

BETWEEN FONTERRA CO-OPERATIVE GROUP LIMITED

Appellant

AND THE GRATE KIWI CHEESE COMPANY LIMITED

First Respondent

AND KAIMAI CHEESE COMPANY LIMITED

Second Respondent

Hearing: 14 February 2012

Court: Elias CJ
Blanchard J
Tipping J
McGrath J
William Young J

Appearances: A R Galbraith QC, J D Every-Palmer and T C E Miller for
the Appellant
J A MacGillivray for the Respondents
S J Mills QC and B Hamlin for the Commerce Commission

CIVIL APPEAL

MR GALBRAITH:

5 If the Court pleases, I appear with Mr Every-Palmer and Mr Miller.

ELIAS CJ:

Thank you Mr Galbraith, Mr Every-Palmer, Mr Miller.

MR MacGILLIVRAY:

May it please the Court, MacGillivray for the respondents.

5 **ELIAS CJ:**

Thank you, Mr MacGillivray.

MR MILLS QC:

May it please the Court, I appear with Mr Hamlin for the Commission.

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ELIAS CJ:

Thank you, Mr Mills, Mr Hamlin. Yes, Mr Galbraith.

MR GALBRAITH QC:

15 If the Court pleases, I thought I'd start simply by identifying the provisions which are
in issue. It seems a good place to start. If the Court wouldn't mind looking at our
bundle of authorities, and the very first place to start, because we're talking about a
regulation here, is looking at the Act for the regulatory powers, and you'll find the Act
under tab 6, the Dairy Industry Restructuring Act, under tab 6, and if Your Honours
20 wouldn't mind turning to section 115, which is on page 82, which is lower left-hand
corner of the Act, you'll see that section 115 provides for regulatory powers
concerning milk and subsection (1) provides that the Governor-General may make
regulations that require the new co-op to supply one or more of the following goods
or services, firstly raw milk, secondly components of milk, thirdly products derived
25 from milk and fourthly transportation, processing, et cetera. The power which has
been exercised here is in relation to 115(1)(a)(i) raw milk.

And then, staying within the same bundle of authorities, if the Court wouldn't mind
going to tab 10, that contains the particular Regulations, the 2001 Regulations made
30 under the Act. Just a slight note of warning, you'll see on page 1 this is the reprint as
at 29 November 2007 so the reprint contains some amendments that were made
subsequently to 2001, but they are noted in the text, and the particular regulation that
we are concerned with is regulation 4, subregulation (1), on page 4, which is in
part (1), the supply of raw milk by new co-op, "New co-op must supply raw milk,"
35 regulation 4(1), "New co-op must supply raw milk to independent processors."
Subregulation (2) provides, "The obligation in subclause (1) is subject to
regulations 5 to 15."

Most of those won't concern the discussion, I don't think, today, but if I can just take the Court to a couple of specific regulations. If you go across to page 6, regulation 8, starts on page 5, "Price of raw milk". The price of raw milk you'll see in subregulation (1) can be agreed for the supply of raw milk but there's a default milk price provided for in subregulation (5), "The default milk price for raw milk supplied to an independent processor is the wholesale milk price plus," and there's some pluses which got added on. Now, the basis for a default raw milk price has changed over time but that's just to indicate that there is a default raw milk price and that is in practice what is applied.

Going across to regulation 11, "Limits on volume of raw milk," you'll see that the – subregulation (2), "The total volume of raw milk that the new co-op must supply to independent processors under regulation 4 is limited to 400 million litres per season." Now that was the operative regulation at the time that the 2001 Regs came in. Subregulation (2A), which you see there as the note below indicates, was inserted in 2007 and the volume has gone to initially 500 for the 2007/2008 season and to 600 for the 2008/2009 season, but it started, these regulations started, with a 400 million litre total volume in the pool.

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ELIAS CJ:

And did that apply throughout the period that we're concerned with?

MR GALBRAITH QC:

25 Yes.

ELIAS CJ:

Yes.

30 **MR GALBRAITH QC:**

Well, no, sorry, because Grate and Kaimai didn't come along until 2008, 2009, so they were in the 600, but when one's looking, in our respectful submission, to interpret what these regulations were targeted at, one has to go back to when they were passed in 2001 and see what was contemplated then, because the next regulation, subreg, I'm just going to draw your attention to subregulation (4) where 250 million litres of that 400 million litres was reserved for New Zealand Dairy Foods Limited, which has become Goodman Fielder, so there was only ever

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150 million litres of free pool, if I can put it that way, that was going to be available under this regulation, and that was the position for –

TIPPING J:

5 Is it the fact of the cap, rather than its amount, that's critical?

MR GALBRAITH QC:

It's both, Sir –

10 **TIPPING J:**

Both?

MR GALBRAITH QC:

– because obviously the smaller the amount the less you can do with it, if I can put it
15 as simplistically as that.

TIPPING J:

Yes, quite.

20 **MR GALBRAITH QC:**

And so what we're saying is the ambitions, or the objective, of these Regulations was modest not, as the Commission would have it, targeted at creating an efficient or encouraging efficient restructure of the industry as a whole. We're saying it was targeted at raw milk processing and so the quantum that was initially allocated is an
25 indication of that.

TIPPING J:

Is there any material available to us as to how these figures were fixed?

30 **MR GALBRAITH QC:**

No, unfortunately. The only thing that one can see, if you go back to regulation 3, is that there was an individual cap of 50 million litres, and so with 250 going to, perhaps use the term Goodman Fielder, because that's what they're now called, that theoretically meant that there could be three other parties with 50 million litres each
35 that took up the balance of the 400 million litres.

McGRATH J:

That's 11(3)?

MR GALBRAITH QC:

5 That's 11(3), yes, Sir.

McGRATH J:

And did I understand you to say that New Zealand Dairy Foods Limited is now simply called Goodman Fielder?

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MR GALBRAITH QC:

Yes.

McGRATH J:

15 It's just a change of name?

MR GALBRAITH QC:

It was spun off in the sense that it didn't come into the merger and it had to be...

20 **McGRATH J:**

So it's now part of Goodman Fielder?

MR GALBRAITH QC:

But it's now Goodman Fielder, yes.

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ELIAS CJ:

While we're trying to get to terms with some of the terms –

MR GALBRAITH QC:

30 Yes.

ELIAS CJ:

– I had a question about “milksolids”. It may be that you're going to come onto that, but I see that “milksolids” is defined as a component of raw milk and I had a question as to whether when “milksolids” is used in the Regulations it's somehow they are measured or there is a process for separating them out while the components remain raw milk. I'm just trying to get a feel for what the processing scope is here and I see

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“milksolids” as important in the setting of the price and so on, but is that because it’s measured or is that because it’s separated out?

MR GALBRAITH QC:

5 My understanding is because it’s measured, it’s part of the – it’s, one could say, almost the effective content of –

ELIAS CJ:

Yes.

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MR GALBRAITH QC:

– of raw milk and so the volume of milksolids is the base upon which payments, et cetera, are made. Now, look, there may be a more scientific – and I’ll ask Mr Every-Palmer who’s probably more up to date with that, but that’s my
15 understanding.

ELIAS CJ:

Yes, it’s just that my naive approach is that raw milk remains raw milk until it’s processed by pasteurisation or something –

20 **MR GALBRAITH QC:**

Or something, yes.

ELIAS CJ:

– like that.

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MR GALBRAITH QC:

It can be separation, or pasteurisation, or whatever. A number of things can be done to it.

30 **ELIAS CJ:**

But that may be important in terms of the definition of “milk”, “milksolids” and “dairy products” –

MR GALBRAITH QC:

35 Yes.

ELIAS CJ:

– which is a – does carry the connotation of some manufacturing.

MR GALBRAITH QC:

5 Yes.

ELIAS CJ:

Yes, or further processing. Yes, thank you.

10 **MR GALBRAITH QC:**

I think that was all I was going to draw your attention to.

TIPPING J:

15 Is your reference to these quantities, Mr Galbraith, designed to show in due course that because of their limits your client's proposition is more likely to be correct than the other proposition?

MR GALBRAITH QC:

20 Yes, Sir, in simple terms, and the other thing I was going to ask if the Court would indulge me with – I spoke with my learned friends – what has to happen each season is that Fonterra has to provide to MAF a schedule of what's anticipated, what's forecast in demand for the season to come, and I just thought it might be useful to the Court to see the forecast which was provided in November last year subsequent to the case being prepared for the 2011/2012 season. It just indicates, it gives you an idea of what the spread of demand is and also indicates the parties. Now it's a confidential document because, of course, it has information about individual processors. If the Court were prepared – would find that helpful, just really as an informative background document.

30 **ELIAS CJ:**

Well, how do you say we could use it?

MR GALBRAITH QC:

35 Look, it's only for information so you have some understanding how this works in practice.

McGRATH J:

No one has any objection? I think it's all right.

BLANCHARD J:

5 On the basis of the argument you've just put up, though, it might be better looking at the forecast for 2001/2002.

MR GALBRAITH QC:

I haven't got that, Sir.

10 **BLANCHARD J:**

I thought you might not.

MR GALBRAITH QC:

No, unfortunately I haven't.

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TIPPING J:

Well, one can understand it conceptually. Whether we're going to be helped by the detail in it, I don't know.

20 **ELIAS CJ:**

I suppose it's an illustration that may make it easier to follow. We'll receive it on that basis. It doesn't sound as if we will be able to make use of it in any way –

MR GALBRAITH QC:

25 No, no.

ELIAS CJ:

– except to help us understand.

MR GALBRAITH QC:

30 That's all I'm suggesting it for.

ELIAS CJ:

Madam Registrar, can you get the material?

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MR GALBRAITH QC:

If I can just assist by just explaining it. If you go to the second page which has got the final forecast of estimated raw milk requirements for the 2011/2012 season, you'll see the first one is Goodman Fielder Dairy New Zealand Limited. The annual total there is 230-odd million litres of milk, so it's less than the 250 million that they're
5 entitled to. You then see Open Country Dairy at 50 million.

Now just perhaps to explain something, you'll see the first column is annual total adjusted for 50 million litre limit. The second column is annual total. What happens is that the companies that want to acquire milk from the regulated pool put in their
10 estimates and then they're calculated on a monthly basis. That can lead to the estimate exceeding the 50 million total and so it gets adjusted back with a 50 million litre limit and that's why it's the first column which is the effective column, and then you'll see so Open Country 50 million, Tatua 46, Synlait 50, Westland 50, New Zealand Dairies 50, Miraka 50 and then it starts coming down, Cadbury 37, and
15 then you get a number of much smaller processors, and the sum, the total at the bottom is 595 million litres, so it's knocking on the 600 million litre cap.

WILLIAM YOUNG J:

Why isn't it 600 million? Why don't they scale those over 50 million back so that it
20 actually hits 600 million exactly?

MR GALBRAITH QC:

Because of the cap, the individual cap is 50 million, Sir –

WILLIAM YOUNG J:

I see, I see, okay.

MR GALBRAITH QC:

– under the Regs, so that's why it happens.

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TIPPING J:

You've got two caps, in effect.

MR GALBRAITH QC:

35 Two caps, yes. There's a total cap and an individual cap.

WILLIAM YOUNG J:

I see.

MR GALBRAITH QC:

5 And there is a proposal at the moment to increase the total cap again to 770 million litres of milk because as you can see the demand at the moment is knocking on the ceiling.

WILLIAM YOUNG J:

10 So why did the companies, the – place order, orders over 50 million then?

MR GALBRAITH QC:

I think it's just a product of the monthly calculation of volume, Sir –

15 **WILLIAM YOUNG J:**

I see, right.

MR GALBRAITH QC:

– that it comes out that way, but they know that they're only going to get 50 million.

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McGRATH J:

They're only going to get 50 million or they're going to get 50 million at the default price, with – be able to buy the –

25 **MR GALBRAITH QC:**

They're only going to get 50 million and odds to evens it'll be the default price, Sir, because my understanding is – I'm not – I don't know that nobody's ever had an agreed price but certainly default prices.

30 **TIPPING J:**

Well, you're not going to agree to a price that's less on one side or more on the other.

MR GALBRAITH QC:

35 No, well, that's right, Sir, you're quite right. I think the economics of that are pretty sound.

WILLIAM YOUNG J:

Except that there is surplus over the 50 million.

MR GALBRAITH QC:

5 Well, at that they've then got to acquire arm's length of course so that's different. So that's what it looks like.

Now going back to the Regulations, the issue and how the issue arises. Now if we could just go back to our bundle of authorities, tab 10, where the Regulations are again. Regulation 4(1) you will recall simply says, "New co-op must supply raw milk to independent processors." You will find if you look immediately above that is regulation 3(2) which says, "The following terms are defined in section 5 of the Act," and the third term down under little (c) is "independent processor" so one says, "New co-op must supply raw milk to independent processors," that's defined in section 5 of the Act, and I'm sorry to take you on a trip but we have to go back behind tab 6 again to the 2001 Act. And on page 14 of the Act, being defined two-thirds of the way down, "independent processor" ... "independent processor (a) means a processor of milk or milk solids or dairy products who is not an associated person of new co-op and, (b), includes New Zealand Dairy Foods Limited and any associated person of that company other than new co-op."

So the issue here is, who is an "independent processor" for the purposes of regulation 4(1) and something I should have mentioned which arises out of one of the questions I was asked. Initially when the Regs were first enacted there wasn't a provision as to what happens if you had more than, a demand for more than 400 million litres of milk so it was a first come first served basis. Once it had been allocated to 400 being allocated, well, that was the end of it.

An amendment was made effective in the 2008 Regs, which you find at tab 11, and you will see on page 4 a new 5(c) down towards the foot of the page. "The chief executive must verify final forecasts and prorate of estimated total amount of raw milk in season is likely to exceed limit on supply." So this was to operate from the 2009 season and so from 2009 on there was, it was to be prorated if there was more demand than was available in the pool.

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TIPPING J:

Just going back to that definition for a moment, Mr Galbraith, and I'm sure we will be looking at it quite hard later, but would it be fair to, at least prima facie, derive from it the idea that "milk", "milksolids" and "dairy products" are all materially different things?

MR GALBRAITH QC:

Yes. Yes it would Sir.

10 **ELIAS CJ:**

But "milksolids" –

MR GALBRAITH QC:

Are part of milk.

15 **ELIAS CJ:**

Are part of raw milk –

MR GALBRAITH QC:

Yes.

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ELIAS CJ:

– in the definition. So the odd man out is all "dairy products" and your case largely turns on what we make of that, doesn't it?

25 **MR GALBRAITH QC:**

Yes, it does, and there is no definition of raw milk, it's not defined though it's a term used in the industry.

ELIAS CJ:30

No, "milksolids" is defined.

MR GALBRAITH QC:

"Milksolids" are, yes, as your Honour said before.

TIPPING J:35

But raw milk is defined isn't it?

MR GALBRAITH QC:

I don't think so.

5 **TIPPING J:**

I thought I saw it somewhere.

ELIAS CJ:

There's a contextual –

10 **MR GALBRAITH QC:**

It's defined in the Regs, Sir, as untreated milk, page 3.

TIPPING J:

Oh I don't – they're defined in the, it's defined in the Regulations –

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MR GALBRAITH QC:

Yes, yes.

TIPPING J:

20 – as milk from a cow which –

MR GALBRAITH QC:

Effectively.

25 **TIPPING J:**

– seems quite illuminating.

MR GALBRAITH QC:

Yes. Well, I can understand that one, Sir.

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McGRATH J:

Mr Galbraith, going back to the conclusion of the statutory definition of the Regulations, there's a provision in the Interpretation Act, isn't there, that does that. I mean, what I'm really wondering is whether it was necessary to bring the statutory

35 definition forward to the Regulations?

MR GALBRAITH QC:

No, that's what would have applied, Sir, in any event.

McGRATH J:

- 5 Does this really mean that "independent processor" is brought in to make it clear that the context of the Regulations isn't excluding the statutory definition in any way; it's bringing forward the whole of the statutory definition.

MR GALBRAITH QC:

- 10 I think that's fair, yes, Sir, I think that's fair. So the issue is who is an "independent processor" for regulation 4(1), and perhaps seemed to be common ground in the Courts below and in the hearing with the Commission that at least between Fonterra and the Commission the definition isn't to be applied literally, so what I mean by that is just because an entity produces milk chocolate or yoghurt or something like that, it doesn't then qualify as an "independent processor" of raw milk for the purpose of
15 obtaining supply under this regulated pool. In other words, it's not a tick the box, you've got that qualification and therefore you're entitled, and then having obtained it you can then do what you will with it. In other words –

ELIAS CJ:

- 20 Doesn't that rather beg the question of whether regulation is concerned with independent processors of raw milk –

MR GALBRAITH QC:

Yes, yes, I'm –

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ELIAS CJ:

– because the argument against you is that it isn't.

MR GALBRAITH QC:

- 30 Yes, it's not, that's right. I'm sorry, I shouldn't have plugged that term into –

ELIAS CJ:

Yes.

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MR GALBRAITH QC:

– into what I was saying. All I was trying to say was that the Commission and Fonterra I think agreed that whoever is getting this raw milk shouldn't be able to simply on-sell it. They've got to do something. They've got to process it them –
5 again, I shouldn't say "themselves" – they've got to process it somehow or other rather than just trade it on. So you can't apply because you're a producer of dairy milk chocolate and get 50 million litres of raw milk and then sell it off into the marketplace to somebody who actually needs it to process.

10 **TIPPING J:**

Just because you happen to be a processor of dairy products, for example.

