IN THE SUPREME COURT OF NEW ZEALAND

SC 39/2006
[2007] NZSC 36

BETWEEN COMMERCE COMMISSION
Appellant

AND FONTERRA CO-OPERATIVE GROUP LIMITED
Respondent

Hearing: 12 December 2006

Court: Elias CJ, Blanchard, Tipping, McGrath and Anderson JJ

Counsel: D J Goddard QC and L Theron for Appellant
J A Farmer QC and A K Rawlings for Respondent

Judgment: 30 May 2007

JUDGMENT OF THE COURT

A. The appeal is allowed and all relevant orders made in the courts below are set aside.

B. The Court declares that the capital referred to in reg 9(1) of the Dairy Industry Restructuring (Raw Milk) Regulations 2001 is the respondent's equity capital.

C. The respondent is to pay the appellant costs of $15,000 plus disbursements to be fixed, if necessary, by the Registrar.

D. In the absence of agreement costs below are to be fixed by the courts below.

REASONS

(Given by Tipping J)

Introduction

[1] This case concerns the meaning of reg 9(1) of the Dairy Industry Restructuring (Raw Milk) Regulations 2001. These regulations were passed pursuant to the Dairy Industry Restructuring Act 2001 which implemented a substantial restructuring of New Zealand's dairy industry. The Act facilitated the amalgamation of the three main dairy co-operatives in New Zealand. The amalgamated entity was named Fonterra Co-operative Group Limited and is the present respondent. Fonterra controls over 98% of milk produced by New Zealand dairy farmers. Its dominance in the relevant market was such that specific authorisation was required for the amalgamation. This was granted by s 7 of the Act. Some regulation of the new entity was seen as necessary. Among the measures introduced was an obligation on Fonterra to supply raw milk to independent processors[1] at a price which, absent agreement, was to be determined by a formula set out in the regulations. The ultimate question on the appeal concerns the meaning of the words "the cost of capital rate used by [Fonterra] in calculating the price of a co-operative share" which appear in reg 9(1) as an ingredient of the price-fixing formula.

[2] The 2001 Act expressly authorised the making of regulations requiring Fonterra to supply milk, prescribing the terms of supply and specifying the methodology for determining the prices to be paid.[2] This authorising provision reflects the general statutory purpose of promoting the efficient operation of local markets for dairy goods by regulating Fonterra's activities in order to ensure contestability.[3] This expression of legislative purpose is reiterated in the statements of purpose and principles in subpart 5 of the Act, which deals generally with dairy

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1 They being processors not associated with Fonterra.
2 Sections 115(1)(a) and (b).
3 Section 4(f).

market regulation and Fonterra's obligations in that regard.[4] These provisions are all plainly directed towards creating a level playing field for all processors in relation to their raw milk costs. They form an important part of the legislative context in which the Raw Milk Regulations were made and against which the crucial provisions in those regulations must be interpreted.

[3] In order to appreciate how reg 9(1) fits into the price-fixing machinery set out in the regulations, it is necessary to refer to several interrelated aspects of that machinery. The basic provisions are contained in regs 8(5) and 8(6) which provide:

> (5) The default milk price for raw milk supplied to an independent processor in a season is the wholesale milk price for that season plus,—
>
> > (a) for raw milk except organic milk or winter milk, the reasonable cost of transporting the raw milk to the independent processor; and
> >
> > (b) for organic milk,—
> >
> > > (i) the reasonable cost of transporting the raw milk to the independent processor; plus
> > >
> > > (ii) the reasonable additional costs to [Fonterra] of procuring and supplying the organic milk; and
> >
> > (c) for winter milk—
> >
> > > (i) the reasonable cost of transporting the raw milk to the independent processor; plus
> > >
> > > (ii) the additional cost of winter milk in the Island in which the winter milk is supplied.
>
> (6) The wholesale milk price for a season is the price per kilogram of milksolids calculated using the following formula:
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> $$\frac{\text{(total payout + [Fonterra] retention – annualised share value)}}{\text{kilograms of milksolids}}$$

[4] Each of the constituent elements of the reg 8(6) formula are separately defined in reg 3:

> **total payout** means the total payment made by [Fonterra] and interconnected bodies corporate of [Fonterra] to shareholding farmers for raw milk supplied by them in that capacity in a season, minus the total winter milk premium for that season

[4] Sections 70 and 71(a).

