IN THE COURT OF APPEAL OF NEW ZEALAND

CA175/05

BETWEEN	COMMERCE COMMISSION Appellant
AND	FONTERRA CO-OPERATIVE GROUP LIMITED Respondent

Hearing: 10-11 April 2006

Court: Hammond, Goddard and Gendall JJ

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

Judgment: 4 May 2006

JUDGMENT OF THE COURT

A The appeal in the discount rate proceeding is dismissed.

B The appeal in the retention proceeding is allowed. The declaration made by the High Court in [34] of the judgment under appeal is set aside. We substitute the following declaration: For the purpose of calculating the wholesale milk price in a season, the term "total payout" means the total payout from profits in that season, and does not include payments to supplier shareholders out of reserves.

C There will be no order for costs in this Court.

REASONS

(Given by Hammond J)

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Introduction

[1] The dairy industry is a mainstay of the New Zealand economy. In 2001, it underwent wholesale restructuring. This required legislation, which took the form of the Dairy Industry Restructuring Act 2001 (the Act).

[2] As part of that restructuring Fonterra was formed out of an amalgamation of New Zealand's largest dairy companies. Fonterra is now the largest company in New Zealand. It controls over 98 percent of the milk produced by New Zealand dairy farmers, and exports 95 percent of its production. It is the world's second largest exporter of dairy products.

[3] One of the many facets of the formation of Fonterra was a concern to see that "independent" dairy product producers would still be able to procure suitable supplies of raw milk from Fonterra, for their own purposes.

[4] Section 115 of the Act enables the Governor-General in Council to make regulations directed to achieving this end. By the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Raw Milk Regulations) Fonterra must supply raw milk to these independent producers at the price set out in the regulations, if the parties are unable to agree on a price by agreement.

[5] Regulation 8(6) of the Raw Milk Regulations provides that the default wholesale milk price (WMP) for a season to these independent producers is the price per kilogram of milksolids calculated using the following formula:

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

[6] The appellant, the Commerce Commission, has certain regulatory powers and default powers with respect to Fonterra.

[7] For reasons which we will detail in due course, the meaning and application of the formula which we have set out in [5] became a matter of dispute, in two respects, between Fonterra and the Commission. First, an issue arose as to the accounting treatment of the utilisation of reserves by Fonterra, in relation to the words "retention" in the formula. Secondly, the "annualised share value" in the formula itself turns in part on the discount rate utilised by Fonterra, and which (by reg 9 of the Raw Milk Regulations) "must be the same as the *cost of capital rate* used by Fonterra in calculating the price of a co-operative share as at 1 June in the relevant season". (Emphasis added.)

[8] At the risk of over-simplification, for the purposes of introducing these appeals, Fonterra took the position that the word "retention" in the regulatory formula encompasses transfers "to" reserves; but does not encompass transfers "from" reserves. On the second issue, Fonterra contends that it has no alternative but

to use the cost of capital rate utilised in calculating the price of a co-operative share, which is a Weighted Average Cost of Capital (WACC). The Commission, on the other hand, maintains that the "cost of capital rate" used should be a "cost of equity capital" rate.

[9] Despite their best endeavours, Fonterra and the Commission were unable to resolve their differences over the interpretation and application of the Raw Milk Regulations. In the result, two sets of proceedings were commenced in the High Court.

[10] The first (what, for convenience, we will call the "retentions proceeding") was commenced by Fonterra on 23 December 2003. It sought a declaration that Fonterra was not in breach of the regulations by not including a sum of approximately $50 million for the 2001-2002 season as a negative retention in the formula. That proceeding is HC AK CIV-2003-404-7350.

[11] The second set of proceedings was an application for judicial review by Fonterra which challenged the view that the Commission had taken as to the appropriate discount rate. We will call this the discount proceeding. That proceeding is HC WN CIV-2004-485-273. The application sought to set aside a decision of the Commission under its default powers provided by reg 9(2) of the Raw Milk Regulations. The Commission elected to defend this proceeding. Fonterra subsequently discontinued the proceeding. That, however, left "live" a counter-claim by the Commission in that proceeding for a declaration in relation to the meaning of the words "the cost of capital rate" used in the Raw Milk Regulations.

[12] It can be said that the events which brought about these two sets of proceedings are now "historic". However the problems of interpretation to which we have referred are not "moot". The contrary is the case: both the Commission and Fonterra say that the resolution of the meaning to be given to the two terms in the regulations which we have identified is an ongoing matter of commercial significance to the largest company in the country, and indeed are matters of public importance. The disputes which have arisen also raise, in their own way, important

questions of statutory construction as to how issues of this kind are to be approached. Essentially, Fonterra contends for a strict "plain meaning" construction; the Commission maintains that inadequate attention was paid to the purposes of the Act and the Raw Milk Regulations, and that when this legislation is properly understood and applied, the meanings ascribed by Fonterra cannot stand.

[13] Both sets of proceedings were heard together, by agreement, before MacKenzie J in the Wellington Registry of the High Court on 30-31 May 2005. His Honour delivered a judgment on both matters on 27 July 2005. The Court declined to make the various declarations sought by the Commission in both proceedings.

[14] The Commission now appeals against the determinations in the High Court judgment, in both sets of proceedings. Again, both appeals were heard together, although they do not form an "all or nothing" basis of appeal.

[15] Against this background, we will proceed by treating each appeal separately. We will add such further factual and statutory material as is required in respect of that appeal, in its specific context. We will begin with the discount proceeding; the retention proceeding concerns a narrower issue.

The discount appeal

Factual context

[16] To appreciate this dispute it is necessary to enlarge on the matters briefly touched on in the introduction to this judgment.

[17] A purpose of the Act was to allow an amalgamation of the New Zealand Co-operative Dairy Company Limited, Kiwi Co-operative Dairies Limited, and Fonterra Co-operative Group Limited (s 4). The Tatua Co-operative Dairy Company Limited and Westland Co-operative Dairy Co Limited, although mentioned in that section, subsequently elected not to be part of the amalgamation.

[18] Normally the formation of a conglomerate of this size would not be permitted under the Commerce Act 1986. However, s 7 of the Act expressly provided authorisation for this amalgamation, and the transactions required to give it effect. Under s 11 of the Act, the new co-operative's constitution was to be as set out in Schedule 1 of the Act.