MR GALBRAITH QC:

Yes.

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TIPPING J:

So it's not status-based.

MR GALBRAITH QC:

20 That's –

BLANCHARD J:

You have to be a processor of the particular raw milk.

25 **MR GALBRAITH QC:**

That's what we would say, and –

BLANCHARD J:

And the Commerce Commission –

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MR GALBRAITH QC:

– and the Commerce Commission also, yes, and perhaps just to indicate where you'll find that in the Commerce Commission determination, the Case on Appeal volume A has the determination in it, and behind tab 7 is the final determination, and in
35 particular paragraphs 134 to 137. You'll find those on page 136, bottom right-hand corner.

WILLIAM YOUNG J:

Para 136?

MR GALBRAITH QC:

5 At 136, yes, Sir. And so under a heading, “The on-sale of regulated milk in its raw
state”, the Commission says although it’s not an issue in the dispute, the
Commission state in the consultation document it did not consider that it was open on
the language of the legislation to adopt an interpretation that would allow an
independent processor to on-sell all or some of the regulated milk purchased under
10 the regulation in its raw state. First, an independent processor could not be
considered to be processing milk that it had not altered either itself or by contracting
a toll processor in any manner. In other words, if a person is on-selling milk in its raw
state then the person will not have processed it in the substantive sense. Second,
the Commission considered such an interpretation would be inconsistent with the
15 purpose of the legislation in that one of the principles in section 7(1)(a) is mentioned,
is that “independent processors” must be able to obtain raw milk and other dairy
goods and services necessary for them to compete in dairy markets. If any of the
milk is on-sold in its raw state, the independent processor is not using it to compete
in dairy markets. So the point that Justice Blanchard very directly made is that you
20 have to process it in some way, the milk which you obtain from the regulated pool,
and that – that’s reflected in the issues as the Commission sets them out in their
submission 63, paragraph 63 and 64, but you won’t find in the submissions, at least I
couldn’t, that direct recognition that on-trading of raw milk is not within the purpose –

25 **TIPPING J:**

We’re not troubled by that –

MR GALBRAITH QC:

No.

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TIPPING J:

– here, are we?

MR GALBRAITH QC:

35 No, we’re not troubled by it, except that it’s relevant, in my submission, to
understanding why it is that the – it’s not just a status.

TIPPING J:

Yes.

MR GALBRAITH QC:

5 It's not just status.

ELIAS CJ:

It's a purposive—

10 **MR GALBRAITH QC:**

It's a purposive, yes.

ELIAS CJ:

— application.

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MR GALBRAITH QC:

Yes.

ELIAS CJ:

20 A contextual application, and that's an indication that the Commission itself accepts that one must take a contextual view.

MR GALBRAITH QC:

25 Yes. It's not quite so clear that the respondents accept that. I think they do. I use that term slightly conditionally. But if one looks at the respondents' submissions, you'll see that there is quite a theme of, "Because we are independent processors of cheese," for example, "therefore we qualify and therefore we're entitled to supply from the regulated pool." Now it doesn't go so far as to say and we could on-sell as — without any processing attempt to this raw milk but there is certainly a theme through
30 the respondent's submissions that status counts. I suspect that, having said that, we're still not at odds on the fact that you can't simply get milk from the regulated pool and on-trade it.

TIPPING J:

35 Well, they're not trying to do that.

MR GALBRAITH QC:

No, no they're not. No, these specific applications of Grate and Kaimai don't seek to do that, Sir, but it's important as her Honour was just saying to me that it indicates that this is a purposive interpretation rather than a status interpretation to be applied
5 here.

ELIAS CJ:

I meant to look it up but, in fact, I think I did look it up and decided that it had no bearing on the case but the regulations that we have here don't include schedule 5, is
10 it, or 7, the one that defines the markets. That's not relevant to the argument.

MR GALBRAITH QC:

No, that – I was looking for that also. It is somewhere, I did see it.

15 **ELIAS CJ:**

I think I did look at it.

MR GALBRAITH QC:

Yes.

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ELIAS CJ:

And I think it is geographical, that's my recollection.

MR GALBRAITH QC:

25 Well, there is a schedule somewhere or other, I will try and find it, which does talk about dairy products and does indicate categories or some categories in dairy products such as yoghurt, for example, but I don't think you'd, I don't think we need trouble with it but I will try and find it for your Honour.

30 **ELIAS CJ:**

It's just that the regulations are directed at competition in the markets identified in the schedule, I think, but anyway –

MR GALBRAITH QC:

35 Look, I'll find that.

TIPPING J:

Is the real issue how can you do the processing?

MR GALBRAITH QC:

5 It – what qualifies as processing, yes, so that’s the real issue because we seem to be all agreed that some form of processing has to be undertaken. We say you've got to actually do it physically. The Commission says no, it can be done in any innovative way which the markets throw up.

10 **ELIAS CJ:**

But isn't that the second issue though because the first – or whether you have to do it. The first issue is, as you said, what constitutes “processing” in the context of regulation of the supply of raw milk?

15 **MR GALBRAITH QC:**

Yes. It's got to be we would –

ELIAS CJ:

Is it a processing of raw milk?

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MR GALBRAITH QC:

It's a processing of raw milk. It's something that changes raw milk from raw milk to a next stage and the next stages could be, pasteurisation is the common one of course, but it could be something different. So there's got –

25 **TIPPING J:**

But is there any dispute that assuming the, what I might call the independent contractor thesis is valid, that there is no ultimate processing. I mean, that's not an issue is it?

30 **MR GALBRAITH QC:**

No, if you can contract it out to Open Country, for example, Open Country do process it –

TIPPING J:

35 Yes.

MR GALBRAITH QC:

– there's no argument about that. So it's not an issue here that it's not being processed. It's really a question of who and how is it being processed or who by.

5 TIPPING J:

Can it be processed by an independent contractor?

MR GALBRAITH QC:

10 It can be. That's the particular issue in relation to the specific applications before the Court, yes. And I was just going to turn to those just to identify, because that's the other part of the, we've looked at the Regulations and the Act in a general sort of form but the other thing is that, so far as this particular case is concerned it relates to the applications by Grate and Kaimai and so I just want to look at those for a moment but they do, what I will be saying is, they do raise all the generic issues in a sense
15 because of the nature of the particular applications.

Now as the Court's no doubt aware from the documents, those two applications came up from Grate for 50 million litres and for Kaimai only for 10 million litres of raw milk. The proposal was that that raw milk in its raw milk state would be processed by
20 Open Country. Open Country itself had an entitlement to 50 million litres of raw milk which it was processing so if the applications had gone ahead on the basis that they were submitted then Open Country would have processed a total of 110 million litres of raw milk, 50 on its own account and 60 for Grate and for Kaimai.

25 There would, and I just want to explain this, that there would then have been some subsequent processing of that first initial processed milk into cheeses and some of that would have been done by Open Country on behalf of Grate and Kaimai, and some of it would have been by Grate and Kaimai themselves. So what you got was Open Country processing all the raw milk into a processed milk form and then Open
30 Country processing more of that processed milk into cheeses and Kaimai and Grate processing some of that processed raw milk into cheeses, and if you look at our paragraph 4.12 in our submissions, and I will have to do it this way because it's a confidential percentage, you will see set out there in the last sentence of 4.12 that Open Country, having done 100% of the raw milk processing, would then have done,
35 and we've got to be, it's a range, somewhere between those two figures of the next stage processing, or the next stages processing. So the bulk of the, all of the raw milk processing and the bulk of the processing of the, at the next stage would have

been carried out by Open Country and it's a little bit more particularly described if one goes to the submissions for the first and second respondents which set out the background to these applications, and if you wouldn't mind just turning to page 3 of the respondent's submissions.

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You will see on page 3 there is a description of what Grate's business was. It, as its name suggested, grates and blends cheese for the commercial market principally in New Zealand, as I understand it. It approached Open Country in 2008 with this proposal of a toll processing arrangement and you will see in paragraph 9 it describes what the process would have been under the toll processing agreement between Grate and Open Country. Grate would own all of the raw milk and resulting product which was to be manufactured to Grate's specifications and labelled and packaged in accordance with Grate's instructions. Grate would carry the entire risk, that's the commercial risk, but the bulk, if not all of the manufacturing of the cheese, would be, including the raw milk processing, would be carried out by Open Country.

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Kaimai was rather different. It was setting up as a speciality cheese manufacturer and what it was seeking to do was to contract, as it says in paragraph 14, to have Open Country pasteurise the raw milk which Kaimai purchased and to have Open Country toll process their hard cheese product for that season, but they were going to, I'm not quite sure where it is but they were going to, Kaimai itself, would do some of the further processing of their soft cheeses and you will see that in paragraph 15(a). So Kaimai intended to take the pasteurised milk and process that into its soft cheese range but the hard cheese range would all be processed by Open Country.

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So that's why in 15(b) the respondents say, well, the first stage of the production process would be physically performed under contract to Open Country and that means 100% of the raw milk processing. Both Kaimai and Grate intended to process at least some of the intermediate dairy product in their own factories. In Grate's that presumably would mean some grating and some labelling and Kaimai, some soft cheese being produced. Subparagraph (c) emphasises the fact that Grate and Kaimai were carrying the economic risk, or the commercial risk, in relation to that production.

30

So that's the factual background to the applications which Fonterra received. In our submission, and this – we are in disagreement with both the Commission and with

35

the Court of Appeal on this – the Grate and Kaimai applications raise both the issues of downstream processing and also virtual processing. Now as I say, we're in disagreement with the Court of Appeal and the Commission that say virtual processing doesn't arise under these applications. But, as will be apparent, the vast bulk of the percentage of the raw milk totally is processed by Open Country as a contractor and the bulk of the subsequent processing is also by Open Country as contractor, so in the terms which Fonterra at least has been using in this litigation that's virtual processing. The – Grate and Kaimai for the bulk of the product don't do any processing at all, they contract it out, and for some of the processing, for some of the product, yes, they do do some processing. They process the soft cheese, for example, or in Grate's situation they do some grating and labelling of their hard cheese to package it into a form that's suitable for commercial retail distribution, and that again, in the terminology which Fonterra at least has used, is downstream processing. So down the stream from the raw milk processing there is some actual processing done by Grate and Kaimai.

So in our submission, these applications do raise the generic issues which cause Fonterra, caused Fonterra and continue to cause Fonterra concern about the prospect of the wider interpretation which the Commission has applied applying to this regulated pool.

And again perhaps just pause and say it's also Fonterra's position that it's no good if you ask for 50 million litres of raw milk to actually process 1 million litres of it. It doesn't mean you can then sell 49 million litres into the marketplace, you can trade the 49 million. You've got to process, under whatever processing means, you've got to process the total volume that you're obtaining from the regulated raw milk pool, and again I'm not sure that's in dispute but –

Now four possible options for how one interprets the regulation purposively were identified by the Commission in its determination and they seem to be agreed between the parties that those are the options. They're probably best seen again back in the Commission's determination, which you'll find in volume A of the Case on Appeal behind tab 7, though they're described again in the Court of Appeal decision, but there's perhaps a fuller description in the Commission's determination and you'll find that behind tab 7, page 124, bottom right-hand corner, or starting on page 123, under a heading, "The four options", and it says, "The Commission has considered four possible options" – or sorry – "four possible interpretations of the term

‘independent processor’ labelled options 1 to 4. All of the possibilities permit an independent processor to processor regulated milks through toll processing arrangements to a greater or lesser degree. None of the options allow under normal circumstances the on-sale of raw milk,” and I’ve already taken you to those
5 references.

The two options which appear, the parties appear to accept the choice should be made between is option 1, which is the option which Fonterra asserts, and that’s that an independent processor must at a minimum physically process in its own facility all
10 of the regulated raw milk at the initial stage of processing and the balance of the processing may be done through toll processing arrangements. In other words, we’re saying that the regulation is targeted at the processing of raw milk and that’s what a processor has to do, and under that option neither Kaimai nor Grate Kiwi would be “independent processors”.

15 Option 2, which wasn’t adopted and I don’t think anybody’s really argued for, is that an independent processor must at a minimum physically process in its own facility all of the raw regulated milk at some stage in the production process. So it wouldn’t matter under that option whether they processed it as raw milk or as hard cheese or
20 as soft cheese. Just simply process it at some stage would be good enough.

The Commission suggests there that Grate Kiwi would be an “independent processor” under that, and with great respect I don’t think that’s correct on the facts as I’ve just outlined them from the respondents’ submissions because Grate Kiwi
25 weren’t processing all of the processed raw milk in their facility subsequently, Open Country were doing, as you will see from those percentages, a great deal of that, and the Commission also –

McGRATH J:

30 But they were not grating cheese in their own factories?

MR GALBRAITH QC:

Well they were doing some but not all of it, Sir.

35 **ELIAS CJ:**

I had missed that. Some of the grating was being carried out by Open Country, was it?

MR GALBRAITH QC:

I don't think they were necessarily grating it all I think some was sort of being sold as hard cheese, exported as hard cheese so Open Country were producing hard
5 cheeses for Grate and Grate were then exporting those, that's my understanding.

You will see in the next paragraph the Commission accepts that under this option Kaimai would only qualify as an "independent processor" for the soft cheese it was in fact processing downstream so my understanding is the same would apply to Grate.

10 Option 3 is simply that an "independent processor" must as a minimum physically process in its own facility some portion at some stage and that, well – and option 4 within an "independent processor" must process all of the regulated milk so, sorry, option 3 would say that you're okay if you ordered 50 million, processed one million at some stage into hard cheese and then –

15

TIPPING J:

Well that can't be, that can't be right. It could be one litre.

MR GALBRAITH QC:

20 No it can't – yes, that's right, it could be one litre in your way so I don't know that was a runner's option really.

And option 4 was an "independent processor" must process all of the regulated milk at all stages of the production process, either in the same facility or by toll
25 processing. So really the choices between option 1 which says you've got to do it yourself, physically, and option 4 which says you can subcontract to somebody else to do it and that's really the distinction between the two.

TIPPING J:

30 They key words are "in its own facility" really, aren't they?

MR GALBRAITH QC:

Yes, yes.

35 **TIPPING J:**

That that's mandatory in 1 and it's not mandatory in 4?

MR GALBRAITH QC:

Exactly, yes Sir. It's a pretty stark difference.

5 **TIPPING J:**

It's a very short point but not a simple one.

MR GALBRAITH QC:

10 A short point, yes Sir, very short point but it's, as the Court has seen, it's led to quite a deal of litigation this matter.

15 So Fonterra says that the option 1 best fits with the text and the context and the purpose of regulations and it minimises the practical difficulties. If I could just pause on the practical difficulties for the moment because you would have seen from both the Court of Appeal decision and also the Commission's submissions that a lot is made of the practical difficulties which might arise if option 1 were chosen and one of the examples, for example, is well what say the factory burns down in the middle of the season.

20 The fact of it is, and this is clear in the evidence, that these regulations in practice for seven seasons before the Grate and Kaimai applications came along, did operate as if option 1, I'm not saying that people thought about it legally, but as if option 1 applied. Everybody who came along and sought milk in that time was an actual processor and since, and something is made of this also in the submissions for the Commission, since the Grate and Kaimai applications came along and the issues
25 arose, there haven't been any other non actual processors who've sought milk supplies.

30 So we've had 10 years of the regulations applying in fact, I'm not saying in law but in fact, as if option 1 applies and nobody has produced any evidence of any practical difficulties which have arisen so at the moment the industry, well up to now, the industry, save for the Grate and Kaimai applications, has proceeded on the basis that it's actual processors, it's actual processors who have applied as actual processors who had the raw milk and processed the raw milk and there hasn't been a practical
35 problem. So I'm a little bit galled by the suggestion that the case being used against this is that this is a, that there is some scaremongering by Fonterra in respect of this. In fact the scaremongering, if there is any, is about the practical difficulties of

applying an actual processing test. It hasn't proved to cause any problems, it's not to say that there can't be theoretical problems but in practice it's worked.

5 The concerns which Fonterra has arise out of the potential of the Grate and Kaimai applications. Firstly, it risks, if virtual processors or downstream processors seek this regulated pool or to access this regulated pool of raw milk, then it seeks – then it risks the possibility of denying some or all supply to persons who actually need raw milk to actually process it, they're in that business, because of the pressure it puts on the, initially the 400 mil, and now the 600 million litre cap.

10

Secondly, it reduces the incentive to go out and compete for raw milk supply, and I'll come to that, and thirdly, of course, it increases, because it increases the pressure on the pool volume then it increases the pressure to increase as it's gone 400, 500, 600 and now there's a proposal 77 – 770 million litres. That increases the pressure to increase the total pool –

15

TIPPING J:

What's wrong with increasing the pressure on the volume, on – I mean, that might be thought to be consistent with the regulations. The more competition, the more people you have competing with Fonterra, the better.

20

MR GALBRAITH QC:

Well, the problem, of course, from Fonterra's point of view, owned as it is by farmer shareholders, is that it takes the raw milk processing away from the farmer shareholders who produce the raw milk in the first place and gives it to some other entity to effectively profit from.

25

WILLIAM YOUNG J:

And you still don't like don't like the current default price formula?

30

MR GALBRAITH QC:

No, but we say –

TIPPING J:

It must be at the bottom of all this. If you're paying a price you like, would it make any difference?