[Fonterra] retention—

(a) means the after-tax profit of [Fonterra] for a season that is retained by [Fonterra] and not paid to shareholding farmers; but

(b) does not include retentions for abnormal or extraordinary asset revaluations or write-offs

annualised share value, in relation to a season, is the amount of a perpetual annuity that has a net present value equal to the sum of—

(a) the price of a co-operative share as at 1 June in the season multiplied by the total number of co-operative shares as at that date; and

(b) the peak note price multiplied by the total number of peak notes as at 1 June in the season

kilograms of milksolids is the number of kilograms of milksolids supplied to [Fonterra] in a season by shareholding farmers in that capacity

[5] Regulation 9(1) provides that the "discount rate used by [Fonterra] in calculating annualised share values must be the same as the cost of capital rate used by [Fonterra] in calculating the price of a co-operative share". This is how the crucial words fit into and become an ingredient of the formula for determining the default price of the raw milk which Fonterra is obliged to supply to independent processors. The purpose of the formula is to identify the price that Fonterra pays its farmers for milk, by subtracting from the total undifferentiated payout the return that farmers receive on their shares.

[6] The capital referred to in reg 9(1) is the capital of the respondent, Fonterra. The cost referred to is equivalent to the rate of return which those supplying Fonterra's capital receive, or would reasonably expect to receive, on their investment. The return to them is the cost to Fonterra. The Commerce Commission, as appellant, contends that the crucial words refer to the rate of return on Fonterra's equity capital. Fonterra, on the other hand, says that the rate concerned is the rate applicable to the weighted average cost of both its debt capital and its equity capital, conventionally represented by the acronym WACC. It used that rate in calculating the price of its co-operative shares and hence that is the rate which applies for the purpose of reg 9(1).

[7] At one stage of the share valuation exercise the cost of Fonterra's capital as a whole is calculated on a weighted average basis, thereby combining the individual

costs of its equity capital and its debt capital. The influence of the cost of the debt capital on the weighted average leads to the cost of Fonterra's capital as a whole (its enterprise capital) being lower than that of its equity capital viewed in isolation. The weighted average calculation uses a rate of return (a discount rate) which is lower than that which is appropriate for establishing the cost of Fonterra's equity capital alone. The nature of the capital concerned drives the discount rate and it is this rate which is ultimately the crucial issue.

[8] The courts below have ruled in favour of Fonterra's contention; that is, in favour of the rate concerned being the WACC rate. They have done so largely on the basis that WACC is a recognised cost of capital rate, it was used by Fonterra, and it comes within reg 9(1). The question for this Court is whether this is the correct construction of reg 9(1). The Commission's principal argument is that the courts below have not taken proper account of the context and purpose of the legislative scheme in which the disputed words appear. The Commission contends, in effect, that the fact that Fonterra used WACC at one stage of the share valuation exercise does not mean that WACC is the rate to which reg 9(1) is referring. Fonterra responds that the courts below were correct in taking the view that the words "cost of capital rate used by Fonterra", in their immediate context, have a plain meaning which should not be displaced by any wider contextual considerations. Fonterra adds that, in any event, those wider considerations do not lead to the result for which the Commission contends. To appreciate the force of the competing arguments, it is necessary to describe in more detail the circumstances in which the issue arises.

Background in more detail

[9] In October 2001 three co-operative dairy companies, Kiwi Co-operative Dairies Limited, New Zealand Co-operative Dairy Company Limited and Fonterra Co-operative Group Limited, amalgamated under the name Global Dairy Company Limited. The amalgamated company was later renamed Fonterra Co-operative Group Limited. Two other dairy companies, Tatua Co-operative Dairy Company Limited and Westland Co-operative Dairy Company Limited, were invited to join in the amalgamation but decided to remain independent. There are other independent

processors which purchase milk from Fonterra. The amalgamation brought together New Zealand's largest dairy processing companies. Fonterra now controls over 98% of milk produced by New Zealand dairy farmers and exports 95% of its production.

