

IN THE COURT OF APPEAL OF NEW ZEALAND

**CA223/2010
[2011] NZCA 67**

BETWEEN FONTERRA CO-OPERATIVE GROUP
LIMITED
Appellant

AND THE GRATE KIWI CHEESE COMPANY
LIMITED
First Respondent

AND KAIMAI CHEESE COMPANY LIMITED
Second Respondent

Hearing: 9 February 2011

Court: O'Regan P, Stevens and Wild JJ

Counsel: A R Galbraith QC and J D Every-Palmer for Appellant
J A MacGillivray and K E Cornegé for First and Second Respondents
S J Mills QC and J B Hamlin for Commerce Commission as
Intervener

Judgment: 16 March 2011 at 10.00 am

JUDGMENT OF THE COURT

A The appeal is allowed in part.

B There will be no order for costs. All costs must lie where they fall.

REASONS OF THE COURT

(Given by Stevens J)

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Introduction

[1] This is an appeal by Fonterra Co-operative Group Ltd (Fonterra) against a decision of Miller J in the High Court upholding a Commerce Commission decision involving the supply of raw milk.¹ The respondents are The Grate Kiwi Cheese Company Ltd (Grate) and Kaimai Cheese Company Ltd (Kaimai). Fonterra appeals against two decisions in the High Court judgment. The first is that Grate and Kaimai are “independent processors” for the purposes of the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Regulations). The second is that Fonterra breached the Regulations by refusing to supply milk unconditionally. Fonterra would only supply on the basis that the regulated price would not apply should the Commission (or Court) find that the respondents were not independent processors.

[2] The third decision of Miller J was that Fonterra did not breach its obligations to supply by originally insisting that milk supplied would be deemed part of the allocation of a third company, Open Country Cheese Company Ltd (Open Country), since the orders had not crystallised at that point and Fonterra changed its position in later correspondence. There is no cross-appeal against this decision.

[3] In addition to the submissions of the parties, the Commerce Commission made written submissions as a result of a minute granting it intervener status,² and

¹ *Fonterra Co-operative Group Ltd v The Grate Kiwi Cheese Company Ltd* HC Wellington CIV-2009-485-1223, 3 March 2010.

² *Fonterra Co-operative Group Ltd v The Grate Kiwi Cheese Company Ltd* CA223/2010, 8 October 2010.

oral submissions as a result of leave granted by the Court at the hearing of the appeal.

Background

[4] Fonterra was formed in 2001 from an amalgamation of New Zealand's largest dairy companies. At that time it controlled over 98 per cent of milk produced by dairy farmers. Such market dominance meant that statutory authorisation was required.³ As part of the restructuring, Parliament decided that "independent" dairy product producers should be able to procure suitable supplies of raw milk from Fonterra. The Regulations require Fonterra to supply raw milk to independent producers at the price set out in the Regulations, if the parties are unable to agree on a price. The history and interpretation of the pricing formula set out in the Regulations was considered in detail in a previous judgment of this Court.⁴ The concept behind the Regulations was that independent producers would be able to access raw milk at the same price as Fonterra, so that they could then compete in downstream markets. However, Fonterra maintains that the formula set by the Regulations underprices raw milk substantially, so that it receives on average less than the amount it pays farmers.⁵

[5] The respondents are cheese manufacturers who sought to capitalise on the pricing formula in the Regulations during the 2008–2009 dairy season.⁶ Grate specialises in producing large catering size packs of grated cheese for the food service market and for house brand retail products. It purchases base cheese from Fonterra and Open Country. Grate then cuts and repackages this cheese, and sells some of it as base cheese in overseas commodity markets. In 2008, it had the

³ Granted by s 7 of the Dairy Industry Restructuring Act 2001 [the Act].

⁴ *Commerce Commission v Fonterra Co-operative Group Ltd* CA175/05, 4 May 2006.