[19] Fonterra is obliged to supply up to 400 million litres of raw milk to independent processors every season (reg 11(2) of the Raw Milk Regulations). Regulation 8(1) provides that Fonterra and an independent processor may agree a price for the supply of raw milk. In the event that does not occur, in order to give effect to the statutory supply obligation the milk must be supplied at a Default Milk Price (DMP). This DMP is itself based upon a Wholesale Milk Price (WMP) which is determined according to a formula set out in reg 8(5) and (6) of the Raw Milk Regulations, as follows:

> (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 new co-op 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:
>
> $$\frac{\text{(total payout + new co-op retention - annualised share value)}}{\text{kilograms of milksolids}}$$

[20] It is necessary to interpolate here that because Fonterra is a co-operative company, its shareholders are also its supplier dairy farmers. These thousands of farmers receive a "bundled" return from Fonterra. This is a single payment which is set out in cl 10.1 of Schedule 1 to the Act. Mr Farmer QC placed some reliance on this clause and we therefore set it out in full:

> 10.1 **Payment for Milk supplied:** After each Season the Board shall determine the payment to be made for Milk supplied by Shareholders during that Season by reference to such components as shall be identified by the Board and subject to such adjustments for Milk volumes or such other factors as the Board determines. In determining that payment, the Board shall have regard to the income from all activities of the Company, including any dividends received or receivable by the Company and any transfers to or from reserves as the Board, in its absolute discretion, determines are desirable, less the costs of the Company. The costs of the Company include all manufacturing costs, costs directly attributable to the other activities of the Company, and any Distribution paid or accrued.

[21] This "payment for milk supplied" accounts for both what Fonterra calls the Actual Milk Return, and Fonterra's earnings from other activities.

[22] Under cl 10.1 the payout in any year is determined by the Board of Fonterra, in its sole discretion. It may include resort to reserves. We use the term "resort" advisedly because the treatment of reserves is an issue before us. In exercising this discretion, Fonterra's Board is constrained both by the regulatory scheme and market forces. Particular emphasis was placed in argument before us on the undoubted fact that farmer expectations are very much a concern for Fonterra.

[23] How this price was to be fixed was apparently a matter of considerable discussion at the time the new statutory scheme was being put in place. The regime created by the Raw Milk Regulations was we think appropriately described by Mr Farmer as an "access regime".

[24] In the season which is the subject of the dispute before us (2001-2002) Fonterra acquired 13.1 billion litres of raw milk from farmer suppliers. The regulated segment of milk supply (400 million litres) is a small proportion (3 percent) of the total milk supplied by farmers to Fonterra. Each independent

processor can get 50 million litres of raw milk but with a cap on the industry total of 400 million litres to independent processors as a group.

[25] There was always going to be an issue as to how the price was to be fixed (if it had to be fixed) for this (up to) 400 million litres of milk. Regulation 8(6) was intended to provide a DMP which was to apply if Fonterra and the particular independent processor could not agree on a price for milk supplied under the Raw Milk Regulations. The scheme which was evolved was to effect this by reference to an average price that Fonterra had paid for raw milk that it acquired from its farmer shareholders - being the total payment for the milk supplied as prescribed by cl 10.1 of Schedule 1 - less the annualised share value as defined in the Raw Milk Regulations.

[26] It is common ground between Fonterra and the Commission, and we agree, that the essential task of the formula in reg 8(6) is to "unbundle" the milk price and the return on capital elements in the bundled payment to supplier shareholders. This exercise is to produce the price to be paid for that part of the milk supply market which is regulated: that is, the provision of up to 400 million litres of raw milk supplied to independent processors each season.

[27] Each of the elements of the WMP formula in reg 8(6) is given more precise definition in reg 3 of the Raw Milk Regulations.

[28] "Annualised share value" means:

> … in relation to a season, … 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.

[29] "Kilograms of milksolids" means:

> … the number of kilograms of milksolids supplied to new co-op in a season by shareholding farmers in that capacity.

[30] “New co-op retention” means:

> (a) … the after-tax profit of new co-op for a season that is retained by new co-op and not paid to shareholding farmers; but
>
> (b) does not include retentions for abnormal or extraordinary asset revaluations or write-offs.

[31] Because the “new co-op” is in fact Fonterra, for ease of reference counsel and the Court have simply referred to the “Fonterra retention”, both in the High Court and this Court.

[32] “Total payout” means:

> … the total payment made by new co-op and interconnected bodies corporate of new co-op to shareholding farmers for raw milk supplied by them in that capacity in a season, minus the total winter milk premium for that season.

[33] “Winter milk” means:

> … raw milk supplied in May or June or July.

[34] The term “annualised share value” is to be calculated as set out in reg 9, which provides as follows:

> **9 Calculation of annualised share value**
>
> (1) The discount rate used by new co-op in calculating annualised share values must be the same as the cost of capital rate used by new co-op in calculating the price of a co-operative share as at 1 June in the relevant season.
>
> (2) If new co-op 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 new co-op must use that rate.
>
> (3) In setting a discount rate under subclause (2), the Commission must have regard to whatever relevant information is—
>
> > (a) used by new co-op in calculating the price of a co-operative share; and
> >
> > (b) made available to the Commission.

A difference emerges

[35] It will be readily apparent that under reg 9(2) the Commission is required to act in any season in which Fonterra does not set the price of a co-operative share.

[36] In the first year of Fonterra's operation, Fonterra did not set a cost of capital rate when establishing the price of its co-operative share. This was because the share price was agreed as part of the merger proposal when Fonterra was first created. Instead, Fonterra asked the Commission to set the discount rate, using its default powers under reg 9(2). The Commission's determination in this respect, setting the discount rate for the 2001-2002 season, was issued by its decision number 501 of 12 June 2003.

[37] In calculating the annualised share value under reg 9(1) in subsequent seasons, Fonterra has in fact used the same discount rate as the cost of capital rate used by its valuers in calculating the price of the co-operative share.

[38] The difference between the parties is that the Commission says that the term "cost of capital" as it is used in reg 9(1) means "cost of equity capital" and cannot mean "weighted average cost of capital" (or WACC), which Fonterra's valuers utilised.

[39] Fonterra maintains that reg 9(1) quite clearly states that the discount rate that it uses to calculate the annualised share value "*must be the same as* the cost of capital rate" *in fact used* to calculate the price of its co-operative share. (Emphasis added.) We will explain shortly how that is arrived at, but for present purposes we note that that cost of capital rate is not set by Fonterra itself. Rather it is set by its valuers (Standard and Poor's) under the terms of Fonterra's constitution. So Fonterra maintains that this cost of capital rate is what must be applied for the purposes of calculating annualised share value under reg 9(1). In that sense, the cost of capital rate is quite beyond its control.

