribute to the efficient operation of dairy markets. Of course, cost may not be the only consideration; the quality of products may also be important to purchasers in some cases, together with the need for persons competing with Fonterra in downstream markets for dairy products to offer a differentiated product. Whatever the mix of cost and quality that customers are looking for, Fonterra (as well as other potential toll-processors) will have an incentive to provide the mix that its customers want. This should enhance competition between Fonterra and other potential toll-processors.
195. In addition, it is important to bear in mind that Fonterra could act as a third-party processor of regulated milk, or products derived from regulated milk, under any of the interpretations (especially options 2, 3 and 4). It is therefore not a consideration that assists the Commission in determining which of options 2, 3, and 4 is the most appropriate interpretation.
196. Finally, an important restriction on the ability of purchasers to restructure their contracts in the way Fonterra anticipates is the “product” aspect of the definition of independent processor. The Commission’s preliminary view is that it favours, in circumstances where an independent processor intends to process a product by toll-processing, an interpretation requiring that the end product of the relevant part of the production process must be milk, milksolids, or dairy products.⁹⁴
197. The Commission does not consider it inherently wrong for parties to restructure their arrangements to arbitrage any difference between the cost of the regulated milk plus the cost of toll-processing, and the cost of purchasing the end product. It does not regard that as an abuse of the Regulations. Allowing such parties access to raw milk still assists them in competing in dairy markets.
198. Option 4 also leaves markets to determine how independent processors can operate most efficiently, so that milk, milksolids or dairy products produced by them compete effectively with Fonterra in downstream markets. It leaves independent processors free to arrange their businesses in the most efficient and competitive manner. Their

⁹³ MAF’s submission on the Consultation Document (17 April 2009), paragraph 23.

⁹⁴ Refer to footnote 49 above.

business structures should not need to be altered based upon whether the milk being processed is regulated milk or other milk.

199. The Commission's view is that it is good common sense, and economic sense, for a person to have products manufactured through a toll-processing arrangement for any parts of the production process where that person does not have comparative advantage. Option 4 would result in participants undertaking the activities in which they do have a comparative advantage, which is conducive to efficiency.
200. In terms of the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets, Option 4 promotes access to dairy goods other than raw milk by independent processors who then use them to compete in dairy markets. That is because Option 4 imposes minimal barriers to entry.
201. Some submissions objected to Option 4 on the basis that it would allow persons with no commitment to the dairy industry, who have made no investment in processing themselves, and who have only a toll-processing contract and a logo, to be supplied with regulated milk.⁹⁵ The Commission does not consider that to be an issue. Any person entering the market will take the risk associated with selling its products. It is the nature of business that businesses will come and go, and not all businesses must endure to produce efficient markets.
202. Furthermore, the Commission does not consider that there is a real prospect of 100% toll-processing of regulated milk occurring on a wide-spread basis. There are risks associated with basing a business plan on regulated milk, the supply of which will cease when the Regulations are revoked. It would not be rational, either, for a toll-processor to offer up significant processing capacity to process such regulated milk, knowing that it would be left with excess capacity when the supply of that milk ceased.
203. For completeness, the Commission records that a further example in the Consultation Document referred to an Australian company that establishes an office in New Zealand, and purchases 50 million litres of regulated milk. The company then contracts with a third party to pasteurise the milk, which it processes into cheese and packages with the company logo. The company then sells the cheese in Australia. Although it is not necessary for the Commission to decide in the context of the current disputes whether such a company would be an independent processor under the Regulations, its preliminary view is that such a company would fall within the meaning of "independent processor", because it would contribute to the efficiency of dairy markets in New Zealand. The company would be involved in a stage of processing in New Zealand, and would be promoting competition in the provision of toll-processing services. There would be likely to be incentives on the Australian company, and on the toll-processor, to keep the costs of production down, resulting in workable competition.
204. The Commission considers that an interpretation that allows an independent processor the freedom to toll-process (or not) some or all of the production process for milk, milksolids, or dairy products best gives effect to the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

⁹⁵ See for example Serra Natural Foods' submission on the Draft Determination (29 October 2008), paragraph 4.

Legislative history

205. The Commission considers that its view as to the interpretation of “independent processor” is also the interpretation that is most consistent with the legislative history. The interpretation maximises the performance of the dairy industry by allowing flexibility in its structure to adapt to changes. It should facilitate the emergence of new competition and new strategies. It should also limit the potential for parties in the dairy industry (farmers, consumers, and other businesses) to be adversely affected by Fonterra’s monopoly power. The promotion of competition through minimising the barriers to entry into dairy markets should increase pressure on the industry as a whole to be efficient and encourage the development of new products. These goals are all referred to in the Explanatory Note to the Act and Regulations.

