IN THE SUPREME COURT OF NEW ZEALAND SC 39/2006

IN THE MATTER of a Civil Appeal

BETWEEN **COMMERCE COMMISSION**

Appellant

AND **FONTERRA CO-OPERATIVE GROUP LIMITED**

Respondent

Hearing 12 December 2006

Coram Elias CJ
Blanchard J
Tipping J
McGrath J
Anderson J

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

CIVIL APPEAL

10.02am

Goddard May it please the Court David Goddard with Liesle Theron for the appellant.

Elias CJ Thank you Mr Goddard, Miss Theron.

Farmer May it please the Court Mr Farmer and I appear with my learned friend Miss Rawlings for the respondent.

Elias CJ Thank you Mr Farmer, Miss Rawlings. Right, now Mr Goddard.

Goddard Your Honour, I have attempted at summarising my argument into one page

Elias CJ	Well that will be delightful, thank you.
Goddard	And a couple of attachments.
Tipping J	Oh such great disappointment Mr Goddard really.
Goddard	I can add to it Your Honour, there's not real risk of that not happening I'm afraid. What Your Honours have there is first of all a one page version and a slightly expanded four and a half page version of the argument
Elias CJ	It was very sly of you to refer to the single page first Mr Goddard.
Goddard	There's something in the oath about one's cunning I think.
Blanchard J	It does make one wonder why one bothered to go through 30 pages of fairly repetitive argument on both sides.
Goddard	Yes I think that it became apparent as I prepared for this hearing that it was possible to do it a lot better and that's what I've tried to do. There's also a replacement page 29, just in case the really full version, including equations, is of interest. There's a replacement copy of the case under tab 12 of the Commission's casebook. We found the official report rather than the unofficial report. I apologise for providing the unofficial one earlier. The other two attachments are an extract from one of my favourite cookbooks – I'll explain the relevance of that later –and a short extract from a Corporate Finance text. Some people may have favourites in that domain but I certainly can't pretend to. As I looked at
Tipping J	This cookbook, no doubt its relevance is going to be eliminated in due course is it?
Goddard	It's all about the question of what's used Your Honour and
Blanchard J	I thought the suggestion was someone was cooking the books.
Goddard	No, nor is it a desperate attempt to provide something that's not half-baked in my submissions.
Elias CJ	Well I understand what the reference to baked blind means but I'd be very interested to know whether my colleagues do, but anyway
Anderson J	Yes I know.
Goddard	I will come to that. I think it will make more sense in context. A theme that will recur in my submissions today. There are really four issues before the Court, two in relation to approach and two of substance. The first, and I'm not sure that there's a huge difference

between the parties on this but it is something which has attracted a range of different formulations, some less helpful than others, is the correct approach to interpretation of the Regulation and in particular some of the statements in the Courts below might be understood to support a two-stage approach to reading legislation looking first at the text divorced from the context in purpose and then bringing context and purpose in for certain limited reasons subsequently and the first part of my submission is really an invitation to this Court to make it explicit that that is not an appropriate way to go about reading legislation today. The related point which arises from the Court of Appeal's approach is that there's no scope for showing deference to Fonterra or for that matter to anyone else when it comes to reading legislation that that's the core function of the Courts in that they defer to no one, whether in the context of a judicial review proceeding or what the Court of Appeal described here as the rump of a judicial review proceeding. In any context the Courts do not defer to other bodies when it comes to interpretation of legislation. Adopting then that approach of reading Regulations in context and paying attention to their purpose, the key substantive question in this appeal really is 'what are we doing here'? 'Why do these Regulations exist'? The whole point of looking for a cost of capital, the only reason that we embark on this exercise is to work out what in any given season Fonterra is paying its supplier shareholders for the equity capital which they supply. They supply two things; equity capital and raw milk; they receive a bundled payment for it. The purpose of these Regulations is to identify the implicit price for raw milk. You do that by starting with the bundled price and backing off what Fonterra pays its shareholders for the equity capital which they supply. The annualised share value, the payment that they expect to obtain, that they do obtain for that equity capital. But what Fonterra's preferred reading, the reading accepted by the High Court and Court of Appeal does is that it produces the absurd result of calculating the annual cost of one thing – equity capital – by reference to the price of another. A mix of equity and debt. The absurdity of that is apparent on its face. I'll go through it in a bit more detail later

Elias CJ But before you do Mr Goddard, isn't the real threshold argument you have to make, because what you say may be perfectly correct in terms of a sensible approach to identifying the cost of milk for the independence but isn't the problem that the Regulation refers to the cost of capital used. Your argument might be fine in terms of how the Commission might set about its task under Regulation 9(2) but how do you get over the fact that Regulation 9(1) refers to the cost of capital rate used by the new Co-op.

Goddard There are two limits to that and I'm happy to anticipate those now because it is fundamental to the appeal. The first is to say that in fact three different costs of capital rates were used by Fonterra in this calculation. Fonterra, and I'll step through the process because it is important later, identified its cost of equity capital; identified its costs

of debt capital; from those calculated a weighted average cost of capital; used that to calculate an enterprise value and then after several more steps arrived at a value for its shares, its share price. Now the Commission's submission is that all of those costs of capital were used in the process. That's where the cookbook comes in. The short point I wanted to make in that is that the recipe for apple pie refers to pastry and apples and I think apricot jam. When one goes to the basics recipes, the recipe for pastry, there's flour and butter.

Elias CJ But if you only get to the step of making the pastry you only have pastry, you don't have an apple pie, even though when you combine them all you might achieve that, isn't that the problem here?

Goddard No Your Honour, I think it's very clear that what we have here is an apple pie. We have a share price which has been made from a weighted average cost of capital which in turn was made from the cost of equity and cost of debt, so my learned friend's argument is essentially that in making an apple pie no flour is used, no butter is used, because they're used at an earlier stage.

Elias CJ But they're superseded and the weighted average capital or whatever it is, is the last.

Goddard It's not the last.

Anderson J Could I take you back to the pre-culinary stage.

Goddard Your Honour.

Anderson J You say there are three costs of capital used?

Goddard Yes.

Anderson J And there's no way of determining which one should be invoked for the purposes of the Regulation.

Goddard And that's

Anderson J Therefore there is no milk price so it follows that your analysis can't be right because the Regulations won't work.

Goddard No I don't think that's right Your Honour because the fact that there are three used actually emphasises the need to understand what's meant by the word 'capital' in Regulation 9(1), because it again becomes apparent if one accepts the starting point that three have been used, is that only one of those can be referred to. Let me give another example of what that is actually necessary. The Court of Appeal reflecting the evidence of Professor Officer notes that there are a number of different way one can do even discounted cash flow valuations and it's perfectly

possible for the valuer in setting the share price to use more than one method of identifying that.

Anderson J The starting point is the fixing of the share price, and the question is why is the share price fixed, it is required to be fixed under s.77 of the Act, and it's apparent from s.72(1), subsection 1 that the share price fixing is for the purpose of accepting applications from new entrants and enabling people to buy or sell shares. It's not fixed for the purposes of fixing milk price.

Goddard No Your Honour.

Anderson J So once the price is fixed in terms of s.77 it's then just a matter of transposing a component of that process into the formula required under the Regulation.

Goddard That's correct but with two important qualifications. The first is that the component must be there. It's possible that it could be done without using a cost of capital rate so one has to go and look, and second one needs to make sure one gets the right component, and perhaps

Tipping J Could I interrupt and suggest that what you're saying can be quite simply rendered by saying it's the cost of relevant capital?

Goddard That's exactly right Your Honour, that is what I was trying to say in more words. If one goes to Regulation 9, which the Regulations are under tab 2 of the Commission's casebook, in fact it's probably to start with Regulation 8(6) which requires the annualised share value to be deducted from the pay out to get the implicit milk price and then back to Regulation 3. Regulation 3 defines annualised share value. It's the amount of a perpetual annuity that has a net present value equal to this value of Fonterra's capital basically on 1 June. That assumes it doesn't say, but a discount rate is needed. To calculate a perpetual annuity you need a discount rate. That's implicit. Where is that discount rate to come from? That is what Regulation 9 is answering, so we're trying to calculate the annualised share value, the amount that Fonterra pays for its equity capital in that year, that's the whole purpose of doing this. To do that you need a discount rate. Where is it to come from? What Regulation 9 contemplates is one of two possibilities. The possibility which is contemplated by sub-clause 2, the one that eventuated in the first year where it was very clear that there was no cost of capital rate used, is that the Commission will set about identifying an appropriate discount rate, and the Commission did that. It turned its mind to what that discount rate should be. It said 'well we're talking about equity capital; we're talking about annualised share value, so the only sensible discount rate to use, the discount rate that's relevant to the sort of capital that all this is about, the relevant capital is equity capital'. That's what it did in decision 501.