[40] The Commission, on the other hand, maintains that Fonterra uses a cost of capital rate to calculate the price of its co-operative share only if it calculates that

price by reference to Fonterra's cost of equity capital; that that cost of equity capital must then be used for the purposes of reg 9(1); and further, that if Fonterra does not proceed in this manner (that is, by reference to its cost of equity capital), then it is required of the Commission that it set a discount rate using its default powers under reg 9(2). This last point should not be underestimated, as to its intrusiveness: the proposition is that if Fonterra does not set a rate at all, or if sets it incorrectly, then the Commission's default powers "kick in".

Calculating the annualised share value

[41] To appreciate the context of this dispute it is necessary to understand the way in which Fonterra's valuers calculate the value of the co-operative shares. Fonterra's co-operative share is referred to throughout its constitution and other documentation as the "Fair Value Share".

[42] Under Fonterra's constitution there is a Shareholder's Council, which is required to appoint an independent valuer to calculate a fair value *range* for Fonterra's co-operative share. For the year 2001, the Shareholder's Council appointed Standard and Poor's (an internationally recognised firm) as the requisite valuer. Once the valuer has turned in a range, the actual price or value of the share is set by Fonterra's Board of Directors after consideration of the fair value range actually recommended by its external valuer.

[43] The constitution of Fonterra prescribes that it is for the valuer to determine a method for establishing this fair value range. But the factors which are required to be taken into account are set out in cl 4.4 of Schedule 1, which we set out hereafter:

> 4.4 **Factors to be taken into account in determining the Fair Value Range for a Co-operative Share:**
>
> The method for establishing the Fair Value Range for a Co-operative Share shall take into account:
>
> (a) the projected sustainable earnings of the Company's Commodity Milk Business based on a cost for Milk supplied to the Company by Shareholders equal to the Commodity Milk Price;

(b) the projected sustainable earnings of all other business of the Company based on a cost for Milk supplied to the Company by Shareholders equal to the Commodity Milk Price;

(c) forecast movements in volumes of Milk to be supplied to the Company and the consequent impact on the capital structure of the Company and the operating and capital expenditure required by the Company;

(d) forecast foreign currency exchange rates;

(e) the rights and obligations of Shareholders to subscribe for further Co-operative Shares and surrender existing Co-operative Shares, in accordance with the Share Standard, for Fair Value and the effect on the Company of the surrender of those Co-operative Shares which in the opinion of the Valuer will be surrendered pursuant to clause 5 in each Season or otherwise;

(f) the number and terms of issue of Supply Redemption Rights issued and estimated to be issued by the Company, the rights and obligations of Shareholders holding Supply Redemption Rights and the effect on the Company of the exercise of the options conferred by the Supply Redemption Rights to receive Co-operative Shares or surrender Supply Redemption Rights which in the opinion of the Valuer will be exercised pursuant to clause 6 or otherwise;

(g) the number and terms of issue of Peak Notes issued and estimated to be issued by the Company, the rights and obligations of the Shareholders to subscribe for further Peak Notes and redeem Peak Notes in accordance with the Peak Note Standard in accordance with the Peak Notes Trust Deed and the effect on the Company of the redemption of those Peak Notes which in the opinion of the Valuer will be redeemed in accordance with clause 7 in each Season or otherwise;

(h) any rights pursuant to any applicable enactment or otherwise of any person who is not a Shareholder to become a Shareholder and supply Milk to the Company, and the terms and conditions on which that person may do so;

(i) the rights and obligations of and limitations on Shareholders set out in the Act, the Co-operative Companies Act and this Constitution; and

(j) the right of Shareholders to receive Distributions, including distributions of the surplus assets of the Company on liquidation.

[44] Under the constitution, not later than 15 May in any given year the valuer is required to determine and advise the Board of Fonterra of the fair value range for the

co-operative share for the next season, and to report on the valuer's method used in determining the range in accordance with the constitution. Generally speaking, the valuation method used by the valuer for each season must be consistent with the valuation method used in the preceding season.

[45] It will be appreciated therefore that the basis on which Fonterra's cost of capital valuation got off the ground is of very real practical significance. Indeed it goes some distance towards explaining the arm-wrestle which has developed between the Commission and Fonterra: once the valuation pattern is settled, it substantially controls the future.

[46] The Board sets the co-operative share price for each season once it is satisfied that Standard and Poor's have applied an acceptable valuation methodology in that season, and recommended an acceptable fair value range. But it is quite clear that under Fonterra's constitution (echoing Schedule 1 of the Act) that it is for Standard and Poor's (or the nominated valuer) to determine the best valuation practice for determining the fair value range of Fonterra's shares.

Standard and Poor's cost of capital rate

[47] It is also necessary to appreciate how Standard and Poor's derived a cost of capital rate. In fairness to the Commission, and because of its central relevance to this proceeding, we note however at this point that what Standard and Poor's was doing (overall) was determining an *enterprise value* for Fonterra. That is, fixing a cost of capital rate was only part of that somewhat larger exercise.

[48] How Standard and Poor's went about this task was summarised by MacKenzie J in [42] to [45] of his judgment:

> [42] The valuer adopted the approach of determining an enterprise value for Fonterra. It did that by calculating separate enterprise values for the main business units of Fonterra, and combining those to produce a total enterprise value. Those enterprise values were calculated using the discounted cash flow ('DCF") methodology as its primary approach and the capitalisation of earnings valuation methodology (or market approach) as its supporting approach, or cross-check. To convert the enterprise value into a share value, the following steps were necessary:

> (a) Deduct from the enterprise value so calculated the amount of Fonterra's debt and external liabilities;
>
> (b) Divide the amount remaining (which represents Fonterra's shareholders' funds, valuing the business at the enterprise value) by the number of shares on issue, to produce a value per share.
>
> [43] Calculating the enterprise value by the DCF method involves forecasting the future cash flows of the enterprise. Those projected future cash flows, and the residual values of the assets producing those cash flows at the end of the forecast period, are converted to their NPV equivalent. That conversion involves the choice of a rate of return, or discount rate. In this part of its methodology, Standard & Poor's adopted a weighted average cost of capital ("WACC") rate as the appropriate discount rate. It described its use of WACC in these terms:
>
>> In the application of the discounted cash flow methodology the projected expected cash flows and residual values of Fonterra and the Fonterra business units were converted to their respective present value equivalent using a rate of return that reflects the systematic risk of an investment in the capital of Fonterra (or its business units), as well as the time value of money. This return is an overall rate based upon the expected individual rates of return for invested capital (equity and interest-bearing debt). This return, known as the weighted average cost of capital, is calculated by weighting the required returns on interest-bearing debt and common equity capital in proportion to their estimated percentages in an assumed optimal or actual expected industry capital structure.
>
> [44] Standard & Poor's describe in some detail, in their description of the DCF methodology, the methods used in their derivation of the WACC. Essentially, it involves estimating the typical capital structure which an enterprise of the nature of the enterprise being valued might have. Standard & Poor's described this in this way:
>
>> Our estimate of the typical capital structure was based on observing typical proportions of interest-bearing debt, preferred equity, and common equity of publicly traded companies in similar lines of business as Fonterra and the Fonterra business units.
>
> [45] For that typical capital structure, rates of return are attributed to the debt and equity components. The rate of return on debt capital is stated by Standard & Poor's to be "the rate a prudent debt investor would require on an interest-bearing debt". The rate of return on equity capital is determined using a capital asset pricing model. Those rates of return are then applied to the typical capital structure, on a weighted basis, to produce WACC.

[49] In the shortest terms, having applied these valuation methodologies to derive an enterprise value for Fonterra, the fair value range is derived by deducting the value of Fonterra's debt from the enterprise value, to thereby arrive at a net present

equity value. The value of an actual share itself is calculated by dividing the equity value by the number of shares in Fonterra.

[50] Mr Goddard QC provided us with a helpful "broken-down" table of the steps taken in calculating the Fair Value Share price according to the methodology used by Standard and Poor's. It is as follows:

(1) Estimate projected expected cash flows and residual values for Fonterra and its business units.

(2) Estimate cost of equity and cost of debt.

(3) Calculate WACC (Weighted Average Costs of Capital) using costs of equity and costs of debt.

(4) Calculate enterprise value by discounting cash flows and residuals to net present value, using WACC (and adding in excess cash within Fonterra and interests in joint ventures).

(5) Calculate net present equity value by deducting Fonterra's debt from the enterprise value.

(6) Calculate share value by dividing net present equity value by the number of shares in Fonterra.

(7) Calculate Fair Value Share range (which by the constitution (cl 4.2) must be within 92.5 percent to 107.5 percent of midpoint).

(8) Fonterra Board determines Fair Value Share price, within fair value range.

[51] Fonterra takes the position that it has no alternative, given reg 9(1), than to take the WACC used by Standard and Poor's "as the cost of capital rate … in calculating the price of a co-operative share … in the relevant season".

But the Commission differs

[52] There are of course a number of possible methodologies for valuing "the cost of capital rate" to be utilised by a company.

[53] One alternative method of valuing Fonterra's shares would be by a discounted cash flow less interest expenses and financing costs as the cost of equity. A cost of equity is utilised in that process. This is the preferred methodology of the Commission, as the process that delivers up a cost of equity that can be used as the discount rate (see Decision 501, paragraphs 30 and 34).

[54] The Commission maintains that the task of determining a discount rate is much more complex than reg 9(1) suggests on its face. The Commission says that the cost of capital rate must be Fonterra's actual cost of equity - otherwise, it says, no cost of capital rate is being applied at all.

[55] In his oral submissions, Mr Goddard strongly urged on us that embedded within the Standard and Poor's calculation there is, as part of the overall Standard and Poor's calculation, a true "cost of equity" calculation which, as it were, forms part of the overall Standard and Poor's calculation. This can be seen as part of the calculation of 1 May 2002, at COA 3/428 giving rise to a rate of 9.7 percent. We reproduce that table hereafter:

Reinvested Beta (B)	Risk-Free Rate (rf)	Country Risk Premium (CRP)	Equity Risk Premium (rm-rf)	Relative Volatility (V)	Cost of Equity (re)	Pre-Tax Cost of Debt (PTrd)	After-Tax Cost of Debt (rd)	WACC (rC)
0.5%	6.8%	0.0%	5.0%	1.0%	9.7%	7.8%	5.8%	8.36%
							Rounded	8.50%

[56] There is therefore, on Mr Goddard's argument, embedded within Standard and Poor's calculation, the kind of answer which could and should have been adopted by Fonterra.

Does the valuation method matter?

[57] The Commission has not lightly entered into this litigation which as we have indicated, is in one sense "historic", although it has on-going ramifications. To understand the force of the Commission's concerns, it is necessary to say something more about the economic thrust of the Commission's argument.

[58] The Commission says that a basic economic policy behind the Act and particularly the Raw Milk Regulations is that independent processors should pay the same price for raw milk as Fonterra, so that they can compete, on the merits, in downstream markets.

[59] There is an underlying difficulty in assessing the price because Fonterra does not pay separately for milk supplied by its supplier shareholders and for the capital which they also contribute. Hence it is necessary to "unbundle" the returns received by supplier shareholders, and identify the component of the bundled price that represents payment for raw milk. This is what the Raw Milk Regulations endeavour, amongst other things, to get at.

[60] What the annualised share value is intended to do is to represent the return for that particular season on the capital which is supplied by the thousands of Fonterra supplier shareholders. In the simplest terms, the deduction of an annualised share value, as Mr Goddard termed it, "backs out" of the total payout an amount representing the return to supplier shareholders in respect of the capital supplied by them to Fonterra.

[61] What the regulations do is to convert the share price (the capital supplied by the supplier shareholders in respect of each kilogram of raw milk supplied in a season) into an annual income stream. The concept is that there has to be calculated the annual payment that Fonterra would need to offer in exchange for the requisite capital, and what would need to be paid to a supplier shareholder in return for providing the requisite capital.

[62] Mr Goddard argued therefore, that the purpose of the formula for calculating the "annualised share value" is simply to answer the question: "How much is Fonterra paying for the equity capital supplied by its shareholders?" As the Commission sees it, and as Mr Goddard argued, the appropriate discount rate to use in the calculation is simply Fonterra's cost of equity capital rate.