Conclusion - application of the meaning of “independent processor” to the disputes

206. The Commission has considered the plain or ordinary meaning of the definition of “independent processor”, the context of the definition, and the purpose of the Act and Regulations, and in particular the purpose and the principle that the Commission is specifically directed to consider in determining disputes. The Commission considers that the most appropriate interpretation is one that requires an independent processor to process all of the regulated milk at all stages of the production process, either by processing it itself in its own facility, or by toll-processing.
207. The Commission is of the view that Kaimai and Grate Kiwi are “independent processors” under the Regulations and are entitled to be supplied with regulated milk by Fonterra.
208. Kaimai and Grate Kiwi consider that the most efficient way of structuring their operations is to contract out some or all of the stages of processing of milk into cheese. Both companies are processors of milk, milksolids or dairy products and have demonstrated a commitment to the dairy industry.

Supply to a nominated delivery address

209. Having determined that Kaimai and Grate Kiwi are “independent processors” under the Regulations and are accordingly entitled to receive regulated milk from Fonterra, the next issue is whether or not Fonterra is required to deliver the milk to premises other than that of the party requesting the milk. As mentioned, Kaimai and Grate Kiwi have requested that Fonterra deliver their regulated milk entitlement to the premises of Open Country, rather than to Kaimai and Grate Kiwi’s respective own premises.
210. Regulation 4(1) simply provides that Fonterra “must supply milk to independent processors”.
211. The Commission must therefore determine whether the meaning of the words “supply... to...” in the context of regulation 4(1) includes the supply of milk to a nominated delivery address.

Ordinary meaning

212. The Commission’s preliminary view, as set out in the Draft Determination, was that the plain meaning of “supply... to...” is that Fonterra must make raw milk available (or provide it) to an independent processor that requires or demands it. The Commission’s preliminary view was that the regulatory supply obligation is to the

- person that owns the raw milk, and that does not preclude receipt on the owner's behalf by a third party contracted by the owner to carry out some processing.
213. The Act and Regulations do not expressly provide for, or prohibit, the delivery of regulated milk to a nominated delivery address that is not the address of the premises of the relevant independent processor.
214. The word “supply” is not defined in the Act or Regulations. The dictionary⁹⁶ defines “supply” as to:
- make (something needed) available to someone. provide with something needed. be adequate to satisfy (a requirement or demand).
215. The dictionary definition is unclear as to whether supply may be carried out through delivery at a nominated address. The breadth of the definition could support a broad interpretation that includes making milk available, or providing it to a person in whatever manner that person specifies.
216. Fonterra submitted that the Regulations only require supply “to” the independent processor that ordered the regulated milk, and that that reinforces Fonterra’s primary submission that the Regulations are designed to make raw milk available to processors who are able to process it.⁹⁷ The latter argument has already been addressed in the analysis of “independent processor” in the preceding section. The analysis in this section focuses solely on the question of whether the supply obligation includes supply to a nominated delivery address.
217. Fonterra submitted that the Commission conflates the right to ownership, and the right to delivery, when the two concepts are entirely different. It submitted that Fonterra’s delivery obligations are separate from the independent processor’s ownership rights, and the delivery obligation is neither consistent nor inconsistent with the ownership rights.⁹⁸ Kaimai and Grate Kiwi consider that Fonterra is obliged to supply them with raw milk and that they can nominate a delivery address.
218. Grate Kiwi submitted that a party purchasing milk is able to specify where it is to be delivered; that to “supply” milk is something that occurs in relation to the party that requests and pays for the milk, and delivery can be specified by the person being supplied and “can be anywhere”.⁹⁹
219. Kaimai submitted that “[o]rdinary commercial practice is such that a purchaser of goods can stipulate a delivery point in its order. There is no justification for an interpretation that delivery must be to facilities owned by the purchaser.”¹⁰⁰
220. The Commission agrees with Fonterra that a requirement to deliver milk, and the ownership of the milk, are distinct concepts. However, the distinction between delivery and ownership does not assist the Commission in determining the ordinary meaning of the “supply” obligation.
221. Since the meaning of “supply... to...” is silent as to whether the milk could be delivered to an address nominated by the purchaser, context and purpose are essential guides to meaning¹⁰¹ in this case.