Tipping J	Is it also possible Mr Goddard when you read the definition of annualised share value with the Regulation 9(1) to view it from the other direction - cost of capital equals return on investment looked at from the other direction if you like and the relevant return on investment is the relevant return that the shareholders are looking for on their investment and that is equity capital?
Goddard	Yes Your Honour, it's the return on that investment. The whole of this is about what the shareholders are paid for their investment. Their investment is an investment of equity, so as a matter of logic common-sense, one would expect the focus to be on the cost of equity capital, one would expect the relevant discount rate to relate to what Fonterra is obtaining, to what it's shareholders are providing which is equity capital with the risk and price that attaches to that equity capital, and that's what happened under 2. Now what is 9(1) doing? What 9(1) is doing is saying well hang on, asking the Commission to set the discount rate involves time and costs and potential disputes. In fact there may be a shortcut which means we can avoid this because each year Fonterra has to set its share price – the price for its equity instruments, its shares, and in the course of doing that it may well turn its mind to what its cost of capital is. What does it cost it to obtain this share capital from its shareholders? If in fact in the course of carrying out that exercise, Fonterra has already identified the relevant then it makes good sense to simply plug it out of that calculation and use it here and a lot of time and cost will be saved. So what does 9(1) say, it says go and look to see if in the calculation of the share price there is a cost of capital rate. Now capital is a very broad word, a very fluid work, a word which Professor Officer, one of the leading experts in corporate finance in Australasia explains, takes its colour from context. Just like in *Cross* on interpretation, the example is given of the word 'chair'. If one says the Law Faculty has received funding for a new chair, then even in the straits of New Zealand tertiary financing, that's unlikely to be a reference to furniture. If I say to my seven-year old daughter, Sarah take your feet off that chair, that's most unlikely to be Professor Mathew Palmer or the Chair of the Commerce Commission for example. So it's a word which is very broad. It takes its colour from its context. What is the cost of capital rate that is referred to here? What is the figure that could just be plucked out? It must mean in my submission if one is to attribute a sensible intention to the framers of this legislation, it must mean cost of the relevant capital, cost of the capital
Tipping J	Is it fair Mr Goddard to say that your argument depends upon this proposition but you have to define what you're looking for before you can say whether it has been used?
Goddard	Exactly Your Honour. Unless you know what you're looking for you can't go the workings of the valuer and find out whether or not that thing is there. Cost of capital rate is a broad term. It could mean cost of equity capital; it could mean cost of debt; it could mean weighted

average cost of capital. Any or more than one of those may have been used. That is perfectly possible because the way in which that's going to be calculated is not pre-judged by the act or Regulation.

Tipping J Because actually all three have been used haven't they?

Goddard Yes Your Honour exactly. All three have been used.

Tipping J So you have to know which one you're looking for before you can say which one has been used.

Goddard Exactly, and it's if you understand which one you're looking for because of context, because of purpose, that the difficulty identified by His Honour Justice Anderson doesn't arise because there's only one thing that you're looking for in the valuer's workings and that thing that you're looking for is a cost of relevant capital cost of equity capital rate.

Anderson J The cost of capital rate used in calculating the price of the share.

Goddard Yes. Can I take Your Honours straight to the very last page of my written submission, my annex 2 on page 30? It's a step-by-step description of the process.

Tipping J Sorry I was making a note, what page?

Goddard Sorry Your Honour, page 30 of my submissions.

Anderson J I found the formula here rather circular.

Goddard It wasn't the

Anderson J Maybe it was the earlier one.

Goddard I think it's the page 29 one. It is all circular. It's intended to show that one can get to the same place in a range of way.

Anderson J It's the one between 28 and 29

Goddard Yes but I'm on 30 here and this was in fact also picked up in para.50 of the Court of Appeal judgment. It was set out there but this is actually a step-by-step description of the process that was followed by the valuer and Fonterra in setting the share price and what I really want to emphasise here is that WACC doesn't come in right at the beginning or right at the end, it happens somewhere in the middle. Saying that WACC is used but the others aren't used involves drawing an arbitrary line.

Tipping J You can't get a weighted average until you've got the factors which you are averaging.

Goddard Absolutely, and to say that you're using the average but not using the inputs into that average is linguistically in my submission simply bizarre, so what one has is step one, estimate cash flows, step two, estimate cost of equity and cost of debt, get those inputs. Step 3, calculate WACC using cost of equity and cost of debt, so way back there we've done that calculation. Then what the valuer did was calculate the enterprise value by discounting cash flows and residuals to the net present value using WACC and adding in a few extra things, it's all explained by Mr Stuart as Chief Financial Officer of Fonterra; then one calculates the net present equity value by deducting the debt from the enterprise value; then one calculates the share value by dividing the equity value by the number of share in Fonterra; then the valuer calculates a fair value share range. The valuer doesn't come with a single number. The valuer identifies a range, plus or minus 7 and a half percent of a mid-point. That range is referred to Fonterra's Board and then Fonterra's Board then determines a fair-value share price somewhere within that range, and in fact steps 1 to 7 aren't even carried out by Fonterra, they're carried out by the independent valuer, in this case, Standard & Poors, appointed by the shareholders' counsel. Step 8 is the only one carried out by Fonterra. Now the High Court Judge, His Honour Justice MacKenzie, grappled with some of the issues this throws up. On one view none of these rates of cost of capital were used by Fonterra, because they were all used by the independent valuer, who's independent, performing a function under the Constitution . His Honour said in my submission quite rightly, well that level of distance from the using can't be determinative because that mechanism was always contemplated by the Constitutional provisions.

Tipping J That's not an issue any more is it?

Goddard No that's not an issue at all, but again it all goes to this point that there's no single last step carried out by Fonterra where a WACC is used but none of the others are. Fonterra actually comes into the process well down the track. The reference to

Blanchard J What actually goes on at the 8th stage?

Goddard There's no prescription of what goes on. It's an exercise of judgement by the Board within that range.

Blanchard J So effectively the Board can reach its own conclusion as a matter of judgement with the WACC and the components of the WACC really only acting as a check prescribing out of limits.

Goddard That's exactly right Your Honour.

Blanchard J Well in that case arguably because of the 8th step, Regulation 1 is never operative.

Goddard	That was the issue that Justice MacKenzie grappled with below and His Honour pointed out in my submission absolutely correctly that that can't have been the intention behind the Regulation. The Regulation of course were made after the Act was enacted and in the schedule to the Act certain provisions of Fonterra's Constitution was set out for the purpose of authorising them for Commerce Act purposes. That's schedule 1.
Blanchard J	So step 8 is specifically authorised?
Goddard	Yes, if one looks at the Act which is under tab 1 of the casebook, the fist schedule to the Act is specified provisions of Fonterra's Constitution and clauses set out it says in schedule 1 'only for the purposes of the Commerce Act authorisation under s.11' and s.4 of the Constitution is the one that prescribes the process of
Elias CJ	Where do I find the Constitution? Sorry
Goddard	Sorry, it's where the provisions are in the schedule to the Act which are under tab 1 in the casebook, the Commission's original casebook, and certain provisions of Fonterra's Constitution are there set out for authorisation purposes. Section on shareholders and how one becomes a shareholder. Section 3 on the co-perative shares standard and then this is the critical one for the present purpose. Section 4 on the fair value of shares and 4.2 provides the value or determines the method for establishing it, so it's up to the valuer, not to Fonterra, and they set that range within 92.5 to 107.5 percent of the mid-point. There's some rules about consistency. At 4.4 factors to be taken into account. 4.5 when the range is to be set, not later than 1 December each year. The valuer provides the Board
Tipping J	Is it of some significance that the 4.2 says the valuer shall determine the method?
Goddard	Yes Your Honour, it's not under the control of Fonterra at all.
Tipping J	Well, but in order to harmonise that with the various steps which you've set out here on your page 30, 9(1) must be read as cost of capital rate used in the method rather than used in fixing the absolute little dollar value.
Goddard	Yes Your Honour.
Tipping J	It must do otherwise it wouldn't made any sense.
Goddard	Yes, used in the course of applying whatever method has been selected. It must be that broad otherwise

Tipping J If methodologically there is no cost of capital, relevant cost of capital rate, then you go to the default. If there is you use it for the 9(1) purpose.