[63] When in 2003 and 2003-2004 Fonterra set its share price using a "discounted cash flow" (DCF) valuation what it was doing was to discount its expected future profits back to give a net present value. The DCF valuation of the entire business (with equity capital and long-term debt capital being treated as the relevant capital corresponding to the asset base to be valued) involved assessing Fonterra's cost of equity capital and cost of debt capital, and using them to calculate Fonterra's WACC. The WACC was then in turn used to value the business as a whole. That figure was in turn used to value Fonterra's equity capital. The equity capital figure was then used as the basis for assessing "a fair value range" for the share price after which Fonterra's Board was to fix the actual share price.

[64] Whatever may be true in other contexts, the Commission argues that it does not make sense to use Fonterra's costs of debt in answering what the Commission sees to be the right question. Nor does it make sense in the Commission's view to use Fonterra's WACC. At the heart of the Commission's concerns is that using either of these costs of capital, it says, would give a lower annual payment than Fonterra actually needs to offer to attract equity capital.

[65] The Act itself provides in s 4 (the purpose section) that the underlying goals of the Act are to ensure the efficient operation of dairy markets in New Zealand; to ensure that dairy markets in New Zealand are contestable; and to enable independent processors to obtain the raw milk necessary for them to compete in those dairy markets (s 71(a)).

[66] Ensuring that independent processors do not have to pay Fonterra a margin on raw milk is necessary to support this competition; to make sure that downstream markets are contestable; and that allocative, productive and dynamic efficiencies are supported and encouraged in those downstream markets.

[67] Arithmetically, there is no doubt that there are practical implications as to the price of raw milk with a discount based on the cost of equity capital as compared to WACC. In 2002-2003 Fonterra used a WACC of 8.32 percent; in 2003-2004 it used a WACC of 8.07 percent. However in the 2002-2003 season the cost of equity used as part of the import into the derivation of WACC was 9.7 percent. It is unnecessary for present purposes to trace these figures through into the actual cost of milk supplied. There is no dispute before us that there is a material difference in the WMP depending on whether the Commission's approach or Fonterra's approach is adopted.

[68] In the course of argument the Court put it to Mr Goddard that the Commission's point, in classical legal terms, is that it is said that Fonterra has asked itself the wrong question: for the purposes of reg 9(1) the reason for setting a discount rate under the regulations is to identify the component of the payment to supplier shareholders that represents a payment for equity capital supplied by those shareholders; and nothing else. Mr Goddard agreed that is the heart of the Commission's concern.

Discussion

(a) Introduction

[69] The arguments which were run before us in this appeal were essentially the same arguments as were advanced in the High Court. There, Fonterra's arguments were upheld by MacKenzie J. We therefore confine ourselves to a discussion of our conclusions on those arguments. In so doing, we intend no disrespect to the concise and lucid judgment of the High Court Judge. There is no point in further encumbering what is necessarily an already lengthy judgment in this Court.

[70] The Commission's argument is that a purposive approach must be adopted to the interpretation of this legislation. Giving effect to the policy of the regulations requires "cost of capital" to be read in reg 9(1) as meaning "cost of [equity] capital". This meaning should be adopted to ensure the Raw Milk Regulations as a whole

achieve their intended effect. That portion of reg 9(1) should not be read in isolation, divorced from the surrounding provisions and from the policy of the regulations as a whole. And when so read, the relevant capital is pure equity capital so that, as Mr Goddard put it, "the only appropriate cost of capital rate is cost of equity capital". In the years in question, Fonterra used measures of costs of capital in its share price calculations. But the only cost of capital that makes sense, Mr Goddard said, consistent with the context and policy of the legislation is here cost of equity capital, which can be subtracted out of the larger Standard and Poor's enterprise calculation.

[71] For Fonterra, Mr Farmer supported MacKenzie J's view. He said the wording of reg 9(1) is plain, and intractable. Regulation 9(1) and 9(2) are directed to two different circumstances. That which is in issue in this instance is reg 9(1). Regulation 9(1) is affirmative: the discount rate to be used "must" be the same "as the cost of capital rate used by [Fonterra] … in calculating the price of a co-operative share … in the relevant season". Fonterra's argument is therefore that it has done precisely what is required by the regulation. Mr Farmer further submitted that this is not a case in which the Commission's "purposive argument" can possibly drive out the plain meaning of reg 9(1).

(b) The approach to interpretation

[72] We of course agree that the words of reg 9 (and indeed the legislation as a whole) have to be considered in light of the statutory purposes. That is explicitly provided for by s 5 of the Interpretation Act 1999: the meaning of an enactment must be ascertained from its text and in light of its purpose.

(c) Purpose(s)

[73] That said, in our view the "purposes" of the Act, and this regulation in particular, are wider than was recognised by Mr Goddard. Or that at least there is, in relation to this regulation, another purpose which has to be emphasised. It is apparent that in setting up this complex scheme in one of the most important

industries in New Zealand, it was appreciated that setting the price of raw milk to independent processors was going to be a difficult matter. It is also apparent that there was much discussion about how this should be done when the legislation and the regulations were being evolved. The possibilities of disputes over the "best" way of doing this were manifest. It is a feature of economic life and regulation in a small country such as New Zealand that setting "fair" or "appropriate" or even "formulaic" rates has given rise to time-consuming and expensive (we are tempted to say "endless") disputes or arbitrations. It might not be too unkind to say that the only actors to profit from such disputes are the senior bar. Our short point is that reg 9(1), as to purpose, recognised this phenomenon and is in and of itself a dispute resolution mechanism. There was not supposed to be a dispute of the kind which has reached this Court, namely, on "the cost of capital rate" actually used.

[74] It must be recalled in this context that it is difficult, to say the least, for Fonterra to manipulate a rate which is suitable to it. It has to employ an independent valuer; the valuer sets the range for the share price using acceptable methodologies, and Fonterra then settles an actual figure in that range. So the fox has not been put in charge of the hen house.

(d) A required cost of capital rate?

[75] There is no "explicit direction", as Mr Farmer termed it, as to which methodology, of a range of possible methodologies, should be used for setting the cost of capital rate.

[76] The money (capital) used to fund a business should earn returns for the capital owner who risks his or her money. For an investment to be "worthwhile" the return on capital must be greater than the cost of capital.

[77] A firm can finance its operations in three ways: by issuing shares (equity), issuing debt, or retaining prior earnings (internal financing).

[78] The easiest part of any calculation of the worthwhileness of a venture is the cost of debt, since debt carries a set interest, and so its cost of capital is the interest payment.

[79] Cost of equity or cost of retained earnings are harder to calculate. For instance, equity does not pay a set definite interest. Instead, this "cost" is based firstly on risk, and secondly on expectations of return elsewhere.

