

PUBLIC VERSION

**IN THE HIGH COURT OF NEW ZEALAND
WELLINGTON REGISTRY**

CIV 2009-485-1223

UNDER	the Dairy Industry Restructuring Act 2001
IN THE MATTER OF	an Appeal under Section 132 of the Act
BETWEEN	FONTERRA CO-OPERATIVE GROUP LIMITED Appellant
AND	THE GRATE KIWI CHEESE COMPANY LIMITED First Respondent
AND	KAIMAI CHEESE COMPANY LIMITED Second Respondent

Hearing: 2 and 3 February 2010

Counsel: J Every-Palmer and N Hegan for the Appellant
J A MacGillivray for the First and Second Respondents
S Mills QC and B Hamlin for the Commerce Commission

Judgment: 3 March 2010

JUDGMENT OF MILLER J

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Introduction

[1] Fonterra Co-operative Group Limited must supply raw milk to “independent processors” under the Dairy Industry Restructuring Act 2001 and the Dairy Industry Restructuring (Raw Milk) Regulations 2001. The Commerce Commission determined that The Grate Kiwi Cheese Company Ltd and Kaimai Cheese Company Ltd are independent processors, and decided that Fonterra breached the Regulations by not supplying them with raw milk in the 2008-2009 season.

[2] Neither Grate Kiwi nor Kaimai intended to handle the initial processing of the raw milk in their own plants. Fonterra would deliver it to Open Country Cheese Company Limited, which would pasteurise it on their behalf under toll-processing contracts. Indeed, some of the raw milk would not be processed in Grate Kiwi and Kaimai plants at any stage; Open Country would make most of it into cheese which Grate Kiwi and Kaimai would sell in commodity markets. Open Country is an independent processor and buys raw milk in its own right under the Regulations.

[3] Fonterra maintains that Grate Kiwi and Kaimai were not at the time independent processors under the Regulations. The central question is whether a processor must ‘own-process’ the raw milk in its own facilities at the first stage of processing, as Fonterra argues, or whether it may toll-process the milk by subcontracting all or any of the work to another firm, as the Commission decided.

[4] If Grate Kiwi and Kaimai were independent processors, Fonterra also says that it did not breach its supply obligation; specifically, it did not fail or refuse to supply by offering raw milk at the regulated price but on terms, initially, that milk supplied to Grate Kiwi and Kaimai would be deemed part of Open Country's allocation, and subsequently, that they must pay a reasonable price for the milk should the Commission decide they were ineligible to buy it under the Regulations.

The protagonists

[5] Fonterra was created under the Act, which authorised an amalgamation among the major dairy co-operatives in New Zealand. The background was summarised in *Commerce Commission v Fonterra*:¹

[1] ...the Dairy Industry Restructuring Act 2001 ... implemented a substantial restructuring of New Zealand's dairy industry. The Act facilitated the amalgamation of the three main dairy cooperatives in New Zealand. The amalgamated entity was named Fonterra Co-operative Group Ltd Fonterra controls over 98 per cent of milk produced by New Zealand dairy farmers. Its dominance in the relevant market was such that specific authorisation was required for the amalgamation. This was granted by s 7 of the Act. Some regulation of the new entity was seen as necessary. Among the measures introduced was an obligation on Fonterra to supply raw milk to independent processors at a price which, absent agreement, was to be determined by a formula set out in the regulations

[2] 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... (Footnotes omitted)

[6] As the Supreme Court observed, Fonterra began with overwhelming control of the milk produced by New Zealand farmers. A December 2009 report from the Ministry of Agriculture and Forestry states that its national market share of the farm gate milk market was originally 96 per cent and had fallen to 92 per cent by the 2008-2009 season. (The phrase 'farm gate market' denotes the market in which

farmers sell raw or untreated milk to firms such as Fonterra.) The Commission found that Fonterra still processes more than 95 per cent of New Zealand’s raw milk.

[7] Grate Kiwi grates and blends cheese, specialising in large catering sized packs of grated cheese and house brands, and cuts and repackages large blocks of cheese. It does not process raw milk, although it has ambitions to do so. It buys base cheese from Fonterra and Open Country, and processes it in its plant at leased premises in Wiri. Grate Kiwi also sells base cheese in commodity markets, so some of the cheese it buys is never processed at its own plant.

[8] The Commission has prepared a table for purposes of a pending compensation claim, and Mr Every-Palmer gave me a copy without objection. It is a draft prepared for consultation purposes. Grate Kiwi and Kaimai also characterise it as a snapshot, and a conservative one at that. It shows plainly that most of the raw milk supplied by Fonterra in the 2008-2009 season would be processed entirely by Open Country. [.....
.....
.....
.....
.....] Grate Kiwi planned in future seasons to increase the amount of cheese that it blended and processed in its own plant, using the raw milk processed by Open Country.

[9] Kaimai is a speciality cheese producer located at Waharoa in the Eastern Waikato. It processes pasteurised milk in its own plant, making soft cheeses. Open Country, whose premises are located just 400 metres away, supplies most of the raw milk. Kaimai does not process hard cheese itself, but it buys some from Open Country and, like Grate Kiwi, it sells hard cheese in commodity markets. It too planned to handle most of the Fonterra-supplied raw milk in this way in the 2008-2009 season, although its longer term goal was to use the milk to increase its own production of specialty cheeses and it also planned to process raw milk itself; indeed, it has now built the necessary plant. [.....
.....

¹ *Commerce Commission v Fonterra* [2007] NZSC 36, [2007] 3 NZLR 767 (SC).

.....
.....]

[10] Kaimai, Grate Kiwi, and Open Country are not interconnected bodies corporate, but they are related. Dairy Investment Fund Limited holds 28 per cent of Kaimai’s shares, 30 per cent of Grate Kiwi’s, and 10 per cent of the shares in Open Country’s parent company. Mr Wyatt Creech is a director of both Kaimai and Open Country, and Mr Nigel Atherfold is a director of both Grate Kiwi and Open Country’s parent company.

The enactment

[11] Under reg 4(1), Fonterra “must supply raw milk to independent processors”, on terms, as to price and otherwise, set out in the Regulations.