Goddard Yes, exactly.

McGrath J You're saying the Regulations have to be made to work within the Act which was passed first?

Goddard That's exactly my submission Your Honour. So the Act was passed including this process of a range being identified pursuant to a method chosen by a valuer, that range being submitted to the Board and then under 4.8 an estimate of fair value being identified by the Board and then finally no later than the 1st June when the season begins, the years for this purpose, seasons run from 1 June to 31 May, the Board has to determine the value which shall be within the fair value range, and the only guidance in response to Justice Blanchard's question to the Board is that the Board must seek to avoid acting in a manner that is likely to be oppressive, unjustifiably discriminatory, unfairly prejudicial to entering and existing shareholders.

Tipping J 4.7 is of some significance too isn't it because they've got to get a very rigorous methodological report with changes identifying themselves and so forth, so that seemed to me to almost clench the proposition that it's a methodological focus, Regulation 9(1), not an ultimate figure focus.

Goddard Absolutely Your Honour. So there's a whole method. There's a whole process. What the Act contemplates, what the Constitution contemplates is a process, a chain of steps to be gone through by the valuer and the Board which after certain weigh points along the way result in a share price. When one asks what is used in calculating the share price, the answer is that everything that the valuer has done in the course of applying the method it has adopted is used. You use all the tools that you bring to bear to create the finished product, and what then happens for the purposes of Regulation 16(4)(h), which is one of the information disclosure provisions where Fonterra has to report the cost of capital that was used, and Regulation 9(1) is that you go to that process as reported under 4.7

Tipping J Sorry, which was the one in Regulation 16 that you referred to.

Goddard Regulation 16 is obligations to publish information, (4), must publish for each season, (h) the cost of capital used by new co-op in calculating the price of a Co-operative share, if any. So you go to the workings of the valuer pursuant to the method adopted that led to the reporting of a range to the Board and so in turn to the selection of a price and you say 'well in here is there a cost of capital rate used in calculating the price' and in the approach that was adopted in 2002/3, in fact the answer is that there's in one sense an embarras de richesse. There are several

cost of capital rates. We've got a cost of equity, a cost of debt and an average of the two. Well which one of those do we look to? Do we look to the equity, the debt or the average? Debt, plainly silly, we're not talking about debt here. Weighted average cost of capital, well equally silly, we're not talking about a mix of equity and debt. The one that actually has some bearing on the issue to which Regulation 8 and 9 is addressed is the cost of the capital, the annualised value of which we're trying to assess - the equity capital.

McGrath J — Mr Goddard in focusing on the immediate cost of capital and ascertaining what that means before you get to used, you then moved from that to you three incidents of cost of capital as you have defined it that you use. It's also open to you isn't it to say that what was used was the WACC, the hybrid, and therefore cost of capital as you defined it wasn't used at all. Is that part of your argument?

Goddard — That was my argument as it began in the High Court

McGrath J — At an early stage?

Goddard — That's right.

McGrath J — Yes, I'd be interested to know why it is that you see that you're three incidents of use of cost of capital as you defined it, why you see that as preferable to the original argument.

Goddard — Because it seems to me to give best effect to the purpose of providing a simple practical way of identifying the cost of capital where that's available. The Court of Appeal said quite rightly I think that my submission on purpose was incomplete. I had explained the purpose of the Regulation as being to set an annual cost of Fonterra's capital and the Court of Appeal said well that's only part of the story Mr Goddard, what about the purpose of providing a simple shortcut to identifying this number that I think His Honour Justice Hammond suggested would ensure that members of the senior bar weren't inappropriately overworked. It was suggested the process otherwise would provide much too much for them. So if one is to give effect to that purpose then it seems to me that used does need to be read in that broader sense that if the relevant figure has been used somewhere in the process, it really does make sense to pick it out and employ it as the discount rate for setting the share value.

McGrath J — It seems to me that the argument does what you're exhorting us not to do. It's starting to bring in used to define cost of capital or to ascertain the meaning of cost of capital.

Goddard — I don't think there's anyway around asking what was used in the course of setting the share price. The Regulation requires us to do that and everyone's focus up till the High Court hearing had been on that really stages 3 through 8 of my appendix 2 and the argument therefore was

well it was a WACC that was used and so no cost of capital rate in the relevant sense was used, so the Commission should set the price. And the Commission was concerned that that might be the position and that it might be failing to perform a statutory obligation. It had to embark on the process of calculating discount rate if that was correct. However in the course of preparing for the High Court hearing there was a more fine grained focus on describing the whole process followed by the valuer, not just what Fonterra had described it as to the Commission but we pushed into it and realised that in fact when one looked at Standard & Poor's report, the report of what they'd done, all of these figures were present, all of them were used on the same page, in the same calculation and so I presented those arguments very much in the alternative in the High Court. I said there are two ways of approaching this.

Tipping J — Mr Goddard can I just interpose, I'm sorry about this, but just while the thought occurs to me. No one presumably has suggested that the relevant capital is debt capital?

Goddard — Exactly Your Honour.

Tipping J — So why should debts capital have an influence on the outcome through the weight of average cost of capital? That's something I don't quite understand.

Elias CJ — That's a submission that's been made.

Tipping J — Well that's something that I will need some help with.

Goddard — And I say it simply shouldn't. Just as it would be bizarre to use a cost of debt capital figure in this annualised share value, so to, to use an average figure that gives substantial weighting to that is bizarre. It simply makes no sense. When there is sitting on the same page of the same spreadsheet a figure which is absolutely relevant to the exercise which the Regulation require to be carried out.

Tipping J — But the return that the bond holders are looking is surely nothing to the point.

Goddard — It's a complete red herring and similarly an average of that and what the shareholders are looking for is beside the point because the bond holders are not relevant to what's happening in these Regulations. We're trying to back out what the shareholders get paid for their equity and what Fonterra's debts costs it is irrelevant. To use a rate which is determined partly be reference to the Act really does make no sense.

Tipping J — Well the debt capital rate would presumably be lower than the equity capital.

Goddard — Yes, substantially.

Tipping J	Yes.
Goddard	If I take the Court to the relevant page where the
Elias CJ	Is this the Standard & Poor's report you're taking us to, because I'd like a reference to that, I haven't read it?
Goddard	Yes, the Standard & Poor's report was supplied to the Commission in bits. Initially part of it was provided on the 4th June 2002, that's in volume 3 of the case on appeal.
Tipping J	Is that the part that you want us to go to now?
Goddard	Yes I'll go to that because it's a good jumping off point. So I'm under tab 25 and at that point that's Fonterra writing to the Commission in June 2002 saying we need you to set a discount rate for the purposes of 2001/02 season and here is an extract of what Standard & Poors has done for the 2002/03 season, and if you turn to the next page, page 379 of the case on appeal, it begins at s.2.03 Weighted Average Cost of Capital. It talks about applying of the discounted cash flow methodology. About four lines down '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 weighing the required returns and then there is a formula which one needn't go into except to note that WAAC equals Kd, after tax return on debt capital multiplied by the debt percentage plus Ke, the rate of return on common equity capital multiplied by the equity percentage. So what you've immediately got there is a formula for assessing WACC which refers to cost of debt and cost of equity. Some of the rest of that report is provided there but not all of it, so there is then a request from the Commission to provide a complete copy of the report and the response is under tab 26. At para.1 you've asked us to provide a complete copy of the Standard & Poor's report. Fonterra declined to do so but it did provide some additional material and there are some spreadsheets to that and if I take the Court to page 404 of the case on appeal, that's a
Tipping J	What volume's that in?
Goddard	I'm sorry, I'm still in volume 3 under tab 26, page 404.
Tipping J	Sorry.
Goddard	Not tab 404 I'm delighted to be able to say. A whole range of comparator companies and various bits of information about them and then there's a box about half-way down the page with certain headings – Beta, Risk-Free Rate, Cost of Equity, ending in a WACC and Fonterra, country New Zealand, Industry average and various figures. This was set out in the Court of Appeal's judgment, this line of the

spreadsheet as well. What one has there is among other things a cost of equity, 9.7%, and that's the figure that Mr Stuart confirms in his affidavit was the cost of equity that was used in that season. A pre-text cost of debt of 7.8 and an after tax cost of debt which is the one that goes into the WACC calculation of 5.8%, so there's a huge difference between the cost of debt and the cost of equity and then a weighted average cost of capital, 8.36, which was rounded to 8.5%. So this is where the pastry is being made and all of these inputs are used to make it, to make the WACC, and then as explained in the report back under tab 25, that WACC calculated using that formula is, and perhaps if we start at

Elias CJ Sorry, which page now?