[80] There is no fixed or "right" answer to calculations of cost of equity. It has to be calculated as the "expected" return on equity during a past or future period (usually annualised) based on interest rate levels and with reference to historical average equity market returns. How this is done is contestable, in the sense that, as in any valuation exercise, there are a variety of techniques available.

[81] The WACC approach, according to all the expert evidence in this case, is a perfectly acceptable methodology, in general terms, and one which is widely adopted. The methodology is used in finance to measure a firm's cost of capital. But it is not the only methodology.

[82] Another approach which is sometimes used to calculate the opportunity cost of equity, and which was mentioned in the course of oral argument, is to use a Capital Asset Pricing Model (CAPM). This model states that investors will expect a return that is the risk of their return plus the security sensitivity to market risk times the risk premium. The risk premium rate is taken from the lowest yielding bonds in the particular market, such as Government Bonds. The risk premium varies over time and place but in some developed countries over the last century or so it has averaged around 5 percent. Under some statements of this model the cost of retained earnings can also be estimated, since it is said investors expect retained earnings to produce the same return as dividends reinvested in the firm.

[83] Still another approach is the so-called EVA method, as to which an accessible lay text is, G Bennett Stewart, *The Quest for Value* (2ed 1999).

[84] What this demonstrates is that finance is no less immune to the blight of fashion than other disciplines. The WACC method owes much to the famous article by Merton Miller and Franco Modigliani, "The Cost of Capital, Corporation Finance, and the Theory of Investment" (1958) 48 Am Econ Rev 261. The CAPM model was jointly introduced by several financial economists, largely building on earlier work by Harry Markowitz on modern portfolio theory. One of these men (William Sharpe) received the Nobel Price in Economics (jointly with Harry Markowitz and Merton Miller). But here is the point: the discipline continues to grow, and new criticisms, refinements, and attempts at new measures are constantly emerging.

[85] The short point here, for present purposes, is that there are a number of methodologies which could be adopted, and even within them there is room for much debate. Some would be more appropriate in some contexts than others. This is the very stuff of MBA degrees, and finance courses. But it appears to us that to avoid this kind of debate, reg 9(1) has utilised what, in many respects, is a quite arbitrary formula: the cost of capital rate to be used is simply that which was used in the complicated exercise of setting the price of a co-operative share in the relevant season.

(e) A strained interpretation?

[86] To make the declarations sought, to which we will shortly turn, actually involves reading into reg 9(1) a term, such that "cost of capital" becomes "cost of equity capital". That, in itself, is problematical in a regulation which was plainly settled after considerable discussion between interested parties and the administration of the day, as a means of avoiding disputes.

[87] Moreover, as Mr Farmer contended, reading the regulation in the way the Commission contended for does lead to a "strained" interpretation: the evidence was that the ordinary usage of the term "cost of capital" amongst finance experts means the aggregated cost of all sources of capital of a company. That is, both equity and debt. The term does not commonly refer to one specific source of capital, such as equity.

(f) Discretion

[88] We have already remarked on the fact that what is before the Court is only the rump (by way of counter-claim) of a proceeding for a judicial review.

[89] It is important to set out the relevant pleading:

> 17 The Commission considers that Fonterra's interpretation of regulation 9 of the Raw Milk Regulations referred to in paragraph 14 above is incorrect, and that:
>
> 17.1 Fonterra uses a cost of capital rate in calculating the price of a co-operative share in a season if and only if it calculates that price by reference to Fonterra's cost of equity capital;
>
> 17.2 if Fonterra does calculate the price of a co-operative share by reference to its cost of equity capital, that cost of equity capital must then be used as the discount rate for the purposes of the Raw Milk Regulations, pursuant to reg 9(1)
>
> 17.3 if Fonterra does not calculate the price of a co-operative share by reference to its cost of equity capital, the Commission must set a discount rate under reg 9(2).
>
> 18 The Commission seeks the Court's guidance on the correct interpretation of reg 9 of the Raw Milk Regulations, under the Declaratory Judgments Act 1908.
>
> *Relief sought*
>
> The Commission seeks:
>
> (a) a declaration that the interpretation of reg 9 of the Raw Milk Regulations set out in paragraph 17 above is correct; and
>
> (b) costs.

[90] In oral argument we pressed Mr Goddard as to whether this issue should be approached as if the Court was dealing with an application for judicial review, or whether it can more properly be considered as a "stand-alone", but in effect, common-law action for a declaration. Unsurprisingly, Mr Goddard was not anxious to see this counter-claim anchored to judicial review considerations (even though the proceeding originated in an application for a review of the Commission's own decision). And in the end this may not matter all that much because as both counsel recognised, relief in any proceeding for of a declaration is discretionary.

[91] We are not persuaded that the High Court Judge was wrong in the view he took of this appeal. But if we had reached the question of the discretion as to whether to make a declaration, we would not have done so. We have a number of concerns.

[92] One is the question of institutional competence. However the problem is approached, the Commission was faced with the difficulty of convincing a court that one possible approach to the cost of capital is the only appropriate approach in these circumstances, and one which must necessarily overwhelm the plain reading of the regulation. That in turn involves the Court saying that Fonterra got it wrong in a proceeding in which there is only affidavit evidence (without cross-examination), and on a matter which is observably contentious and distinctly beyond the ken of lay observers. The form and context of the proceedings are themselves inherently unsuitable for what would be a very powerful declaration.

[93] In this connection we recall that what the Commission is asking in 17.3 of the pleading goes a very long way indeed: it not only locks Fonterra into a long-term pattern for the cost of milk; it would mean the Commission has an intrusive power to intervene unless Fonterra does things a particular way. Even in a contested lis by way of judicial review, it has to be doubted whether such pre-emptive and affirmative relief would be granted.

[94] There also has to be borne in mind the point made earlier that, as in other disciplines, new approaches to financial valuation are constantly evolving. Institutions such as Standard and Poor's could be expected to "stay on top" of such

methodologies, which may perhaps involve other variations, over the passage of time. And if Standard and Poor's is, for good and sufficient reason, replaced as valuer, yet another view again as to the approach to be taken may be adopted by that valuer.

[95] Additionally, in the exercise of a discretion, from a remedial standpoint all alternatives to a given problem should be considered. The High Court Judge understandably took the view, and we agree, that it is difficult to see why if there is a deep-seated problem with the regulation it could not readily be amended. The institutional competence of those responsible for amending the regulations for this purpose patently transcends the ability of this Court. Significantly, when we pressed Mr Goddard on this issue, the answer seemed to be that exercising such an option would simply be too difficult. But this in itself is revealing, for it necessarily recognises that various points of view are possible.