35

MR GALBRAITH QC:

If – in a sense it wouldn't. I mean, if it was evens across the board and there was no incentive one way or the other then possibly it wouldn't make any difference, but then possibly you wouldn't get people continuing to year after year apply for
5 50 million litres of raw milk because they go out and do it by contracting with farmers at the farm-gate and getting the advantage they could get there, and to some extent the fact that there is this continuation of companies that do have direct supply still seeking their 50 million litres of raw milk from this regulated pool is a pretty clear indication they see some advantage in doing that. If there was no advantage in
10 doing that, they wouldn't do it.

TIPPING J:

But should we interpret the regulations on account of Fonterra's view that the default price is too low?
15

MR GALBRAITH QC:

No – well, I suppose yes and – well, perhaps no and yes is the answer to that, if I could put it that way. I don't think that should be the driving, in any sense, the driving thing, but the fact that – if that is a fact, if there is an incentive there, an economic
20 incentive to obtain regulated raw milk rather than go out into, and compete to obtain direct raw milk supply from the farm-gate then it doesn't assist competition at the farm-gate, and I accept that the Act doesn't give primacy to that, but undoubtedly that was where the Act was first designed to bite, to try and stimulate competition at the farm-gate. And so it preserves, if I can use a bit of a pejorative term, it preserves
25 really a bit of a feather-bedding situation where the regulated pool really is an easy way out for persons who want access to raw milk. So it's not just Fonterra's farmers.

BLANCHARD J:

But that's a complaint about the way in which the raw milk price is being fixed, and
30 for the purposes of this litigation haven't we got to assume that the raw milk default price is a fair price?

MR GALBRAITH QC:

I'm not sure that you should assume that, Sir, because initially the default raw milk price, Fonterra would say, wasn't a proper price and we would say that was
35 recognised when the default raw milk price was altered because it was recognised that a –

BLANCHARD J:

But they altered it presumably to get it fair.

5 **MR GALBRAITH QC:**

To try and make it, yes. We say they missed, and so it's – I mean, it's an open question. Your Honours can't decide whether we're right or whether we're wrong on that obviously, but put it this way, it's still a question whether it's a fair price or not and there does seem to be incentives to companies to continue to seek milk from the regulated pool, and they must have some reason for doing that, so there's some benefit which doesn't appear to be priced in, Sir, which leads to that.

You can understand in relation to the small companies because much harder to go out and negotiate to get 100,000 litres of raw milk somewhere or other from farmers, but not when you're talking about 50 million.

In any event, that's –

ELIAS CJ:

20 Don't you have to step back from that though because that's a moan –

MR GALBRAITH QC:

It's a very – yes.

25 **ELIAS CJ:**

That's a moan about the way it's operating, but don't you have to say that the Act is concerned with competition at the farm-gate for milk, that the Act envisages that regulations can be made in relation to the supply of other dairy products, that these regulations are focused on the competition at the farm-gate –

30

MR GALBRAITH QC:

Yes.

ELIAS CJ:

35 – and that it's not – that that is not fostered on your argument by enlarging the pool of regulated milk if it doesn't have the effect of stimulating competition at the farm-gate?

It's a leg up for those who are going to set up processing facilities, on your argument, and who will be contracting farmers.

MR GALBRAITH QC:

5 It's – yes. It's for those who were there and were going to potentially suffer as a result of a merger and those who wanted to be there and would have difficulty establishing themselves with farmers because they had no track history. That's – I mean, your Honour's put our submission in an accurate nutshell.

10 **TIPPING J:**

So you are allowed to go to farmer X, are you, and say, "I want to buy Y litres of raw milk from you"?

MR GALBRAITH QC:

15 Yes, well, what the Act did when it – I mean, it has its general purpose of efficiency, et cetera, et cetera, but what was actually done, because they were concerned that you were merging Kiwi and New Zealand Dairy – whatever it was called then – that they had by far the bulk of the farmer market, if I can put it that way, and that it would be – that would grow. It'd be difficult for others to compete with that. So we say that
20 the provisions of the Act and these Regulations which were intended to actually bite rather than the generic provisions which talked about efficiency, et cetera, were targeted at the farm-gate, getting raw milk from – the ability to negotiate or contract with farmers to obtain raw milk and if one looks at the Act you will see –

ELIAS CJ:

25 And Fonterra at the outset had something like 95%?

MR GALBRAITH QC:

Between the two of them there was – it was a percent –

30 **ELIAS CJ:**

Between the two of them, yes.

MR GALBRAITH QC:

– of somewhere up there between the two of them, yep. But if you look back at the
35 Act you'll see what was done in the Act to – so it's in our bundle of authorities behind tab 7, and if we go across to section 107 –

ELIAS CJ:

Is it 6? Behind 6?

5 **MR GALBRAITH QC:**

106, yes. There were two principal things which were done. First thing was farmers had to be able to come in and out of Fonterra without any restriction. That was the first thing. So Fonterra couldn't bind you in there. You were able to, if you could – you could contract with Fonterra but you could leave Fonterra. You couldn't be
10 locked in. The second thing was, if one looks under "Regulation of milk supply" on page 76, there was regulation of the supply contracts. So just as farmers could come in and out of Fonterra, the intention was that farmers could also come in and out of their contracts to supply. So if you look under section 107 you'll see they've got to – the new co-op's got to offer new entrants contracts as shareholding farmers for
15 one season. They can offer contracts for longer, in subsection (2), but under subsection (3) at all times 33% or a greater percentage of the milk solids produced within a 160 kilometre radius of any point in New Zealand is supplied under contracts with independent processors or is supplied under contracts that expire or may be terminated by the supplier at the end of the current season. So there's a 33%
20 minimum got to be up for grabs every season, or potentially up for grabs every season.

Secondly, under section 108, subsection (1), you'll see that shareholding farmers are entitled to allocate to independent processors up to 20% of their weekly production
25 throughout the season. So whatever the contracts say, they can still sell 20% off to independent processors.

So while I accept entirely, and the Courts have said this, the Act doesn't say primacy to farm-gate competition, it doesn't say that. It talks about efficiency and competition
30 and dairy products markets, et cetera.

The Milk Supply Regulation and the provisions which, in my respectful submission, actually buy it at that time in relation to raw milk, were provisions which said, well the opportunity is there for independent processors to obtain raw milk supply from
35 contracting with farmers because of these 33% floating free every 12 months and 20% available. Now, of course, you can – and the Act says all that but that doesn't mean it's going to happen, I mean that's the problem. Independent processors still

have to go and negotiate and farmers have got to be prepared to supply, you can't force farmers to supply.

5 So we say that the regulations which were in the – the raw milk regulations which we've looked at were a measure to ensure that while that was working through, while the incentives were worked through with independent processors seeking to obtain direct supply from farmers there would be a safety net, a pool, a regulated pool that was available so that those who were already processing raw milk or those who wanted to enter were able to access this pool of raw milk.

10

Now what we also say is that this was a targeted stopgap measure, if we'd like to use that term. It wasn't intended to be a measure that was to change or influence the changing of the structure of the dairy products industry overall, it was targeted at raw milk and it was targeted at a problem which one could quite readily identify as likely to arise in the initial stages of the merger.

15

What I haven't mentioned, and I should have mentioned when I was describing the Act, is that the Act had sunset provisions in. These regulations were initially to effectively only stay in force until there was 12.5% in the North Island independent supply and a volume percentage in the South Island. It then got modified later on to 20% of milksolids but these – there is, there are sunset provisions so this regulated pool isn't contemplated to last forever.

20

Now what the Commission does is, with respect, is rather different because what the Commission does, it takes the regulations and it says, well we look at, back at the Act and there are in section 71, for example, and section 4 subsection (f), there are provisions which say we've got to ensure efficiency in the dairy industry, et cetera. And so we look at these regulations and see how they can be best interpreted to assist in making the dairy industry more competitive, more efficient and the way you do that is, is you do that by lower barriers to entry and so we prefer, or the Commission prefers, option 4 because that says, anybody who can claim to be, to come under any of those three heads of the "independent processor" definition can obtain raw milk and subcontract, contract it out to be processed and if the person you contracted out to then sells it on your behalf to India or China or wherever else, well, that's a good thing, there's more competition and it's fundamental economic theory, the more competition you have, well, in theory, the more efficiency you have.

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So the Commission says, well, even if this does produce virtual processors, people who simply claim on the pool, that they qualify in a status way, they then claim on the pool, contract everything out to be done by Open Country or anybody else then it gets sold. They never physically touch the product. That's adding one more competitor to the industry and therefore that's the best way to interpret the intent or the purposes of regulation 4(1).

Now there are a number of problems about that. One is, of course, that can be at the cost of actual processors because as I've described, initially it was first in first served and now it's pro rata so if you have two Grates coming along and both asking 50 million of – litres of raw milk your 595 which you're at at the moment becomes 695 and everybody has got to be prorated down. So it has an effect on those who actually do process and do require it but also, and again if I could take you to the determination you will see how theoretical in a sense this is.

Again, if we go to volume A of the case in tab 7 and paragraph 185 of the determination. This is, there is a very comprehensive discussion of the various options which is, was produced first in draft determination and then in the final determination, but under option 4 on page 144, in particular paragraph 185, it says, "Option 4 is the least likely of the four options to directly encourage farm-gate competition. However, option 4 would ultimately promote competition at the farm-gate as option 4 has the lowest barriers to entry of all the options. It should thereby encourage entry into dairy market which may in turn encourage farm-gate competition." So this is the sort of stark difference between the two views.

Fonterra says, look, the problem that was envisaged and sought to be dealt with under the regulations was a raw milk problem. Raw milk comes from cows on farms and so that was the purpose of these regulations, to make sure there was access to raw milk coming from the cows on the farms to be processed.

The Commission's approach is, we're concerned about, because of these generic provisions in the Act, we're concerned about barriers to entry into the industry as a whole and so we should interpret these regulations as encouraging new entrants, whoever they might be and whatever they are going to do, and even if they are not going to themselves process any of the dairy product which is going to be produced from the raw milk, and in that way, over time, however long it might be, there will be some increase in efficiency in the dairy industry. So we say target it at raw milk. If

there was a problem beyond raw milk that was subsequently identified then the regulations allowed, the regulation making power under section 115 allowed for regulations to be made for if there is a cheese bottleneck, or a yoghurt bottleneck, or whatever else there might be, but the regulations which were chosen to be made and those specific provisions of the Act which bite were targeted at raw milk coming from farms to be processed and then it flows on, of course, into the other products which are produced from that processed raw milk.

Now –

10

McGRATH J:

So in terms of purposive interpretation you say we must focus on the particular purpose of regulation 4(1) and it's misleading if we start looking more broadly at the general statement such as the section 71 –

15

MR GALBRAITH QC:

Yes.

McGRATH J:

20 – of the purpose of efficient markets across the industry?

MR GALBRAITH QC:

Yes, it's a – it's quite normal for regulations to be, for an Act to be general of course and regulations to be targeted to a particular issue and we say there is nothing unusual about that and in the context –

25

ELIAS CJ:

Particularly, perhaps, when the Act envisages or anticipates that there may be discrete regulation of different markets.

30

MR GALBRAITH QC:

Yes, of different markets.

ELIAS CJ:

35 And that sets it out.

MR GALBRAITH QC:

5 Yes. So that that choice is always there. If there's a problem with the other market, well, you do something about it but you don't, well, it's certainly arguable that in choosing simply to regulate the raw milk market that was what the focus of the regulations were intended to be and there are a number of indications of that.

10 Now I know the sensitivity about referring to Cabinet papers and the Commission raises that issue but can I just take you to the Cabinet papers, not as saying that that indicates that this word means X or this word means Y but just to explain a little bit of the background of how both the Act, well the merger one should say and the Act and the regulations grew out of that because it's a rather different process than that which I think one would normally see where an Act goes through Parliament and then regulations are spawned out of that, that this was a negotiated process that led to the legislation into the regulations and that's –

15

ELIAS CJ:

Well, I think that can be accepted though Mr Galbraith –

MR GALBRAITH QC:

20 Yes, well –

ELIAS CJ:

– that that was the background but the question is, what are we to make of the legislation and the –

25

MR GALBRAITH QC:

Yes.

ELIAS CJ:

30 – regulations, and if you're right about the purpose of the regulations and subject to what is said I think that there is a powerful argument in support of that. You still then have to get onto the textual argument as to whether that was achieved –

MR GALBRAITH QC:

35 Yes.

ELIAS CJ:

– in the regulations.

MR GALBRAITH QC:

5 No, I accept that entirely, your Honour. You can negotiate to your heart's content but if you don't express it correctly, well, you'll – it depends on that.

Perhaps just on that, the Commission has, I think, cited from a speech of the Minister in the introduction to the Act where he himself acknowledges it was a result of a political deal that was struck, and a political deal, the Cabinet papers make it clear, included negotiation of the regulatory framework that was going to apply in the initial stages and it's – and we would say that, without you going to the Cabinet papers, you can see that the regulatory framework was targeted at raw milk just as those sections of the Act that I referred to, the 33% and the 20%, were targeted at making sure that there was the opportunity for independent processors to obtain, to negotiate for raw milk supply directly from the farmers.

TIPPING J:

Have you finished with the Commission's determination for this purpose, because there is, if you have, one point I want to raise in relation to a paragraph that immediately follows –

MR GALBRAITH QC:

Certainly, Sir.

25 **TIPPING J:**

– the one that you cited. It's 186 on page 32 of the determination, tab 7. I just wondered about the validity of the reasoning of the Commission here, having read it again. They say, "The Commission agrees that any new entry will increase the overall demand for regulated milk and put pressure on the overall cap." This is in response to your submission, which seems to be quite an important one.

MR GALBRAITH QC:

Yes, Sir.

TIPPING J:

The pressure on the regulated amount upwards. They say, “This is caused not by the interpretation of what is meant by ‘independent processor’ but by the existence of the cap.” That’s a bit difficult, isn’t it, because you have to interpret “independent
5 processor” in the light of the existence of the cap.

MR GALBRAITH QC:

Yes, Sir, and the wider your definition of “independent processor”, of course, the more pressure because, as I said before, if there were three Grates coming along at
10 50 million subcontracting to Synlait, Open Country and Westland, for example, for processing.

TIPPING J:

I’m completely agnostic as to where this leads one but that rather leapt off the page
15 at me as being a rather, subject to further argument, a rather curious way of, back to front way of looking at it.

MR GALBRAITH QC:

It’s back to front, Sir, because the cap doesn’t create the pressure. It’s the fact of
20 how many people you have demanding milk under it.

TIPPING J:

Well, the cap has the potential to create pressure but –

MR GALBRAITH QC:

25 Only when you get up.

TIPPING J:

– depending on which interpretation you adopt the pressure will be greater or less.

30 ELIAS CJ:

On your argument both cap and the sunset clauses are pointers to this being a transitional measure aimed at encouraging competition in the purchase of milk from farmers.

35

MR GALBRAITH QC:

Yes, yes, your Honour. So the cap puts – the pressure the cap puts on is to push people out to do that –

5 **ELIAS CJ:**

To go to farmers.

MR GALBRAITH QC:

– rather than –

10

ELIAS CJ:

Yes.

MR GALBRAITH QC:

15 – to keep put, pulling, pushing the cap up, and unfortunately we’re getting caught in a situation where the cap keeps going up and not enough pressure to push people out.

Perhaps just in that context I, again, excuse me saying this from the bar, but there’s been a review of the Regulations which I think the Commission refers to in its
20 submission. There’s a proposal to change the effect of the cap in relation to entities which have in fact got raw milk supply so that from I think the middle of 2015 if an entity has 30 million litres or more of raw milk supply for more than three years then it won’t be eligible any more, and that would push out these 50 million litre ones that you see in this list here because there’s not enough pressure unfortunately with a, I
25 describe as a feather-bedding position at the moment. Now that’s only a proposal. That’s not necessarily in effect.

So leaving Cabinet papers to one side, I’ve already indicated some of the matters which in our respectful submission indicate that this was targeted. There is
30 something in the specific wording of the regulation. You’ll see the Court of Appeal picked up our submission that if you look up the dictionary “processing” means “processing”. That’s what it says in the dictionary, and there are indications, and I accept that they’re not at all decisive, but they’re indications, where there’s a requirement to deliver to an address, et cetera. Now you can look at that as an
35 agency provision, which the Commission did, or you can look at it as making sense that it’s actually got to be physical delivery. As I said, certainly that’s how the

industry itself seems to have treated these, this opportunity under the regulated pool for, or apart from Grate and Kaimai, for all of the last 10 years.

5 There's the, the fact of the 400 million litres which was the amount provided initially as against 250 million going to Goodman Fielder so with 150 million litres it, with great respect, clearly wasn't intended to restructure the dairy industry. I mean there wasn't any chance on earth that that was going to be sufficient to cause any radical restructuring. What it was intended to do was to alleviate the problems which would arise immediately from the merger and protect those persons who were, or entities
10 already processing raw milk or might have been intending to immediately enter to do so.

McGRATH J:

I take it that the allocation that ended up with Goodman Fielder really is just germane
15 only to its business; we can't pick out anything from the nature of its business.

MR GALBRAITH QC:

No it was, it was, I mean it was a significant – they wanted to keep a significant competitor in the market place I think is what it boils down to and that's why it was
20 provided.

TIPPING J:

Is the term "independent processor" used in the Act in any way that might illuminate its intended meaning? I haven't done a search –
25

MR GALBRAITH QC:

No.

TIPPING J:

30 – through the Act as to the number of times it's used but I –

MR GALBRAITH QC:

It is used, it is used in a number of contexts including in the sunset provisions, for example. It's ambiguous I suppose is what one might say. We would say that unless
35 it does mean an independent processor of raw milk, when you come to the sunset provisions, for example, it could lead to manipulation there but we don't, we don't place any particular emphasis on that, Sir.