Goddard Page 384 might be the next point to move to.

Tipping J Why did they say in 378 that that rate is 8.25%?

Goddard That's because that was for part of the business only. One of the areas in controversy between Fonterra and the Commission was whether one should use a whole of Fonterra rate or only a commodity milk business rate.

Tipping J Right thank you.

Goddard But what is I think common ground is that in talking about the cost of capital rate used in setting the share price for Fonterra, one has to look at the rate relevant to the whole of Fonterra not just a part of it. Although if one moves forward to 384, and this might be helpful here. 2.03.3 Consolidated Company. The specific inputs based on the approach utilised we concluded that the appropriate WACC for use solely in connection with our analysis is 8.5%. So that's 8.5% for the whole of Fonterra. Over the page, 385, the Commodity Business, I think this answers the question Your Honour, 8.25 is the WACC for that, then the Value Added Business 8.5 and various other Business Units.

Tipping J But the whole has to be used of course for the share?

Goddard Absolutely, and then the rest of the process continues using that WACC to discount expected cash flows and residuals to get the enterprise value backing off the debt. So that's what Standard & Poors did and one misconception which I am very keen to dispel is the suggestion of the Court of Appeal judgment that the Commission in some way criticises what it did or suggests that some other method should be adopted. That is not at all the Commission's position. The Commission is entirely neutral as to the approach to be adopted by the valuer. It's not it's role to determine that or to comment on it in any way. The valuer does what the valuer considers to be appropriate. All that is happening here is that one needs to work out whether a figure

that will provide a sensible shortcut for calculating annualised share value has been used in the course of what the valuer has done. So the Commission's concern is to understand what it is looking for, cost of capital but which capital, equity capital, because that's what the Regulations are about. They have got nothing to do with bond holders, nothing to do with debt. We're looking for a cost of equity capital. Is there one in there? Now on some methodologies there will be no cost of capital at all, easy. You can look at it, you say no, they've done something completely different and so the Commission needs to set a discount rate. That was the case in the first year of Fonterra's operation where the figure was simply set by agreement in the amalgamation proposal. Other years the valuer might adopt the method of doing a discounted cash flow analysis of cash flows attributable to equity holders. The only cost of capital rate you need to refer to would be a cost of equity capital rate. You'd go straight to it, also easy. But what happens if the method or methods, because valuers can adopt more than one and cross-check and that actually is what happened here, if the methods employed involve a number of different assessments of the costs of a number of different forms of capital, what does the Commission go looking for and I think this really addresses Your Honour Justice McGrath's question, there are two possible approaches. One might be to draw a line at some stage in the analytical process and say everything used after that point is used, stuff used before, that's consumed I think, or used up or whatever Your Honour The Chief Justice's phrase was, that's gone, so anything after that line is used. If after that you find a cost of equity capital, 9(1) applies, if you don't you set a discount rate, and that's a possible approach but in my submission it's a little artificial because there is no magic point in the process, no magic point in the method, especially given that the method's at large which one can select as the point after which things are used but before which they aren't, and if there's no magic line one can draw with things after it used things before it consumed, then what one has to do is look at the whole of what the valuer did and ask whether in the course of that method, that process, that resulted in the setting of a share price, a relevant costive capital figure was used, and in my submission the better view is that it was here, it was that 9.7% figure that Mr Stuart refers to in his evidence that I showed the Court a moment ago in the spreadsheet where one sees cost of debt, cost of equity and an average of those. That in a sense is why, well it is why, my argument put so much emphasis on a contextual, on a purposive reading of the phrase 'cost of capital used by Fonterra'. It's contextual in two senses. The first is that you need to know what capital you are talking about otherwise you simply don't have a workable 9(1) because sometimes you'll have too many things to look at. It's also contextual in the sense that one needs to pay attention when reading those general words to the sort of capital that's being discussed in the Regulations and there's only one sort of capital in there, only equity capital, only shares, we're only interested in what the shareholders get paid for the capital they supply that's why we're messing around with annualised share values.

Tipping J	If you just look at 9(1) on its own and I am not inviting that course for one moment but this is what the plain meaning exponents presumably would wish one to do, I'm not at all sure that you don't get to equity capital anyway, because when you're talking about returns on shares, which is effectively what you're talking about, and the discount rate if you apply for that exercise, I would have thought you're talking about equity capital, at least prima facie anyway, but that presumably is not a view that has commended itself hitherto.

Goddard	That's certainly how I would read it. It hasn't commended a very much more widespread acceptance than just me so far but I am heartened that Your Honour puts the question in that way.

Tipping J	I'm just exploring it Mr Goddard, I'm not expressing any form of ultimate view at all but I mean what struck me as a bit odd quite frankly is that people should immediately say that plain meaning was WACC.

Goddard	Yes. If one has to pin down cost of capital to a particular type of capital then it seems to me the plain meaning read in the context of just 9(1) is most naturally equity capital. The way as I understand it that Fonterra gets around that is to say that the cost of capital, well it's two ways, they say WACC is a cost of capital, so if it's been used

Tipping J	And we used it.

Goddard	Yes and we used it so that's enough, but that takes you straight into the 'but there were three' problem and which one do you pick. It seems to me though that any uncertainty one might experience about how to read that in isolation is dispelled as soon as you read it in the context of the Regulations as a whole and bear in mind what one is trying to achieve, and

Anderson J	In effect you're saying that in Regulation 1 and 2 capital should be read as equity capital?

Goddard	Yes Your Honour, or relevant capital.

Anderson J	I thought the you were saying equity was the only relevant capital

Goddard	I am, but I

Tipping J	But you've got to interpose the word 'relevant' in order to aid your examination of use.

Goddard	I don't know that I do need to do that. Well I'm not saying you absolutely have to but I would have thought that, well I'm repeating what we were discussing before, so I won't.

Goddard I think it helps but because capital is such a broad word one has to read it as relevant. The capital we're talking about here and picking up His Honour Justice Anderson's query, the one we're talking about here is just equity capital so one can equally happily write relevant capital or equity capital. Both of those make sense but WACC simply does not. It's bringing an alien concept what Fonterra's debt costs it into Regulations that have nothing at all to do with Fonterra's cost of debt.

Tipping J Is there any possible argument that the cost of debt if somehow or other relevant to the enterprise value and the enterprise value is a feature if you like of the exercise that the valuer does, therefore there is some relevance of cost of debt and you can't simply take the view that I proffered a few minutes ago to forget all about debt.

Goddard I actually wonder if that isn't the line of reasoning that in my submission led the High Court astray because what the High Court Judge actually said in response to my argument that all three were used in calculating the share price was WACC is the only one used to calculate the enterprise value. Now in my submission that's not quite right because you can't use an average unless you've used the inputs and of course you can write the formula with the inputs as well as with the average in it, but more importantly neither 9(1) nor the broader Regulations are asking how did we calculate the enterprise value? If there was a focus on the enterprise value and you were looking at the last step in calculating that, maybe, maybe you could start down that path though in my submission context would push you away from it pretty quickly, but there's no reference to calculating the enterprise value in 9(1). That's one possible path to getting to a share price but not the only one and if you do that you have to then, from your enterprise value, back out the debt again and the valuers say they do just that, that's step

Tipping J It's step 5.

Goddard Five. At the point where you've backed out the debt you've backed out the part of the capital to which the cost of debt was relevant, so you've taken away the only bit that brought into play briefly cost of debt and Professor Officer explains very helpfully, and I tried to explain in my appendix 1, but obviously much less helpfully, how you can go through either of those two processes. They process the same answer; they are in that sense circular.

Tipping J Well you could put it in and then take it out or you don't put it in at all presumably.