⁵ The Dairy Industry Restructuring (Raw Milk) Amendment Regulations 2010 and the Dairy Industry Restructuring (Raw Milk) Amendment Regulations (No 2) 2010 amended the Dairy Industry Restructuring (Raw Milk Pricing Methods) Regulations 2001, r 8. The formula seeks to approximate the price Fonterra pays farmers at the farm gate, plus reasonable transport costs and a fixed margin of \$0.10 per kilogram of milksolids. These regulations came into effect from 1 June 2010. Fonterra maintains that this formula continues to underprice raw milk and future changes to the regulatory regime are likely. In fact, the Dairy Industry Restructuring Act 2001 has been amended to allow the Governor-General to make regulations to allow for an auctioning system to allocate the raw milk.

⁶ A season runs from 1 June to 31 May of the following year: s 5 of the Act.

opportunity of entering into a toll-processing arrangement with Open Country whereby it could purchase raw milk from Fonterra and then have it processed into cheese in Open Country's plant, thereby utilising available processing capacity. Under the arrangement, Grate would retain ownership of the milk, but would pay Open Country a fee for the processing.

[6] Kaimai is a specialty cheese manufacturer located at Waharoa in Eastern Waikato. It buys pasteurised milk and hard cheese from Open Country. Kaimai makes the pasteurised milk into its soft cheese range in its own premises, but its hard cheese range is made in Open Country's plant according to Kaimai specifications. Kaimai also sells hard cheese in commodity markets. It too sought to purchase raw milk directly from Fonterra, the majority of which would be processed in Open Country's plant under a similar toll-processing agreement to Grate.

[7] Kaimai and Grate are not interconnected for the purposes of the Act.⁷ Dairy Investments Fund Ltd is a shareholder in Grate (30 per cent), Kaimai (40 per cent) and Open Country Dairy Ltd (10 per cent), the parent company of Open Country.

[8] Both Kaimai and Grate gave Fonterra notice of their intention to purchase raw milk in early 2008. Fonterra initially agreed to supply the milk on the basis that it would form part of Open Country's allocation under the Regulations. The Regulations provide that each "independent processor" is entitled to 50 million litres of raw milk at the price set by the Regulations.⁸ Open Country already claimed its full entitlement and would have no incentive to transfer part of it to Kaimai and Grate. Fonterra said that it would only consider Kaimai and Grate to be "independent processors" if they processed the milk on their own premises.

[9] Further correspondence ensued. The respondents referred the dispute to the Commerce Commission under subpart 5 of the Dairy Industry Restructuring Act 2001 (the Act). The Commission wrote giving its preliminary view that Grate and Kaimai were independent processors. Fonterra then agreed to supply milk at the

⁷ See "interconnected body corporate" as defined by s 5 of the Act, which refers to the definition in s 2(7) the Commerce Act 1986.

⁸ Regulation 11. The exception is New Zealand Dairy Foods Ltd, which has a 250m litre cap: reg 11(4).

Regulation price on a without prejudice basis. If the Commission (or the Court) ultimately decided that the Regulations did not apply, then Fonterra intimated it would claim a fair and reasonable price for the raw milk. Neither of the respondents was prepared to take this risk. Grate did not order any raw milk in the 2008–2009 season. Kaimai ordered raw milk in October but said that Fonterra should only deliver on an unconditional basis.⁹ Fonterra supplied that milk.

[10] The Commission decided that the respondents were independent processors and that Fonterra had not met its obligations to supply the raw milk. That decision was substantially upheld by the High Court. Fonterra now appeals.

The statutory scheme

[11] One of the stated 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.¹⁰ Such purpose is the subject of subpart 5 of the Act, the subpart that is directed at the regulation of dairy markets and the obligations of Fonterra, and specifically promoting the efficient operation of dairy markets in New Zealand.¹¹

[12] There follows a statement of principles, that relevantly provides:¹²

- (a) independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets:
- (b) [Fonterra] must accept applications by new entrants and shareholding farmers to supply it with milk, as shareholding farmers:
- (c) [Fonterra] must not discriminate between new entrants and shareholding farmers whose circumstances are the same:
- (d) shareholding farmers who withdraw from [Fonterra], and cease or reduce supply, must receive their capital in [Fonterra] without unreasonable delay.

⁹ Kaimai did this to protect its entitlement to regulated milk for the season. If Kaimai had not ordered milk in October, it would not have been entitled to regulated milk for the remainder of the season.