McGRATH J:

You're simply saying, as I understand it, it's an available meaning that you actually have to process it.

5

MR GALBRAITH QC:

It's an available meaning, yes, yes.

McGRATH J:

10 You've got one or two indications in the Act.

MR GALBRAITH QC:

Yes.

McGRATH J:

15 You're trying to supplement that with what happened for 10 years which –

MR GALBRAITH QC:

Yes.

20 **McGRATH J:**

– perhaps isn't quite an indication –

MR GALBRAITH QC:

No, no.

25 **McGRATH J:**

– relevant to interpretation.

MR GALBRAITH QC:

No.

30

McGRATH J:

But you're really saying it's an available meaning.

MR GALBRAITH QC:

35 It's an available meaning and it works, it's worked.

TIPPING J:

And it's the more consistent with the purpose I think is really –

5 **MR GALBRAITH QC:**

Yes.

TIPPING J:

– your key point isn't it?

10

MR GALBRAITH QC:

Yes.

TIPPING J:

15 You've got to show it's available –

MR GALBRAITH QC:

Yes.

20 **TIPPING J:**

– I mean if it's not available that's the end of it.

MR GALBRAITH QC:

Oh that's the end of it, yes.

25

TIPPING J:

But if it's available and you can show it's more consistent with purpose –

MR GALBRAITH QC:

30 Yes.

TIPPING J:

– then you're making progress?

35 **MR GALBRAITH QC:**

Yes. It's a targeted purpose we say –

McGRATH J:

Yes.

MR GALBRAITH QC:

5 – as against a generic purpose and that's the choice and, to be fair, the Commission saw it as a choice, that they preferred the generic, I don't mean this at all critically, one can understand where the Commission sees the words "efficiency" in a generic provision they immediately light up and think of –

10 **ELIAS CJ:**

Thinking of throwing all the balls into the air.

MR GALBRAITH QC:

Well something, yes I'm being a bit careful what I said, whereas farmers of course
15 see it rather differently. They see it, you know, what happens every day when they get up at 4.00 am or something.

It's part of the test of, sorry, and there's the 50 million cap for any processing and, if one wants to be purely academic about it, you wouldn't have a cap if all you were
20 talking about was generic encouraging competition because it would be best price wins and there's the sunset provisions which also, as I say, show that it wasn't intended to carry on and there's the point that her Honour made. That the focus is solely on raw milk and all the other choices are still available.

25 But one can also look at the inconsistencies or what appear to be inconsistencies that the option 4 does produce and the one which has been most debated during the prior hearings has been the one which, if option 4 is the interpretation which is applied, then there is no reason why Fonterra can't be a contractor to a downstream or virtual processor for the milk provider from the regulated pool and to the
30 Commission's credit its submission is intellectually honest, it's consistent. It has always said that if option 4 is the option and so anybody who qualifies in a sense ticked the box an independent processor but can then subcontract or contract out the processing, then if Fonterra has the surplus capacity or Fonterra has the best price then in economic terms then it's desirable that Fonterra do the processing rather than
35 somebody else who would have to build the capacity or would charge a higher price.

ELIAS CJ:

Would you run – wouldn't Fonterra run foul of the definition of independence?

MR GALBRAITH QC:

5 Well it wouldn't be under this, it would still, the processor would still be under this approach, of course, the person who orders the milk not –

TIPPING J:

Could be me.

10

MR GALBRAITH QC:

Could be his Honour, and his Honour would then contract with Fonterra who's not the, I mean of course is the processor in a dictionary sense –

15 **TIPPING J:**

In the literal sense.

MR GALBRAITH QC:

– but not the processor in the legal sense –

20 **TIPPING J:**

And I then become the independent processor.

MR GALBRAITH QC:

25 You're the independent processor, Sir, and Fonterra is a processor but not one under the Regulations. So the Commissioner has always accepted that as being a consequence of the economic logic or the economic theoretical logic of its argument.

30 It's been said and was said by the Court of Appeal that would be terrible if Fonterra did that and there were submissions, in response submissions suggesting prospects of sham but the reality is that Fonterra has no wish to misapply the rules of the game but if that's the rule of the game and people come to them and say, what's your price, and Fonterra's price is best and it's arm's length then Fonterra would have great difficulty in refusing because of section 36.

35 **BLANCHARD J:**

What would be the vice in that?

MR GALBRAITH QC:

Well there's no economic vice, Sir, I agree with you, there is no economic vice and that's the point that the Commission of course makes, but I suppose there are two
5 issues. One is, with great respect, I don't believe anybody ever anticipated that would be the intention and now the words couldn't make it the intention but I don't believe that was what was ever contemplated that Fonterra would do that and it may have an impact, Sir, on, in relation to incentive to go and obtain raw milk contracts, et cetera, because Fonterra has got all those contracts, it's not free raw milk that the
10 pressure would then go on so it probably has some vice, Sir, in it.

McGRATH J:

But what you say really is, it could well be just simply an unanticipated consequence, and if it emerged the Regulations could be changed to address it which I think is what
15 the Commission is saying.

MR GALBRAITH QC:

Well that's what they say if it's then decided it was not desirable. I should say it is –

McGRATH J:

I'm not sure how much this bears on interpretation, I mean –

MR GALBRAITH QC:

No, except that, well except it's been a much debated issue, Sir, in the Courts below
25 and it isn't actually before you, but in fact exactly this, these propositions have been put to Fonterra so –

ELIAS CJ:

Well, if an interpretation leads to a result that is strange that may assist –
30

MR GALBRAITH QC:

Yes.

ELIAS CJ:

35 – in the interpretation, in the other interpretation.

MR GALBRAITH QC:

And everybody seems to think this is a strange result. When I say “everybody”, sorry, but the Court of Appeal thought it was a strange result and the respondents suggested it's a strange result and to be honest –

5

ELIAS CJ:

And the Commission says it would have to be fixed.

MR GALBRAITH QC:

10 Yes and Fonterra thinks it's a strange result. Well the Commission only says it would have to be fixed if it was being abused in some way. I don't think they would say that –

McGRATH J:

15 Yes.

ELIAS CJ:

I see, yes.

20 **MR GALBRAITH QC:**

– its, it has to be fixed –

McGRATH J:

If it emerged, if the consequence emerged, yes.

25

MR GALBRAITH QC:

Yes.

BLANCHARD J:

30 Would the vice be that it would reduce farm-gate competition?

MR GALBRAITH QC:

Yes, I think it would, Sir, because, as I say, Fonterra has already that milk locked up, it's not like it would have to go and get some more milk or that whereas for an independent processor there would there be, there would have to be – there would
35 be that incentive.

TIPPING J:

It would still be coming through the pool.

MR GALBRAITH QC:

Still be coming through the pool.

5

TIPPING J:

Instead of coming out of the pool and back in again.

MR GALBRAITH QC:

10 And back in, yes, exactly. So it seems odd but it is a consequence of the Commission's view and as I say, I –

ELIAS CJ:

15 Is "processing" one of the goods can be regulated for so that Fonterra can be required to supply it. I just noticed that this is not only – it's "goods" and "services" isn't it that get regulated?

MR GALBRAITH QC:

Yes.

20

ELIAS CJ:

It's at 115.

MR GALBRAITH QC:

25 115. Processing is listed, yes it is under, in little Roman iv. So it could be.

ELIAS CJ:

30 So if there was a bottleneck in competition because there weren't, there wasn't sufficient processing capacity under this, regulations could be made requiring Fonterra to process milk supplied by –

MR GALBRAITH QC:

Yes.

35

ELIAS CJ:

– and that wouldn't be contrary to competition at the farm-gate because it would be sourced, presumably, directly from farmers, to the extent that it wasn't part of the regulated milk supply.

5

MR GALBRAITH QC:

But it wouldn't increase competition at the farm-gate –

ELIAS CJ:

10 No.

MR GALBRAITH QC:

– because Fonterra has already got that milk so –

15 **ELIAS CJ:**

Well, no, I just wonder whether that doesn't envisage that Fonterra could be required to be a toll processor of outsourced milk.

MR GALBRAITH QC:

20 I think they could be under that but, with respect, I don't believe that was ever contemplated at the time. The idea was to keep Fonterra out of this area, it was all about restricting Fonterra's impact and not wanting Fonterra to spread its wings too far and so, as I say, I don't believe that was ever contemplated.

25 **ELIAS CJ:**

I'm not sure about that because the background to this is a huge, well I suppose it wasn't a monopoly but, you know, whatever the other –

MR GALBRAITH QC:

30 Well it's a –

ELIAS CJ:

– expression, less critical expression is and they do, the Act does seem to reserve the powers to intervene to force competition wherever there –

35

MR GALBRAITH QC:

Yes.

ELIAS CJ:

– proves to be a problem.

5 **MR GALBRAITH QC:**

Yes, and there's no argument about that, it certainly does and what we say was the problem – I'm repeating myself.

ELIAS CJ:

10 Well, your argument is that the problem addressed by these regulations, though, was the problem of obtaining milk from farmers.

MR GALBRAITH QC:

15 It was a problem they could see at the time. That was the problem that was going to happen on day one of the new merged entity and that's why they had the other provisions in the Act because that was the obvious immediate problem and that's where it all starts from.

TIPPING J:

20 I see "independent processors" is referred to in 108, section 108 –

MR GALBRAITH QC:

Yes it is, Sir.

25 **TIPPING J:**

– this is this 20% they are entitled, presumably notwithstanding any other contractual provisions to allocate the independent processor up to 20% of weekly production.

MR GALBRAITH QC:

30 Yes.

TIPPING J:

Now might it be thought that an expansive view of what "independent processor" means would be helpful to farmers in that respect?

35

MR GALBRAITH QC:

Well, I suppose in the sense, Sir, that the more independent processors you've got then the more competition that there is. Yes, I think that's...

5 **TIPPING J:**

So it's not a one way street. This is where I was asking for help as to how this "independent processor" notion works throughout the Act never mind these – I take your point about the Regulations being targeted but they've made a bit of a point of saying the meaning is the same as in the Regs as in the Act. I mean they've underlined that as Justice McGrath was pointing out.

MR GALBRAITH QC:

Yes.

TIPPING J:

15 Which means you've got to bear in mind what it properly means in the Act too.

MR GALBRAITH QC:

Oh yes.

20 **TIPPING J:**

Which takes a wee bit away from the targeting. It's a –

MR GALBRAITH QC:

25 Well, yes, except that, I mean that's correct but these "independent processors", as used here, of course, would then be seeking to obtain raw milk from the farmer. They've then got to – and they can, they can then cheerfully go off and get a process wherever they jolly well like.

TIPPING J:

30 I suppose that's right. It may not be *in pari materia* it's a different –

MR GALBRAITH QC:

No, it's not the same.

TIPPING J:

35 – it's a different issue.

MR GALBRAITH QC:

It's different, Sir, because it's the access to the regulated pool which is the issue –

5 **TIPPING J:**

Yes.

MR GALBRAITH QC:

– we've got under the Regulations so nothing stops the virtual processor going and –

10 **TIPPING J:**

But we're going to have to look pretty carefully around the whole Act, aren't we, to make sure we don't come up with a definition or an interpretation –

MR GALBRAITH QC:

15 That doesn't –

TIPPING J:

– that clashes with some feature of the Act.

20 **MR GALBRAITH QC:**

I don't think there is any. I don't think, as I said before, while we made some submissions on this now, written submissions, on reflection we're not – and I think our view is it doesn't really help us one way or the other but Your Honour is quite right, we don't want a definition that then –

25

TIPPING J:

No we don't want –

MR GALBRAITH QC:

30 – doesn't fit.

TIPPING J:

– that's going to be horrible over here.

35

MR GALBRAITH QC:

No, no. I believe our definition, actually I believe both definitions actually don't run into a problem with the Act. It's really just a question of deciding which is the more appropriate for the Regulations, Sir, perhaps the Regulations.

5

TIPPING J:

Well, but if anyone can later help with that would –

MR GALBRAITH QC:

10 I think – yes well look, we'll have another think about it.

TIPPING J:

– it would set my mind a bit at rest.

15 **MR GALBRAITH QC:**

We'll have another think about that, Sir.

TIPPING J:

20 They don't normally have in Regulations, do you, incorporation of definitions in Act because doesn't that –

MR GALBRAITH QC:

Well they –

25 **TIPPING J:**

– doesn't that apply under the Act, in the – what's it called now – the Interpretation Act.

MR GALBRAITH QC:

30 Yes, yes it does, it does.

TIPPING J:

But they seem to have brought in some of the definitions but not them all. I suppose they've just brought in the ones they thought were relevant.

35

MR GALBRAITH QC:

5 Yes, and it's a pretty confined regulation, Sir, so they seemed to have just gone through and picked five or six of them I think and just brought them in, but as his Honour, Justice McGrath made that point, Sir, before, it normally just comes in under the Interpretation Act.

TIPPING J:

Yes, but I wonder why they did it?

10 **MR GALBRAITH QC:**

I don't know, Sir.

ELIAS CJ:

15 Well, it may, and this is contrary, of course, to your argument –

MR GALBRAITH QC:

Yes.

ELIAS CJ:

20 – be a matter of emphasis.

MR GALBRAITH QC:

It may, though they would have been there in any event, so...

25 **McGRATH J:**

Well, they perhaps didn't want any reading down of the term when used in the Regulations, through the context of the Regulations, it seems to me. They wanted to –

30 **TIPPING J:**

That's why I'm worried – that's why I'm anxious to make sure.

McGRATH J:

35 – to just affirm it. That was the point I was making earlier, yes.

TIPPING J:

Yes, well, that's why I'm anxious to make sure it's okay with the Act too.

BLANCHARD J:

It's a bit odd though because they've done it with the word "Commission".

MR GALBRAITH QC:

5 Yes.

BLANCHARD J:

Well, what else could it have possibly meant?

10 **MR GALBRAITH QC:**

Well, I agree, Sir, but there's – yes, well, some is just style of a draft –

TIPPING J:

Perhaps there's something in the Cabinet paper about that, Mr Galbraith.

15

MR GALBRAITH QC:

Perhaps there is. I'll have a look. I don't think there is, Sir.

McGRATH J:

20 One can imagine a lot of people were drafting this Act in the final stages but everybody got something in, yes.

TIPPING J:

It's like a judgment.

25 **MR GALBRAITH QC:**

It's one of those Acts where there would have been a lot of pressure on in any case and the style can sometimes – I don't know the particular reason.

ELIAS CJ:

30 Would it be convenient to take the adjournment now?

MR GALBRAITH QC:

Yes.

35

ELIAS CJ:

Are you getting to the end of something?

MR GALBRAITH QC:

Well, I think actually we're probably getting to really the end of what I need to say. I
5 mean I can – the choice between the two interpretations I think is probably quite clear
to the Court and the reasons why there are the two views are quite obvious.

Perhaps just finally this I should say that we wouldn't agree. The respondent's
10 submissions tend to say because Grate and Kaimai were taking the economic risk
that therefore in some way that's relevant. In our submission there's no difference
between a good virtual processor and a bad virtual processor. Fonterra can't get into
the position of trying to gauge whether in the argy-bargy between the so-called
independent processor and their subcontractor, it's 99% of the profit to the
15 independent processor or 99% of the profit to the contracting party, but you can see
how in that argy-bargy or those negotiations there could be effectively a transfer of
most of the profit in any case to the contractor, the person who's actually physically
processing, rather than to the independent processor, depending upon capacity
that's available and price, et cetera. So from Fonterra's point of view it needs
something which is a pretty clear line. It doesn't want to have to investigate the
20 particular circumstances of contractual relations between parties.

Probably that –

TIPPING J:

25 Well, it couldn't matter on the terms of the independent contract. It's a point of – it's a
conceptual point, not a detail point, surely.

MR GALBRAITH QC:

Yes though, your Honour, you could see, just like the one litre as against the
30 whatever, that if the independent processor is only taking, you know, 0.1% of the
gain –

TIPPING J:

I can – yes, I understand that.

MR GALBRAITH QC:

– yes, and the contractor's getting 99.99% of the gain then you've really got effectively a trading situation because the independent processor's only buying them –

5

TIPPING J:

Yes, it could be –

MR GALBRAITH QC:

10 – to trade it on.

TIPPING J:

It could be a device.

MR GALBRAITH QC:

15 Yes.

McGRATH J:

Yes.

20 **MR GALBRAITH QC:**

Exactly, and we don't want to get into that sort of difficulty.

ELIAS CJ:

I suppose too on the argument that it doesn't matter if you contract out, you could
25 have someone who was simply selling a –

MR GALBRAITH QC:

Mmm, yes, exactly.

30 **ELIAS CJ:**

– a product throughout the whole thing –

MR GALBRAITH QC:

Yes.

35

ELIAS CJ:

– as a processor as long as they had contractual arrangements with someone who would process it at some stage.

5 **MR GALBRAITH QC:**

Yes, and the risk with a new proposal for the sunset proposal, at least the proposal which says if you've got 30 million litres you drop out is that a processor simply says to its customers, "Well, you apply to the pool and we'll sell you processing capacity."

10 Now there's nothing illegitimate or illegal about that but that would in effect subvert that proposal because –

ELIAS CJ:

Well, you could in fact have a retailer of these products who, you know, Foodtown or something, which was a processor on the argument that you have to meet.

15

MR GALBRAITH QC:

Yes, and I think we want to get the supermarkets out of – well, no, I shouldn't say that but –

20 **ELIAS CJ:**

All right, is there –

MR GALBRAITH QC:

That's probably all I need to say at this stage.