[12] “Independent processor” is defined in the Act. It:²

- (a) means a processor of milk or milksolids or dairy products who is not an associated person of [Fonterra]; and
- (b) includes New Zealand Dairy Foods Limited and any associated person of that company other than [Fonterra]

All definitions in the Act apply unless the context otherwise requires.³

[13] Under the Interpretation Act 1999, a word or expression used in a regulation has the same meaning as it has in the enactment under which it was made.⁴ In this case the Regulations go further, specifying that “independent processor” is defined in the Act.⁵

[14] “Milk” is not defined, but the Regulations define raw milk as “untreated milk from a cow”, indicating that milk includes both treated and untreated or raw milk.⁶

² Section 5(1).

³ Section 5(1).

⁴ Section 34.

⁵ Regulation 3(2).

⁶ Regulation 3(1).

“Milksolids” is defined in the Act as the milk-fat and protein components of raw milk.⁷

[15] Persons are relevantly associated if they are both bodies corporate and they consist of substantially the same shareholders or are under the control of the same persons, or if either of them is able, directly or indirectly, to exert a substantial degree of influence over the activities of the other.⁸

[16] The regulation-making power is found in subpart 5, the purpose of which is to promote the efficient operation of dairy markets in New Zealand.⁹ Subpart 5 is intended to promote certain principles, the first of which is that:¹⁰

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

[17] Subpart 5 contains a suite of provisions directed to supplier (farmer) rights of entry and exit and ensuring that independent processors may acquire raw milk from farmers. Fonterra must accept a new application to become a shareholding farmer.¹¹ Section 97 states: a shareholding farmer who wants to cease or reduce the supply of milk as a shareholding farmer to Fonterra may give notice of withdrawal,¹² and succeeding provisions ensure that the surrender value of the farmer’s shares and peak notes is not affected by withdrawal. Fonterra may not discriminate between shareholding farmers and new entrants.¹³ Supply contracts for raw milk are regulated; Fonterra may offer contracts for terms longer than one season, but under s 107(3) it must:

... ensure that, at all times, 33% or a greater percentage of the milksolids produced within a 160 kilometre radius of any point in New Zealand—

- (a) is supplied under contracts with independent processors; or
- (b) is supplied under contracts with new co-op that—

⁷ Section 5(1).
⁸ Section 5(2).
⁹ Section 70.
¹⁰ Section 71(a).
¹¹ Section 73.
¹² Section 97.
¹³ Section 106.

- (i) expire or may be terminated by the supplier at the end of the current season without penalty to the supplier; and
- (ii) on expiry or termination, end all the supplier's obligations to supply milk to new co-op.

[18] Shareholding farmers may allocate to independent processors up to 20 per cent of their weekly production throughout the season.¹⁴ A shareholding farmer who withdraws totally from Fonterra may also require Fonterra to sell a milk vat situated on the farm to the shareholding farmer or an independent processor.¹⁵

[19] Sections 147 and 148 are sunset provisions which determine when subpart 5 will cease to apply in the North and South Islands respectively. I need refer only to s 147(3), which provides:

The Minister must, as soon as practicable, make a recommendation under subsection (1) or subsection (2) if the Minister is satisfied that independent processors collected 12.5% or more of milksolids collected from dairy farmers in the North Island in a season.

[20] I now turn to s 115, which provides that regulations may be made requiring Fonterra to supply a number of goods or services, of which raw milk is but one:

- (1) The Governor-General may, by Order in Council made on the recommendation of the Minister, make regulations that—
 - (a) require [Fonterra] to supply in New Zealand 1 or more of the following goods or services:
 - (i) raw milk:
 - (ii) components of milk:
 - (iii) products derived from milk:
 - (iv) transportation, processing, and packaging of milk, components of milk, and products derived from milk; and
 - (b) prescribe the terms of supply for goods or services regulated under paragraph (a), and specify a price, or a methodology for determining a price, for those goods or services; and

¹⁴ Section 108.

¹⁵ Section 109.

- (c) subject to subsection (2), limit the amount of goods or services that [Fonterra] is required to supply, including different limitations for—
 - (i) different independent processors; and
 - (ii) different geographical areas; and
- (d) allow [Fonterra] to require independent processors to give [Fonterra] advance notice of their requirements for the goods or services to which regulations under paragraph (a) apply, prescribe the maximum period of advance notice that it may require, and authorise [Fonterra] to require buyers to buy the amount of goods or services specified in an advance notice; and
- (e) empower the Commerce Commission to fix a discount rate in calculating the price of goods or services regulated under this section; and
- (f) require [Fonterra] and independent processors to provide periodic returns of milksolids collected from dairy farmers; and
- (g) authorise [Fonterra] to perform obligations imposed by the regulations through an associated person.

(2) Regulations made under subsection (1) must not require [Fonterra] to supply a total amount of goods or services that exceeds, in the Minister's opinion, 5% of the amount of those goods or services produced by, or supplied to, [Fonterra], as the case may be.

(3) A regulation under this section is not invalid because it leaves a matter or thing to be decided by a person.

[21] Industry participants may enforce Fonterra's obligations by application to the Commission. I considered the Commission's powers under subpart 5 in an earlier judgment.¹⁶ In short, the Commission decides disputes between industry participants and Fonterra. It may determine whether Fonterra has breached its obligations under subpart 5 or the Regulations, and it may award compensation. An appeal against a determination lies to this Court on a question of law.¹⁷ In this case, the Commission has determined that Fonterra breached the Regulations but it has yet to fix compensation.

¹⁶ *Fonterra Co-Operative Group Limited v The Grate Kiwi Cheese Company Limited* HC Wellington CIV 2009-485-223, 8 December 2009.

¹⁷ Section 132.