¹⁰ Section 4(f).

¹¹ Section 70.

¹² Section 71(a)–(d).

[13] The term “independent processor” mentioned in s 71(a) is defined in the Act as follows:¹³

independent processor—

- (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].

[14] The rights of entry and exit of supplier farmers is dealt with in subpart 5. Hence, under s 73, Fonterra must accept an application to become a shareholding farmer from a new entrant. Equally, a shareholding farmer who wants to cease or reduce the supply of milk to Fonterra may give a notice of withdrawal.¹⁴ Further, Fonterra is not permitted to discriminate between shareholding farmers and new entrants.¹⁵ Hence, supply contracts for raw milk are regulated.¹⁶ Pursuant to s 107(3), Fonterra 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 [Fonterra] that—
 - (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 [Fonterra].

[15] Shareholding farmers are entitled to allocate to independent processors up to 20 per cent of their weekly production throughout the season.¹⁷ Also, a shareholding farmer who withdraws totally from Fonterra may require Fonterra to sell a milk vat situated on the farm to the shareholding farmer or to an independent processor as the case may be.¹⁸

¹³ Section 5(1).

¹⁴ Section 97.

¹⁵ Section 106.

¹⁶ Section 107.

¹⁷ Section 108.

¹⁸ Section 109.

[16] The regulation making powers are contained in s 115. Such powers extend to possible regulation of a range of goods and services including raw milk. At the time of the dispute, the Act relevantly provided:

- (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
 - (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;

...

[17] If an industry participant has a dispute with Fonterra as to the application of subpart 5 of the Regulations, it may apply to the Commerce Commission for a determination.¹⁹ The Commission has a range of powers including the power to direct payment of compensation.²⁰ An appeal lies to the High Court on a question of law and then to this Court with leave.²¹

[18] One of the key focuses of subpart 5 concerns farm gate competition. We agree with the summary of Miller J when he stated:²²

¹⁹ Section 120.

²⁰ Section 126(1).

²¹ Section 132.

²² At [46].

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.

[19] Provision is made in ss 147 and 148 as to when subpart 5 will expire in the North and South Islands respectively. Section 147(3) provides that:

- (3) 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] Regulations promulgated pursuant to subpart 5 provide for the supply of raw milk by Fonterra. Under reg 4(1), Fonterra "must supply raw milk to independent processors". By virtue of reg 3(2) the term "independent processor" is specifically given the same definition as in s 5 of the Act, set out in [13] above.²³

[21] Milk is not defined, either in the Act or the Regulations. But the Regulations provide that "raw milk" means "untreated milk from a cow".²⁴ This suggests that milk includes treated and untreated (raw) milk. The term "milksolids" is defined in the Act to mean "milk-fat and protein components of raw milk".²⁵

The High Court decision

[22] In the High Court, Miller J first considered whether the respondents are "independent processors" for the purposes of reg 4(1). He discussed whether such a processor must 'own-process' the raw milk in its own facilities or whether it may toll-process the milk by subcontracting all or any of the work to another firm.²⁶

²³ Regulation 3(2); Interpretation Act 1999, s 34. "Associated person" is also defined in s 5(2) of the Act.

²⁴ Regulation 3(1).

²⁵ Section 5(1).

²⁶ A question posed by Miller J at [3].

[23] The Commission had identified four possible meanings of “independent processor”. These formed the basis of the analysis in the High Court:²⁷

- (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 of 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.

[24] The High Court adopted a purposive approach and held that Option Four was the preferred interpretation. Miller J considered that the statutory definition of “independent processor” was disjunctive in that a processor could process raw milk or milksolids or dairy products.²⁸ He considered that “processor” was a sufficiently broad term to encompass an entity that processes any of those products and that there was nothing in the context of the regulations to justify the narrower interpretation in Option One, contended for by Fonterra.²⁹ Furthermore, he considered that adoption of Option Four best gave effect to the purposes behind the Act. He considered that allowing independent processors to use toll-processing arrangements would encourage new processing facilities to emerge and thus promote farm gate

²⁷ At [27].