Goddard Exactly, you can put it in and take it out or you can just never put it in but it seems very odd to say that when you've put it in and taken it out it's somehow important, too relevant, too central to the process in a way that cost of equity, the thing that has to be in there, is not. Again where had I got to? The Regulations are about working out the implicit

price of raw milk. You do that by backing out of the bundled price at the cost of equity capital. To do that you have to work out what the annualised share value is. That requires a discount rate. Where do you get that discount rate from? Well either the Commission sets it under 9(2) and I'm just noting in passing, Justice MacKenzie accepted that in doing that it was sensible to use a discount rate assessed by reference to Fonterra's cost of capital and so it would be slightly odd if you were looking for different things under 2 and 1, but in my submission you're not because what 9(1) is all about is saying but hang on there may be a shortcut, rather than sending the Commission off to work out what the right, the appropriate discount rate is for the relevant capital, share capital, we may be able to just pick up a number that's been identified by Fonterra and its valuer in the course of the process approved by the valuer for setting the share price. Let's go and look if the relevant cost of capital rate, the cost of relevant capital rate, the cost of equity capital rate is in there. If it is, good, we pick it up and then we've achieved all the objectives of the legislation. We've got a relevant rate which will produce an appropriate implicit milk price and it's very brief, it's very quick, or if there's not an appropriate rate waiting to be picked up, we go and ask the Commission to do the calculation. In fact the Commission must do it'.

Tipping J: Is the whole problem here derived from the fact that they have this bundled price for raw milk and return on capital, and somehow or other you've got to distinguish one from the other?

Goddard: That's exactly right Your Honour. Step back again to the broader policy goals - there's layers of policy goals here - of these Regulations. As Mr Stuart explains in his evidence, Fonterra controls about 98% of the milk produced in New Zealand. Before the merger an independent processor, someone like Kapiti, the icecream and cheese people up the Coast. This is all about keeping the price of icecream and cheese down. This legislation raises a strong culinary theme to the whole argument. They could go to New Zealand Co-operative Dairy Company or they could go to Kiwi. They could play them off to try to get the best possible price for raw milk to make into their cheese, to make into their icecream. With the merger even that very limited competition in the market is lost. Someone like Kapiti Icecream face a monopoly supplier of raw milk effectively, unless they can contract with individual farmers which some are starting to do but that's a little bit complicated. There are logistical difficulties. So what the Regulations are saying is Fonterra you must supply independent processors and we're going to require you to supply them at the price you pay your suppliers for raw milk. But there's a problem. It's not easy to identify that price because supplier shareholders in Fonterra, like every dairy co-operative, supply two things. They supply raw milk and they supply capital. They have to supply capital in proportion to the amount of milk they supply. That's the whole concept of the share standard. Every season you have to hold enough shares to supply the amount of milk you supply. If you don't have enough shares you have

to buy more – you're under-shared. If you have too many you have to sell some back. It's all in the Constitutional provision set out at the back of the Act. So you're supplying two things strictly in proportion - raw milk and equity capital – and you get one pay out. When Fonterra announces that it's going to pay out $5.30 per kilogram of milk solids that's a payment for the raw milk that's supplied and for the capital that's been supplied. Now how do you work out what the raw milk has cost Fonterra, because you're going to let Fonterra pass that cost on but not also the cost of the capital because it's not providing any capital to independent processors. Kapiti Icecream is not getting capital from Fonterra, just raw milk. So what cost of raw milk should it be allowed to pass on so that those independent processors can compete in downstream dairy markets on a level playing field on the merits, so that if they're more efficient in their processing and transport and things like that they'll be able to sell lower and if they're less efficient Fonterra will out-compete them. In order to do that you have to assess how much of the bundled payment represents payment for the capital supplied by the supplier shareholders.

Tipping J The return on capital in other words?

Goddard Indeed.

Tipping J The return on equity capital in other words?

Goddard Indeed, because that's what they're supplying. They don't supply debt, they supply equity capital and raw milk so you have to back out what Fonterra has paid in that season for the equity capital supplied by its shareholders and what you're left with is the implicit, unbundled price paid for raw milk. You start with everything that's paid for capital and raw milk. You work out what Fonterra is paying its shareholders for the share capital, the equity capital that they supply on an annualised basis. What's the one-year cost, the annualised share value of that equity capital? What's left is the raw milk price and that's what Fonterra's allowed to pass on, and the practical result of using WACC rather than cost of equity capital is that the discount rate is lower because the cost of debt is lower than the cost of equity, so if you average them you pull down the cost of equity to something less than it was. You get down from your 9.7 to your 8.5 and when you use that as a discount rate to calculate a perpetual annuity, in accordance with the Regulation 3 definition, you get a lower annual.., when you're given an amount of share capital you'll get a lower annual cost because instead of multiplying you know so many billion dollars by 9.7% you're multiplying it by 8.5% you get a smaller number, that means you're subtracting a smaller number from the bundled payment and attributing a larger part of that to raw milk, so Fonterra gets paid more for raw milk by the independent processes than it is implicitly paying its own suppliers. You actually end up with not only the wrong result but a result that is systematically necessarily biased in favour of under-estimating what Fonterra pays for capital and therefore over-estimating

the residual attributable to raw milk and therefore over-estimating what Fonterra can pass on to the independent processors, so Kapiti pays more and the icecream's dearer.

McGrath J Now all this obviously depends on our being able to find in the Act the purposes that underpin your submissions. Will you be coming to those at some stage?

Goddard I will, they are present at a number of levels. One can start right in Regulation 9 talking about the price of co-operative shares and say well the purpose obviously has something to do with that capital, that share capital. Pushing out more broadly to the Regulation I say that the purpose of finding a cost of capital rate which is to calculate the annual cost to Fonterra of its share capital is just written all over the Regulation. One doesn't have to actually look very far at all. What is one looking for? An annualised share value. What are the shareholders supplying? Shares and milk. So it's right in there and in those broader purposes of contestability and efficiency those are explicit in the primary legislation and in particular

McGrath J To the extent I think you have to take it don't you of showing that the independent producers were to get the same price, sorry, were to pay the same price as the suppliers were getting? Don't you have to take it to that extent?

Goddard I don't think I do need to take it to that extent and I think that is what the Regulations do. It's hard to see how else you could describe what they do, but it's enough for example to say that they should pay the implicit price for raw milk calculated in this way.

Tipping J Isn't this a formula that is designed to control what Fonterra can charge the independents?

Goddard Yes, that's the purpose of the formula

Tipping J And therefore you've got to get the right discount rate otherwise the intended control will not bite, or will not bite as was intended?

Goddard In setting the bar here there'll be a bit of ceiling room. It just gives Fonterra just a bit more room, a higher ceiling within which, if it has market power, which is the premise of this whole regulatory regime, it can raise price and exercise that market power.

McGrath J I appreciate that Mr Goddard but I suppose what's in my mind is that the position the Court of Appeal took against you really was that, and I'm putting it a bit colloquially, an arbitrary stipulation was reached in the end which the drafters of the Regulations thought was good enough, it would get close enough and it would be simple and that's the approach they took and it seems to me that you're saying no that you can see, and I understand your argument here in the scheme of

these Regulations, some very fine tuning's involved and it was going to be the same price. Now I'm just wanting to, and I think what you've said is a lot, possibly as much as you can about the provisions of the Regulations themselves. I'm really interested in where the broader purposes of the legislation and the Regulations might help us reach the conclusion that the same price was the purpose and we then start to look at whether the words will able to support it I suppose, though some would say we do it the other way around.

Blanchard J Mr Goddard the shareholders could be said to be being paid a return not on their capital but for their investment in the enterprise.

Goddard The next question one always has to answer when you say I've invested in enterprise is what sort of investment and where do you sit in the pecking order in terms of payment. In my submission you can't talk about an investment in an enterprise without knowing whether you're a secured debt holder, an unsecured debt holder or whether you hold some sort of equity. People expect to be paid different amounts depending on which of those they're supplying, because different risk are attached to those different forms of investment and companies expect to pay different amount for those

Blanchard J Well what's the purpose then of trying to establish an enterprise value?

Goddard It's one method, but only one method, it's not **..11.13.07 ??** by the Regulations, the Regulations don't require an enterprise

Blanchard J I know, but it's a standard method of valuation isn't it?

Goddard It's certainly a standard method of valuing companies because that's what one is trying to do.

Blanchard J Yes, which is value on shares.