[10] Being a co-operative, Fonterra is owned by shareholders who comprise all the farmers who supply milk to Fonterra. A dairy farmer who supplies milk to Fonterra must be a shareholder in Fonterra. Shares must be sold if the farmer ceases supplying Fonterra. Shares are bought and sold at their current value. The number of shares which a farmer must own is in direct proportion to the amount of milk the farmer supplies to Fonterra in a season. Farmers who supply milk to Fonterra must also acquire what are called peak notes. It was common ground that these are a form of equity.[5] The notes are issued at a set value of $30.00 each. As they have no relevance in themselves to the issue which must be resolved, we will make no further mention of them.

[11] A farmer's investment in Fonterra is represented by the value of the shares which the farmer holds. The value of the farmer's milk production is represented by the price paid by Fonterra for the milk which the farmer supplies to it. Each year farmers receive from Fonterra what is described as a "bundled" payment, comprising a return on their shares and payment for the milk they supply. The dividend component, that is the return on their shares, is not separately identified in the annual payout, the total of which is based on a price per kilogram of milk solids supplied.

The regulations

[12] As already observed, regs 8(5) and 8(6) of the Raw Milk Regulations, read together, contain a formula for calculating the default price which independent processors must pay for milk which Fonterra supplies them. Because the amount which Fonterra pays its shareholders each year does not distinguish between the dividend component and the amount paid for the milk itself, it is necessary, when fixing the default price payable by the independent processors, to subtract from the

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[5] Peak notes are non-interest-bearing loans to Fonterra that are designed to offset the inefficiencies caused by peak processing requirements. Farmers are required to purchase peak notes in proportion to the "peakiness" of their production.

total Fonterra payout that part which represents the dividend component. The balance is the price Fonterra is deemed to pay its supplier/shareholders for their milk. That figure, plus the permitted additions,[6] becomes the default milk price. By this means the two ingredients in the total payout (return on equity capital and price of milk) are "unbundled". The lower the return which the shareholding dairy farmers receive on their capital in Fonterra, the higher is the price which they are deemed to be paid for their milk, and the higher the default milk price will be.

[13] Regulation 8 allows Fonterra and the independent processors to agree a price for the milk which Fonterra is bound to supply to them. But, by way of control on what Fonterra can charge for this milk, the regulation provides for a default price which must apply if there is no agreement.[7] Effectively therefore, Fonterra cannot charge the independent processors more than the default price. This protects them from any attempt by Fonterra to use its market power to raise the price above the default level. The reason for the present dispute is that, as we have said, the lower the capital return, the higher will be the default milk price. The Commission contends that by adopting the discount rate applicable to its weighted average cost of capital, Fonterra is wrongly reducing the cost of its equity capital and thereby wrongly increasing the default price of milk. The difference is 8 cents per kilogram of milk solids.

[14] For present purposes the key component of the reg 8(6) formula is the annualised share value. It is the annualised share value component of the formula which is designed to establish the amount of the annual return on a farmer's shares, and thus on their contribution to Fonterra's equity capital. The cost of capital rate (or discount rate) is a vital ingredient in calculating annualised share value.

[15] Against that background we come to reg 9(1), which is effectively paired with reg 9(2):

> **9 Calculation of annualised share value**
>
> (1) The discount rate used by [Fonterra] in calculating annualised share values must be the same as the cost of capital rate used by [Fonterra] in

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6 Described in reg 8(5).
7 See reg 8(2).

> calculating the price of a co-operative share as at 1 June in the relevant season.
>
> (2) If [Fonterra] does not use a cost of capital rate in calculating the price of a co-operative share, the Commission must set a discount rate for calculating annualised share value and [Fonterra] must use that rate.