⁹⁶ As taken from the *Concise Oxford English Dictionary* (11th edition), Oxford University Press, Oxford, 2006.

⁹⁷ Fonterra’s submission on the Consultation Document (17 April 2009), paragraph 2.30.

⁹⁸ Fonterra’s submission on the Draft Determination (31 October 2008), paragraph 4.4(a).

⁹⁹ Grate Kiwi’s Application for Dispute Determination (14 July 2008), paragraph 3.3.

¹⁰⁰ Kaimai’s Application for Dispute Determination (25 June 2008), paragraph 51.

¹⁰¹ *Commerce Commission v Fonterra Co-operative Group Limited* [2007] 3 NZLR 767, paragraph 24.

Context

222. Fonterra submitted that there are a number of contextual indications that support its view that the Regulations only require supply to the independent processor who has ordered the regulated milk. They have already been referred to by the Commission in the “independent processor” section above. The Commission has the following additional comments as to the significance of the provisions for the supply obligation, as follows:¹⁰²
- the reference in regulation 4(1) to the obligation to “supply milk to independent processors”. Fonterra submits that this supports an interpretation that the raw milk must be delivered to the party that required it, the independent processor. The Commission considers that such an implication could have been made explicit in the Regulations if it had been considered that supply was only to occur to the premises of independent processors. The Commission does not therefore consider that regulation 4(1) is of significant assistance to it in determining whether supply to a nominated address is required by the Regulations;
 - the reference to “the reasonable cost of transporting the raw milk to the independent processor” in regulation 8(5). Fonterra referred to Decision 570,¹⁰³ in which the Commission noted that the reasonableness of transport charges under regulation 8(5) were to be assessed by reference to “the circumstances of the independent processor to whom milk is being delivered”.¹⁰⁴ However, as stated in the Draft Determination, although the use of the definite article could suggest an interpretation providing for supply to the processor’s physical address only, Decision 570 did not discuss whether the circumstances of a particular independent processor could also encompass delivery to a nominated third party address. The Commission considers that regulation 8(5) can be read consistently with the provision of milk to a nominated address; and
 - the reference to Fonterra’s ability to “require an independent processor to contract to notify [Fonterra] of its actual requirement for raw milk by noon on the day before the raw milk is to be supplied” (regulation 10(4)). Again, as mentioned earlier in this Determination (at paragraph 115), the Commission’s view is that this requirement can also be read consistently in relation to a processor that requires milk to be delivered to a nominated address. Such a processor is still capable of having an “actual” requirement for raw milk. It may be that that requirement reflects the availability of processing capacity on the part of the third-party processor to whom an independent processor has requested the milk be delivered, but that does not mean that there is not an “actual requirement” for the purposes of regulation 10(4).
223. The Commission is not able to conclude on the basis of the above contextual indicators that the Regulations were intended to exclude supply of regulated milk to a nominated delivery address. All of the provisions referred to can be read consistently with the proposition that Fonterra’s obligation to supply milk includes delivering the milk to an address nominated by the relevant independent processor.

¹⁰² Fonterra’s submission on the Draft Determination (17 April 2009), paragraph 4.2.

¹⁰³ Fonterra’s supplementary submission (27 August 2009), paragraph 32(b).

¹⁰⁴ *Decision 570: Open Country Cheese Limited/Fonterra Co-operative Group Limited* (23 December 2005), paragraph 163.

224. Therefore, as with the analysis of “independent processor”, the Commission considers that contextual considerations do not provide a great deal of assistance in interpreting the supply obligation in regulation 4(1). The question then arises as to which interpretation best promotes the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