Goddard Well one can

Blanchard J You're not doing an evaluation

Goddard You can be valuing a business including assets funded by death and in that case you actually are interested in the value of the whole business as funded by both debt and equity but more commonly one sets out to value the equity of an enterprise of a company and there are a number of ways of doing that. A very common one is to start by identifying the enterprise value and then back off the debt. As Professor Officer explains, one needs to be a little bit careful about even talking about the enterprise in that sense because already judgements will have been made about what debt to expense above the line and what's left below and Professor Officers explains in his affidavit that it's common to expense above the line short term debt and certain non-interest bearing debt, but also short term interest bearing debt with a cut off often

though not invariably being 12 months, one year and so then what you're doing is looking at debt for longer periods and equity, but it's just a line you can draw anywhere. There's no magic in it and what you've got to be clear about he says is what is it you're valuing and for that what is the relevant discount rate, what is the relevant cost of capital rate, because the mix of capital will determine what cost of capital rate to use.

Anderson J Mr Goddard could you help me with this please, the bundled payments. Obviously one component of the bundle is payment for milk supplied under I suppose clause 10 of the Constitution?

Goddard That covers both Your Honour. Both milk and capital.

Anderson J So distributions is not part of the bundle?

Goddard No, Fonterra doesn't normally pay, in fact I don't think it's ever paid dividends distributions. Co-operatives, for tax reasons, don't normally distribute any of their profits as distributions as dividends. It's theoretically possible but what has happened in the relevant years is that the whole of earnings after allowing for retentions, gets paid out under 10.1 of the Constitution as the payment for milk.

Anderson J Which allows the Board to take into account the costs of the company, all the costs.

Goddard In deciding what to pay because you wouldn't want to pay out more than your net earnings.

Blanchard J Mr Goddard I really didn't get an answer to the question I asked you a few minutes ago, probably because I didn't pose it very well and this is a question asked out of ignorance. I need some help in understanding why valuers who are asked to assess the value of a company which essentially is then translated by subdivision into the value of shares, use WACC in order to do that. Why is that considered an appropriate method of valuing shares?

Goddard Because, and it might be helpful to look at Professor Officer's affidavit, because it is in a sense directed to exactly that question. It's in volume 2 of the case on appeal under tab 14 and if one begins at page 154 in the case on appeal, para.18 of Professor Officer's affidavit, I think to answer Your Honour's question it's the right place to begin. What is WACC, and then 20 says 'the logic of applying a WACC to the value or capital base of an entity can best be described in the context of the financial statements of a hypothetical company', so I think this directly tackles Your Honour's question 'what's the logic of using WACC'. There's a statement of financial performance of a hypothetical company. An explanation of each of these items, operating revenue expenses, earnings before interest and taxes, interest expense, tax, earnings after interest and taxes, and goes through the

various claimants on the revenue. Look at the statement of financial position. Equity, interest bearing debt, payables and other liabilities. Notes that in calculating WACC not all debts are included. Will exclude payables and other liabilities which are not paid out of EBIT. At the foot of 23 in general it's only interest-bearing debt that's included in the capital base on interest bearing debt that is included in the capital based, non-interest bearing debt expensed above the EBIT line. Discussion of trade credit and it says half-way through 24 'one could back-out the cost of trade credit put it below the EBIT line and then include trade credit as part of the capital base for which the cost of capital has to be estimated, but this would be tedious and would not change any investment decision, so you can do it but it's unpractical'. 25 is important. 'Similarly not uncommon for interest to be expenses on short term credit debit but to treat long term debt as below the EBIT line'. So what he's saying is that it's just a matter of practice. You draw the line somewhere and it doesn't matter where as long as you're consistent in choosing an appropriate cost of capital rate for the mix of capital that you treat as below the line. So not uncommon to expense interest on a short term debt and an example would be creditors, including bank credit, extending out less than 12 months. In this circumstance the WACC would include debt and equity capital but the debt capital would only be long term debt, because the short term debt is expensed. Once again insofar as cost of debt is accurately expensed there would be no change to an investment decision'. So again I'm making the point it doesn't matter as long as you're consistent throughout.

Tipping J But this isn't quite the point I don't think unless I've missed it. The point is why do you involve yourself with debt at all if I can ask that?

Goddard Sorry I was getting on to that. Because at 26 what he says is 'actually you can also do it without debt at all'. And in these circumstances equity capital is capital of a company, asset based is one of all equity and

Tipping J Well 'this would mean that the net cash flows that had to service the providers of share of equity capital were being identified'. It's that concept is it?

Goddard That's right Your Honour, so you can do that. What Professor Officer says is that you can do that.

Tipping J Is that why you back out the debt at step 5?

Goddard Yes, because you've included something which is not relevant to valuing the shares

Blanchard J But why do you include it in the first place? That's what's got me curious. There must be a purpose.

Goddard It makes no difference and I think that's common ground between the parties. There's no dispute about that; you can do it either way. It is common to calculate an enterprise value because that's relevant to some types of corporate finance decision, it's not actually relevant to this one, but what the valuer has done is go through an orthodox enterprise valuation, but then because what they want to do is set the share price back out the debt.

Blanchard J Yes I understand all that but my curiosity is, and this may well help you, I'm not sure, why does one customarily, because it's very common, use this method which has debt taking into account in it and then back the debt out again?

Goddard I suspect we might be getting a little away from the immediate context but it's because one of the decisions that one has to make in running a company is how best to finance its long term capital needs and what mix of long term debt and equity is appropriate, so it's actually useful for a range of financing decisions to have an enterprise value, to have a total capital figure, including equity and long term debt, and then to pay intelligent attention to the balance between those, so because there are a number of corporate finance decisions where you want to know the whole enterprise value and the mix of equity and debt which makes up the enterprise value, which funds the enterprise value, it is very common to calculate that, but for this purpose there are two equally good paths to the same end. That point and the fact that it will produce the same answer is made expressly in para.39 of Professor Officer. And again 40 and 41 goes on to explain that. At 41 'the valuation exercise undertaken by Standard & Poors uses WACC to calculate an enterprise value of Fonterra not the value of Fonterra's shares. The share value should then be derived from this enterprise value by deducting the value of Fonterra's debt. That kind of process is necessary because the capital that is ultimately being valued is the share capital, not the enterprise capital'.

Blanchard J So the enterprise value is the gross value?

Goddard Yes, of equity and long term debt, not short term debt.

Elias CJ So does the existence of step 5 in your appendix 2 really highlight the point that you're making that the capital rate here must be the equity capital?

Goddard Yes, absolutely.

Elias CJ Yes, because otherwise why take it out in this very calculation.

Goddard Exactly Your Honour. You've taken out the only bit in the enterprise value to which the debt component of WACC had any relevance. All you're left with is the bit to which the cost of equity capital was relevant.

Tipping J Is there a slight subtlety that the backing out is struck from enterprise value. It's a tool to come to share value, it's not as it were definitional of equity capital? Sorry that's a bit elusive Mr Goddard, but anyway I understand essentially the point that's been made.

Goddard Another way of looking at this, just coming back to Justice Blanchard, is my appendix one, pages 28 and the replacement page 29, because I tried to provide here an illustration of the two different ways of tackling this. My example was a medium sized company with long term debt of $4 million with an interest of 8%, expects annual profits. It's got a very stable cash flow like Fonterra of $1.2 million after tax but before servicing debt. Has a million shares. Someone's gone off and done the same sort of exercise, perhaps using the Capen methodology of Standard and Poor's and said well your cost of equity is about 14.67% and we know your cost of debt as 8, so your WACC 12% and then what I've got is two different ways of valuing it. One is with the capital base as equity and long term debt capital. If you do that, if you're valuing the whole enterprise, sorry page 28 of my submissions, my long 30 page version. You see there are two italicised headings on page 28. One valuing the company capital base as equity and long term debt the other valuing the company capital base equity capital. The first one, if you value it using, and you're valuing the whole enterprise – the equity and the long term debt as your capital base – then you look at the whole of the cash flows before servicing long term debt at equity, that's $1.2 million per annum, we have a weighted average cost of capital. That's relevant because we're looking at both equity and debt of 12% and we discover that the value of the company is $10 million. If you want to know what the equity capital is worth, what the shares are worth, you then have to back off the debt - $4 million you get an equity value of $6 million, because there are a million shares, the value of each share is $6. So we've gone via an enterprise value to a share value of $6. You don't have to go that way and that's what the next heading – valuing the company capital base equals equity capital does. You would also do it from the predicted return to shareholders alone. You can say well what is the income stream left after we've serviced the long term debt? We're paying 8% per annum on $4 million, that's $320,000 so we've got an income stream cash flow attributable to equity of $880,000 per annum and to work out it's NPV we need to use the appropriate discount rate, that's the cost of equity capital. Over the page $880,000 divided by the cost of equity capital and again we get $6 million. You can go either way, and

Tipping J Well that's what the Professor was saying that one's just the inverse of the other.