25

COURT ADJOURNS: 11.29 AM

COURT RESUMES: 11.49 AM

MR MacGILLIVRAY:

30 Firstly just to be clear about the scope of the argument. It is the respondent's position consistent with Fonterra and the Commission that an "independent processor" who purchases milk under the Regulations must be doing so in order to process it to compete in dairy markets, that it is not permissible simply to purchase milk under these Regulations to on-sell the milk. So we're in agreement on that point
35 and the disagreement between us is whether that first stage of processing needs to be carried out by own processing, that's to say, in a facility owned by the independent processor as opposed to in the case of a person who is a cheese

manufacturer by another company and facilities owned by that company on behalf of the end processor.

ELIAS CJ:

5 So, but you do say that somewhere down the chain they have to own process?

MR MacGILLIVRAY:

No, your Honour.

10 **ELIAS CJ:**

No?

MR MacGILLIVRAY:

We agree with the Commission's option 4 –

15

ELIAS CJ:

Yes.

MR MacGILLIVRAY:

20 – that if someone wants to contract out the entire process they can do so.

ELIAS CJ:

So if a supermarket –

25 **McGRATH J:**

But the effect of that is really that the ownership of the milk will have to remain with your clients.

MR MacGILLIVRAY:

30 Correct.

McGRATH J:

The contract would have to make provision for that unless they have to make provisions for processing, the contract can't be written in a way that would allow the

35 milk to be sold directly.

MR MacGILLIVRAY:

Absolutely. The independent processor would have to own the raw milk, pay for the processing, own the processed product, correct. In that sense they're a processor. Now –

5 **ELIAS CJ:**

So a supermarket –

McGRATH J:

It's all a matter of how the contracts are framed, is it, in the end?

10

MR MacGILLIVRAY:

It certainly is, and Kaimai and Grate are in relation to the milk that they tried to get from Fonterra, and it's important to emphasise that in relation to Kaimai and Grate this is now a hypothetical historical issue. They are not going to get this milk from Fonterra now but what they were going to do –

15

WILLIAM YOUNG J:

Sorry, what do you mean by that?

20 **MR MacGILLIVRAY:**

Simply, Sir, that the, there's a –

WILLIAM YOUNG J:

Because they are now – they can now process?

25 **MR MacGILLIVRAY:**

No, simply, Sir, that the issue of whether they are going to get milk from Fonterra or not is in the past. They didn't get the milk, the Court of Appeal rejected the argument that that was a breach –

30 **WILLIAM YOUNG J:**

Yes.

MR MacGILLIVRAY:

– of the Regulations and there is no cross-appeal on that point so –

35

WILLIAM YOUNG J:

It's for the future.

MR MacGILLIVRAY:

It's for the future.

5

WILLIAM YOUNG J:

Yes, but it is for the – it's significant for the future.

MR MacGILLIVRAY:

10 Potentially, but it happens that the opportunity in relation to Open Country is not there at the moment but, yes, there is the opportunity for the future. So –

ELIAS CJ:

15 Can I just get an answer to the question. Is a supermarket able to be an independent processor provided it retains ownership of the milk?

MR MacGILLIVRAY:

20 This is a question your Honour raised shortly before the break and in my submission there would be nothing wrong with a retailer of milk deciding that it wanted to purchase regulated milk and to pay for that milk to be processed at Open Country's factory, for example, which is a cheese factory but has a pasteurisation plant for a local retailer in the Waikato, near Open Country –

BLANCHARD J:

25 You said, "Retailer of milk," but you didn't mean that did you?

MR MacGILLIVRAY:

Well –

30 **BLANCHARD J:**

It's not going to be retailing it as milk.

MR MacGILLIVRAY:

35 It's going to be retailing, well it could be retailing it as milk but not as raw milk, your Honour.

BLANCHARD J:

Right.

TIPPING J:

5 As pasteurised milk, for example.

MR MacGILLIVRAY:

Indeed. And remember, on Fonterra's case all that needs to happen to qualify you to be an "independent processor" is to pasteurise the milk. After that you could sell it
10 back to Fonterra, you could sell it to Open Country, you can do what you like with it, that's Fonterra's argument. But to come back to the question, there would be nothing wrong with a local would be retailer or an existing retailer in the Waikato thinking, well we think we can make more money rather than going and buying milk from Fonterra which might be what we do at the moment to retail, for us to get regulated milk, pay
15 Open Country to pasteurise it on our behalf and label it for us, and to sell it in supermarkets and they would then be the processor of that milk. They would have made the business decision that that made sense to them and rather than build their own pasteurisation plant they could take advantage of some excess capacity that exists in the industry at the moment. Nothing wrong with it.

20

TIPPING J:

That would, ex hypothesi, have to be excess capacity presumably?

MR MacGILLIVRAY:

25 Correct, absolutely.

TIPPING J:

Or it would have to be worthwhile for the actual, if I can call it that way, the actual processor to expand their capacity.

30

MR MacGILLIVRAY:

But that's absolutely right and that's a very important answer to the specter that's raised of virtual processors swamping caps. For there to be any processing there needs either to be excess capacity or investment in new capacity. Someone is going
35 to need to build capacity, and I'm leaping well ahead into my submissions, but the – there's nothing the matter with virtual processors if it leads to actual processing which it must.

TIPPING J:

Well, there must be some actual processing going on somewhere.

5 MR MacGILLIVRAY:

Well, that's absolutely right, and the point is that no one is likely to invest in actual processing capacity in reliance on picking up toll processing opportunities under these Regulations. It might be something that they do while they're building to full capacity but it's unlikely to have them on a large scale, or continuously, or at least in
10 a way that's unduly reliant on the opportunity to get default milk, because this is a temporary set of Regulations which can be amended. They frequently are amended.

So the whole idea that there's going to be all of this sort of bad virtual processing going on that isn't real, in the sense of really building the industry, is simply fictitious.
15 For there to be virtual processing, there needs to be actual capacity. Someone needs to have made that actual investment in the industry. And if it's economically efficient for those competing with Fonterra not to be vertically integrated, for example, for someone to say, "Well, I'm going to set up a pasteurisation plant and offer services as a toll processor of milk and offer those services to a number of different
20 would-be sellers of milk into the market," that will be economically efficient. It's perhaps unlikely to happen but if that happens then there's nothing – there's no mischief in that, no mischief in the fact that that pasteurisation is virtual processing.

TIPPING J:

25 Mr – I don't want you to anticipate, Mr MacGillivray, but Mr Galbraith's client seems to be very concerned about the pressure on the cap upwards. Is there – leave it if it's more convenient to come to it.

MR MacGILLIVRAY:

30 No, no. I'm certainly very happy to deal with it, with that now, and in doing so I can hopefully clear up a question that was asked earlier on which was about how the volume was set. The only indication that we have for this, but I believe the Commission can probably confirm that this is correct, is in section 115(2) of the Act, which is in the appellant's authorities behind tab 6, where you'll see that the
35 regulations made under the power must not require new co-op to supply a total amount of goods or services that exceeds, in the Minister's opinion, 5% of the amount of the goods and services produced by new co-op, and I understand that the

400 million litres was the best guess at the time of 5% of Fonterra's production, and what's happened is there have been subsequent amendments to that limit to recalibrate it to 5% of Fonterra's total production on the basis that Fonterra continues to prosper –

5

TIPPING J:

But that's a protection, if you like, on the amount of the cap.

MR MacGILLIVRAY:

10 That's right, and what is now proposed under the new raft of changes is simply to have it so that the limit is 5% so that it will simply adjust automatically rather than having to keep coming back and amending it.

15 So you've got a cap that is designed to be 5% of Fonterra's total production. That's the judgement that's been made of how much of Fonterra's production should be opened up to – should be sort of forced – there should be forced contestability in relation to, and there's nothing in there, or any of the background papers, to suggest that this was intended to be a small or narrow range. Certainly there's nothing in the Regulations or the background to the Regulations that suggests that in picking
20 400 million litres and giving a certain amount to Goodman Fielder it was intended to be so narrow and small in opportunity that it must only be for those who were own-processing raw milk. It simply relates back to section 115 and the judgement in the legislature's view that the appropriate amount of Fonterra's total production to open up to potential competition was 5%.

25

ELIAS CJ:

I'll just – because I haven't really focused on section 115(2), just looking at the fact that it's the amount of those, that it's the 5% of those goods or services produced by or supplied to new co-op as the case may be, what do you say is the – the 5% here
30 under the Regulations is presumably the raw milk supplied to Fonterra?

MR MacGILLIVRAY:

Correct, your Honour.

35 **ELIAS CJ:**

Yes.

MR MacGILLIVRAY:

Yes that's right. And that those words, goods or services, relates back to section 115(1)(a) where there's the power to require new co-op to supply one or more of the following goods or services.

5

So that's all you've got in the Act or the Regulations about the cap as it relates to the Regulations. The overall purpose, which I will come onto in more detail in a moment, perhaps is to ensure contestability –

10 **TIPPING J:**

Just before you leave this point.

MR MacGILLIVRAY:

Yes.

15

TIPPING J:

Just to put it absolutely precisely. Is your answer to Mr Galbraith's client's concern, at least in significant part, that the upward pressure on the cap is controlled by the 5%, and to the extent that it reaches 5%, Parliament was perfectly comfortable with it being at that 5%?

20

MR MacGILLIVRAY:

That's absolutely right, and if it's considered that the upward pressure on the cap is occurring again but without the progress towards the sunset provisions, which are based on farm-gate competition having occurred and a certain amount of raw milk being actually collected from farmers by independent processors, then that's something that will no doubt be reviewed.

25

But in the meantime, Parliament has decided that's the appropriate cap and the principles of the Act which drive the Regulations are then to ensure that that cap is open to competition, is contestable. And it can't be, in my submission, a logical answer to say you've got to read down someone's ability to contest within that cap because there will be too much competition and you might get to the top of the cap. The idea is to promote competition and contestability and Fonterra says it is greatly concerned with farm-gate competition.

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The fact that you've got a limited cap and that every new entrant comes in and takes some of that cap, it self drives farm-gate competition because if you are going to get the amount of milk you want to compete in the way that you want you can't simply sit back on your heels and rely on this cap. As new people come in it will drive you to go out and compete at the farm-gate.

If you create an environment where, in fact, it's a nice cosy club of participants who have access to the cap by reading down and restricting the definition of "independent processor", you are more likely to lead to the opposite result that those who can comfortably simply get regulated milk will not be driven to go to the farm-gate and compete with farmers.

ELIAS CJ:

So you accept that the purpose of this Regulation is competition at the farm-gate?

MR MacGILLIVRAY:

Not specifically, no.

ELIAS CJ:

No.

MR MacGILLIVRAY:

Certainly not. The – Parliament has chosen competition at the farm-gate having occurred to a certain degree as the trigger point for the sunset provisions. So behind the Act, in that sense, the overall good that the Act is aiming at is an outcome in terms of farm-gate competition but there is nothing to indicate, in terms of the Regulation making power or the Regulations themselves, that they are concerned specifically, or even specially, with farm-gate competition.

ELIAS CJ:

Well I understand that in terms of the Regulation making power because it specifically envisages other – regulation of other products and services but you'll have – well you'll take us to the Regulations in support of that submission.

MR MacGILLIVRAY:

Yes.

ELIAS CJ:

Yes.

MR MacGILLIVRAY:

5 Perhaps it's convenient to look at again at the purposes of the Act because my learned friend has attempted to isolate the purposes, the general purposes of the Act, and say that you've got to look at the specific purpose of the Regulation and, in my submission, that you can't isolate the purposes of the Act in that way.

10 The starting point is section 4(f) of the Act and I'm very sorry but I spotted too late that section 4(f) is not, certainly not in my version of the Act, in the bundle...

BLANCHARD J:

Four little "f"?

15

MR MacGILLIVRAY:

Yes four little "f".

BLANCHARD J:

20 I think we've got it.

McGRATH J:

We've got it, yes.

MR MacGILLIVRAY:

25 You do have it, I'm – it's just my copy then.

McGRATH J:

Page 11 it is, yes.

30 **MR MacGILLIVRAY:**

And the, I think it's common ground that the relevant, the relevant part of section 4 is (f) where it says, "That the purpose of the Act is to promote the efficient operation of dairy markets in New Zealand by regulating the activities of new co-op to ensure that markets for dairy goods and services are contestable." So you've got an overall aim

35 which is efficient operation of dairy markets and the means by which that aim is to be furthered, that's to say by regulating Fonterra.

So you have in this purpose of the Act, a direct link to the Regulations. The purpose is to regulate the activities of Fonterra to ensure that markets for dairy goods and services are contestable.

5

And then that links forward to section 70 which sets out, for the purpose of the sub-part, the regulatory sub-part, is to promote the efficient operation of dairy markets in New Zealand which links back to the words in 4(f).

10 **ELIAS CJ:**

It is in the plural.

MR MacGILLIVRAY:

Absolutely. That's correct.

15

ELIAS CJ:

Yes.

MR MacGILLIVRAY:

20 And I'm going to come on to the significance of the fact that the only regulation that's been made so far is to raw milk and –

ELIAS CJ:

Yes.

25

MR MacGILLIVRAY:

And what you can take from that.

30 You then have in section 71 a number of principles. The first of which is that "independent processors" must be able to obtain raw milk and other dairy goods and services necessary for them to compete in dairy markets. So whatever Regulations have been made under this sub-part the Court should, when carrying out for the purpose of interpretation of those Regulations, bear in mind that the driving principle is that "independent processors", as defined, must be able to obtain raw milk and
35 other dairy goods and services necessary for them to compete.

ELIAS CJ:

Is it necessary for these processors to obtain raw milk in order to compete with their, in their dairying markets?

5 **MR MacGILLIVRAY:**

Yes, your Honour, it is, and we say Fonterra puts far too high an emphasis on the word "necessary" in section 71(a). That this is not a, some strict necessity test that if you can only get it from Fonterra, if you can't get it from anywhere else then you qualify –

10

ELIAS CJ:

No that's, I'm not really buying into that argument so much –

MR MacGILLIVRAY:

15 No.

ELIAS CJ:

– but it's –

MR MacGILLIVRAY:

20 Well, if you take the example of Kaimai, for example. Kaimai, at the time it made this application, didn't own a pasteurisation plant. It wanted to increase its production of soft and hard cheeses. Soft it produces in its own plant. Hard cheeses it has always contracted out to Open Country, before and after seeking milk from Fonterra. It wants to increase its participation in the market and it is necessary for it to do so for it
25 to get milk.

ELIAS CJ:

Well, yes, but is it necessary for it to get raw milk, is the question, because where's the indication, there's no regulation of pasteurised milk?

30

MR MacGILLIVRAY:

No absolutely not.

ELIAS CJ:

35 So does that not suggest that there is no problem with the supply of downstream products?

MR MacGILLIVRAY:

In my submission the opposite is the case. The fact that the Minister has chosen, given all of the suite of options available to the Minister under section 115, to regulate
5 only access to raw milk and to make that access available to all types of independent processors leads you to the conclusion that Parliament intended that providing access to the base product from which everything else is derived would be sufficient, rather than trying to regulate at different stages of the process. I mean – and you can see why you would do that. It would become very complicated to think for the
10 cheese maker we've got to, we've got to regulate the supply of milk fat solids for the, for Grate who process at a further stage downstream, we've got to regulate the supply of block cheese, for another person we've got to supply something different. Instead what's been done is simply to regulate the supply of raw milk and to say that that raw milk must be made available to independent processors, and this comes
15 back to my learned friend's submissions in relation to targeting, that where my learned friend gets to with all of this is to say really you derive the purpose of the regulations from the fact that they're targeted. Well, yes, they are targeted but they're not targeted in the way that Fonterra would suggest. They're targeted in terms of product at raw milk. In terms of who can have access to that product,
20 they're targeted very clearly on the words of the Regulations at "independent processors". It would have been very easy for Parliament to have targeted raw milk and processors of raw milk, and had they done that then we would have a much more difficult argument that someone who is not an own processor of raw milk can come along and say, "Oh, yes, but I'm going to contract out that part of it so I really
25 am." They haven't targeted it at certain independent processors. They've simply said, "We'll give everyone within that definition access to the product from which all else is derived," and the ready implication from that, in my submission, is that there would then be flexibility for those independent processors to work out how they were going to turn that raw milk into the downstream products that they needed to
30 compete in their markets.

So the fact that Parliament has a suite of regulating powers available to it and has said, "Well, we're not actually going to do anything specifically to help the cheese maker, specifically to help the cheese grater, we're simply going to make raw milk
35 available," is not a good reason for reading that restrictively to say that, in fact, the grater, the cheese maker, is to derive no benefit from these regulations at all and

they'd simply be dependent on other independent processors choosing to sell them downstream products.

McGRATH J:

5 When you say everybody has access, access is not targeted, are you relying on the meaning of "independent processor" in the Act as –

MR MacGILLIVRAY:

Yes, your Honour.

10 **McGRATH J:**

– as going beyond a processor of milk to the other product as product defined?

MR MacGILLIVRAY:

Correct. That's absolutely –

15

McGRATH J:

So is that part of your –

MR MacGILLIVRAY:

20 Yes –

McGRATH J:

Is that a supporting part of your argument?

25 **MR MacGILLIVRAY:**

Absolutely.

McGRATH J:

The key part of your argument?