²⁸ At [42].

²⁹ At [55].

competition. Thus he concluded that the Commission had not erred by determining that Grate and Kaimai were independent processors in the 2008–2009 season.³⁰

[25] The second issue was whether Fonterra had breached its supply obligations. It had offered to supply at the regulated default price pending the determination by the Commission but on terms that, should Grate and Kaimai be found ineligible to receive regulated supply, the price of the milk supplied in the interim would be fixed by a court on a fair and reasonable basis. Miller J held that the Commission was correct to determine that Fonterra had breached the Regulations by insisting, after 1 October 2008, that the price for milk supplied would be adjusted retrospectively, in circumstances in which that insistence resulted in the non-supply of milk that Kaimai and Grate required.³¹

[26] We will set out the submissions for both sides before discussing the merits of the appeal on the first issue.

Fonterra’s submissions

[27] Mr Galbraith QC, for Fonterra, argued that the real contest was between Options One and Four. He sought to rely on the plain meaning of the word “independent processors”, in conjunction with indicators within the text of the Regulations, which suggest Option One is the only available interpretation. The Regulations are silent on whether the processor must necessarily process the raw milk in its own facilities. However, Fonterra submitted this is implicit in the description “processor”. The Oxford English Dictionary definition of “processor” supports this, as it suggests that processor is an entity that actually carries out the processing:

A person who or thing which performs a process or processes something;
spec. ... (b) a food processor.

[28] This definition supports Option One, since a processor utilising toll-processing does not carry out the processing in its own facilities. Fonterra also

³⁰ At [57].

³¹ At [92].

pointed to its obligations to supply *to* independent processors.³² It said these supply obligations must mean that the independent processor is the entity that actually processes the milk. This would preclude toll-processing.

[29] Fonterra also pointed to other provisions in the Regulations and the Act that only made sense if “independent processors” meant actual processors of raw milk. It suggested that if “independent processors” means any 100 per cent toll-processor, then there is nothing to stop Fonterra triggering those provisions by organising for a number of end-product buyers to order large quantities of raw milk, which Fonterra would then process at its own facilities. But this would make a nonsense of the Act’s sunset provisions.³³

[30] Fonterra argued that allowing what are termed “virtual processors” to access raw milk would be inconsistent with the 50 million litres cap on supply of raw milk under the Regulations.³⁴ It gave the example of a processor which enters into toll-processing arrangements with two companies. Each company orders the maximum 50 million litres of regulated raw milk for processing into cheese for exporting. The two companies, being virtual processors, are paid a nominal consideration for their share. As long as the companies are not interconnected, Fonterra suggested such an arrangement is permitted under Option Four. Ultimately, such an approach could lead to a reduced share for smaller niche companies, since the Regulations provide for apportionment of the overall cap of 600 million litres should the orders exceed that overall cap.

[31] Fonterra also argued that if Option Four is adopted, there would be nothing to stop Fonterra acting as a processor and preventing most of the milk from going to actual competitors, since to the extent that the overall cap is exceeded, the orders would be reduced proportionately. The Commission did not see this as an issue, considering that allowing Fonterra to act as a toll-processor might contribute to the overall efficiency of dairy markets. If Fonterra was the lowest-cost toll-processor then it would enhance competition between Fonterra and other toll-processors. However, the Commission did not address the circularity of such an arrangement.

³² Regulations 4(1), 8(5) and 11(3).

³³ Sections 147–148.

³⁴ Regulation 11(3).

The purpose of the Regulations is to promote competition by other competitors. If Fonterra is right that it can be a toll-processor, there might be little to stop it from denying the Regulations of any utility by changing all of its current supply contracts so that current buyers of Fonterra end-line milk products apparently order raw milk.