Purpose and principle

225. The Commission’s approach to the purpose element of the statutory interpretation of “supply... to...” is the same as the approach set out in relation to “independent processor”. The Commission must, in determining whether the interpretation of “supply... to...” includes supply to a nominated delivery address, consider the two matters set out in section 125 of the Act:
- the purpose of promoting the efficient operation of dairy markets (section 70); and
 - promoting the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets (section 71(a)).
226. As discussed, purpose is a key driver of interpretation when the ordinary meaning and contextual indicators are not clear, but in this case the importance of purpose is even greater given the statutory direction that the Commission specifically consider it in determining disputes.
227. Kaimai has stated that for Fonterra to “police the ownership of all processing facilities at which raw milk is being delivered could not have been the intent of the Regulations.” Kaimai argues that as the Regulations are silent on this point, regard must be given to industry practice, which is that a purchaser may nominate a delivery point.¹⁰⁵
228. The Commission has considered the relevance of industry practice in relation to whether delivery to a nominated address has occurred. Regulation 10(3) specifically acknowledges that Fonterra or an independent processor may require a contract for supply of raw milk to include terms that are reasonable having regard to industry practice before the commencement of the Regulations. However, the Commission has not identified any evidence of the industry practice, before the commencement of the Regulations, of raw milk being delivered other than to the processor requesting the milk. In any case, apart from regulation 10(3), any industry practice or understanding does not assist in determining the application of the Regulations to the current disputes. Enactments apply to circumstances as they arise.
229. The Commission considers that allowing an independent processor to request that Fonterra deliver raw milk to a nominated delivery address (i.e. the physical address of the third-party toll-processor that will undertake the first step in the processing of that raw milk) is consistent with the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

¹⁰⁵ Kaimai’s Application for Dispute Determination (25 June 2008), paragraph 51.

230. An interpretation that required Fonterra only to supply regulated milk to an independent processor at its physical address would frustrate the ability of that processor to arrange for the first stage or stages of processing to be efficiently carried out by a toll-processor. For the reasons already discussed, the Commission considers that an interpretation of the Regulations that allows independent processors the greatest flexibility in arranging for the processing of the milk is most consistent with the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.
231. The Commission therefore considers that an interpretation of the supply obligation that allows delivery to a nominated address is most consistent with the purpose of the promotion of the efficient operation of dairy markets in New Zealand, and the principle that independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets. It leaves independent processors free to arrange their businesses in the most efficient and competitive manner, and the absence of a specific requirement as to where the milk must be delivered should enhance the ability of independent processors to compete in dairy markets.

Conclusion

232. The Commission has considered the plain or ordinary meaning of “supply... to...”, the context of the definition, and the purpose of the Act and Regulations, and in particular the purpose and the principle that the Commission is specifically directed to consider in determining disputes. The Commission considers that the most appropriate interpretation is one that allows independent processors to require that regulated milk be delivered to a nominated delivery address, whether that is the processor’s own premises, or the premises of a toll-processor who will process the milk on behalf of the independent processor.
233. For the reasons set out in relation to “independent processor” above, that interpretation is also most consistent with the legislative history.
234. The Commission is of the view that Kaimai and Grate Kiwi, as independent processors, can request that Fonterra deliver Kaimai’s and Grate Kiwi’s regulated milk to the premises of Open Country.

COMMISSION’S DETERMINATION

Decision on the Matters in Dispute

235. Section 126(1)(a) of the Act requires the Commission to state its decision on the matters in dispute.
236. The Commission’s decision is that Kaimai and Grate Kiwi are independent processors for the purposes of regulation 4(1) of the Regulations. Fonterra must supply regulated milk to Kaimai and Grate Kiwi on request, to the delivery addresses that Kaimai and Grate Kiwi nominate, subject in particular to regulations 5 to 15 of the Regulations as well as compliance with all other aspects of the Regulations.

Has a Breach Occurred?

237. Section 126(1)(b) of the Act requires the Commission to state clearly whether a breach of subpart 5 of Part 2 of the Act, or any regulations made under section 115 of the Act, has occurred.
238. Kaimai and Grate Kiwi both submitted estimates to Fonterra of their raw milk requirements for October 2008 as required by regulation 6(2), and requested delivery of the regulated milk to Open Country's premises.¹⁰⁶
239. Kaimai and Grate Kiwi requested to be supplied with milk in October because they considered that the effect of the October Rule would be that if they did not require any milk in October, they would not be entitled to request milk for the remainder of the season. (The Commission's view is that requiring milk to be supplied in October, but not necessarily actually being supplied with that milk, would have been sufficient to entitle them to require milk for the rest of the season.)
240. Initially, Fonterra wrote to Kaimai and Grate Kiwi (separately) stating that if Fonterra is required to deliver raw milk to Open Country's (or any other independent processor's) facility, then Fonterra would count that milk as part of the regulated milk allocation of Open Country (or the other independent processor) as that processor would be processing the raw milk.
241. Fonterra subsequently offered, after the release of the Draft Determination, to supply Kaimai and Grate Kiwi with raw milk in October at the regulated price on the basis that if either was found in the Final Determination not to be an independent processor, then the relevant company would be required to pay the difference between the default milk price and a "fair and reasonable market price", which was not specified. In earlier correspondence with Kaimai and Grate Kiwi, Fonterra had suggested that the price for the milk, if Kaimai and Grate Kiwi were found not to be independent processors, would be "the market price during October" (then [] per kilogram of milksolids excluding GST). This compared to a default milk price at the time which was estimated to be around [] per kilogram of milksolids, meaning that Fonterra's suggestion of a fair market price was approximately []% higher than the regulated price.¹⁰⁷
242. Grate Kiwi elected not to be supplied with milk by Fonterra for October, or any other month since then, because it was not prepared to run the risk associated with the price of the milk, should it be found not to be an independent processor. Grate Kiwi submitted that the price risk implied by Fonterra's stance equated to in excess of [] for the month of October alone.¹⁰⁸ Grate Kiwi stated that that amount approximately equals Grate Kiwi's earnings before interest and tax in a good year, and as such was clearly not a risk that it could afford to take.¹⁰⁹