30

MR MacGILLIVRAY:

It is the argument –

McGRATH J:

35 Yes.

MR MacGILLIVRAY:

– your Honour. It really is the argument that when you look at the way that this has been targeted, it's been targeted at "independent processors" as defined, and those are processors of milk, processors of milksolids, and processors of dairy products, and – and the point was raised earlier as to whether really the only odd one out there is dairy products. No, quite the contrary. On Fonterra's argument, a processor of milk is not even necessarily an "independent processor" because Kaimai, for example, wanted raw milk, it would be pasteurised at Open Country's factory, put in a truck and delivered 400 metres down the road where Kaimai would process that milk into soft cheese. So no doubt Kaimai was a processor of milk. Fonterra says, "That's not good enough. You're not an 'independent processor'."

ELIAS CJ:

Well, it says it's not – you're not a processor of raw milk and in the context of the regulations raw milk is intended.

MR MacGILLIVRAY:

And the point I'm making here, Your Honour, is it isn't even as if Kaimai, that Fonterra are saying of the three possibilities in the definition only one applies. Only a subset of one applies, because the processor of milk who contracts out that first processing stage of pasteurising it is not an "independent processor" according to Fonterra.

TIPPING J:

Well, your point really is that the definition doesn't say a processor of raw milk can stop there.

MR MacGILLIVRAY:

Absolutely not. It doesn't – it's processors in milk, and that could be pasteurised milk, it could be untreated milk. The regulations have chosen not to force Fonterra to supply treated milk to people. It would have been one possibility to say that Fonterra has to pasteurise milk and make pasteurised milk available. It's chosen instead to go right back to the base product, raw milk, from which everything else is derived, but the people who can access that product to which everything else is derived are processors of milk, milksolids or dairy products, and as I said the necessary implication of that is that they might need to, they are going to need to find some way of processing that raw milk into those downstream products and one of those ways is

by contracting out, another would be to invest in plant which Kaimai has now done. And you have the situation where Fonterra says, well, for a processor of cheese like Kaimai, it's okay if Kaimai pasteurise the milk and then sell the whole lot to Open Country to turn into cheese or contract out the whole cheese making process to
5 Open Country, that's okay, nothing wrong with that. But if Kaimai choose to contract out pasteurising and do everything else itself so that they are in a very full and real sense the processor of that cheese, that milk into cheese, that's not okay and that, in my submission, is an arbitrary result that makes little logical sense.

10 **TIPPING J:**

So you've really got two strings to your bow. One, the contracting out is not per se a problem and, two, in any event you do process milk personally?

MR MacGILLIVRAY:

15 Well, Kaimai does in relation to some of that product, that's certainly right and my learned friend's correct –

TIPPING J:

Not all of it though.

20

MR MacGILLIVRAY:

Not all of it, no, absolutely.

ELIAS CJ:

25 And you acknowledge that it wouldn't be necessary for anyone to actually process themselves.

MR MacGILLIVRAY:

Absolutely.

30 **ELIAS CJ:**

Yes.

MR MacGILLIVRAY:

That's a necessary –

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ELIAS CJ:

So the fact that Kaimai does is not important to your argument?

MR MacGILLIVRAY:

5 No it's not it's, I'm simply using it as an example of where Fonterra's interpretation
leads you on this which is this rather arbitrary requirement that as long as you
pasteurise it or perhaps filter it or separate it that you qualify if you do it in a factory
that you own, but if you do everything but contract out that first stage you are not an
"independent processor", and my learned friend sought to define Fonterra's position
10 as a usage argument. In my submission it's not a usage argument it's an ownership
argument because we agree that you'd have to be an "independent processor", there
must be some qualification that you be an "independent processor". You'd need to
be independent of Fonterra, for example, so the definition clearly has relevance to
qualify you. We accept that there is a usage component which is that you can't
15 simply on-sell the product, you have to be getting it to process it.

ELIAS CJ:

I'm sorry, I thought you just said, not use, it's not use but ownership, but you say it's
ownership but there must be a use component, is that what –

20

MR MacGILLIVRAY:

I beg your pardon, your Honour, I haven't explained myself properly. Where I part
from, where we part from Fonterra is that we agree that there is a usage component;
that the milk can't be being obtained from Fonterra to on-sell. Where we part from
25 Fonterra then is we say you do not need to own the facility in which the –

ELIAS CJ:

I see, own the facility.

30 **MR MacGILLIVRAY:**

– first processing step takes place. Fonterra say you do need to own the facility in
which the first processing step takes place. Exactly the same thing can happen to
the product on both examples. On Fonterra's example it's simply that the
independent processor owns the plant that does the pasteurisation –

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McGRATH J:

When you say "owned" do you mean own or lease?

MR MacGILLIVRAY:

Well, this is a problem that Fonterra says that should just be sort of ignored almost and left for another day, that the, I think that the way that it's put in their submissions
5 is that the precise contours of what it means to own process can be left for a case in which they matter, but you will need to ask my learned friend where Fonterra says that it's okay if you lease a factory. I'd understood in the Courts below that Fonterra might suggest that, no that's not good enough that you actually need to own a factory. And this is –

10

McGRATH J:

But on your argument.

MR MacGILLIVRAY:

15 Well on our argument you don't need to own it, you don't need to lease it, you simply need to be the person –

McGRATH J:

Contactoer.

20

MR MacGILLIVRAY:

– who owns, who owns the product.

McGRATH J:

25 Okay, the products, so you're not going there as far as – it's not your argument, you're not going there?

MR MacGILLIVRAY:

Well, I don't need to go there and when you try and go there you quickly see that it
30 can't have been Parliament's intention that the Commission and the Courts have to grapple with this type of issue of, what does it mean to own process? There is no concept of "own process" in the Act. It simply talks about the people who have access to the milk, we accept that they have got to have access for the purpose of having it processed but after that, we say, you just leave it to the way these things
35 happen in ordinary business.

And the point was made, well for 10 years nothing like this has ever happened before. That's, in my submission, incorrect and I'll take you to an example, and I point this out merely as an example of when the sort of thing we are saying would be readily contemplated by Parliament has happened in practice which is – if you take up volume C of the case on appeal and look behind tab 53, there's a letter from Fonterra to the Commerce Commission in relation to the determination, and if you have a look at paragraph 4 you'll see that in response to a request for information by the Commerce Commission, Fonterra outlines that there have been a couple of situations where Goodman Fielder did not carry out initial processing of raw milk and in –

WILLIAM YOUNG J:

Sorry, what paragraph is that?

MR MacGILLIVRAY:

Paragraph 4, your Honour, page 663 behind tab 53.

BLANCHARD J:

That's interesting because Goodman Fielder doesn't have to be an "independent processor". It qualifies as Goodman Fielder.

MR MacGILLIVRAY:

Indeed.

BLANCHARD J:

And I was – I thought about that earlier and didn't ask a question about it because I thought, oh, it's probably not very likely that Goodman Fielder's been breaking the rules that would apply if it was on the Fonterra definition – the rules that would apply on the Fonterra definition if it was an "independent processor".

30

MR MacGILLIVRAY:

Absolutely, and I should add that what Fonterra says about this letter is that, "Well, we've entered into a specific supply contract with Goodman Fielder so now it's no longer really supply under the regulations," and I don't seek to rely on this as being an example of supply under the regulations where Fonterra have allowed something other than own processing. I merely point out in Goodman Fielders' business affairs there have been a couple of occasions where one, because of capacity issues, and

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two, for no reason that's given, they've chosen to have some of their milk processed at somebody else's factory.

WILLIAM YOUNG J:

5 But it – sorry – Goodman Fielder is treated as an “independent processor” under clause 11 – rule 11 of the – regulation 11 of the Regulations –

MR MacGILLIVRAY:

Absolutely.

10

WILLIAM YOUNG J:

– because it's within the – its allocation is within the “independent processors” allocation.

15 **MR MacGILLIVRAY:**

Absolutely. They are treated as an “independent processor”.

WILLIAM YOUNG J:

Something that's puzzling me a little, what practical difference does this issue now have as between the parties? Kaimai has its own pasteurising plant. Does it have
20 limited capacity?

MR MacGILLIVRAY:

Sir, no. From Kaimai and Grate's perspective, this litigation has no practical application for it. It has no current toll processing opportunities. It had hoped to
25 obtain compensation for what it saw as a breach by Fonterra. As I said, that's been rejected and there's no cross-appeal. We – Kaimai and Grate – are here simply because Fonterra have chosen to appeal this aspect of the case and –

WILLIAM YOUNG J:

30 So all that's practically in issue is costs?

MR MacGILLIVRAY:

Absolutely. Practically that's all that's in it. Now it may –

35 **ELIAS CJ:**

What about for Grate?

MR MacGILLIVRAY:

Well, the same for Grate.

ELIAS CJ:

5 Same for Grate.

MR MacGILLIVRAY:

Open Country are full and, as I said, my instructions are that Grate and Kaimai have no current plans to toll process, and that will – if they can do in future, that will
10 depend on whether there's some spare production capacity that's going for sale at the right price. So the people who might be most interested in the outcome on my side of the table, I suppose, are all the other would-be independent processors out there who might, for example, look at a new entrant like Miraka and say, "Well, if Miraka's got some spare capacity could we go and buy that, could we use it," by
15 getting milk under the regulations.

WILLIAM YOUNG J:

And is this because Kaimai has sufficient pasteurising capacity to accommodate the likely requirements of Kaimai and Grate?

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MR MacGILLIVRAY:

Certainly Kaimai now doesn't need to have milk pasteurised because it's got its own pasteurising plant. That's certainly correct. It doesn't need to contract out that part of its business any more, and it still contracts out the making of hard cheese to Open
25 Country but Fonterra says, "Well, that's not a problem because you've done that because" –

TIPPING J:

You've got past the critical point.

30

MR MacGILLIVRAY:

Exactly.

TIPPING J:

35 It seems that the critical point is the pasteurising.

MR MacGILLIVRAY:

No, with respect, your Honour, the critical point is owning the pasteurising plant.

TIPPING J:

5 Well, specifically, yes, yes, but it seems that you can sin at the pasteurising stage but all other sins are not sins.

MR MacGILLIVRAY:

10 Correct. That's absolutely right. That's where Fonterra's interpretation leads. From Grate's perspective, Grate simply now has to do what it's always done and go back and buy cheese from a cheese manufacturer, which includes Fonterra. Grate commonly buys cheese from Fonterra and others to process. So it presents – if the appeal is dismissed, it presents future opportunities for Grate and Kaimai potentially, but in practical real terms the only issue is costs. Immediate terms, I should say.

15

The point that I really wanted to make in relation to the Goodman Fielder document was merely this, that it's not this unusual thing that an "independent processor" might, for good business reasons, at times outsource parts of production, including the initial stages of production. It has happened with Goodman Fielder. It could happen in future, and on – leaving aside the fact that Goodman Fielder are apparently under special terms now, if they weren't, then on Fonterra's, by Fonterra's lights, Goodman Fielder would have not been an "independent processor" of the milk on these two occasions and would have had to pay market price for the milk rather than the default price.

20

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BLANCHARD J:

But they are an "independent processor" because they come within definition, the definition paragraph (b) in the Act.

30 **MR MacGILLIVRAY:**

Yes, your Honour, that's correct; and I say that a processor of milksolids or dairy products is an "independent processor" because they fall within the definition as well.

BLANCHARD J:

35 Mmm.

ELIAS CJ:

I suppose it is – is it relevant that Goodman Fielder was a processor of other derivatives of raw milk and that the treating of it as an independent processor must hook up all those in a definitional sense? I'm sorry, I'm not explaining that very well
5 but it may be that that is a pointer to this being a status as Mr Galbraith referred to it.

MR MacGILLIVRAY:

Unfortunately the fact I don't, I can't inform you of is whether Goodman Fielder, prior to the regulations, processed raw milk. I don't know the answer to that. Certainly if it
10 didn't then it would be an indicator.

But one gets into all sorts of complexities about all of this if one tries to decide which type of independent processor should get access or can have access. If you simply follow the definition and say, "Look, subject to the restriction that you can't just be
15 buying this to sell it, if you're an 'independent processor' within the definition you've got access to it. How you process it is up to you. It's – we've decided that we're not going to force Fonterra to make its pasteurisation plant available to you. We're not going to force it to provide cheese to you. You've got raw milk. What you do with it is over to you," and one of the ways that you can participate then is by building plant
20 to process it right the way through. Another is by contracting out at any stage of the process, or even all stages of the process.

Ranged around somewhat, I did just want to point out for the sake of completeness before leaving the text of the legislation that "milksolids" is defined, as a defined term
25 in section 5, as meaning milk fat and protein components of raw milk, so the two – when raw milk is processed at an early stage it can be separated out into two separate components and different products can be made with those separate components so "milksolids", in my submission, can't be regarded as simply another way of saying raw milk, it is something different. You can make whey protein
30 concentrate, for example, with one of the components of milk just to point that out, and I've already emphasised the fact that independent processor is defined as "processor of milk" rather than as in the Regulations, "raw milk" which is defined in the Regulations.

35 I wanted to touch on when Fonterra moves onto its purposive interpretation, a lot of the focus is on what it says about the quality of the outcome that the interpretation

leads to in terms of participation and competition and wanted to make some brief points on that.

5 Firstly, just to very briefly repeat a point I think I have made which is that there is no indication, textual or in all of the background material, to suggest that one form of participation or competition was to be preferred over another. The other was to draw an analogy with Fonterra's complaints about the way that the raw milk price aspect of the regulation works because Fonterra says "well this produces, whereas this is meant to produce a fair price this produces," they say, "a cheap price." Now that's a fact, that sometimes regulations will aim to achieve an outcome and may or may not actually achieve that outcome in practice. It would be a mistake, in my submission, to take one view of the type of competition that is being produced or may be produced by a regulation and to pass a judgment on whether that's a good outcome and then to go back to the Regulations and interpret them to reach a better outcome. 10 There's a line to be drawn here between purposive interpretation and sort of retrospectively trying to fix up problems with Regulations. 15

McGRATH J:

20 Are you saying that if it's an unanticipated consequence it can't be relevant to the purpose?

MR MacGILLIVRAY:

Absolutely.

25 **McGRATH J:**

That it wasn't anticipated?

MR MacGILLIVRAY:

30 No we say that when you are looking at purposive interpretation here the correct question is simply this, is allowing "independent processors" as defined to obtain access to raw milk and to be able to process that raw milk in a facility that they do not own at the early stage contrary or inconsistent with the Regulations, with the purposes behind the Regulations, such that it can't have been Parliament's intention. So although the definition appears to say that "independent processors" are three 35 categories of "independent processor" simply can't have been Parliament's intention because it's offensive to the purpose of the Regulations for an "independent processor" not to own a pasteurisation plant. In my submission, you simply can't say

that, there's nothing that is inconsistent with the principle of making this amount of raw milk contestable between independent processors to say that one or more of those independent processors might contract out that first stage. Fonterra might say, well that's not going to lead to the best result or we think that there are some mischiefs that might be created by that, but that's not the same thing as saying, look, it's obviously inconsistent with the stated purpose of the Act and Regulations. In my submission it's entirely consistent with the purpose of the Act or Regulations because it allows greater access, greater contestability and greater flexibility, and Kaimai again is a very very good example of this. In the years when it was investing in cheese making facilities and chose to situate itself next to another company with a pasteurisation plant it could defer the cost of building a pasteurisation plant itself and get access to the dairy markets by getting Open Country to do it for it. On Fonterra's argument that would be, it would be prevented from doing that. One is consistent with access and contestability, the other is not, and you can see that conflict here in, between Fonterra's purposive approach which they say is designed to stimulate competition and contestability and the argument that they have put forward, although not in submissions today so much in terms of the word, reading the word "necessary" in 71(a) in a way that imposes a high threshold on access because it interferes with Fonterra's property rights, and in that argument you see the germ of truth in Fonterra's argument which is that really this is about imposing barriers to entry which is inconsistent with the purpose of the Act.

And just to deal with that point very briefly, and the Commission deals with this in its written submissions, we simply say in relation to that argument that you should put a lot of weight on the word "necessary" and read it as imposing a high threshold that you can't import that principle that says you read –

TIPPING J:

I would have thought it simply meant "to enable that".

MR MacGILLIVRAY:

Absolutely. Fonterra want to bring in a principle of general law that if you can read a statute in a way that does least violence to someone's existing property rights then you should.

TIPPING J:

Oh that's a bit –

MR MacGILLIVRAY:

And the point here is that's the case where you've got legislation coming in and interrupting someone's existing rights, the context here is these Regulations are part
5 of a set of preconditions for Fonterra coming into existence and without those preconditions it wouldn't exist and wouldn't have these rights so the principle can't, in my submission, apply.

In relation – I'll deal briefly with the argument that the proposed interpretation of the
10 Regulations would enable Fonterra to obtain benefit from the processing of raw milk, regulated raw milk, and that can't have been intended. Perhaps it wouldn't have been intended and it falls into the category of unintended consequences that can't then be read as a guide or an accurate guide to interpretation. What it would say is that one of the things that section 115 specifically contemplated was that Fonterra
15 might be obliged to make processing services available to other people and if that was one of the things that they could be forced to do then it's hardly offensive or a mischief to say that Fonterra might offer independent processors access to processing services, toll processing services and if it's willing to do so the respondents see no harm in that. The type of arrangements that are proposed by
20 Fonterra would call into question really whether there is any processing even virtual or toll processing going on by the independent processor because it looks a lot like simply the sale of milk for a margin but that's not something that we need to deal with particularly today. It's sufficient for us to say that to the extent that Fonterra wanted to genuinely toll process there's nothing that's actually wrong with that, it seems
25 unlikely that it's going to happen.