[22] I return to the Regulations. They contain a mechanism for fixing the price of raw milk. Under reg 8(5), the default milk price for raw milk, which is paid in the absence of agreement, is the wholesale milk price for the relevant season plus the reasonable costs of transporting the raw milk to the independent processor. The wholesale milk price is defined as the price per kilogram of milksolids calculated using the following formula:

$$\frac{(\text{total payout} + [\text{Fonterra}] \text{ retention} - \text{annualised share value})}{\text{kilograms of milksolids}}$$

kilograms of milksolids

[23] Fonterra maintains that this formula under-prices raw milk substantially, so creating an arbitrage opportunity if, as the Commission's determination would permit, independent processors may outsource processing to others, including Fonterra. The Government appears to agree that raw milk is underpriced. I have been referred without objection to a Government Bill, the Dairy Industry Restructuring (Raw Milk Pricing Methods) Bill, the explanatory note to which states that the current formula under-prices raw milk; indeed, Fonterra sells raw milk for less than the average price it pays farmers for the same milk. The explanatory note also states that the Regulations provide no guidance on managing excess demand for raw milk by independent processors. The Bill would replace the formula with a price comprising the Fonterra farm gate milk price plus a seasonal margin of 10c/kg of milk solids; the margin is intended to compensate Fonterra for certain costs imposed by its supply obligation. The Bill would also permit an auction system.

[24] The Regulations cap the amount of raw milk that Fonterra must supply. There is an aggregate cap, which was set at 600 million litres in the 2008-2009 season, and an individual cap: under reg 11(3), the total volume of regulated raw milk that Fonterra must supply to one independent processor and its interconnected bodies corporate is limited to 50 million litres per season. Bodies corporate are relevantly defined as interconnected if one is a subsidiary (within the meaning of ss 5 and 6 of the Companies Act 1993) of the other or both are subsidiaries of a third.

[25] When the Commission made its determination Fonterra was supplying approximately something in excess of 461 million litres per season to more than 35

processors. The list, I am told, includes a number of niche processors who, because of their diminutive size, do not compete at the farm gate and are never likely to do so. Kaimai and Grate Kiwi wanted 60 million litres between them, a substantial quantity. A number of niche processors buy less than 1 million litres per season.

[26] Ministry of Agriculture and Forestry officials contemplate that the aggregate cap may soon be reached. The Regulations were amended from 1 June 2009 to introduce a rationing mechanism, under which the amount supplied to each independent processor will be reduced pro rata where orders exceed the aggregate cap, which remains at 600 million litres. I note in passing that the Ministry also predicts the sunset provisions may be triggered by 2012.

Independent processor

The Commission's findings

[27] The Commission identified the issues as, first, what it means to process something (the substantive aspect), and, second, whether a processor may contract for the processing to be done by another or must carry out the actual processing itself (the agency aspect). It identified four permutations:

- (a) Option One – the processor must, at a minimum, physically process in its own facility all the regulated raw milk at the initial stage of processing;
- (b) Option Two – the processor must own-process all the regulated raw milk at some stage of the production process, with the balance being handled through toll processing arrangements;
- (c) Option Three – the processor must own-process some portion of the regulated milk at some stage in the production process, with the balance being handled through toll processing;

- (d) Option Four – the processor must process all of the regulated milk at all stages, by own-processing or by toll-processing. That would allow all processing to be done by other firms through toll-processing arrangements.

[28] The Commission determined that to process a product is simply to carry out any step that changes it, chemically or physically, and so adds value to it. Processing includes grating, cutting and packaging but excludes logistical functions such as transportation and packaging. It excludes bare resale of raw milk, because a processor must carry out an action or step needed to create the end product. The Commission did not need to decide whether a processor must also produce something that is itself a dairy product, since both Grate Kiwi and Kaimai do, so it left that issue for another day.

[29] Turning to the agency aspect, the Commission found the ordinary meaning of “a processor of milk or milksolids or dairy products” revealed nothing about whether the processor can process solely by toll-processing arrangements or must do some of the processing itself. Nothing in the context of the Regulations or the Act required that the definition in the Regulations be given a narrower meaning than that accorded it in the Act. While option One would encourage competition at the farm gate, which is an object of the legislation, a broad interpretation best promoted the statutory purpose of efficient operation of dairy markets and the principle that Fonterra’s rivals must have access to raw milk and other dairy goods and services necessary to compete in dairy markets. To insist that an independent processor own-process raw milk at the first stage would be to prevent rivals focusing on those aspects of production in which they enjoy comparative advantage, so inhibiting efficiency, and would likely limit new entry because of the expense of a first-stage processing plant. Nor must an individual new entrant show it needs milk to compete, for the Regulations work on the premise that it is. A liberal approach would leave the markets to determine how processors can best compete, and would promote access to dairy goods other than raw milk. Although option Four presented monitoring difficulties for Fonterra, so did option One.

[30] Accordingly, the Commission concluded that while a processor must take a step that changes the product and so adds value to it, the processor may do so either by own-processing or by contractual arrangements with other processors.

[31] Having adopted option Four, the Commission decided without difficulty that on the facts Grate Kiwi and Kaimai were independent processors. It also held that they were independent processors under option Two, but only to the extent that they took a processing step on the products into which the raw milk is made. Under option Three, both would be independent processors. Under option One, neither would be.

[32] The Commission addressed another issue; whether Fonterra must deliver raw milk to any address nominated by Grate Kiwi and Kaimai, or only to processing plants that they own and operate. In argument Mr Every-Palmer acknowledged, I think inevitably, that if Grate Kiwi and Kaimai were independent processors under the Regulations, Fonterra must deliver the milk to addresses they nominate. Accordingly, I say no more about it.

Fonterra's case

[33] Fonterra's case is that an independent processor under the Regulations is a firm that own-processes raw milk at the first stage of processing, typically by pasteurising it. By "own-processing", Fonterra means that the independent processor must own and operate the plant and equipment, and employ the labour, that treats the milk at the first stage. All other stages of processing may be outsourced.

[34] Mr Every-Palmer's arguments can be grouped under several propositions. First, the Act contemplates regulation of various products and services but the only regulations actually made concern raw milk. So the broad definition may not apply, in context. The definition also focuses on independence from Fonterra, not processing. Even on the Commission's approach, words must be read into the definition to serve the purpose of the Act; for example, the Commission accepts that an independent processor may not simply resell raw milk and it envisaged (without deciding) that the processor must produce a dairy product as its end product.

Fonterra says that reg 4(1) should be read so that it “must supply raw milk to independent processors *of raw milk*”.