¹⁰⁶ Email from Wyatt Creech to the Commission (20 August 2008); email from Grate Kiwi to the Commission (29 September 2009).

¹⁰⁷ Fonterra's submission on the Draft Determination stated that the Fonterra offered to supply Kaimai and Grate Kiwi during October, and that the price should be the regulated price, as it was directed or ordered to do so by the Commission in its preliminary decision. The Commission does not accept that the effect of the Draft Determination was to order or direct Fonterra to undertake any particular course of action. The purpose of the Draft Determination was to set out the Commission's preliminary views as to the determination of the disputes.

¹⁰⁸ Grate Kiwi's submission on the Draft Determination (23 October 2008). Grate Kiwi noted that it based this calculation on an assumption that the raw milk provided would contain 8.5% milksolids, which is an approximate figure.

¹⁰⁹ Grate Kiwi's submission on the Draft Determination (23 October 2008).

243. Kaimai decided to take milk from Fonterra in October 2008 as it wished to protect its entitlement to regulated milk for the remainder of the season, should it be found to be an independent processor. Kaimai commenced taking supply on 6 October 2008 and ceased on 2 November 2008. The terms on which the milk was supplied are not clear. Kaimai's view is that, since Kaimai requested the milk on the basis that it was being provided at the default milk price, Fonterra's supply of the milk meant that Fonterra accepted that the regulated price applied. Fonterra's view is that it supplied the milk on the basis that if the Commission determined that Kaimai was entitled to milk under the Regulations, the regulated price would apply; and if the Regulations did not apply, then the milk would have been supplied without any agreement as to the price (and a court would determine a fair and reasonable price, or market price).
244. Neither of the offers of supply set out in paragraphs 240 and 241, nor the actual supply to Kaimai (at Open Country's premises, from 6 October 2008 until 2 November 2008) were consistent with the Regulations. The Commission therefore determines that Fonterra, notwithstanding its offer to supply both Kaimai and Grate Kiwi with raw milk nor its supply of raw milk to Kaimai, breached the requirement in regulation 4(1) to supply raw milk to Kaimai and Grate Kiwi as independent processors, in accordance with the Regulations, from 1 October 2008 to 30 April 2009.

Terms and Conditions and Compensation

245. Sections 126(1)(d) of the Act requires the Commission to include the terms and conditions on which the determination is made. Section 126(1)(e) states that the Commission must specify the actions that a party to a determination must do or refrain from doing, which may include (without limitation) payment of compensation by one party to the other.
246. The Commission has already stated that Fonterra must supply regulated milk to Kaimai and Grate Kiwi on request, subject in particular to regulations 5 to 15 of the Regulations as well as compliance with all other aspects of the Regulations. Fonterra must deliver the regulated milk requested by Kaimai and Grate Kiwi to the delivery address or addresses that Kaimai and Grate Kiwi nominate.
247. The Commission determines that Fonterra must pay compensation to Kaimai and Grate Kiwi to compensate them for the loss associated with the fact that they did not receive regulated milk from 1 October 2008 until 30 April 2009, in light of the Commission's view that they were entitled to receive that milk.
248. Kaimai submitted, in a supplementary submission prior to the Draft Determination, that any decision related to this matter "should as much as is practicable leave the applicant (Kaimai) in the same commercial position" it would have been in, had it purchased milk under the regulations from 1 October 2008.¹¹⁰
249. The Commission agrees that orders for compensation should attempt to restore the parties to the position that they would have been in had they been purchasing regulated milk from 1 October 2008 until 30 April 2009.
250. Kaimai and Grate Kiwi both advised that they have incurred costs in purchasing their relevant input products, over and above the costs they would have incurred by purchasing regulated milk from Fonterra and having it toll-processed into the relevant input products. Kaimai and Grate Kiwi are entitled to compensation from Fonterra to

¹¹⁰ Kaimai's supplementary submission (5 September 2008), page 4.

reimburse them for any additional costs incurred by purchasing input products, rather than having those input products toll-processed from regulated raw milk.