[32] It is clear from the definition in the Act that an independent processor does not have to process raw milk; it might process milk solids or dairy products instead. However, Fonterra argued that the Regulations should be seen as a subset of the Act. Since they deal only with the supply of raw milk, this implicitly limits independent processors to those who process raw milk. Fonterra pointed to Regulation 4(1), which provides that Fonterra must “supply raw milk to independent processors”. The processors are also referred to as “milk processors” in the explanatory note to the Regulations.³⁵ Fonterra submitted that the raw milk regulations are only meant to cover pricing for entities that actually process raw milk. It pointed to the fact that s 71(a) appears to set a necessity threshold for recipients of raw milk. It provides:

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

[33] Fonterra argued that s 71(a) of the Act sets a high threshold for access to raw milk. Adopting Option One as the correct interpretation would satisfy that threshold since it would limit the availability of raw milk to actual processors who actually need a supply of milk to operate. Fonterra submitted that allowing “virtual processors” to access raw milk does not meet a “necessity” test, but a “desirability” test, since such entities could in fact purchase the products they need from normal processors without having to obtain a raw milk share. The respondents could have purchased, and in fact did purchase, processed milk products from Open Country in the 2008–2009 season. Thus they must not be the “independent processors” envisaged by the Regulations. Fonterra also argued that other regulations could easily be promulgated under s 115 for base cheese, for example, if such regulations were considered “necessary” to ensure that cheese processors can compete in dairy markets.

³⁵ Dairy Industry Restructuring (Raw Milk) Regulations 2001 (explanatory note).

[34] In summary, Fonterra's submissions relied on a careful textual analysis of the Act and the Regulations, which it said revealed that Option One was the only available interpretation.

Respondents' submissions

[35] For the respondents, Mr MacGillivray supported the reasoning in the judgment of Miller J, particularly the choice of Option Four. He submitted that both Grate and Kaimai qualify as independent processors under the definition in the Act. There is no warrant for reading down the obligation on Fonterra under reg 4 so that Fonterra must supply raw milk to physical processors of raw milk, particularly when such words do not appear in the regulation itself.

[36] Mr MacGillivray submitted that contracting to have processing carried out by a tolling arrangement is a normal commercial activity, which is common in the dairy industry. The ability to have raw milk toll-processed through an agent may be an efficient means of taking advantage of excess processing capacity within the industry. He emphasised that the virtual processor example raised by Fonterra is not the present case. The prospect of participants from outside the industry engaging in virtual processing was remote and should not be used as a basis for reading down the scope of Fonterra's obligation in reg 4.

Intervener's submissions

[37] For the Commission, Mr Mills QC emphasised the purposes of the Act and the Regulations, particularly the promotion of efficient operation of dairy markets³⁶ and the access principle for independent processors.³⁷ Mr Mills supported the Commission's endorsement of Option Four as being an available interpretation and consistent with the purposes and principles of the Act.

³⁶ Section 70.

³⁷ Section 71(a).

[38] Mr Mills accepted that the possibility of “virtual processing” was probably not foreseen by the legislature. But that said, it does not assist the Court in interpreting the Act and the Regulations.

Discussion

[39] We begin our analysis by noting that, when the Regulations were developed to address Fonterra’s obligations to supply raw milk, the definition of independent processor in the Act was expressly adopted.³⁸ This definition does not relate to raw milk only. Instead, it covers processors of three types of product: milk, milksolids and dairy products.³⁹ Such breadth of definition is important when it comes to interpreting and applying the access principle in s 71(a), which provides an ability for independent processors to be able to obtain raw milk and other dairy goods and services. An independent processor may well be operating in a downstream dairy product market (as opposed to processing raw milk) yet would still require access to raw milk to facilitate its participation in its own market(s).

[40] It is true that the Regulations deal only with raw milk. Only part of the wide regulation making power in reg 115 has so far been utilised. The interpretation of the Regulations must occur in context⁴⁰ and it must be purposive. We do not agree with Fonterra that a contextual analysis shows that Option One is the correct interpretation. Purpose (f) in s 4 of the Act speaks of promoting 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. We see this purpose as guiding the judgment.

[41] In our view, there is no basis, either in the Regulations or in the Act, for reading the supply obligation in reg 4(1) to require Fonterra to supply raw milk only

³⁸ Regulation 3(2)(e). *Police v Thompson* [1966] NZLR 813 (CA) at 818 confirms that where a term is defined in an enactment, the court’s starting point will be that the legislature intended the word or phrase to have its statutory meaning. The case was decided at a time when a literal approach to statutory interpretation was the norm and we note that modern courts may be willing to depart from the definition where the context and purpose requires it. See J F Burrows and R I Carter *Statute Law in New Zealand* (4th ed, LexisNexis, Wellington, 2009) at 422.