[35] Second, the language of the Act and the Regulations together compel a narrow interpretation. When the Act uses “independent processor” it contemplates physical assets and actual processing. Specifically: under s 107(3) Fonterra must ensure that 33 per cent or more of milksolids produced within a 160-kilometre radius of any point in New Zealand are supplied under contracts with independent processors, or contracts with Fonterra that expire or may be terminated at the end of the season without penalty; s 116 and the Regulations speak of supply to independent processors, and supply naturally connotes physical delivery; the explanatory note to the Regulations, although not part of them, describes Fonterra’s obligation as being to supply milk “to milk processors that are independent of Fonterra”, while reg 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 other parts of the Regulations provide that Fonterra may require an independent processor to notify Fonterra of its actual requirement for raw milk before delivery; and, lastly, s 147(3) contemplates that subpart 5 will expire when independent processors collect a certain amount of milk.

[36] Third, the objectives of Part 5 envisage supply of raw milk to a processor who actually processes it. Any wider approach oversteps the “access principle” in s 71(a) by making dairy products available even if the buyers do not need them to compete. The regulatory regime constructs an entry pathway into the milk processing industry, with a view to competition at the farm gate. Mr Every-Palmer sought to find support for this proposition in the Ministry of Agriculture and Forestry review mentioned above. Competition at the initial processing stage facilitates farm gate competition, since such firms have a strong incentive to seek supply from farmers rather than from Fonterra. By contrast, the Commission’s approach permits arbitrage, under which new entrants with no investment in the dairy industry will exploit differences in price between raw milk and the relevant derivative product while adding no value themselves. Such firms will also reduce the amount of regulated raw milk available to actual processors, swamping their demand with large orders that cause aggregate demand to exceed the 600 million litre cap. Under the

Regulations as they stood in 2008-2009, actual processors would be denied regulated raw milk once the aggregate cap was reached. Under the Regulations as they now are, the supply to all firms will be reduced *pro rata* once it is reached. So “virtual processors” such as Kaimai and Grate Kiwi will constrain the very farm gate competition that is the desired goal of the regulatory regime. Further, the Commission erred by doubting that there is any real prospect of 100 per cent toll-processing of regulated milk occurring on a widespread basis; the facts show that both Grate Kiwi and Kaimai intended to act as ‘virtual processors’ of much of the raw milk.

[37] Fourth, the Commission’s interpretation allows Open Country (or other actual processors) to evade the individual processor cap of 50 million litres by having associated persons order regulated raw milk on the basis that it will be first processed in Open Country’s plant. It is no answer to this that the independent processor ordering the milk carries the economic risk associated with it; that risk could be assigned to reflect the greater economic benefit that Open Country may gain from such arrangement. The Commission’s approach is tantamount to on-sale of regulated raw milk because Open Country may contract with virtual processors to toll-process the raw milk they order, then purchase it from them at the regulated price plus a processing margin, leaving the virtual processor with little if any risk.

[38] Fifth, monitoring and enforcement is very difficult under the Commission’s approach. It requires that Fonterra know there is a toll-processing agreement in place, as opposed to a direct on-sale of raw milk, and that it monitor processing so it can verify whether the regulated raw milk was used to produce the toll-processed product. The regulatory regime contains no specific information-gathering powers and none of inspection, and independent processors will naturally resist disclosing commercially sensitive information to Fonterra.

[39] Lastly, Mr Every-Palmer argued that even if the true construction of the Regulations does not lead to option One, the Commission erred by adopting option Four. For the reasons already given, option Four is unavailable. Option Three is merely a variant of option Four, for it would allow Grate Kiwi and Kaimai to own-process none of the regulated raw milk. The only viable alternative construction is

option Two, under which, he contended, neither Grate Kiwi nor Kaimai were independent processors in the 2008-2009 season.

Construction of defined terms

[40] “The meaning of an enactment must be ascertained from its text and in the light of its purpose.”¹⁸ The different prepositions, one simple (from) and the other compound (in the light of), mark a distinction between the relationships of meaning to text, on the one hand, and meaning to purpose, on the other. The one is more immediate than the other. It follows that the Court departs cautiously from a meaning that the enactment expressly affixes to a defined term.

[41] The leading authority remains *Police v Thompson*.¹⁹ In issue was the meaning of ‘bar’, which was defined as having a given meaning unless the context otherwise required. The Court accepted that context must prevail over the definition if the term is used in a context that the definition will not fit, but North P held:²⁰

... where a statute contains a definition section giving a word or phrase an extended meaning beyond its ordinary meaning, a Court of construction should commence its inquiry by assuming that the Legislature intended the word or phrase to have its statutory meaning. I would think that only rarely indeed will the Court be justified in departing from that meaning. It is entitled to do so only if the language of the section under construction requires a different meaning.

And McCarthy J held:²¹

Nevertheless it would take a conflict of unmistakable character, in my view, to justify a Court departing from a specific meaning which a statute expressly requires to be applied, if it reasonably can: a compelling reason, said Viscount Simonds, in *Attorney-General v Prince Ernest Augustus of Hanover* [1957] A.C. 436, 463; [1957] 1 All ER 49, 55.

Construction: independent processor

[42] The defined term in this case means more, in its ordinary meaning, than an own-processor of raw milk. It is disjunctive; it means processors of milk, or

¹⁸ Interpretation Act 1999, s 5(1).

¹⁹ *Police v Thompson* [1966] NZLR 813 (CA).

²⁰ At 818.

²¹ At 823.

milksolids, or dairy products. The concept of processing is correspondingly general. It is not defined, but in s 115(1)(a)(iv) the Act draws a distinction between processing and transportation or packaging of milk, which is consistent with the Commission's broad definition.

[43] So the question is whether the purpose of the Act and the Regulations require a much narrower meaning - much narrower because by Fonterra's definition independent processors comprise a subset of one of the three classes of independent processor recognised by the Act's definition; they are processors not even of milk, but of raw milk. This distinction matters: Kaimai processed treated (pasteurised) milk in the 2008-2009 season, but not raw milk.