The key feature of reg 9(1) is that the discount rate for calculating annualised share value must be the same as the cost of capital rate Fonterra used in calculating the price of a co-operative share. This linking of those two rates suggests that there is a logical identity between the concept of annualised share value (that is, rate of return on equity capital) and the capital, the cost of which (that is, the return on which) is referred to in reg 9(1).

Discussion

[16] The main thrust of Fonterra's argument was that the plain meaning of reg 9(1) requires the use of the WACC rate as the discount rate, because the WACC rate was in fact used by Fonterra. This approach to the interpretation of reg 9(1), which is driven by the word "used", is fundamentally different from the approach advocated by the Commission. It requires identification of the capital referred to in reg 9(1) prior to consideration of whether Fonterra has used a rate applicable to that capital. The resolution of the issue thereby arising is best examined in two stages. First it is necessary to determine the correct approach to the interpretation of reg 9(1). As we consider that the meaning of reg 9(1) is not driven by the word "used", and that the phrase "cost of capital rate" must refer to a specific kind of capital, the necessary second step is to determine what that capital is.

[17] The essential flaw in Fonterra's argument, and in the decisions of the courts below, lies in their failure to identify the nature of the capital referred to in reg 9(1) as a separate exercise which must be undertaken before examining the process by which Fonterra calculates the price of a co-operative share. Put very simply, it is essential to be clear what cost of capital rate one is looking for before determining whether Fonterra has used it. Unless one does this prior exercise, there is major potential for error in identifying a cost of capital rate which Fonterra happens to have used in that process and saying that this must be the rate to which reg 9(1) is

referring, irrespective of its appropriateness for the task it is designed to perform. In order properly to undertake the initial exercise it is essential to take account of the context in which the phrase "cost of capital rate" has been used in reg 9(1).

[18] It is difficult to drive the interpretation of reg 9(1) off "use" once it is appreciated that if a WACC rate is used in the process of calculating the price of a co-operative share, it is inherent in its use that its necessary ingredients (cost of equity capital rate and cost of debt capital rate) have already been identified in the same process. Use of the WACC rate for share valuation purposes must necessarily mean that the valuer has used three cost of capital rates in the process as a whole, they being the two ingredients of WACC and WACC itself. Each of these three rates has been used, but the regulations can hardly have been framed on the basis that Fonterra could choose which of them it would employ for reg 9(1) purposes. Furthermore, as we will explain, Fonterra's "use" of the WACC rate in the course of the share valuation methodology was strictly for the purpose of establishing enterprise value, not share value.

[19] This analysis is supported by a closer examination of the share valuation methodology actually employed in the present case. The valuer identified cost of capital rates applicable to both Fonterra's equity capital and its debt capital. Those rates were used to determine the weighted average cost of capital rate which was used in ascertaining Fonterra's enterprise value. But significantly, for the purpose of establishing Fonterra's share value, the influence of Fonterra's cost of debt capital was eliminated ("backed out") before the crucial final step in the assessment.[8] The elimination of the debt component for the purpose of the ultimate share valuation supports the Commission's point that cost of debt capital, either in itself or as an ingredient of WACC, cannot logically feature in an exercise designed to establish a proper return on share capital.

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[8] This was done by deducting the value of Fonterra's debt from its enterprise value to arrive at a net present equity value, as explained by Mr Graham Stuart, Fonterra's Chief Financial Officer.

[20] A further reason why reg 9(1) cannot turn on "use" is that this would create an untenable conflict with reg 9(2). We discuss this point more fully below.[9] It is sufficient for present purposes to say that regs 9(1) and 9(2) apply in different circumstances, but both require identification of a discount rate appropriate to calculating annualised share value. It cannot have been intended that the discount rate referred to in reg 9(1) could be determined on a materially different basis from the discount rate in reg 9(2). That being the case, "cost of capital rate" must have a specific meaning, which must be ascertained before considerations of usage by Fonterra enter the arena.