³⁹ The definition in s 5(1) refers to a processor who is not an associated person of Fonterra.

⁴⁰ As Lord Steyn said in *R (Daly) v Secretary of State for the Home Department* [2001] UKHL 26, [2001] 2 AC 532 at [28]: “In law context is everything.” See also Baroness Hale in *Stack v Dowden* [2007] UKHL 17, [2007] 2 AC 432 at [69].

to independent processors of raw milk. This would do violence to the definition of independent processors that the Regulations specifically import from the Act.

[42] Reading the words “of raw milk” into reg 4(1) does not promote the purposes of the legislation, which, as noted, include promoting the efficient operation of dairy markets. Such efficient operation is to be secured, according to s 4(f) of the Act, “by regulating the activities of [Fonterra] to ensure New Zealand markets for dairy goods and services are contestable”.

[43] We agree that a literal interpretation of “processor” applying a purely dictionary definition leaves open the interpretation that the party itself should carry out the processing. But such an interpretation could require the purchaser to invest in a new processing plant, even where there is spare processing capacity in the industry. Such investment could potentially involve considerable sunk costs, the details of which were not fully explored in the evidence. A purposive interpretation to the Regulations suggests Option One cannot be correct, since it would create an immediate barrier to entry. There is nothing in the Act or Regulations expressly requiring own processing. Any such requirement could readily have been stipulated if it had been intended. With respect to the definition of “processor” advanced by Fonterra, we prefer an interpretation that permits the contracting out of the processing function: Option Four.

[44] Parts, or sometimes all, of processing and manufacturing activities are contracted out in commerce. Yet those who contract it out are still commonly called “processors” or “manufacturers”. Drawing the line could create difficulties or lead to artificial distinctions. For example, if Open Country’s processing plant burnt down in a fire, they would no longer be entitled to raw milk on Fonterra’s analysis because they would not be able to process the raw milk themselves. This cannot have been intended by the Regulations. Upon an agency basis, there is little difference between setting up a factory and employing people to process the milk, and sub-contracting to another firm to do it. In both cases, the company itself does not carry out the work, its agents do. The ordinary meaning of the word “processor” does not resolve the issue of how far the company’s agency can extend.

[45] Even if Fonterra were correct that the processor must actually process raw milk, nothing in its argument suggests that the processor must use its own premises to process the raw milk in order to be entitled to regulated milk. As the respondents argued, the words “supply to” refer to the legal owner, not to a physical address. Even a processor falling within Option One might have a number of different premises and factories. These might be held in a variety of different ways, including leasehold, freehold or partly leased facilities shared with another company. Such holding methods are not economically different to a toll-processing arrangement. All involve an outlay of money by the company to secure a raw milk processing service. The processor must be able to nominate the address to which supply must occur, and Fonterra could not withhold such supply simply because the facilities were not owned by the processor. Such an obligation would artificially constrain the market and prevent it operating at maximum efficiency. These factors all suggest that independent processors may toll-process.

[46] We note in passing that the explanatory note to the Dairy Industry Restructuring Bill 2001 suggests that one of the “mischiefs” the Act sought to correct was the concern that a monopoly power over raw milk would lead to an inefficient market in which the cost of milk products for consumers was high.⁴¹ The Regulations respond to that concern by making a quantity of raw milk at the regulated price available to processors. This provides a check on Fonterra’s virtual monopoly over raw milk since it prevents the charging of monopoly prices to competing companies.