[44] Fonterra's arguments focus on the concept of supply as used in the Act, reading down the Regulations by reference to the language of the Act. Yet the Act contemplates extensive regulation to promote efficiency in dairy markets generally; Fonterra may be required to supply raw milk, milk components, products derived from milk, processing services, transportation services, and packaging services to firms that process milk or milk solids or dairy goods. It is true that these Regulations deal with raw milk only, but they expressly adopt the Act's broad definition of independent processor.

[45] In ordinary commercial usage "supply", says the New Shorter Oxford Dictionary, means to provide or furnish for use or consumption. That object can be achieved by assuming contractual obligations under which others may physically deliver goods; it does not require that the supplier itself deliver. The Act and the Regulations together point to contractual relationships, such as those under which Fonterra purchases raw milk from its suppliers, and the access principle does not assist Fonterra, for the decision that independent processors need raw milk to compete has been made in the Regulations; individual processors need not show they have need of it. Mr Every-Palmer came close to acknowledging that by submitting that it is debatable whether the Regulations are *intra vires*. Nor was counsel correct to argue that, almost by definition, firms which outsource the first stage of processing do not in fact need raw milk to compete. So long as raw milk is an input

into the products that they do sell, they may need it to compete in their chosen markets.

The enactment's purpose

[46] Does the enactment's purpose require a different meaning? There is a sense in which subpart 5 is a pathway to farm gate competition, since the legislature has evidently decided that farm gate competition will meet the purpose of subpart 5 once it has reached a sufficient level. Several provisions concern themselves with what happens at the farm gate: s 147 ensures subpart 5 will cease to apply when independent processors collect 12.5 per cent or more of milksolids collected from dairy farmers; ss 97 to 105 limit Fonterra's ability to exploit power over shareholding farmers to inhibit competition; s 107 inhibits its ability to impose long-term contracts on suppliers; and s 108 gives farmers the right to supply independent processors. The legislature evidently considered Fonterra's control over its suppliers an important source of its market power.

[47] The Commission also accepted that competition in first-stage processing may facilitate farm gate competition. Owners of such facilities face an incentive to secure their own suppliers because of the sunk costs of the plant coupled with the risk that regulated milk will not be available indefinitely.

[48] However, the premise that farm gate competition is the desired means of delivering efficiency in dairy markets does not lead to the conclusion that the regulatory regime promotes farm gate competition in preference to other forms. Subpart 5 promotes competition in dairy markets generally, so encouraging their efficient operation. It is not confined to particular dairy markets, such as those for raw milk or processing services. It does not focus on a particular form of competition, such as farm gate competition. And while the Regulations deal with raw milk only, other regulations may be made requiring Fonterra to supply downstream goods and services, including processing services. It seems that the legislature, not knowing if farm gate competition was viable or when it might acquire vigour, decided in the meantime to authorise regulation of all markets in which Fonterra enjoys market power. And the Minister, on whose recommendation

the Regulations were made, must know that raw milk is not merely a dairy product in its own right but also an essential input to many others. Against that background, the Regulations would go to some pains to restrict supply of raw milk to firms that engage in farm gate competition, if that was the intention.

[49] Fonterra's singular focus on farm gate competition leads to a further difficulty. Because the Regulations deal with the sale of raw milk by Fonterra, and not with the purchase of raw milk from farmers, it must argue that the Act and Regulations treat competition in first-stage processing as a proxy for competition at the farm gate. Mr Every-Palmer argued that in practice firms which own-process at the first stage are more likely to engage in farm gate competition. That may be true as a generalisation, but I have already noted (at [25]) that not all such firms do so in fact, or are likely to. And the Act does not attach particular importance to processing, or treat it as a necessary adjunct to farm gate competition; on the contrary, it is mentioned in s 115 as a separate service, and only one of a number at that.

[50] Nor can it be said that the pursuit of rivalry at the farm gate means that competition in first processing must be promoted at the expense of other forms. The Commission recognised that if independent processors who use toll-processing arrangements emerge, new processing facilities may be encouraged, so facilitating farm gate competition. Put more broadly, the Commission found that competition in other markets may lead to competition in processing and so to the desired farm gate competition. I observe here that the parties agree the definition of independent processor is a question of law, and so within this Court's appellate jurisdiction. That is plainly correct. But to the extent that the interpretation question turns on whether one form of competition is more apt to advance the statutory purpose than another, it becomes substantially a question of opinion about facts. The appellate issue then would not be whether my opinion differs from the Commission's, but whether its opinion exceeded any reasonable scope for judgement permitted by the legislation.

[51] I accept that demand from firms which do not own-process at the first stage must result in other firms receiving reduced supplies of regulated raw milk whenever the quantity of regulated raw milk demanded exceeds the aggregate cap. But for

reasons just given, I do not accept that the Act focuses on promoting own-processing raw milk at the expense of other forms of competition.

[52] So far as the individual cap is concerned, it is correct that on the Commission's approach, a single processor such as Open Country could process more than 50 million litres of regulated milk per season by purchasing some directly and toll-processing the rest for other independent processors. However, the Act and Regulations together recognise both associated persons and interconnected bodies corporate. A processor is not independent if it is an associated person of Fonterra - that is, if Fonterra is able to exercise a substantial degree of influence over it - but independent processors may be associated persons of one another. Put another way, firms exercising a substantial degree of influence over one another may nonetheless separately order regulated raw milk. The legislature, through the definition of independent processor, and the Minister, through the Regulations, must have accepted that they might use the influence they may have over one another; in short, they might co-operate. The important point, then, is not that the independent processors are competing with one another at each stage of processing but that they are competing in dairy markets at some stage. That they do by processing regulated raw milk even if the processing is contracted out to another firm, whether another independent processor or Fonterra itself.

[53] There is force in Mr Every-Palmer's submission that monitoring poses difficulties for Fonterra. It cannot demand disclosure of independent processors. (Under the Regulations it is entitled only to estimates of demand.) Yet under option Four it may need evidence that a firm seeking raw milk intends to take some processing step either itself or under toll-processing contracts, and that it is not simply selling the raw milk to the toll-processor. Mr Every-Palmer suggested that it might even find itself at risk of breaching the Regulations should it reduce supply to eligible processors by allocating some of the 600 million litres of raw milk to a firm that is ineligible.