[21] We turn now to the second stage of the inquiry. We do not consider the word "capital" in the phrase "cost of capital rate" has such a clear or plain meaning divorced from its context that the phrase can only refer to the WACC rate. It is already apparent that in the abstract it can refer to equity capital, debt capital or capital as a whole. Different costs will apply depending on which type of capital is being referred to. The cost of equity capital will reflect the rate of return appropriate to capital of that kind for the enterprise in question. The cost of debt capital will reflect the interest rate payable to the suppliers of that form of capital. The cost of capital as a whole will conventionally be the weighted average of the cost of both debt and equity capital. The concept of weighted average cost of capital is appropriate only if the capital being costed consists of both equity and debt capital. It can have no bearing if the capital concerned is only equity capital.

[22] It is necessary to bear in mind that s 5 of the Interpretation Act 1999 makes text and purpose the key drivers of statutory interpretation. The meaning of an enactment[10] must be ascertained from its text and in the light of its purpose. Even if the meaning of the text may appear plain in isolation of purpose, that meaning should always be cross checked against purpose in order to observe the dual requirements of s 5. In determining purpose the court must obviously have regard to

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[9] At para [26].

[10] "Enactment" means "the whole or a portion of an Act or regulations": see s 29 of the Interpretation Act 1999.

both the immediate and the general legislative context. Of relevance too may be the social, commercial or other objective of the enactment.[11]

[23] But, in any event, we cannot accept Fonterra's submission that the plain and ordinary meaning of "cost of capital rate" is the weighted average cost of capital. Critical to establishing Fonterra's so-called plain and ordinary meaning was the evidence of Professor Bowman as to the meaning usually attributed to "cost of capital" in relevant textbooks. The concept of a plain and ordinary meaning does not involve the court having recourse to external sources such as expert evidence and textbooks.[12] If the court has to do that there can hardly be a plain meaning. If one has to go outside the immediate text in this way, there is no logical reason to stop there. Any suggestion of a plain meaning must then evaporate.

[24] Where, as here, the meaning is not clear on the face of the legislation, the court will regard context and purpose as essential guides to meaning. Professor Officer was correct in his observation that the answer to the question what capital reg 9(1) refers to is not to be found in textbooks but rather by identifying the meaning of the phrase "cost of capital rate" from the context and purpose of the regulations.

[25] The definition of annualised share value implies a need to identify a discount rate, or rate of return, whereby the amount of the perpetual annuity referred to in the definition can be calculated from the price of the shares. The discount rate comes from reg 9(1) and is the cost of capital rate referred to there. The discount rate for the purpose of calculating the annualised share value must be a rate appropriate for assessing what is effectively a deemed dividend, being a return on shares. The discount rate must therefore be a rate applicable to equity capital because the return the shareholders receive on their shares is necessarily the cost to Fonterra of its equity capital. It would be illogical if the cost of capital rate specified in reg 9(1) referred to capital other than equity capital.

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[11] See generally *Auckland City Council v Glucina* [1997] 2 NZLR 1 at p 4 (CA) per Blanchard J for the Court, and Burrows, *Statute Law in New Zealand* (3rd ed, 2003), p 146 and following.

[12] Reference to recognised dictionaries is, of course, in accordance with the plain meaning approach.

[26] Regulation 9(2) supports this view. The fact that it was likely to be of limited application does not diminish that support. Regulation 9(2) was designed to operate if Fonterra did not use a cost of capital rate in calculating the price of a co-operative share. In, context "a" cost of capital rate in reg 9(2) must mean the same as "the" cost of capital rate referred to in reg 9(1). If reg 9(2) applies, the Commission is required to set a discount rate for calculating annualised share value and Fonterra is obliged to use that rate. The default rate fixed under reg 9(2) must properly relate to the annualised share value calculation. It must accordingly relate to a proper return on equity capital. Those who framed the regulations could hardly have meant the position under reg 9(1) to be different. There is no justification for having dissonance in this respect between the two provisions, the purposes of which are materially the same, that is, to establish a proper discount rate for calculating annualised share value. The relevant cost of capital rate cannot therefore be the weighted average cost of capital, which necessarily includes debt capital. That cannot sensibly apply to a perpetuity arising from share value, the more so when the whole point of the exercise is to calculate an implicit dividend so as to remove it from the total payout in order to produce a figure for the milk itself.