[47] We agree with Miller J that one of the purposes behind subpart 5 was to facilitate competition at the farm gate.⁴² The Commission reached a similar view, reasoning that the owners of first-stage processing facilities face an incentive to secure their own suppliers because of the sunk costs of the plant coupled with the risk that regulated milk would not be available indefinitely. But toll-processing still requires the investment of capital in processing plants. In fact, it may encourage a more efficient market if toll-processing is permitted. In any case, farm gate competition should not be viewed in exclusion to other forms of competition, such as

⁴¹ Dairy Industry Restructuring Bill 2001 (139-1) (explanatory note) at 5.
⁴² At [46].

competition in downstream markets, which is also a legitimate purpose of the Act. Allowing toll-processing would better enable small players to enter the dairy market without making the substantial outlay of capital required to set up a processing plant. It might act as a stepping stone for them to build their own plants or simply mean that new toll-processors emerge to meet the demand. We consider that Option Four better promotes competition both at the farm gate and in downstream markets and is more consistent with the overall purposes of the Act and the Regulations.

[48] With respect to Fonterra’s argument that allowing “virtual processors” would distort the supply cap,⁴³ we do not place any weight on this point. First, we consider that it is an *in terrorem* argument. We do not accept that it is a valid methodology to reason backwards from an exceptional, and possibly fictional, situation.

[49] Second, we consider it would do no credit to Fonterra if the company were to seek to subvert the Regulations.

[50] Third, it is likely that the new auction system will remove Fonterra’s concerns about virtual processors and the prospect of arbitraging.⁴⁴ Moreover, if Fonterra itself were to attempt this, and were successful in distorting the market for regulated milk, we would expect Parliament would act swiftly to deal with it.

[51] In any event, issues concerning virtual processors do not involve this case. They are best left until the legality of any actual arrangement giving rise to them can be tested.

[52] For the above reasons, the decision of Miller J on the first issue is upheld. We consider that the proper interpretation of “independent processors” in the Regulations is Option Four. The processor must process all of the regulated milk at all stages, by own-processing or by toll-processing. All processing may be done by other firms through toll-processing arrangements. Such an approach best meets the purposes of the regulations to promote competition in dairy markets in New Zealand.

⁴³ Currently set at 600 million litres: reg 11(3).

⁴⁴ Contemplated by the Dairy Industry Restructuring (Raw Milk Pricing Methods) Bill 2009.

Breach of supply obligations

[53] In the High Court, Miller J held that Fonterra had breached its supply obligation when, after 1 October 2008, it insisted in correspondence that the price of milk supplied would be adjusted retrospectively should the respondents not qualify as independent processors.⁴⁵ Fonterra says this decision was wrong since all it was doing was recognising that there was a dispute over entitlement, and stating the legal position should Fonterra succeed in that dispute.

[54] On 3 October 2008, Fonterra changed its position from that adopted in earlier correspondence. It advised the respondents that it would comply with the Act and the Regulations. Moreover, it would ensure that Grate had access to milk during October in accordance with the preliminary report of the Commission. It would meet orders at the regulated price “where it is finally determined that [the respondents are] entitled to milk under the Regulations”. The email added:

... to the extent that the Commission (or a Court) determines that the Regulations do not apply, then the milk will have been supplied without any agreement between us as to price. In these circumstances we are entitled to a “quantum meruit”, that is a fair and reasonable price under both the Sale of Goods Act and the law of restitution. We believe this will match the market price.

[55] When Grate received this email it responded by insisting that it would take milk only at the default price. It could not accept the reservation of rights by Fonterra because of “the commercial risk of supply at an undefined price”. Grate decided not to order milk.

[56] Fonterra wrote to Kaimai in similar terms. Kaimai rejected the proposal and insisted that milk should be delivered under the Act and the Regulations. Fonterra reiterated that it was prepared to supply and that a price based on a quantum meruit would be payable if the outcome was that Kaimai was not entitled to raw milk. Kaimai refused to accept supply on such terms. We note that it did order milk for a period between 6 October 2008 and 2 November 2008 to protect its entitlement to

⁴⁵ At [92].

regulated milk for the rest of the season. That milk was supplied by Fonterra, but Kaimai did not order raw milk during the balance of the season.