[54] However, those difficulties are not much less daunting under option One. Fonterra would have it that an independent processor must own and operate the plant in which first processing of the regulated raw milk occurs, which requires both

verification of commercially sensitive arrangements and use of judgement about their economic significance. Must the processor own the fee simple, for example, or is it enough that it leases the land? What happens if it leases the plant too, or subcontracts some of the labour? What happens if it on-sells some raw milk without distinguishing the milk supplied by Fonterra from that which it collects itself? The most that Mr Every-Palmer could say is that such arrangements would be uncommon, but that is an unsatisfactory answer. The argument also assumes unwillingness to disclose commercial information, such that the regime is unworkable without compulsory disclosure. Yet the correspondence summarised later in this judgment illustrates that both Grate Kiwi and Kaimai volunteered details and offered assurances, evidently accepting that Fonterra was entitled to them, and Fonterra seemed content to accept them.

[55] For these reasons, I am not persuaded that the context requires a narrower meaning of “independent processor” than that plainly appearing from the definition. This conclusion eliminates Option One, for Fonterra may be required to supply raw milk to a firm that is an independent processor in the sense that it processes milk, milksolids or dairy products, and not raw milk.

[56] Option Four highlights the issue of arbitrage. Mr Every-Palmer argued that a firm may purchase from Fonterra up to 50 million litres of raw milk per season and process and sell it profitably without doing any processing in its own facilities. Mr MacGillivray and Mr Mills were inclined to deny that this is a real possibility, but I prefer Mr Every-Palmer’s submission that it is. If it is correct that the regulated raw milk price is less than that Fonterra pays to its suppliers, and that Fonterra’s rivals enjoy a cost advantage in that they may “square” their supply curves at its expense, then an arbitrage opportunity logically arises under the Regulations. The behaviour of Grate Kiwi and Kaimai in the 2008-2009 season tends to confirm it, albeit not conclusively. But this form of competition results primarily from inefficient pricing of regulated raw milk. The Commission considered that if pricing were addressed, competition should focus on comparative advantage. Further, the Commission concluded that arbitrage is not necessarily bad, since allowing such firms access to regulated raw milk still promotes competition in dairy markets.

[57] In any event, the reasons I have already given lead me to reject the submission that processing means own-processing at some stage. Put simply, nothing in the language and policy of the Act or the Regulations requires that conclusion. Indeed, it would be a striking thing if it did, for if processing means own-processing, it follows that a processor must be vertically integrated, like Fonterra, through all stages. Fonterra does not go as far as that, accepting that a processor may outsource every activity other than the initial processing of raw milk, but that distinction finds no support in the Act and Regulations, which do not isolate initial processing, or any other phase of processing, and prescribe that it must be done in-house.

Conclusion

[58] It follows that the Commission did not err in law by determining that Grate Kiwi and Kaimai were independent processors in the 2008-2009 season.

[59] It may be, as Fonterra would have it, that this outcome conforms neither to industry expectations nor to the original design of Ministry officials, although I find the extraneous material provided equivocal. If Fonterra is correct, the remedy lies in amendment. The question for the Commission and the Court is one of construction, and in the end the meaning of the Act and Regulations is clear.

Breach of Fonterra's supply obligation

The narrative

[60] On 26 February 2008 Kaimai wrote to Fonterra giving notice of its intention to order raw milk under the Regulations, explaining that the milk was for Kaimai's own purposes but that Open Country would pasteurise it. By letter of 27 March it supplied Fonterra with forecast demand and completed an account application. The forecast anticipated that supply would begin in October.

[61] On 4 April Fonterra replied:

While Fonterra is willing to supply raw milk to you in accordance with the Dairy Industry Restructuring (Raw Milk) Regulations and our standard terms of supply, we give you notice that any milk delivered for you at the Open Country Cheese Company's facilities (or any other independent processor's facility) will count toward the Open Country Cheese Company's (or other independent processor's) 50 million litre allocation under the Regulations, as they clearly will be the processor of the Raw Milk.

If, however, your intention were to process the Raw Milk on your own premises, then you will be deemed to be the Processor and, under the terms of the Regulations, Fonterra would then be able to supply you up to 50 million litres per season.

[62] Kaimai responded that it was a processor in its own right and did not cease to be so merely because it outsourced pasteurisation. Further correspondence followed, but on 12 June Fonterra wrote confirming that it considered Open Country the independent processor for purposes of the Regulations, and therefore for the supply limits under the Regulations, while Kaimai was a customer of Open Country. It invited Kaimai to refer the matter to the Commerce Commission for a determination. Kaimai did so on 25 June.

[63] Fonterra had required a two-month forecast of demand. On or about 29 June Kaimai provided Fonterra with a two-month forecast under which supply would begin on 1 October.

[64] Grate Kiwi's application followed a very similar path. It advised Fonterra of its requirement for raw milk under the Regulations by letter of 4 March 2008, and explained in a letter of 31 March that Open Country would process the milk but ownership of the milk and products made from it would remain with Grate Kiwi at all times. The raw milk and the products made from it would be kept separate from all other goods at the Open Country plant, and Grate Kiwi would ultimately sell the products. By letter of 4 April Fonterra advised that any milk delivered for Grate Kiwi at Open Country's facilities (or those of any other independent processor) would count towards the allocation of Open Country (or other processor) under the Regulations. Grate Kiwi responded by insisting it was an independent processor and demanding a separate entitlement. By letter of 1 July Fonterra confirmed that milk delivered to Grate Kiwi at Open Country's facility would count towards Open Country's allocation. Grate Kiwi applied to the Commission for a determination on 14 July.

[65] On 1 August Grate Kiwi provided Fonterra with a demand forecast under which supply would begin on 1 October.

[66] The Commission handled the two applications together. In correspondence with the Commission, Fonterra insisted that it had not refused to supply raw milk, but maintained that an independent processor must process raw milk and any raw milk delivered to Open Country under the Regulations would count towards its allocation.

[67] On 26 September 2008 the Commission wrote to Fonterra advising that it had reached a preliminary view that Grate Kiwi and Kaimai were independent processors, and that Fonterra must deliver milk to an address nominated by them. The Commission had advised the parties of its preliminary view because it was conscious of the milk season.