Why the decisions below were wrong

[27] In presenting his submissions in this Court Mr Farmer QC said his client's argument was nowhere better put than in the judgment of MacKenzie J in the High Court.[13] It is therefore appropriate to examine the material parts of that judgment in order to identify why we cannot accept the Judge's conclusion.

[28] The Judge directed himself to consider whether the meaning of the words in issue was plain, and, if so, whether that meaning was "contrary to a sufficiently obvious purpose, to which the strict grammatical meaning must yield, or whether there is an obvious drafting error which must be corrected".[14]

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[13] *Fonterra Co-operative Group Ltd v Commerce Commission* (High Court, Wellington, CIV 2003-404-7350 and CIV 2004-485-273, 27 July 2005, MacKenzie J).

[14] At para [38].

[29] The Judge correctly said that the question was what was meant by the term "cost of capital rate" for the purposes of reg 9(1). But he then immediately said:[15]

> If what is used by Fonterra in the calculation of its share price in a particular season *falls within* that term, then that rate will become the discount rate for the purpose of calculating the annualised share value. If what is used by Fonterra does not fall within that term, then the Commission must fix the discount rate.

The Judge added that in answering the question a more detailed description of the process of calculating the Fonterra share price, under cl 4 of its constitution, was necessary. He then proceeded to embark on that description.

[30] As earlier foreshadowed, we consider this approach incorrectly fused two discrete questions: (a) what is meant by "cost of capital rate" in reg 9(1); and (b) whether Fonterra used such a rate. As we have earlier observed, if the two questions are fused, there is a distinct risk of begging the first question by identifying what may seem to be an appropriate rate which has been used in the course of the share price calculation. We consider this is what has occurred, because a little later the Judge said:[16]

> The essential question in this proceeding is whether the WACC rate used … in the calculation of the *enterprise value* of Fonterra *falls within* the meaning of the term "the cost of capital rate used by Fonterra in calculating the price of a co-operative share" in reg 9(1).

[31] The correct question was not whether the WACC rate used in the calculation of the enterprise value[17] of Fonterra "fell within" the meaning of the term "the cost of capital rate used by Fonterra in calculating the price of a co-operative share" in reg 9(1). Rather, the correct question was whether the WACC rate was the rate to which reg 9(1) refers.

[32] Consistently with this error the Judge said later that the "essential question" was "whether the WACC rate is *a* 'cost of capital rate' within the meaning of

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15 At para [39] (emphasis added).
16 At para [46] (emphasis added).
17 Note the Judge's (strictly accurate) reference to enterprise value when the terms of reg 9(1) require that the rate must be used in calculating share value.

reg 9(1)".[18] In reality the essential question was whether the WACC rate was *the* cost of capital rate referred to in reg 9(1).

[33] When addressing Fonterra's submissions the Judge said:

> [50] Fonterra's approach to the interpretation of reg 9(1) is essentially a "plain meaning" approach. Fonterra submits that it cannot be correct to say in any circumstances that a WACC is not a cost of capital rate at all. It submits that the evidence provided by the Commission does not suggest that WACC is not a cost of capital rate, but only that it is not the correct cost of capital rate to have applied under reg 9(1). Fonterra submits that it is not inconsistent with valuation best practice, or with the natural and ordinary meaning of the term "cost of capital" to apply a WACC for the purposes prescribed under reg 9. Fonterra submits that the term "cost of capital" can refer to both equity capital and debt capital. Professor Bowman, Professor of Finance at the University of Auckland, deposes that a number of standard textbooks use the term "capital" in a way which is consistent with referring to both equity capital and debt financing.
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> [51] Accordingly, Fonterra submits that Fonterra has … used a WACC in determining its share price, that a WACC is within the ordinary and natural meaning of the term "cost of capital rate", and that reg 9(1) accordingly applies to make that WACC rate the discount rate in calculating the annualised share value.