251. The Draft Determination invited submissions from the parties outlining whether they considered that compensation was appropriate and why, and a suggested method for calculating any such compensation.
252. In submissions on the Draft Determination, Kaimai said that the process has given rise to cost and uncertainties for Kaimai, but did not attempt to quantify those costs.
253. Grate Kiwi submitted that it estimates the “profitability of default milk is [] per kgMS (at the EBIT line).”¹¹¹ Grate Kiwi multiplied these values by the quantity of kilograms of milksolids it required from Fonterra in October and estimated a loss of profits in October 2008 of [].
254. No other submissions as to compensation were received from Kaimai, Grate Kiwi, or Fonterra.
255. The differing circumstances of Kaimai and Grate Kiwi may bear on the process that should be followed in considering the appropriate level of compensation.

Kaimai

256. Kaimai’s estimate for October was for [] litres of milk. Kaimai was supplied with [] litres of milk by Fonterra in October, and an additional [] litres in the first two days of November. Although Kaimai purchased milk in October, it did not commence purchasing until 6 October 2008, due to the delay imposed by the determination process. The Commission considers that the calculations of what would have been purchased for the remainder of the season should be based on Kaimai’s October forecast of [] litres. The monthly entitlement of Kaimai to regulated milk for the rest of the season would have been limited by the amount it forecast for October plus 10%. The Commission considers that it is reasonable to base the amount of compensation on the October 2008 forecast being repeated for each remaining month of the season, subject to Kaimai’s internal budgets confirming its intention to purchase such volumes.
257. Since Kaimai ceased taking supply of raw milk from Fonterra, Kaimai has purchased pasteurised milk from Open Country for processing into soft cheese, and purchased hard cheese from Open Country to sell under the Kaimai label.
258. Kaimai submitted, prior to the Draft Determination, that “[t]he volume of milk purchased would finally depend on how long after 1 October the Determination is finalised. To the extent it reduced milk purchases, the business arising from the processing and selling of that milk would be lost.”¹¹² This submission suggests that the variation in the input costs may have affected the volume of production for Kaimai, which may have led to losses beyond those that would be covered by a measurement of the difference in the cost of purchasing regulated raw milk and toll-processing it into pasteurised milk and cheese, and the cost of purchasing pasteurised milk and cheese.
259. In Kaimai’s case, any changes in the level of production due to a change in the cost of its inputs would affect its entire production, because its entire production was to be based on regulated milk. Therefore, a comparison could be made of its anticipated

¹¹¹ Grate Kiwi’s submission on Draft Determination (23 October 2008), page 2.

¹¹² Kaimai’s supplementary submission (5 September 2008), page 3.

levels of production and its actual levels of production for the relevant time period. In order to take into account any variation in production levels in calculating compensation, the variation would need to be shown to have resulted from Kaimai's lack of supply of regulated milk.