[57] In relation to the question of breach, Miller J reasoned in summary that:

- (a) the issue turned on Fonterra's offer of 3 October as set out above;
- (b) the Commission's determination that both Grate and Kaimai were independent processors applied with retrospective effect, in that it applied from 1 October 2008 onwards;
- (c) in reserving its right to claim on a quantum meruit basis should the respondents order milk but turn out not to be independent processors, Fonterra refused to supply the respondents unconditionally under the Regulations pending the Commission's determination; and
- (d) by doing so, Fonterra took the risk it would have to compensate the respondents if the determination went against it, to the extent that its stance caused the respondents not to order milk from 1 October 2008.

[58] Accordingly, Miller J concluded:⁴⁶

[90] ... 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.

...

[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.

⁴⁶ At [90], [92].

Respondents' position

[59] The respondents say that the email of 3 October imposed an extra condition on the supply of milk, in that it would be supplied at market price should the respondents not be entitled to regulated milk. Thus Fonterra did not meet its obligation to supply under the Regulations because this condition caused the respondents to withdraw their orders for the season, apart from the milk Kaimai ordered in October. Further, it imposed an obligation on the respondents to continue the Commerce Commission process, at considerable cost to them.

Evaluation

[60] In our view, the flaw in this argument is that it was not Fonterra's position that led the respondents to cancel the orders, but the fact of the dispute itself. As Fonterra rightly submitted, it was prepared to supply the milk at the regulated price. It was only if Fonterra were to win the dispute that they would then claim compensation. This is a logical corollary of the dispute. By noting that "we believe this will match the market price", Fonterra was not stipulating a pricing regime should the respondents not be independent processors as a condition to the supply of the milk. Instead, it was reserving its position should a dispute arise over the proper price for the milk.

[61] An analogy can be drawn with a dispute over the obligation to supply in a continuing contract. A party would not breach its obligations to supply if it offered to supply on a without prejudice basis, even if that party insisted on a mistaken interpretation of the contract.⁴⁷ The respondent is correct that repudiation under a contract is not a perfect analogy to a statutory requirement to supply, since there is no issue of cancellation under a statute. However, the contractual analogy helps draw the line between willingness, and failure, to perform. The respondent submitted that Fonterra agreed to perform "only in a manner substantially inconsistent with [its] obligations".⁴⁸ We disagree. Fonterra agreed to perform its

⁴⁷ *Starlight Enterprises Ltd v Lapco Enterprises Ltd* [1979] 2 NZLR 744 (CA).

⁴⁸ Which would amount to repudiation: *Ross T Smyth & Co Ltd v T D Bailey Son & Co* [1940] 3 All ER 60 (HL) at 72.

obligations exactly but reserved its position in light of the dispute. Such conduct would not constitute a failure to perform a contract, and neither does it constitute a failure to perform a statutory supply obligation.

[62] In short, we consider Fonterra was doing no more than expressing a view to the respondents as to the legal position that would apply if Fonterra's supply of milk was not a regulated supply. We are satisfied that in so doing it cannot be said that Fonterra was offering to supply subject to a condition. Moreover, Fonterra did not require the respondents to accept its view as to the legal position if this was not a regulated supply, before it supplied milk to them.

[63] Further, as Fonterra points out, it supplied milk to Kaimai in October, despite the absence of any agreement on what price would apply if Kaimai was not entitled to milk. The respondents withdrew their remaining orders, presumably because they were not prepared to bear the risk that they might have to pay a higher price for the raw milk. This risk arose because of a genuine dispute over the drafting in the regulations, not because of Fonterra's conduct.

[64] We emphasise that a court would not look kindly on Fonterra manufacturing disputes so as to discourage small players from accessing raw milk. However, here the respondents could point to no evidence to suggest that Fonterra commenced this dispute in bad faith. There was a genuine issue as to the meaning of the Regulations.

Outcome

[65] The appeal succeeds in part. We are satisfied that the respondents are "independent processors" for the purposes of the Regulations and that processing of raw milk may be achieved by own or toll-processing. That ground of appeal is dismissed. However, Fonterra did not breach its obligations to supply the raw milk. That ground of appeal succeeds.

Costs

[66] Neither party has made submissions on costs. Since both have had a measure of success, it is appropriate to leave costs to lie where they fall. There will be no order as to costs.

[67] The Commerce Commission was granted leave to make submissions on the basis that it would not seek costs in this Court. It did not do so.

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