[34] This argument, which is essentially the same argument as that advanced for Fonterra in this Court, misses the essential point, which is the need to determine what the cost of capital rate is for the purpose of reg 9(1) before looking to see whether Fonterra used it. The fact that WACC is *a* cost of capital rate and was one of the rates used in the course of the share value calculation does not necessarily mean that it is *the* cost of capital rate to which reg 9(1) refers.

[35] The Judge acknowledged later that reg 9(1) was referring to only one cost of capital rate.[19] He also indicated that he had:[20]

> no hesitation in accepting Professor Officer's evidence, so far as it relates to the task of the Commission under reg 9(2). *The discount rate for the annualised share value is clearly a rate which is related to the equity capital of Fonterra.* Thus, where the Commission is exercising a judgment under reg 9(2), it may well consider it appropriate to focus on a discount rate which will reflect the cost of equity capital to Fonterra.

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18 At para [49] (emphasis added).
19 At para [55].
20 At para [58] (emphasis added).

But to confine the Professor's evidence in that way creates an illogical uncoupling of regs 9(1) and 9(2), with the primary provision being materially different from the default one. The Judge correctly recognised that the discount rate for the annualised share value was "clearly" a rate related to equity capital. He did not, however, recognise the significance of that proposition for the ultimate issue. The Judge should have recognised that Professor Officer's evidence strongly supported the proposition that both reg 9(1) and reg 9(2) were concerned with Fonterra's equity capital.

[36] The Judge had, however, earlier observed:[21]

> In considering the context, the distinction between the discount rate set under reg 9(1), and that set under reg 9(2) is, in my view, important.

He went on to explain what he saw as the essential differences. But, with respect, we do not consider the differences he identified were material differences. Again, the Judge seems to have been allowing a rate used by Fonterra to drive the meaning of reg 9(1) rather than the reverse. He thereby missed the important point that a construction which deprived regs 9(1) and 9(2) of their logical symmetry must be regarded as suspect.

[37] In coming to his conclusion that the "plain meaning" of cost of capital rate had not been displaced the Judge said:[22]

> In those circumstances, if the intention had been to exclude WACC as a discount rate for the purposes of reg 9(1), it might reasonably be expected that that intention would be clearly expressed. This is not a situation where it is necessary to apply the regulation to a situation not specifically envisaged by the drafter.

[38] And, in conclusion, he said:[23]

> For these reasons, I hold that, on the plain meaning of reg 9(1), read in its context, WACC is a "cost of capital rate". I further hold that there is not a sufficiently obvious purpose, which the promulgators of the Regulations could not have regarded as being achieved if WACC were used, to justify a departure from that plain meaning.

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21 At para [53].
22 At para [61].
23 At para [65].

Again the Judge refers to *a* cost of capital rate rather than *the* cost of capital rate specified in reg 9(1).

[39] We mean no disrespect to the Court of Appeal by not referring separately to its reasons for dismissing the appeal from MacKenzie J.[24] Essentially they were the same as those which he had given, albeit expressed differently in places. In the course of his submissions in this Court, Mr Farmer did not seek to rely on or adopt any particular passage from the judgment of the Court of Appeal. That Court also addressed certain procedural and process issues which, in the light of the way the case was presented in this Court, it is not necessary for us to address. The parties agreed that it would be sufficient for their purposes if this Court simply made a declaration as to the true meaning of the words "cost of capital rate" in reg 9(1).

Fonterra's submissions

[40] We come now to why we do not consider that Fonterra's submissions in this Court, to the extent they are not already addressed, support the conclusion for which Fonterra contends. Fonterra argued that the purpose of the regulations could not be to fix a price for independent processors which was the same as that which it paid for the milk, because that price varied during the year. But the fact that the actual price of milk may vary from time to time throughout a year does not, in our view, have any relevance to the purpose and effect of reg 9(1). The default price of milk may not exactly match the actual price paid at some point during the year. However, the purpose of the default price is clear enough, namely to constrain what Fonterra can charge the independent processors. None of this seems to us logically to affect the proper identification of the cost of capital rate to which reg 9(1) refers.