260. The Commission has considered whether a discount factor should be applied to a calculation of the compensation owed to Kaimai to take account of the fact that Fonterra supplied Kaimai with raw milk from 6 October 2008 to 2 November 2008, and offered to continue that supply for the remainder of the relevant term. The Commission considers that it was reasonable for Kaimai to refuse the offer of continued supply from Fonterra. The terms on which Fonterra supplied Kaimai in October and on which it would have continued to supply Kaimai would have exposed Kaimai to significant financial risk. This risk was made apparent by the approximately []% price differential between Fonterra's suggested market price and the estimated default milk price at the time. That price differential suggests that the offered price would have been unprofitable for Kaimai. Although the correspondence on the matter finally suggested that a court could decide on the fair market price, any price determined by a court would have been uncertain. The Commission has therefore determined that no discount for Kaimai's refusal to accept the offer should be applied in these circumstances.
261. The Commission orders that Kaimai and Fonterra should use their best endeavours to agree on an appropriate amount of compensation, taking into account:
- the amounts that would have been paid by Kaimai to Fonterra for its forecast volumes of regulated milk, based on its October 2008 forecast being repeated for the subsequent relevant months, subject to proof of Kaimai's intention at a board level, in the form of internal documentation, to purchase such volumes;
 - the amounts that Kaimai would have paid to toll-process that regulated milk into pasteurised milk and cheese;
 - the costs that Kaimai actually incurred in purchasing pasteurised milk and cheese;
 - any changes in Kaimai's volume of production that are directly attributable to its lack of receipt of raw milk at the regulated price from 1 October to 5 October 2008, and from 3 November 2008; and
 - any other factors that the parties consider bear on the appropriate amount of compensation.
262. In addition, the Commission orders Fonterra to pay Kaimai interest (at the prevailing 90 day Bank Bill Rate) on the amount of compensation calculated. Interest should apply from the date of each payment for the relevant input products (or the date the loss was suffered) to the date of the actual payment of compensation.
263. If Kaimai and Fonterra are unable to agree on the final amount of compensation, either party may apply to the Commission for a decision on the appropriate level of compensation. Any such application for a decision should be made no later than three months from the date of this Determination and should be accompanied by:
- evidence of the amount that would have been paid by Kaimai to Fonterra for its forecast volumes of regulated milk;
 - evidence of the amount that Kaimai would have paid to toll-process that regulated milk into pasteurised milk and cheese;

- evidence of the costs that Kaimai incurred in purchasing pasteurised milk and cheese;
- if Kaimai is arguing that the lack of supply affected its production levels:
 - board papers approving the budget and planning the production for the 2008-2009 dairy season; and
 - evidence supporting the fact that a change in production occurred due to the lack of supply of regulated milk;
- supporting evidence of any other factors being put forward by either party; and
- a certificate from two of Kaimai's directors verifying that all information and documents provided to the Commission in support of the application for further directions are accurate.

Grate Kiwi

264. Grate Kiwi required 50 million litres of regulated milk for the 2008/2009 season on 4 March 2008. It followed up that request on 31 March 2008 with monthly forecasts for [] litres for each month from October 2008 through to April 2009.
265. Fonterra outlined its forecasting requirements to Grate Kiwi in a letter of 1 July 2008. It purported to require Grate Kiwi to submit three-month forecasts on the first day of each month. However, in the same letter, Fonterra makes it clear that it considered Open Country to be the independent processor for the purposes of the Regulations. It considered that Grate Kiwi would simply be a customer of Open Country and if Fonterra delivered the raw milk to Open Country, it would count towards Open Country's 50 million litre entitlement.
266. Grate Kiwi informed the Commission that, given that Fonterra had informed it that it was unwilling to supply Grate Kiwi with regulated milk, it did not see the point in providing weekly forecasts. Grate Kiwi stated that it would provide weekly forecasts once it was confirmed that Fonterra has a supply obligation to Grate Kiwi. Grate Kiwi also informed the Commission that although it provided three-month forecasts for October and December, it in error omitted to do so for November 2008.¹¹³
267. In the Commission's view, this omission is unlikely to affect Grate Kiwi's entitlement to compensation. The Commission notes that on one hand, even though the arrangements were not subject to the Regulations, Grate Kiwi had begun providing estimates, which was a practice that might have been expected to continue. In addition, if Grate Kiwi was insisting on Fonterra's compliance with the Regulations, then it should comply with the Regulations itself. On the other hand, it may have been reasonable for Grate Kiwi not to have prioritised the provision of estimates to Fonterra, given that Fonterra had already taken the position that it would not supply Grate Kiwi with regulated milk. The Commission anticipates that the parties may wish to take this into account in agreeing on the appropriate amount of compensation, but the Commission would not expect it to be given undue weight.
268. Grate Kiwi did not take any milk in October 2008. However, as mentioned in paragraph 240, the Commission considers that Grate Kiwi's forecast for October 2008 is sufficient for Grate Kiwi to have "required" regulated milk in October for the purposes of the October Rule in regulation 8(3).

¹¹³ Letter from Grate Kiwi to the Commission (29 September 2008).