[68] In the meantime, Fonterra had suggested an interim supply arrangement, apparently after the Commission outlined its timetable for the determination. Fonterra evidently recognised that an interim arrangement was necessary if Grate Kiwi and Kaimai were to obtain milk during October. The proposal was put to the Commission in a 'without prejudice' letter of 15 September, then offered to Kaimai and Grate Kiwi by letter of 25 September. Fonterra no longer insisted that the milk would form part of Open Country's allocation. Supply would be at the regulated price on an interim basis, conditional on the Commission determining that the relevant supply was under the Regulations. If Grate Kiwi and Kaimai were not entitled to the milk, the final price for it would be the market price during October, at that time \$9.86 per kg of milksolids, with interest payable at 11 per cent per annum on the difference.

[69] Grate Kiwi rejected that proposal. It also wrote to Fonterra on 2 October providing weekly estimates for 6-11 October and requiring Fonterra to supply on those dates, at the default price.

[70] Fonterra responded by again changing position. It advised on 3 October that it would comply with the Act and Regulations and would ensure that Grate Kiwi had

access to milk during October in accordance with the Commission's preliminary views. It would meet orders at the regulated price "where it is finally determined that Grate Kiwi is entitled to milk under the Regulations". But to the extent that the Commission (or a Court) determined that the Regulations did not apply, the milk would have been supplied without any agreement as to price and Fonterra would be entitled to a quantum meruit - that is, a fair and reasonable price - under both the Sale of Goods Act and the law of restitution. Should Grate Kiwi be ineligible under the Regulations, and absent agreement, Fonterra would ask the Court to fix such price. (I record that there seems to be a factual error in the Commission's Determination, which states at [241] that Fonterra made this offer after the draft Determination was released.)

[71] In an exchange of emails on the same day Grate Kiwi insisted that it would take milk only at the default price. It could not accept a reservation of rights by Fonterra, citing "the commercial risk of supply at an undefined price". Fonterra reiterated its commitment to its obligations and repeated that the only issue was what to pay if Grate Kiwi was not entitled to the milk.

[72] Grate Kiwi decided not to order milk. On 8 October Fonterra urged the Commission to advise when it anticipated issuing the draft Determination. The Commission responded that because it wished to consult more widely, it would not do so within the two weeks originally estimated. The draft Determination was actually released on 16 October.

[73] Kaimai also rejected Fonterra's offer of 25 September, insisting that Fonterra's proposal would impose harsh terms and carried high risk for Kaimai, which had worked out its business plan on the understanding that it was entitled to regulated milk at the regulated price. The proposal was unreasonable. Fonterra wrote to Kaimai on 3 October in the same terms as its letter of the same date to Grate Kiwi (paragraph [70] above). Kaimai rejected that proposal, insisting that milk be delivered under the Act and the Regulations. Fonterra reiterated that it would supply and that a quantum meruit price would be payable if Kaimai was not entitled to the raw milk. It maintained that it was happy to supply, asserted that the only issue was

what to pay if Kaimai was not entitled to the milk, and denied that it was trying to transfer risk to Kaimai.

[74] Kaimai refused to accept these terms, but it did order milk for the period 6 October 2008 to 2 November 2008, apparently to protect its entitlement to regulated milk for the rest of the season. The milk that it ordered was supplied. Kaimai did not order raw milk during the balance of the season.

[75] Mr Every-Palmer accepted I might assume, for purposes of this appeal, that but for Fonterra's stance Grate Kiwi and Kaimai would have ordered more raw milk than they did during the 2008-2009 season. It is for the Commission to decide to what extent that is true in fact.

The Commission's findings

[76] The Commission found that in two respects Fonterra breached its obligation to supply Grate Kiwi and Kaimai from 1 October 2008 to 30 April 2009. The first was the offer of supply on terms that the milk would count as part of the regulated allocation of Open Country. The second was the offer to supply raw milk in October at the regulated price on the basis that Grate Kiwi and Kaimai would pay the difference between that price and a fair and reasonable price should they fail before the Commission. For the same reason, the actual supply to Kaimai from 6 October until 2 November also contravened the Regulations.

Fonterra's case

[77] Fonterra says that there was no breach, for two reasons. First, liability cannot arise for non-supply unless milk is first ordered. Orders must comply with the Regulations and Fonterra met all orders that were made. It is immaterial that Grate Kiwi and Kaimai would have ordered milk but for Fonterra's insistence, initially, that it would form part of Open Country's allocation, and subsequently, that a price differing from the regulated default price would be paid if the Commission found they were not entitled to it.

[78] Second, the offers of interim supply were consistent with the Regulations; to observe that a fair and reasonable price would be payable if Grate Kiwi and Kaimai lost was merely to state the applicable law.

Does liability require a prior order?

[79] It is implicit in the Regulations that Fonterra will not be liable for non-supply to a given independent processor unless that processor has first required supply under the Regulations. The obligation to supply is subject to regs 5 to 15, which deal with estimates, price, minimum and maximum quantities, and the caps. Those Regulations speak both of Fonterra supplying milk and of the processor requiring it.

[80] However, the Regulations prescribe no mandatory forms or procedures for making orders. Rather, they permit Fonterra to require estimates of the buyer, up to three months, and also up to one week, before the date on which the milk is to be supplied. Such estimates may be required for “a quantity of raw milk to be supplied in 1 day”.²² No doubt Fonterra does insist on estimates for sound practical reasons, but its obligation to supply is not contingent on them. The Commission might find that Grate Kiwi and Kaimai had nonetheless required milk under the Regulations, so triggering the obligation to supply, and if Fonterra’s insistence on terms to which it was not entitled caused them not to order milk at all, it would be no defence that they had failed to provide demand forecasts.

Offer to supply under Open Country’s allocation

[81] Breach of reg 4 requires that Fonterra be shown to have not supplied an independent processor who had required raw milk.

[82] Fonterra’s initial insistence that any milk supplied would form part of Open Country’s allocation rested on its view that Kaimai and Grate Kiwi were not independent processors. They were, and so entitled to buy raw milk in their own right. It follows that Fonterra would breach the Regulations if it did not supply for that reason.