Goddard One involved putting something in and then backing it out again, or valuing the whole and then backing it out, the other involves just

	valuing what you're interested in and here they are equivalent. That's what the Professor was saying.
Tipping J	And could you say that the question might be what is the relevant capital base?
Goddard	Yes, and what is
Tipping J	Here it's not gross enterprise value, it's equity capital.
Goddard	Because what we're interested in is how much Fonterra pays for that equity capital in each season. I'm conscious of the time Your Honours.
Elias CJ	Yes, is that convenient?
Goddard	Yes.
Elias CJ	Alright we'll take the morning adjournment now thank you.
11.30am	Court Adjourned
11.46am	Court Resumed
Elias CJ	Thank you. Mr Goddard we think we understand your argument. We would be assisted if you could take up the suggestion made by Justice McGrath about taking us to the general provisions in the Act which support the purpose that you're contending for?
Goddard	Yes I would be very happy to do that Your Honour. I wonder if I could just attempt a slightly fuller answer to Justice Blanchard's questions first, having had the opportunity to seek some guidance from those who really do understand corporate finance, over the adjournment. I got it partly right why one does an enterprise value. The answer is that it is common though not universal practice
Blanchard J	I hope you've got a better answer than that.
Goddard	Second, that I was right to say that that's because it is not only useful but necessary for some corporate finance purposes though not if what you want to do is calculated as share value, and the third is a practical reason that it's often easier, more convenient to identify the total value of debt and back that out at my stage 5 than it is to go through the more painstaking task of identifying all the cash flows attributable to the debt financing of an enterprise and back those out of the cash flows that turn up in the EBIT line of the statement of revenue and expenditure. So it's a practical reason that it's easier often to do that but none of these things are either necessary or invariable. With that perhaps if I turn to purpose and I deal with that on page 3 of the summary I handed up this morning. The relevant provisions of the primary legislation which is

under tab 1 of my bundle of authorities, firstly s.4 of the Dairy Industry Restructuring Act, there's a quite detailed purpose provision. Para.(a) is to allow the amalgamation to proceed and then turning over to (f) promote the efficient operation in dairy markets in New Zealand by regulating the activities of new co-op to ensure New Zealand markets for dairy goods and services are contestable, so those key concepts of efficiency and contestability come into play. That's the Act as a whole. The relevant sub-part of part 2 is sub-part 5 which begins at s.70 of the Act. It's again one of the modern acts that suffers from many sub-parts and few parts as a result of the exigencies of Parliamentary procedure but in sub-part 5 beginning at s.70 is the group of provisions concerned with regulation of dairy markets. The purpose at the highest level, s.70, to promote the efficient operation of dairy markets in New Zealand and then a statement of principles – 71(a) is the most important. The intention of this sub-part is to promote the following principles (a) independent processors must be able to obtain raw milk and other dairy goods and services necessary for them to compete in dairy markets. So the path to contestability is

Elias CJ — It's quite weak really for the emphasis you're placing on things - obtaining raw milk.

Goddard — And it's really the contestability phrase that I'd emphasise above all. For a market to be contestable one need not only be able to obtain raw milk but to obtain it at a price which enables those downstream markets to be contestable. Contestable there meaning 'on the merits depending on the relative efficiencies of Fonterra players' otherwise it wouldn't be contestable in the sense in which that term is normally used.

Elias CJ — But does the Commerce Act use contestability, I don't know?

Goddard — No Your Honour, it talks about competition. Contestable is a somewhat weaker concept because a market can be contestable even if there's one player in it at any given time providing you've got ease of entry and exist, provided there are no barriers to entry or exit. So what this is about is taking away the barriers to entry that would prevent the markets being contestable, the barrier to entry being access to raw milk, which Fonterra controls 98% of at a price which enables competitive operations to occur. And then the empowering provision, s.115 provides for regulations to be made which require new co-op to supply certain things including raw milk and to prescribe the terms of supply. So in terms of purpose my primary emphasis is in fact on the scheme and function of the regulations themselves. What they're trying to do and the argument that it's inherent in that, that the only cost of capital that one cares about, the only cost of capital that's relevant is the cost of equity capital. But stepping back and looking at the empowering legislation, the goal is to provide for efficient operation of dairy markets, to ensure that they're contestable despite the creation of this large amalgamated entity which controls almost all

raw milk in New Zealand and my submission is that the concern was that Fonterra's market power would enable it either to refuse to supply or to set a price for supply to high that no one could effectively compete with it. That it would not be subject to the pressures which would ensure it was efficient and that consumers in New Zealand obtained dairy products at competitive market prices, at efficient market prices. The way that that was addressed was through providing for Fonterra to be required to supply raw milk at a prescribed price. It was in my submission implicit in this that the price it will be required to supply at, the regulated price, would be the price that promoted efficiency, that promoted contestability in downstream markets and that that would be the same price that it was paying so that competition occurred on the merits on all other dimensions.

McGrath J — You emphasise consumers but does that make an assumption as to what the independents do? Are they mainly processors, are they supplying the domestic market with milk or

Goddard — They're supplying the domestic market with dairy products – yoghurt, icecream, cheese.

McGrath J — Dairy products, processed products, yes.

Goddard — There's a definition in the Act itself in s.5, a processor of milk solids or dairy products who's not an associated person of a new co-op, including New Zealand Dairy Foods which is New Zealand's largest producer.

McGrath J — So are you looking at the definition of independent processor.

Goddard — Yes Your Honour, and that's what they do.

McGrath J — Thank you.

Goddard — So those are the broad goals and they are expressed at a fairly high level of generality but their regulations in my submission dovetail very neatly into those because what they do is precisely to start with say in Regulation 4. Perhaps we'll go to the Regulations just quickly. After the definitions you've got in part 1 must supply all milk. That obligation to supply raw milk to independent processors and then a range of provisions about the terms on which that will be done and some advanced estimates, winter milk, but price of raw milk in Regulation 8, there's a Regulation 9 default milk price which is the wholesale milk price, that's the figure that is dealt with in the formula in 6 plus one sees organic milk, certain reasonable costs of transport and a reasonable additional costs to new co-op for procuring and supplying the milk and again parallel for winter milk. So 5, the default price, what's the price that you pay if you can't agree a price under 8(1), well it's the wholesale milk price plus in (a) the reasonable cost of transporting the milk to the independent processor and for organic

and winter milk again the reasonable costs associated with those more expensive specialised types of milk. So the scheme of the Regulations again is that Fonterra is passing on its costs of these things. It's not taking a margin, it's not being permitted to exercise market power.

McGrath J Does that mean actual cost or could it be averaged cost?

Goddard It has to be its reasonable and among the issues that have come before the Commission for determination in relation to transport are for example whether it should be an average cost across the whole of New Zealand or whether it should be localised into regions. That's been the subject of a separate determination.

McGrath J So what you're saying is there's an argument about that?

Goddard There's an argument about that, and what the Commission determined was that it should be regionalised to a certain extent. That there should be certain differences, but what the test is is the reasonable cost and so again looking back at wholesale milk price that supports the submission that the basic scheme of the Regulations is that to ensure contestability in order to ensure efficiency this raw milk must be passed on at cost to Fonterra. Fonterra is not allowed to take a margin on it which would undermine efficiency, would undermine contestability and just as it provides transport at cost, just as it provides organic milk at the reasonable additional cost of procuring and supplying that, so to for the basic raw milk that's not winter, not organic, what it can pass on is its cost of raw milk. But what is its cost of raw milk, we have this problem of the unbundled price, we have to back out the cost of the equity capital to get to the cost of the raw milk. So broad scheme efficiency contestability, regulations designed to give effect to that by requiring supply at cost and providing machinery for identifying the cost of the raw milk because cost of transport – you can look at what a transport operation costs to run. It's not trivial but it's relatively simple. But cost of raw milk, Fonterra's not paying for that separately. How do we work it out- that's what the rest of Reg 8 and Reg 9 are doing, they're working out that cost and so what the Regulations are trying to do is develop a cost based approach to what Fonterra can charge in the interests of efficiency and contestability.

Tipping J It's not cost plus it's cost.