[96] We are not satisfied that the High Court Judge was wrong to refuse a declaration; let alone that a declaration in the powerful terms sought should be granted in this particular case. Accordingly, this appeal fails.

The retentions appeal

Introduction

[97] This proceeding originated out of a letter which the Commission sent to Fonterra dated 18 September 2003 advising Fonterra that:

> … the Commission considers that Fonterra *is at risk of being found to have breached* the Raw Milk Regulations by not including the amount of Fonterra's after-tax loss, as a negative retention, in the calculation of the default price of raw milk. (Emphasis added.)

[98] In the 2001-2002 season Fonterra had incurred an after-tax loss of approximately $50 million. The Commission's position was that this should have been included in the reg 8(6) calculation, as a negative retention.

[99] This was a very strong letter. It could reasonably be read (and was) as indicating that the Commission considered Fonterra had likely breached the Raw Milk Regulations. This would be what, for convenience, we will call a "regulatory" offence.

[100] Unsurprisingly, therefore, Fonterra's defensive reaction to this letter from the Commission was ultimately to issue proceedings seeking a declaration that:

> … for the purposes of calculating the wholesale milk price component of the default milk price, in accordance with the formula set out in reg 8(6) of the Raw Milk Regulations, Fonterra's "retention", as defined in reg 3 of the Raw Milk Regulations, means the after-tax profit of Fonterra for the relevant season that is retained by Fonterra and not paid to shareholding farmers and does not include the amount of Fonterra's after-tax loss (if any).

[101] By its statement of defence at 7.3 the Commission pleaded:

> 7.3 the Commission considers Fonterra's interpretation of the definition of "wholesale milk price" for the purposes of the Raw Milk Regulations to be wrong in law, having regard to the words and the objects of those regulations and the Act. Either:
>
> 7.3.1 where Fonterra makes a payment out of reserves to shareholder suppliers in a season, that payment should be treated as a negative retention for the purposes of calculating the wholesale milk price in that season; or
>
> 7.3.2 for the purposes of calculating the wholesale milk price in a season, the term "total payout" means the total payout from profits in that season, and does not include payments to shareholder suppliers out of reserves.

[102] We indicate here that we raised with counsel at the outset of the hearing before us, that if a summary prosecution were to be contemplated for a breach of the regulations it would now undoubtedly be outside the six-month period provided for in the Summary Proceedings Act 1957. And, if the proceeding were for a pecuniary penalty under s 141 of the Dairy Industry Restructuring Act, s 144(4) of the Act provides for a limitation period of three years after the matter giving rise to the contravention arose. Why, we asked, should the Court be invited to make a declaration as to a regulatory offence that on its face would be statute-barred?

[103] However, neither party sought to rely on these limitation provisions; indeed, Mr Goddard contended that, on his preliminary view, the Commission might well still be within s 144(4), though we confess the argument was hard to follow.

[104] What has happened is that both parties have proceeded on the footing that a curial determination as to the meaning of the retentions provision in the regulations is required, because this general issue is not moot. How Fonterra is to handle retentions for the purposes of the formula is an important on-going issue. For instance, we were told from the bar that, in 2002-2003, approximately $93 million was retained by Fonterra.

[105] It is also convenient to add here that it is common ground that the treatment of reserves does affect the downstream price of milk. In response to our enquiry, we were told that the cost of raw milk for independent processors in 2001-2002 was higher than the cost of raw milk for Fonterra by 4.5 cents per kilogram of milk solids, by reason of this factor.

How the present problem arose

[106] In the 2001-2002 season, Fonterra did not in fact make an "after-tax profit". It instead incurred an after-tax loss of approximately $50 million. That sum was drawn down from capital reserves to be included in the payout provided to its farmers. This was to meet farmer expectations. When calculating the "retention" component of the WMP for that season, Fonterra used a figure of zero.

[107] The Commission was concerned about the downstream effect of this on raw milk purchasers. Its objective was to see the raw milk price paid by independent processors reduced by 4.5 cents per kilogram to make it the same as the implicit price paid by Fonterra.

[108] The Commission took the view that Fonterra ought to have applied the WMP formula for that season by either, (a) recording a "negative retention" in the WMP formula; or (b) including as "total payout" in the formula, the total payout from profits in that season, but excluding payments made from capital reserves.

[109] Fonterra replied that it was (precisely) applying reg 8(6).

The High Court determination

[110] MacKenzie J found that:

- the definition of "total payout" clearly includes all payments made to shareholding farmers for raw milk supplied in the season; and

- the definition of "Fonterra retention" on its plain words is limited to after-tax profit retained by Fonterra.

[111] The Judge accepted the "same price policy" underlying the Raw Milk Regulations, but he was not confident that the purpose of those regulations necessarily required transfers from and to reserves to receive identical treatment. The High Court considered that it might be possible that the drafters may have seen a difference to be justified.

Downstream consequences

[112] We have already noted that in the 2001-2002 season the raw milk producers had to pay more for their raw milk than what Fonterra was paying for it. The WMP, calculated using the formula in the way Fonterra used it, did not reflect the real cost to Fonterra of raw milk: it was artificially inflated by a transfer from reserves, the amount of which was determined by Fonterra's Board, on what Mr Goddard described as a "discretionary and unreviewable" basis.

[113] The Commission's concern is that this approach would also increase the average price paid by those purchasers over time, increase the volatility of the raw milk price for the independent purchasers, and, at least in theory, create opportunities for Fonterra to "manipulate the raw milk price and thus 'double count' the after-tax profits made in a particular season". As Mr Goddard said in his oral submissions,

this would be "all swings and no roundabouts". Instead of on-selling raw milk at its effective cost to Fonterra, Fonterra would be able to charge a margin on that milk.

[114] Mr Goddard advanced a number of hypotheticals to illustrate the nature of the problem. One, which is simply grasped, is to ask what the position would be if Fonterra were to retain $50 million in 2005-2006 from its profits, and then pay that sum out to shareholders in 2006-2007. On the High Court ruling:

- the retention would be added back into the formula in 2005-2006, so that the retention would not affect the raw milk price in that season;

- but the payment out of reserves in 2006-2007 would be counted as part of the total payout in that year, with no adjustments for "negative retentions". That payment out of the reserves would directly increase the raw milk price for that season, even though there was no corresponding reduction the previous year.