[41] Fonterra also argued that the purpose of reg 9(1) was to provide a simple and easily identifiable methodology for the unbundling exercise. To an extent that may be so but it is simplistic to suggest that this proposition leads to the conclusion that just because Fonterra used WACC in the share valuation exercise, it is WACC to

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24 *Commerce Commission v Fonterra Co-operative Group Ltd* (Court of Appeal, CA175/05, 4 May 2006).

which the regulation is referring. The methodology which the regulations prescribe has greater significance than its supposed simplicity.

[42] It was suggested that regs 9(1) and 9(2) were different both in purpose and in effect. We have already touched on this point and rejected the purport of the submission but add the following. So far as is material to the issue in the case, we consider subregs (1) and (2) of reg 9 have an identical purpose, that is, to establish the appropriate discount rate for calculating annualised share value. As already noted, MacKenzie J correctly found that the discount rate for calculating annualised share value was clearly a rate "which is related to the equity capital of Fonterra".[25] He went on to say, however, that it did not follow that in reg 9(1) the reference to the cost of capital rate used in calculating share value must necessarily be to a cost of equity capital rate. He said that reg 9(1) set out the circumstances when the rate-fixing exercise in reg 9(2) would not apply. He then proceeded to discuss the history of the regulations and the expert evidence, all to show that WACC was a legitimate and available method and fell within the scope of reg 9(1).

[43] The Judge concluded that:[26]

> The inclusion in reg 9(1) of a reference to the use of a cost of capital rate used in the calculation of Fonterra's share price does not suggest that the rate used in the most common method of valuation used in calculating a share price has to be excluded, in the absence of express words to that effect.

This is simply another manifestation of what we consider to have been an error of approach in Fonterra's argument. Fonterra cannot drive the correct interpretation of reg 9(1) simply on the basis that it used a WACC rate and that rate is, in general terms, commonly used in share valuation methodology.

[44] The regulations cannot have been framed so as to allow Fonterra to adopt any rate used in the course of the share valuation exercise. The regulations must have been designed to dictate a rate appropriate for the purpose for which it was to be used. A discount rate appropriate for WACC is demonstrably not a rate appropriate for the calculation of annualised share value. Since that calculation is the focus of

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25 At para [58].
26 At para [61].

both regs 9(1) and 9(2), we find Fonterra's arguments seeking to distinguish them unpersuasive. Regulation 9(2) is, as the Judge found, clearly directed at a rate applicable to the cost of equity capital. So too is reg 9(1). Only by giving that meaning to the phrase "cost of capital rate" will the statutory purpose of creating a level playing field in relation to raw milk costs of processors be achieved.

Summary

[45] It may be helpful to summarise the reasons for our conclusion. Regulation 9(1) cannot turn on the "use" by Fonterra of the WACC rate because Fonterra used three cost of capital rates in the course of calculating share value. Although the WACC rate was the rate used to calculate enterprise value, Fonterra's debt was "backed out" before the share value was assessed on the basis of net present equity value. In substance therefore the WACC rate, while used for calculating enterprise value, was not used to calculate share value. A focus on the "use" by Fonterra of a particular rate would also create inconsistencies between regs 9(1) and 9(2). It cannot have been intended that the discount rate for calculating annualised share value, as a step in determining the proportion of the total payout that represents the return on shares, could be based on different types of capital depending on whether Fonterra or the Commission was responsible for the calculation. The phrase "cost of capital rate" must have a particular and fixed meaning.

[46] The capital referred to in the phrase must be equity capital. It makes no sense to calculate annualised share value using a rate that pertains to anything other than equity capital, because farmers provide only equity capital. The return to the farmers on their shares is necessarily the cost to Fonterra of its equity capital. The discount rate must therefore be a rate applicable to equity capital.

Formal orders

[47] For the reasons we have given the appeal should be allowed, the orders made in the courts below should be set aside, and a declaration made that the capital

referred to in reg 9(1) of the Raw Milk Regulations is Fonterra's equity capital. The Commission should have costs in this Court of $15,000 plus disbursements to be fixed if necessary by the Registrar. Costs in the courts below should be as agreed or as fixed by those courts in the light of the outcome of the proceedings in this Court.

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