²² Regulation 6(1).

[83] Is that what happened? Battle lines are commonly drawn some time before a disputed obligation falls due. If they remain fixed, a Court or Tribunal will assess liability, the obligation by then having fallen due, by reference to the original justification for non-performance. Here, Fonterra did insist that it would not supply Kaimai and Grate Kiwi as independent processors. But it took that stance between 4 April and 25 September 2008, when it changed tack, accepting that it would supply the two firms in their own right, albeit on terms that they found unacceptable for other reasons. Neither Grate Kiwi nor Kaimai had required that Fonterra supply milk before 1 October. The Commission did not consider whether that sequence of events affected the first of the two breaches that it found.

[84] I prefer the view that Fonterra's liability for non-supply did not crystallise until supply was required and not made. Accordingly, Fonterra did not breach its supply obligation before 1 October. By that date it had abandoned its requirement that the milk form part of Open Country's allocation, so it did not breach the Regulations by imposing that requirement. (It might have done so if delay in changing its stance caused Grate Kiwi and Kaimai not to purchase raw milk in October, but it seems they were able to take supply at short notice.)

Offer to supply subject to quantum meruit

[85] This issue turns on Fonterra's offer of 3 October to supply at the regulated default price pending the determination on terms that, should Grate Kiwi and Kaimai be found ineligible for regulated supply, the price of the milk supplied in the interim would be fixed by a Court on a fair and reasonable basis.

[86] This offer Kaimai and Grate Kiwi saw as an attempt to assign risk to them. The Commission shares that opinion. Fonterra says that the offer merely recorded what was incontrovertibly true; if the Regulations did not control the milk sold, then it had been sold without agreement as to price and Fonterra was entitled under the law of restitution to a fair and reasonable price. It was reasonable to reserve its position, and it did no more than that. It is implicit in Mr Every-Palmer's submission that there could be no justification, in the face of legal uncertainty, for

requiring Fonterra to assume all risk by supplying at the regulated price come what may.

[87] It is true that from their *ex ante* perspective, awaiting the Commission's determination, the parties confronted uncertainty. I accept too that Fonterra might lawfully reserve its position on liability pending the Commission's determination. So it would not breach the Regulations if it supplied milk at the default price pending the determination, reserving its right to cease supply (or to demand an agreed price) for milk supplied after a Determination in its favour. The question is whether it breached the Regulations by insisting that the price for milk supplied *before* the Determination would be adjusted *afterward*, should Grate Kiwi and Kaimai lose. By doing that, it caused them not to order milk. But as matters turned out, they won.

[88] When Judges declare the law, they do so with retrospective effect.²³

the law as declared by the judge is applicable not only at the date of the decision but at the date of the events which are the subject of the case before him, and of the events of other cases *in pari materia* which may thereafter come before the Courts.

[89] This rule is derived from the declaratory theory of law, which holds that Judges merely discover and declare the law which was there all along, waiting to be revealed. Judges now acknowledge that they do make law, and that the declaratory theory of law is a fiction.²⁴ But the rule that judgments state the law with retrospective effect remains.²⁵ There have been rare cases in which Courts declined to apply the rule, or indicated that its effect might be limited as a matter of policy,²⁶ but this is not one of them; in particular, it cannot be said that the Commission's Determination changed settled law in reliance upon which the parties had arranged their affairs.

²³ *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349 at 381 per Lord Goff.

²⁴ *Kleinwort Benson; In re Spectrum Plus (in liquidation)* [2005] UKHL 41, [2005] 2 AC 680; *Lai v Chamberlains* [2006] NZSC 70, [2007] 2 NZLR 7 at [135] per Tipping J.

²⁵ *Deutsche Morgan Grenfell Group v IRC* [2006] UKHL 49, [2007] 1 AC 558 at [23] per Lord Hoffman.

²⁶ *Lai v Chamberlains* per Tipping J at [143-145]; *Millar v Dickson* [2001] UKPC D4, [2002] 1 WLR 1615.

[90] So the Commission's Determination, which is substantively judicial in nature for reasons given in my earlier judgment, stated the law as it was at 1 October 2008, and not merely from the date of the Determination. By refusing to supply unconditionally under the Regulations pending the Determination, Fonterra took the risk that it might be liable to compensate the buyers if the Determination went against it, to the extent that its stance caused them not to order milk in the meantime. It seems that the risk has come home.

Conclusion

[91] The Commission erred in law by determining that Fonterra breached the Regulations when it insisted that any milk supplied would form part of Open Country's allocation. Fonterra did not actually fail or refuse to supply on that ground.

[92] The Commission correctly concluded that Fonterra breached the Regulations by insisting, after 1 October 2008, that the price for milk supplied would be adjusted retrospectively, should Grate Kiwi and Kaimai not be entitled to it, in circumstances where that insistence resulted in non-supply of milk that they required.

Disposal

[93] Fonterra's appeal extended to aspects of the Commission's decision affecting compensation, which the Commission has yet to fix. In particular, the Commission addressed a methodology for assessing compensation. By consent, I adjourn those parts of the appeal, so they can be argued together with any subsequent appeal from the compensation Determination.

[94] As noted above, the Commission's conclusion that Fonterra breached its obligation to supply by insisting that milk supplied would be deemed part of Open Country's allocation was wrong in law. To that extent the appeal is allowed.

[95] The appeal is otherwise dismissed.

Costs and ancillary matters

[96] Although the appeal has succeeded in part, the respondents have prevailed in substance. They and the Commission will have costs on a 2B basis, the Commission for two counsel. Counsel must seek agreement. Memoranda may be filed if they cannot agree.

[97] Fonterra sought at an early stage to file a small quantity of new evidence relating to the breach issue, in the form of further correspondence which completed the record. I reserved the application for decision as part of this judgment. The accuracy of the narrative matters, and the application was not opposed. It is granted.

[98] Two versions of this judgment have been prepared. The first, which is confined to counsel for the parties, is subject to confidentiality orders. The second is a public version from which confidential data has been redacted.

Miller J

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