[115] The Commission's concern is therefore that the approach endorsed by the High Court would distort the calculation of the WMP by biasing it upwards over time, and increasing volatility from season to season. What was described as the "asymmetry" contended for by Fonterra accordingly makes no sense: the average price for raw milk over the two years would be higher than if the retention and repayment had not occurred. A discretionary decision by Fonterra's Board would alter the price paid in the second year, and increase the average price over the two years. This is said to be undesirable, even if it arose as a result of a perfectly good faith commercial decision by Fonterra's Board. It was pointed out that, more malignantly, Fonterra could deliberately adjust payouts, and transfers to and from reserves, to systematically bias the raw milk price upwards.

[116] In fairness to Fonterra, we must make it plain that on the material in front of this Court there is no suggestion that this sort of course has, consciously or otherwise, actually been pursued. There is here a true "lis": the cards have simply fallen as they have as a result of Fonterra's reading of the regulations.

Fonterra's response

[117] As we apprehend it, Fonterra's response is this. First, the legislation is express. It does not provide for any adjustments in respect of payments out of reserves. Secondly, Fonterra accepts that its approach *can* increase the price paid for raw milk by independent processors above what it would have been, absent the transfer from reserves, but says that is justified by the regulation itself. Thirdly, Fonterra argues that adopting the Commission's preferred approach would "stifle" Fonterra's ability to make legitimate commercial decisions about the appropriate price for milk in the market. Fourthly, it appears to be suggested that the Commission's approach would force Fonterra's farmer shareholders to subsidise the acquisition of raw milk by independent processors.

The economic merits

[118] We have to say that, on the evidence, the merits of the economic argument appear to us to be substantially with the Commission. Treating transfers out of reserves symmetrically with transfers to reserves would ensure that there is not a subsidy either way; and even Fonterra accepts that the approach it relies on can increase the price paid for raw milk by independent processors beyond Fonterra's acquisition price. As a matter of policy, that was not supposed to happen - there was supposed to be a level playing-field for the price of raw milk. Realistically, given the arbitrariness of reg 9(1) it will likely never be entirely level, but the way "reserves" are treated can create substantial rocks on the playing-field.

The appropriate reading of the legislation

[119] The issue therefore comes down to whether there is a reading of the Raw Milk Regulations which avoids the undesirable consequences we have noted, but without doing any violence to the wording of those regulations.

[120] A starting point is perhaps to note that cl 10.1 of Schedule 1 of the Act itself recognises that there may be "transfers to or from reserves". So Parliament was

aware in enacting the head legislation that there might be transfers both ways. This sits oddly with the definition of "new retention" in the regulations: "the after-tax profit [of Fonterra] for a season *that is retained* by [Fonterra]". (Emphasis added.) Was this deliberate, particularly given the undesirable consequences which could result?

[121] In any event, the Commission contends that the conundrum can be avoided by reading the Fonterra retention provision as capable of being either a positive amount, where profits are retained, or a negative amount, where there is a transfer from reserves.

[122] Mr Goddard acknowledged that if this was the Executive Council's intention, then it would have been more satisfactory to refer expressly to payments out of reserves, whether by a further component in the formula, or by adding an additional limb to the definition in reg 3. He urged on us that the Court should strive for an interpretation which would make the legislation work in the manner that the Court presumes must have been intended, and that the finding of a proper implication within the express words of an enactment is a legitimate and, indeed necessary function of the Court in this case.

[123] Alternatively, Mr Goddard urged us to read the term "total payout" as implicitly limited to total payout from earnings in that season. The argument is that when the draftsman referred to the "total payout" in a season, the draftsman must have had in mind a payout from earnings in *that* season (which could be less than the total earnings in that season, and hence the need to provide for treatment of retentions).

[124] We are not persuaded by the first alternative suggested by Mr Goddard. It involves "reading-in" words to the regulation. The drafting of the regulation may be unfortunate, but "is retained" has a present sense, rather than applying, textually, to something which is subsequently transferred "from reserves".

[125] It is far more satisfactory, as a matter of statutory construction, to "read-down" existing terms, so as to exclude undesirable consequences. That said, it

strikes us that it may not even be necessary to go that far. The whole context of the relevant regulations appears to us to be that those provisions are temporally limited to the particular season. For instance, both reg 8(6) and reg 3 use the words, "for *a* season" and if the Fonterra retention for one season is used in the formula, as it must, then it ought not logically be able to be used again in a later season's "pay out". (Emphasis added.)

[126] This approach is more consistent with the economic concerns of the Act and the Raw Milk Regulations, even though it may (over time) make it more difficult for Fonterra to "smooth" (ie, make more consistent) payouts to farmers. Mr Farmer appeared at one point to suggest that the 3% "tail" of the independent producers should not wag the 97% "dog" of Fonterra's suppliers. But of course the creation of Fonterra was only permitted by Parliament with the precise safeguards the Commission has sought to enforce.

[127] For the foregoing reasons, we take the view that Fonterra and MacKenzie J were wrong as to the appropriate construction of reg 8(6), on the retention issue.

Relief

[128] MacKenzie J held that:

> [34] For these reasons, I consider that the appropriate declaration is that sought by Fonterra, namely that, for the purposes of calculating the wholesale milk price component of the default milk price, in accordance with the formula set out in reg 8(6) of the Regulations, the "Fonterra retention" means the after-tax profit of Fonterra for the relevant season that is retained by Fonterra and not paid to shareholding farmers and does not include any amount transferred from reserves by Fonterra for the purpose of calculating the total payout. For completeness, it is necessary also to make a declaration that the amount of any transfer from reserves which is included in the total payout is not excluded from the definition of "total payout".

[129] That declaration will be set aside. We substitute instead a declaration that, for the purposes of calculating the WMP in a season, the term "total payout" means the total payout from profits in that season, and does not include payments to supplier shareholders out of reserves.

Conclusion

[130] In the result, the Commission's appeal in the discount rate proceeding is dismissed. The consequence is that the declaration made by the High Court in [65] of the judgment under appeal, will stand.

[131] The Commission's appeal in the retention proceeding is allowed. The declaration made by the High Court in [34] of the judgment under appeal is set aside. We substitute a declaration in terms of [129], above.

Costs

[132] As to costs, in this Court both parties have enjoyed a real measure of success. Costs will therefore lie where they fall.

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