ELIAS CJ:

Sorry, what do you mean, genuinely toll process?

MR MacGILLIVRAY:

By that I mean that if Fonterra had spare capacity that it would go out and offer a commercial, a commercially realistic price that would enable someone to access that production capacity and have some milk process by Fonterra. Again the example
30 might be of a local milk company who wants to get Fonterra to pasteurise milk and bottle it and label it for it. If Fonterra's willing to offer that service at a market price
35 then that would –

ELIAS CJ:

Well on your argument it can't matter at all who the identity of the processor is.

MR MacGILLIVRAY:

5 That's absolutely right, it can't matter.

I've really covered all my points I think so unless you have any further questions.

ELIAS CJ:

10 No, thank you Mr MacGillivray.

MR MacGILLIVRAY:

Those are my submissions.

15 **ELIAS CJ:**

Mr Mills, we don't always hear from interveners but I'll just – you've heard the arguments that have been run. We'll hear you on anything that you want to stress.

MR MILLS QC:

20 Well, I'm conscious of the fact that I'm only here for pretty limited purposes and – so there might just be a couple of points that I'd –

ELIAS CJ:

Yes, that's fine. Come forward.

25

MR MILLS QC:

– touch on with the Court, if that's suitable.

30 The first thing I thought I might just mention, given that it's come up in the course of the questions from the Court, just does relate to this position of Goodman Fielder, and the reason for just saying one or two more things about this is that without wanting to, you know, engage actively in this argument, it does, in my submission, cast a useful light onto the consequences of Fonterra's position which clearly weighed, not specifically in relation to Goodman Fielder but as a principle, weighed
35 very heavily with the Commission when it was deciding how it should interpret this legislation and the regulations, and it's the fact that Goodman Fielder, as the Court has already noted, is an "independent processor" under the Act and as an

“independent processor” they as well would be, on the Commission’s view of things, entitled to get access to regulated raw milk. But on – and Goodman Fielder, at the time at which the legislation and the regulations were put in place, was seen as a significant existing potential competitor to Fonterra.

5

On Fonterra’s view of the argument, as I understand it, it would follow that Goodman Fielder would be under the same strictures that the respondents here would be under in terms of the way they could treat any regulated raw milk that they accessed. Now if it’s not – if that’s not the position and Fonterra says, and I don’t know whether they do, that Goodman Fielder is in a category of its own even though it’s an “independent processor”, and it can do what it likes, it can contract out to another party to process and so on, then of course that creates an uneven playing field between independent processors such as the respondents and Goodman Fielder who they are potentially competing with.

10

15

BLANCHARD J:

That’s the way I read it, that Goodman Fielder stood on its own. By being Goodman Fielder they were deemed to be an “independent processor” and therefore the rules wouldn’t apply to them.

20

MR MILLS QC:

Well, I’m not sure that that’s right. It could be so. It’s interesting that –

BLANCHARD J:

25

Well, on the definition, “independent processor” includes New Zealand Dairy Foods Limited and associated persons.

WILLIAM YOUNG J:

30

But it’s not raw milk supplied to them qua independent processors, your argument, I guess, Mr Mills, is it?

MR MILLS QC:

Yes, so –

35

WILLIAM YOUNG J:

They’re an “independent processor” but this isn’t raw milk supplied to them in that capacity if you accept Mr Galbraith’s argument.

MR MILLS QC:

Yes, correct. Certainly they are defined as an “independent processor” but the issue potentially with that is are they then, in terms of what they can do with that milk that they are entitled to have, insofar as it’s regulated raw milk, are they entitled to choose someone else to do the initial processing of the raw milk to pasteurised milk or whatever else that initial stage is? If the answer to that is yes then they are – it’s not an even playing field between Goodman Fielder and these other independent processors, such as the respondents. If the answer is no, they can’t, then of course it’s a different kind of uneven playing field.

Now it’s interesting that –

ELIAS CJ:

Sorry, just what does that mean? There’s a different kind of uneven playing field because it has happened in the past?

MR MILLS QC:

I mustn’t be making myself entirely clear. The question I’m raising, and I don’t know what Fonterra’s position is on this, although in a moment I’ll take you to something that indicates that Goodman Fielder had some concerns around this, is what’s the effect on Goodman Fielder as an “independent processor” in terms of whether they would face the same restrictions as Fonterra is raising against all other independent processors. In other words, you can’t contract out the initial processing stage, you must do that yourself, and if the answer is, no, no you’re in a category of your own and then you can contract it out if you want to then that creates an uneven playing field with other independent processors –

ELIAS CJ:

No, I would have thought that rather the position of Fonterra has to be whatever happened on that occasion in fact was not in accordance with the Regulations.

MR MILLS QC:

In other words, that they wouldn’t be restricted from being able to contract out, is that your Honour’s –

ELIAS CJ:

No, that they would be restricted.

MR MILLS QC:

5 Right.

TIPPING J:

There can't be a special –

10 **BLANCHARD J:**

I'm not sure about that, I –

ELIAS CJ:

All right.

15

BLANCHARD J:

– and I think it does create a difficulty for Fonterra's interpretation overall. It seems to me that that "independent processor" means Goodman Fielder.

20 **WILLIAM YOUNG J:**

But isn't the issue whether this is raw milk supplied to them as an "independent processor".

TIPPING J:

25 But they get a slice of the –

BLANCHARD J:

But if they are by being Goodman Fielder an "independent processor", not by because they otherwise do things that would be regarded as independent processing, then there is an obligation to supply the raw milk to them.

30

WILLIAM YOUNG J:

But it's to them, not to someone else.

MR MILLS QC:

35 Yes, yes.

BLANCHARD J:

Yes but again they could contract with somebody who has got another facility with spare capacity.

5 **ELIAS CJ:**

Well that's the issue.

MR MILLS QC:

It is the issue, yes.

10

ELIAS CJ:

But the point that I'm really saying, Mr Mills, is that I'm not sure that this correspondence, interesting though it is, is going to answer for us the question of interpretation of the Regulations.

15

MR MILLS QC:

No, I accept that, your Honour. I raise it only because at the core of the Commission's thinking on this question when it was doing its determination, thinking its way through this legislation, was the importance of a level playing field amongst the independent processors who would be emerging so the regulators hoped to compete with Fonterra and the importance that there be a highly contestable environment out there and so to the extent that Fonterra's interpretation of the legislation, which is to some extent put in issue by the Goodman Fielder issue, the extent that that does create an uneven playing field then that, in my submission, well it's certainly not a king hit by any means, is relevant to considering what is the correct interpretation.

20
25

I just mention in passing that when the Commission put the draft determination out for comment that one of the comments came in from Goodman Fielder and they had a concern about option 1 on the ground that it would prevent them from using spare capacity elsewhere in the industry to get their milk processed.

30

TIPPING J:

They're being treated as an "independent processor" aren't they –

35

MR MILLS QC:

They are.

TIPPING J:

– because they take the first slice of the regulated maxim.

5 **MR MILLS QC:**

Over the regulated raw milk, yes.

ELIAS CJ:

10 But you mean that their concern was that their ability to toll process for other independent processors would be imperilled by that interpretation?

MR MILLS QC:

Either way –

15 **ELIAS CJ:**

Yes.

MR MILLS QC:

20 – either that way or because they might want to use someone else's spare capacity to do some processing, so either way.

WILLIAM YOUNG J:

As they did.

25 **ELIAS CJ:**

As they did on that occasion.

MR MILLS QC:

Yes, indeed, yes.

30 **ELIAS CJ:**

I'm not sure that this really assists us enormously. It's an interesting side show but –

MR MILLS QC:

Yes.

35

ELIAS CJ:

– I think –

MR MILLS QC:

5 Yes, as I say, so I raised it because it had, I knew it had been raised by Justice Blanchard and –

ELIAS CJ:

No Mr – if Justice Blanchard thinks it's significant. Carry on.

10

MR MILLS QC:

– so I thought I would touch on that. And of course the, all these independent processors are competing with Fonterra and Fonterra is not restrained should it ever choose to put milk out to others to process so, but I will move on from that.

15

The discussion that's gone on this morning to some extent does underscore the level of judgement that the Commission was engaged in as it moved beyond the question of that immediate point of interpretation to the question about well, what possible effect could one give to that when applying that to a set of facts and define their
20 four options, and on one view of it the real interpretation issue here is the question of whether the term "independent processor" as defined in the Act does have the same meaning in the Regulations, and if it does then I won't repeat what my learned friend, Mr MacGillivray, said because I think it's all been well-canvassed by him, but then you're into a different aspect of this and it's the area where all the complications are
25 arising, which is what's the – given that toll processing is accepted by Fonterra as part of what an independent processor can do, and all it's saying is you can't do that at the initial stage. You've got to have your own plant, equipment and labour at the first stage, but after that there's nothing inconsistent between being an "independent processor" taking regulated raw milk and contracting out. You can do that.

30

So the difficult issues, it seems to me, and the ones that the Commission found difficult, were over where are the lines. If you're an independent processor, you're entitled to access to the regulated raw milk. At what point in effect do you disentitle yourself because the way in which you're going to then use that milk once you've got
35 it crosses a line, and, of course, Fonterra is setting one line, which is you cross that line and you fall outside of your entitlement again if you don't own process, using own plant, equipment and labour, right at that first point. The Commission took a different

view of that, and the other options that the Commission put up were all thinking their way through what was the best way to apply their conclusion that the same meaning of “independent processor” followed through from the Act into the Regulations to the facts that they were confronted with with these particular respondents.

5

Now it’s an issue that I just mention perhaps somewhat hesitantly because it’s only had passing discussion in the Courts below, but I did begin to wonder as I listened to the argument, and particularly when I was reading again the written submissions where the proposition is put that the definition isn’t what really matters, it’s the usage that the regulated raw milk is going to be put to by the respondents, the extent to which this is really moving into the area which this Court has recently considered in *Vodafone v Telecom* [2011] NZSC 138, for example, and the question of where’s the line between questions of law and questions of fact?

15 And that’s touched on in Justice Miller’s judgment where he says, and I can take your Honours to the passage if you’d like me to, but where he comments, without fully developing it, it doesn’t refer to any cases, that really when we move beyond the question of what’s the correct interpretation of “independent processor” and start getting into areas of judgement about where is – what is the type of usage which is most appropriate here, whether there’s a different judicial test to be applied to that, which is captured in effect in the discussion in this Court and, of course, there’s a line of cases behind it both here and overseas, about what is law, what is fact?

25 So I just mention that in passing, but the Commission here has identified a series of options. In the High Court, although my learned friend, Mr Galbraith, now says the choices are between options 1 and 4, in the High Court Justice Miller records counsel for Fonterra, who wasn’t Mr Galbraith at that stage, saying well, option 2 was a possible viable alternative option, which just really underscores, in my submission, the extent to which there’s an exercise of judgement here about what best achieves the statutory purposes if you are within the definition of “independent processor” and if the Commission is correct in its interpretation in saying that the same meaning applies both under the Act and in the Regulations.

TIPPING J:

35 But is anyone suggesting otherwise that the same meaning doesn't apply?

MR MILLS QC:

That it doesn't carry the – that it doesn't carry the same meaning?

TIPPING J:

5 I have not heard anything said that suggests that we abandon the clear statutory directions it's the same meaning as in the Act.

MR MILLS QC:

10 Well I certainly had understood my learned friend to say that the definition which follows through into the Regulation itself was “independent processor” of course is in there, does carry a narrower meaning than under the Act itself. It's an independent processor of regulated raw milk who own processes using own plant equipment and labour.

15 **TIPPING J:**

Well it would have been pretty odd if Parliament intended that and they said that it's the same definition as in the Act.

MR MILLS QC:

20 Well that's certainly the view the Commission took, so you're preaching to the converted.

ELIAS CJ:

25 Well the question is whether the case turns on definition –

MR MILLS QC:

Yes.

ELIAS CJ:

30 – leading to a status, as Mr Galbraith said, or whether it turns on a contextual application of the definition.

MR MILLS QC:

Yes.

35 **ELIAS CJ:**

So –

MR MILLS QC:

Well I agree, okay.

5 **ELIAS CJ:**

I mean that's really, what it boils down to –

MR MILLS QC:

Yes.

10

ELIAS CJ:

– there's a choice between those. I don't think you need to be concerned about passing beyond the statutory interpretation point in this case because that is really what we're – the only thing that we're concerned with.

15

MR MILLS QC:

Yes.

WILLIAM YOUNG J:

20

Are you suggesting that really whether it's an entity as a processor or not should be treated as a question of fact a la *Brutus v Cozens* [1972] 2 All ER 1297, and we should, as it were, defer to the expertise of the Commerce Commission?

MR MILLS QC:

25

No, no not at all. Really the opposite.

WILLIAM YOUNG J:

Well I thought you were sort of sidling up to that sort of proposition.

30

MR MILLS QC:

No, no, no, I would know that wasn't going anywhere.

ELIAS CJ:

Well it would with Justice Young in the hands of –

35

WILLIAM YOUNG J:

I think even with me it wouldn't have gone in this, in this respect.

MR MILLS QC:

No, completely the opposite. The question of what's the correct meaning of "independent processor" within the Regulations is absolutely quintessentially a question of law for this Court. The issue I'm raising is the extent to which when one moves beyond that into these difficult questions about, well when can you contract out? How much contracting out can you do? Can you lease the land instead of owning it? All those sorts of issues, those are, those involve some very difficult judgments which were the subject of the four options, the draft determination that went out, the industry comment that came in and ultimately the conclusion being reached and that's the point Justice Miller has made in his judgment.

BLANCHARD J:

Yes, well, it's probably even finer than that if you start to think about how commercial lawyers would draft around the problem created by Fonterra's interpretation, it's not just a matter of leasing land, it might be a matter of leasing equipment and then you are into sort of –

MR MILLS QC:

Yes.

BLANCHARD J:

– wet lease, dry lease, like aircraft.

MR MILLS QC:

Yes, indeed.

BLANCHARD J:

Do the employees of the equipment owner come with the equipment? Is that permissible or is it not? It gets very abstruse potentially.

MR MILLS QC:

It does indeed. Yes, well, you see those are all issues which led the Commission of course to say that that can't be what this is meant to be drawn into. Now it's clear that whether one chooses option 1 or option 4 or any of the other options that were identified, there are some loose ends with it but this is a very complicated regulation as we're seeing and what we have seen, and the Court's had this brought to its

attention, is that the regulators are watching this whole field of play extremely closely and we've seen repeated interventions to tweak the Regulations, to tweak the legislation all, in my submission, aimed at ensuring that the original goal which was trying to curb Fonterra's dominance and create competition in the marketplace is achieved and the Commission's view, as the Court will be aware, was that the form that that competition should take was not to be dictated. What was required was to give the opportunity for competition and then for competition to take such form as it took, which is why the Commission reached the conclusion that regulating raw milk, and raw milk only, was really focusing on the potential choke point and I think you can see that in the Act as well with the passages that my learned friend, Mr Galbraith, took you to: the 20% raw, the open entry and exit. It's all about the choke point, which potentially Fonterra, with its overwhelming dominance in the distribution of raw milk, had the potential to close off. The Commission's view was if you keep that open, and that's what the regulated raw milk regulations were intending to do, then you – and I think this is clear when one looks at the background to the regulations – the regulators can then afford to wait and see what happens and if they need to intervene again in some other aspect of the market, and there's been discussion about other ways in which intervention could take place, then they will, but the focus was on minimum intervention initially, make sure that that choke point isn't squeezed and then let the market take its own form and that's best achieved by option 4.

So that, I think, in essence is where the Commission was coming from, and I acknowledge and the Commission acknowledges that there are loose ends and some issues around that about which my learned friend has identified, but there are many more with option 1 and they are included in the ones that Justice Blanchard just mentioned, and that it would mean that the independent processor couldn't enter the market without setting up its own plant equipment and so on. The excess capacity elsewhere couldn't be utilised and the Commission's view was that that was not the best way to allow a more competitive market to develop and it would mean that there'd be barriers to entry created immediately by that need for own plant, equipment and labour and so on. So –

ELIAS CJ:

Does that conclude your submissions, Mr Mills, or do you –

MR MILLS QC:

Well, unless there's things that would be helpful. I mean, I'm aware of the fact the argument has been well-canvassed. The Commission's determination, while it is very long, sets out its position. The Courts below have canvassed it, and unless
5 there are issues I could be helpful with then I don't want to bore the Court by simply canvassing old ground.

ELIAS CJ:

Thank you. All right, we'll take the adjournment and we'll hear Mr Galbraith in reply
10 after lunch.

COURT ADJOURNS: 1.02 PM**COURT RESUMES: 2.14 PM****ELIAS CJ:**

Yes, Mr Galbraith.

MR GALBRAITH QC:

I'll be brief. Just dealing briefly with Goodman Fielder, the position was that
20 Goodman Fielder, and whatever its previous name was, was owned 50% by New Zealand Dairy Group, and it was a – it did full service, if I put it that way, so it did pasteurising of raw milk. It was a condition of the merger that there be a divestment of the 50% shareholding in New Zealand Dairy Foods, which became Goodman Fielder, within 12 months of the merger taking place, and that's what occurred.