269. Grate Kiwi's production exceeds that of the volume that could be made from 50 million litres of regulated milk. Instead of purchasing raw milk during the 2008/2009 dairy season, Grate Kiwi purchased cheese from various sources, including Fonterra, for processing into grated cheese blends and/or blocks, as it had done in past seasons. If it had purchased regulated milk, it would have replaced some of the cheese it purchased with cheese that it had toll-processed from regulated milk. Given this fact, the Commission considers that the likely counterfactual, had Grate Kiwi been supplied with regulated milk, is that it would have taken its forecast volumes.
270. Grate Kiwi submitted on what it considered to be its loss for the month of October 2008. However, Grate Kiwi's calculation of its lost profits (set out at paragraph 253) seems to overstate the size of its loss, because it is based on the total profit per unit of regulated milk. Rather, the estimated loss should be based on the difference in input costs actually incurred and the input costs that would have been incurred using regulated milk.
271. The Commission has considered whether a discount factor should be applied to a calculation of the compensation owed to Grate Kiwi to take account of the fact that Fonterra offered to supply Grate Kiwi with raw milk from 1 October 2008 and Grate Kiwi refused the supply. The Commission considers that it was reasonable for Grate Kiwi to refuse the offer of supply from Fonterra. The terms on which Fonterra would have supplied Grate Kiwi would have exposed Grate Kiwi to significant financial risk. This risk was made apparent by the approximately []% price differential between Fonterra's suggested market price and the estimated default milk price at the time. In fact, Grate Kiwi submitted that the difference in the default price and Fonterra's suggested fair market price, when related to Grate Kiwi's regulated milk requirement for October, equated to its earnings before interest and tax for an entire year. That indicates that the suggested fair market price would have been unprofitable for Grate Kiwi. Although the correspondence on the matter finally suggested that a court could decide on the fair market price, any price determined by a court would have been uncertain. The Commission has therefore determined that no discount for Grate Kiwi's refusal to accept the offer should be applied in these circumstances.
272. The Commission orders that Grate Kiwi and Fonterra should use their best endeavours to agree on an appropriate amount of compensation, taking into account:
- the amount that would have been paid by Grate Kiwi to Fonterra for its forecast volumes of regulated milk, based on its October 2008 forecast being repeated for the subsequent relevant months;
 - the amount that Grate Kiwi would have paid to toll-process that regulated milk into cheese;
 - the costs that Grate Kiwi actually incurred in purchasing cheese; and
 - any other factors that the parties consider bear on the appropriate amount of compensation.
273. In addition, the Commission orders Fonterra to pay Grate Kiwi interest (at the prevailing 90 day Bank Bill Rate) on the amount of compensation calculated. Interest should apply from the date of each payment for the relevant input products (or the date the loss was suffered) to the date of the actual payment of compensation.
274. If Grate Kiwi and Fonterra are unable to agree on the final amount of compensation, either party may apply to the Commission for a decision on the appropriate level of

compensation. Any such application for a decision should be made no later than three months from the date of this Determination and should be accompanied by:

- evidence of the amounts that would have been paid by Grate Kiwi to Fonterra for its forecast volumes of regulated milk;
- evidence of the amounts that Grate Kiwi would have paid to toll-process that regulated milk into cheese;
- evidence of the costs that Grate Kiwi incurred in purchasing cheese;
- evidence of the volume of Grate Kiwi's production from 1 October 2008 to 30 April 2009;
- supporting evidence of any other factors being put forward by either party; and
- a certificate from Grate Kiwi's two directors verifying that all information and documents provided to the Commission in support of the application for further directions are accurate.

Expiry Date

275. The Commission has not specified an expiry date for this Determination under section 126(2) of the Act.

Costs and Pecuniary Penalties

276. Kaimai submitted that it would not be unreasonable to seek a costs award against Fonterra "based on the actions it has taken to deny supply on a normal timely basis" to Kaimai. It also submitted that "the Commission should consider that the operation of the default milk scheme recognises that should Fonterra unreasonably refuse default milk supply it should be liable for damages."¹¹⁴

277. Although the Commission has determined that Fonterra is in breach of the Regulations by not supplying Kaimai and Grate Kiwi in accordance with the Regulations, the Commission has not seen any evidence to persuade it that an order of costs against Fonterra is appropriate.

278. The Commission does not consider that any party has contributed unreasonably to costs or delays associated with this Determination and therefore considers that the parties to this Determination should bear their own costs, in accordance with section 129 of the Act.

279. The Commission does not consider this to be an appropriate case to exercise its discretion to seek a pecuniary penalty under section 141 of the Act.

DATED this 5th day of June 2009

Denese Bates

Denese Bates QC
Chair – Division determining disputes between Kaimai and Fonterra, and between Grate Kiwi and Fonterra

¹¹⁴ Kaimai's submission on Draft Determination (30 October 2008), paragraphs 39 and 42.