25

Just in relation to the particular issue as to Goodman Fielder and the regulations, that document under – that letter under tab 53 of volume C that my learned friend, Mr MacGillivray, referred to – or it might have been Mr Mills actually – that was a letter that was a cover letter to the Commission explaining Fonterra's understanding
30 of the way the regulations had been applied. It does record that Fonterra wasn't aware of any situations where an independent processor who'd acquired milk under the regulations hadn't carried out the initial processing. It did refer to those two particular situations with Goodman Fielder where at one stage Goodman Fielder was short of capacity or storage capacity and at another stage asked for 95,000 litres
35 of raw milk, a very small amount, to be delivered somewhere else. But, as you'll see from the letter, that was dealt with under an independent supply arrangement, not

under the regulations, so so far as Fonterra was concerned it wasn't a supply under the regulations, it was a supply under normal contractual or commercial terms.

WILLIAM YOUNG J:

5 But was it debited to the then 400 million litres per season?

MR GALBRAITH QC:

I can't tell you the answer to that, Sir. I just don't know. It shouldn't have been, I think is the view I would take in any case, but I wasn't asked at the time.

10

Now Fonterra's case, and I'm not going to repeat it, Fonterra's case is, as the Court understands it, is that the regulations have to be interpreted contextually. I won't go through the features I referred to before but if I could just point to or just explain a couple of matters.

15

The 400 litres, the 400 million litres which was the initial cap, I was asked if there was any evidence as to where that came from. I have been provided with something over the break. As I said, there has been this review ongoing by MAF and in the MAF summary of proposed amendments it does note that when the raw milk regulations were initially put in place the volume was set at 400 million litres as this was approximately the size of the domestic market at the time.

20

TIPPING J:

Well, that was the 5%, was it, that Mr MacGillivray referred to?

25

MR GALBRAITH QC:

No, the 400, Sir, not the 5%. I –

TIPPING J:

30 Wasn't the 400 though the amount that had to be supplied to the independent processors?

MR GALBRAITH QC:

Yes, Sir, and that was approximately, along with the Goodman Fielder, 250 of that, was approximately the size of the domestic market at the time and that's –

35

McGRATH J:

The domestic market in?

MR GALBRAITH QC:

5 Processing raw milk.

ELIAS CJ:

Outside Fonterra, the independent –

10 **MR GALBRAITH QC:**

Outside of Fonterra, yes, I'm sorry, and it –

TIPPING J:

So you were saying it was the 100%, not 5%?

15

MR GALBRAITH QC:

It was 100% of what the non-Fonterra part of the market would require, the demand in the non-Fonterra –

20 **TIPPING J:**

But did it equate to 5% of the whole –

MR GALBRAITH QC:

I don't –

25

TIPPING J:

– production, because that's what Mr MacGillivray was referring –

MR GALBRAITH QC:

30 Yes, my understanding is no –

TIPPING J:

That's what he said it was.

35 **MR GALBRAITH QC:**

– because in 2007 when – it goes on to say, "In 2007 when demand for regulated milk was forecast to exceed that amount the total volume was increased to the

current 600 million litres which is approximately 3% of Fonterra's total milk supply." So I don't believe, with respect, that there was a – 5% was always the cap. Sorry, that was under the Act. They couldn't regulate for more than 5% but my understanding, or at least MAF's understanding was that the 400 mil and the 600 mil
5 came from market demand, not from arbitrarily imposing 5%.

Now, having said that, what they go on to say is that – they go on to say that so long as the raw milk regulations remain in place, there should be sufficient regulated milk for all new entrants and to order – in order to meet the key objective of providing an
10 entrance pathway. MAF therefore considers that the total volume of milk available under the raw milk regulations should be increased to 5% of Fonterra's total milk supply with the amount being reviewed periodically, for example, every three years, to ensure that it continues to represent approximately 5% of Fonterra's total milk supply. There appears to be little policy rationale for setting a limit other than the 5%
15 available under the legislation and it doesn't, it doesn't suggest, Sir, that it was 5% from day one. From day one, or they started out, which is exactly what you'd expect them to do, by having a cap which approximated to what the demand was out there. That's at least the MAF view of it and they administer these Regulations so are more likely to know the answer than I do.

20

TIPPING J:

And that document is somewhere in our papers?

MR GALBRAITH QC:

25 No it's not, Sir, because it's a post case on appeal document. We can make it available, Sir. We have got copies available.

ELIAS CJ:

Well, I can't see that it is going to matter myself but –

30

MR GALBRAITH QC:

No, all right, but I just want to clarify –

ELIAS CJ:

35 Yes.

MR GALBRAITH QC:

– the 5% wasn't automatically 5% from the start –

TIPPING J:

5 Well the parties are not agreed then as to how the – as to where that 400 million came from.

MR GALBRAITH QC:

Yes.

10

TIPPING J:

You say it's from demand, Mr MacGillivray says it's from –

MR GALBRAITH QC:

15 Well MAF says that, Sir, I –

TIPPING J:

Well yes, sorry. I'm saying you're putting forward that as a view.

20 **MR GALBRAITH QC:**

Yes, yes.

ELIAS CJ:

But in any event it has come to be –

25

TIPPING J:

To be 5%.

ELIAS CJ:

30 – five percent.

MR GALBRAITH QC:

Well it hasn't yet.

35 **ELIAS CJ:**

It hasn't yet got to that –

MR GALBRAITH QC:

Hasn't yet, it's only 3% at the moment

ELIAS CJ:

5 – yes I see, 3%, yes.

TIPPING J:

I see.

10 **MR GALBRAITH QC:**

So it's never stayed at the 5% if it ever –

TIPPING J:

Doesn't the fact of that cap though give some protection from the concerns that you
15 were expressing on behalf of Fonterra this morning?

MR GALBRAITH QC:

Well the problem you will have seen from that other letter, which I said I wasn't going
to rely upon, but that shows 595 million litres already knocking at the cap and that's
20 with – that those were actual processors at least as far as Fonterra's concerned so,
but if what your Honour is saying to me, yes, the cap can be increased and the
legislation provides for that.

TIPPING J:

25 Proportionately to your total production but it's linked to your total production.

MR GALBRAITH QC:

It can be, yes it can be.

30 **TIPPING J:**

Well it is.

MR GALBRAITH QC:

Sorry, yes but it can be increased.

35

TIPPING J:

It can be increased, yes.

MR GALBRAITH QC:

Yes, yes, no I agree with that but in doing that, as I say, as I said before I think, first it's got to be done otherwise what you have got is a pro rata effect on those who actually do need it and, secondly it, unless people actually need it, it is just a featherbedding situation of increasing it. It's – well the MAF position seems to be that it was initially identified as being necessary for those who were actually processing raw milk and if you introduce other parties –

TIPPING J:

10 The feathers in the bed are the price are they?

MR GALBRAITH QC:

Yes, something like that, Sir. Well, the feathers in the bed are the price but also the fact that there seems to be potentially other reasons, if one presumes the price is all right, other reasons why Open Country and Tatura and that still pick up the 50 million litres rather than go out and get it themselves. It must be easier if all you've got to do is write a letter saying I want 50 million litres then go out and negotiate with a bunch of farmers. So one would I think say that there is a convenience factor to my featherbedding use of that term, Sir. Perhaps it's not an appropriate term.

20

The other matter which I did refer to before but just to, excuse me, re-emphasise is the fact that the Commission itself recognises in the determination, paragraph 185, that option 4 doesn't best deal with the bottleneck because it says option 1 is the way that's going to stimulate, best stimulate, people going out and dealing with farmers to try and obtain raw milk. So we've heard about the bottleneck but the option they picked is the one which is going to be the least effective of the two options in dealing with the bottleneck.

25

Just briefly on what "own process" means. Yes, we have in this submission used the term "own the facilities". I think the effect of, substance of what "own process" means is that the processing party must physically and economically control the processing.

30

WILLIAM YOUNG J:

What's the difference between doing it by an employee or doing it by an agent?

35

MR GALBRAITH QC:

By an agent you're not going to, you're not going to be able to direct the employee, turn the tap this way or turn the tap that way, the agent will simply go and do whatever the agent will do. So you haven't got that, the same control which you –

5

WILLIAM YOUNG J:

Why would that worry Fonterra?

MR GALBRAITH QC:

10 It doesn't, it doesn't worry Fonterra in the sense that whether an agent turns the tap one way or the other or an employee turns the tap one way or the other but it has the effect that it multiplies or compounds the number of entities that potentially can access this who, in a sense, don't have a significant stake in the game, whereas if it's got to be own processed then there is a sufficient stake in the game to both stimulate
15 the own processor to seek alternative supply because of the sunset provision, et cetera, and also, of course, it doesn't apply the pressure to the cap which could end up with people who do have a sufficient stake in the game being prorated, so it has at least those two potential impacts.

20 Now I understand what Justice Blanchard says about the ingenuity of contractual drafters, but –

BLANCHARD J:

Particularly at the stage in the process which is probably the least sophisticated.

25

MR GALBRAITH QC:

I'm not sure, Sir, whether it's the least sophisticated or not so I won't comment. But it hasn't been a problem, ingenious contractual drafting hasn't come up as a problem in
30 10-odd years.

30

BLANCHARD J:

Well, they haven't needed to because it – nobody's actually sought to do this.

MR GALBRAITH QC:

35 No, no.

BLANCHARD J:

So it's only now that the niceties of the potential situations come to be explored.

MR GALBRAITH QC:

5 Yes, but on – yes, I accept that, Sir, but one can also, of course, imagine the ingenuity of contractual drafters in relation to option 4 also where you effectively get what my learned friend, Mr MacGillivray, talked about it being a sale of milk at the margin, and I think I discussed that with Justice Tipping before lunch that – sorry, before the morning tea break – that if one has the situation of you're a virtual
10 processor and somebody's got capacity, it's simply a negotiating point as to who makes most of the profit, and the profit could come down to a very small amount that the so-called "independent processor" earns as against the actual processor. So it's – at the margins there are always going to be some difficulties. In fact, it hasn't proved a difficulty in reality so far.

15

Perhaps just –

McGRATH J:

What concerns me just a bit, I suppose, Mr Galbraith, is that normally, or quite often
20 in regulations, if there's concern about people operating as virtual processors and so forth, they'll put in an anti-avoidance provision, a general anti-avoidance provision. If you –

MR GALBRAITH QC:

25 Well, I don't think at the time that these regulations were promulgated, anybody would – well, I'm sorry, I see the headline in *The Dominion* today that we're going to have virtual public servants now so – but those – these are all sort of newish concepts, to me at least, and I think in 2001 they probably hadn't thought that possibility through, and I think in fact the Commission says that in its submission, that
30 really at the time nobody had contemplated that these sort of arbitrage potentialities might arise, and I think that's fair, Sir. I think what was – they were worried about, as I said before, they were worried about the fact in a merged entity, milk getting out into the, raw milk getting out into the marketplace might dry up, if that's not the right way to put it, and so this was, this was a pool as a safety net there and it was pretty
35 immediate concept they were worried about. And so when you take up, for example, the possibility that's been debated here now of supermarkets, for example, I'm – I'd say I'm sure but – it would be surprising if they'd thought of that possibility when they

were drafting the regs back in 2001 and – and if one takes up that possibility, of course, and I’m not saying this in a pejorative sense, that if you take up the proposal which I referred to before which MAF have now made that if you’ve got 30 million litres of your own supply that you shouldn’t be able after 2015 to qualify under the pool, then the obvious thing to do is go along to Foodtown if you’re Open Country and say, “Well, look, you tender for regulated supply under this pool, we’ll process it for you,” and so it’s not a question of excess capacity, it’s simply a question of a different independent – you change the name of the independent processor from Open Country to Foodtown and away you go again. So I’m not suggesting that in any pejorative way but that wouldn’t appear to be consistent with the purpose of the regulations, and I think it emphasises that the problem which, that paragraph 185 acknowledged, that option 4 doesn’t drive competition for farm-gate raw milk supply. Option 1 does, because it wouldn’t allow that sort of thing to happen.

And so my final submission is that objectively, if one looks at the fact that they singled out raw milk and there was the concern about the farm-gate situation, and the statutory provisions which were put into effect were obviously going to take some time to work through and there was a domestic demand for processing raw milk and they had to protect that, that objectively these Regulations were targeted in a much more limited way than the Commission’s approach, which the Commission’s approach is to say, well, they’re a stepping stone to restructure the dairy industry as a whole.

Unless there are any questions...

25

TIPPING J:

I have a question, Mr Galbraith, please. A point that’s weighing with me, or troubling me, is the proposition that your client’s argument leads to the outcome that someone can do absolutely everything downstream of pasteurising but not pasteurising, if I paraphrase. Now (a) is that right and (b) what do you say to that being something of an anomaly?

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MR GALBRAITH QC:

Well, it’s not – because these Regulations only deal with raw milk so what happens downstream is not dealt with by the Regulations so...

35

TIPPING J:

Well, no, but it's the consequence. They must have been aware when they drafted these Regulations that this would be the outcome, if your contention is sound.

5 MR GALBRAITH QC:

Well, it's always been that some parties might just process, might turn milk into pasteurised milk and sell it on, that people do that. That's part of the business. So there's nothing unusual about that happening. What we say is unusual is that because it – if somebody downstream does something with it, that then qualifies
10 them to jump into the shoes of the original processor and obtain the regulated raw milk so –

TIPPING J:

But the very same party that is said to be an "independent processor", if your argument is sound, is not an "independent processor" even though they do
15 themselves the downstream things but don't happen to do themselves the pasteurising.

MR GALBRAITH QC:

Well, they're an "independent processor" in a status sense of whatever it might be, cheese, or yoghurt, or something other else, but they're not an "independent"
20 processor of raw milk.

TIPPING J:

No, no, according to your argument.
25

MR GALBRAITH QC:

According to my argument, yeah.

TIPPING J:

30 Now I see that as anomalous but you say that shouldn't be the view.

MR GALBRAITH QC:

Well, that's – I think in fact that's always been the position in the sense that some people process raw milk and some people process pasteurised milk into yoghurt.
35 There's nothing unusual about that, that's just the way the world is.

ELIAS CJ:

And there's the ability to regulate the other stages if –

MR GALBRAITH QC:

5 They can still do that.

ELIAS CJ:

– if there are bottlenecks.

10 **MR GALBRAITH QC:**

Section 115 does that, but if you wanted – if you want to clear the bottleneck then the best way to do it is, in our respectful submission –

TIPPING J:

15 So the real, or a key to your argument is not to have the definition interpreted in what we call a status-type way but more in a usage-type way, if you like.

MR GALBRAITH QC:

Yes, yes, indeed.

20

ELIAS CJ:

I see the force of that argument but if – but Mr MacGillivray, I think, made a very strong counter to it which was that – so I accept that a purposive approach would allow you to use the part of the definition that fits in the Regulations and that if the
25 Regulations are concerned with, are regulating the supply of raw milk, it's that part of the definition that is contextually used, but Mr MacGillivray says that using, permitting any downstream processor, including someone – including a retailer, anyone, itself can increase competition for raw milk.

30 **MR GALBRAITH QC:**

Yes, and he's right but it's the point that the Commission accepts in paragraph 185 of their determination, it'll take longer to do it that way than if you do it directly by option 1 which limits it to people who really do have skin in the game on processing raw milk.

35

ELIAS CJ:

But is that the right enquiry for us, because the right enquiry for us is not which might have been a better interpretation, and it's a problem I have with the Commerce Commission's approach. It's just is there absurdity in the interpretation of using the whole definition in the status sense?

MR GALBRAITH QC:

In the status sense?

10 **ELIAS CJ:**

Yes, because if it has the benefits that are sought by the purpose of the Regulations then why would one not simply stick with the available meaning rather than a purposive meaning?

15 **MR GALBRAITH QC:**

Well, a couple of reasons, your Honour. The – I mean, it fits with the purpose but it fits with the purpose –

ELIAS CJ:

20 Less well.

MR GALBRAITH QC:

– ineffectually, put it that way, or it wouldn't promote the efficiency in the same way that the option 1 would promote the efficiency, so it's certainly not the – it's not what you would have expected objectively to have been intended because they would have – because this is the bottleneck, which everybody keeps emphasising, which it is, you would expect it to be the most effective way that had been chosen to try and eliminate the bottleneck. It also provides for effectively gaming, or the opportunity of gaming, for those –

30

ELIAS CJ:

That's the way it's been done, though.

MR GALBRAITH QC:

35 When you say that's the way it's been done, it's only –

ELIAS CJ:

That's your complaint about the pricing.

MR GALBRAITH QC:

5 Well, yes, but also if you apply the status then it does really allow for gaming. You've
still got to impose this limitation of saying but they can't trade it on, and if it's status
why can't they trade it on? I mean, the only reason you can't trade it on is because
you're imposing a usage requirement. So it's not a – it can't be – if we're all right and
we all agree that you shouldn't be able to trade it on then immediately you're
10 imposing a usage requirement and so it's not purely status. And then the question is
what is the usage requirement, and that's where we get into the argument.

ELIAS CJ:

Effectively you are trading it on, I suppose, if you're simply arranging for it – I
15 suppose you take the responsibility though on the arguments.

MR GALBRAITH QC:

Well, you can minimise your responsibilities. There's all sorts of – and that's what I
was really saying about the – at the margins. It's perfectly possible for somebody to
20 go so close to trading it on, because they're taking so little risk and making so little
profit out of it, that you effectively are trading it on, so that's another ingenious way of
getting round the Regulations. So I guess what Fonterra's really saying is, asking the
Court to be robust about it and say, well, it's one thing or the other and what Fonterra
submits would make the Regulations more effective in terms of what we say is the
25 target of the bottleneck at the raw milk processing end.

ELIAS CJ:

Right, thank you. Thank you, counsel, we'll take time to consider our decision in this
matter. Thank you for your help.

30

HEARING CONCLUDES