Goddard Exactly Your Honour, and if you want to get cost of raw milk you need to make sure that what you're backing off the bundled price of equity capital and raw milk is the cost of equity capital, otherwise you overstate the cost of the raw milk and you've got a cost plus situation. You've got a little allowance to debt even though debt's got nothing to do with it. So that's I think how the purpose of the primary legislation relates to the specific purpose of the Regulations and their scheme that really covers from my summary paras.12 through 17. I've talked a little bit about para.18, the practical function served by 9(1). The

shortcut, and again the key point in my submission on that is that it's a shortcut that you adopt where it's available where the relevant cost of capital figure is waiting to be plucked out. There's no mandate anywhere in the scheme or language of the Regulations for suggesting that you just pluck out whatever figure happens to be available even if it's not actually relevant to the purpose in hand. The next few paragraphs talk about how that purpose is implemented and I think I have covered this. It's hard to overstate the importance of the point in para.20 that it's both illogical and unprincipled to use the price of one thing, to assess the annual cost of another just makes no sense, and that's there's no difficulty in reading the Regulations in this way. 23 and 24 in my summary deal with the suggestion that I'm urging a strained interpretation on the Court. Now strained interpretation is used as a term of art for example by Benion in his code as meaning an interpretation other than any of the grammatical interpretations that the language can bear and in my submission that is not what I'm suggesting at all, rather this is the sort of open textured language, capital in that sense is just like the word chair, that takes its colour, that takes its sense from context. If one had to stick labels on the interpretative process, one might say that it's an ambiguous phrase because it's capable of referring to more than one type of capital. One needs to know which one, but in my submission that's not really a very helpful way of thinking about it, rather the question is what of the various available meanings of cost of capital which one actually makes sense reading this as a whole, reading this in context and there's only one that actually makes sense that doesn't turn the Regulation into an invitation to do something very odd, very illogical, very unprincipled. It was also suggested by the Court of Appeal that the Commission's reading was inconsistent with the administrative simplicity goal and that's a point which my learned friend put some emphasis on in his submissions before this Court. That's simply not the case. First it is no harder to extract the cost of equity capital figure from the spreadsheets used by the valuer than it is to extract the WACC, it's just a matter of knowing what to look for, and then you pick that out and you publish it under 16(4)(h) and you use it in the calculation. So in the year in question and subsequent years, there's no difference in it.

Elias CJ Well what was published in this year?

Goddard Fonterra published its WACC. It's acted consistently on what I would say was a misconception of what 9(1) and 16(4)(h) were referring to. And Fonterra seeks to argue from what was published under 16(4)(h) to the conclusion that therefore that must be used under 9(1), but in my submission that just doesn't work. First of all one works out what cost of capital one is talking about here. Having identified that one looks to see if such a cost of capital was used. You publish that, you use it.

Elias CJ I think we understand that argument Mr Goddard.

Goddard Sorry, I'll stop going over that again. But the Commission would say that Fonterra has also published the wrong rate under 16(4)(h) but it would have been just as easy to pick out publish the correct one. And if in fact there is no cost of equity capital rate in the workings of the valuer, and it's not easy to imagine how that could come to pass so long as a discounted cash flow is being carried out, because whether one does a discounted cash flow the enterprise as a whole or just of cash flows attributable to equity just of the equity capital, you need to use a cost of equity capital rate. But if that were to happen then the Regulations do not require Fonterra to use independent processors to pay a price based on an irrelevant and inappropriate and systematically understated cost of capital. Rather there's a mechanism for ensuring that an appropriate discount rate is set and the Commission will do that, that's its statutory function. I think I've dealt with my submission on workability as well and I won't go over that again and I've also dealt, just jumping ahead to my page 6 with the red herring, the argument the Commission has a view on how Fonterra should set its share price. It doesn't, it's completely agnostic on that. What it has a view on is what you go looking for in the workings. That only leaves the Court of Appeal's approach to relief. I don't know whether it's helpful for me to spend

Elias CJ Well that's fully covered in your written submissions which we've read Mr Goddard so unless there's anything you want to add to that there's no need I think to enlarge upon it unless anyone has some questions.

Tipping J I have just one question. I couldn't quite, maybe I didn't invest enough intellectual effort Mr Goddard into trying to find out exactly what the Court of Appeal's problem was here. Is it said against you that if we are, or if any Court was of the view that what they were doing was wrong, ie, they had misinterpreted Regulation 9(1), somehow or other the Courts either shouldn't or couldn't intervene because of some discretion or margin of appreciation – I couldn't quite follow it but maybe it's better to wait to see whether Mr Farmer picks it up and then deal with it if you have to in reply might be preferable quite frankly, but can you state in a couple of sentences what it was that the Court of Appeal was concerned about, just to help me?

Goddard The Court of Appeal did seem to be saying, I also had some difficulty understanding this part of the judgment. It's taken me a lot of time puzzling over it and the relevant passage is paras.90 and following of the Court of Appeal's judgment. It's at volume 1 of the case on appeal under tab 10, page 91 and para.90 and following. A great deal of time was spent at the hearing discussing whether this was in some ways still a judicial review proceeding whether the shadow of judicial review hung over this because the proceeding began its life

Elias CJ What would it matter?

Goddard Well that was my answer.

Elias CJ	Yes, well I don't think you need to expand on this Mr Goddard.
Tipping J	Let's see what if anything Mr Farmer makes of the point.
Goddard	There was a suggestion there was a discretion to refuse relief to me even if the Court thought I was right. I struggled to understand
Tipping J	If they're doing it wrong well it should be corrected.
Goddard	Yes, that was my submission and that the Courts should always be willing to say so, yes. In that case unless Your Honour the Court has any questions about anything else.
Elias CJ	Thank you Mr Goddard. Yes Mr Farmer.
Farmer	Just picking up on that last point Your Honours, I have a feeling that possibly the Court of Appeal felt that they were rather ambushed and that's why they at the end of the day were left in a somewhat nervous state that if my learned friend's argument was right at least to the extent of establishing that the WACC shouldn't have been used or wasn't the appropriate measure of rate that should be used for some reason, then it didn't necessarily follow that cost of equity as the Commission, or rather as my learned friend persuasively described it in Court, should simply then form the basis of a declaration for the future, for the whole of the future and to understand that I think you've got to go back to how this started of course, which was judicial review proceeding brought by Fonterra challenging that initial Regulation 9(2) determination that the Commission made which it did make on the basis of cost of equity and that of course related only to that first year of Fonterra's operation where it had not had to use a cost of capital rate in calculating a share price because a share price was agreed at the very beginning. What happened was that Fonterra ultimately discontinued that claim because it was able to reach a commercial settlement with the only independent milk processor who was making a fuss about it, but in the mean time the Commission jumped in with the counter-claim and thought well here's a great opportunity to deal with this forever for the future and to get a ruling from the Court that would continue into the future that unless Fonterra used a cost of equity rate then it would simply have failed to make a valiant determination under Regulation 9(1) and that would then open the door for the Commission to leap into Regulation 9(2) and do the same thing again that it already had done. So that was the way in which it was pleaded. In fact if you, I won't take you to it, but if you were to look
Elias CJ	I would like to see how it was pleaded. I was just looking it up.
Farmer	Volume 1, tab 4, the counterclaim that the Commission brought is on page 17 and you will see that para.15 invoked immediately Regulation 9(2) which was where the Commission was always aiming at that point

and then para.16 said that Fonterra claims that it is using a cost of capital rate which in calculating the price of a co-operative share if it calculates the price by reference to WACC, which in fact that's exactly what Fonterra was doing and secondly that Fonterra was claiming that WACC is the cost of capital that must then be used under the Regulation, Regulation 9(1) and then para.17 is the key paragraph that was pleaded at the time. The Commission considers that Fonterra's interpretation of Regulation 9 is incorrect and that (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.

Elias CJ Well that is the argument.

Farmer That's the argument, but it's

Elias CJ I just don't understand why you say this was an ambush.

Farmer Well I'll come to that. So the argument really was that unless Fonterra used a cost of equity capital, it simply wasn't using cost of capital at all and therefore the Commission could then come in under Regulation 9(2) and fix the rate under that provision. Now what I'm saying Your Honour is relevant to the other main submission that my learned friend makes which is that in fact Fonterra did use a cost of equity rate because he says in the Standard & Poors spreadsheet you can find a cost of equity rate in the schedule so it did use it and therefore that's the appropriate rate that the Court should not endorse. And while I think, and I must say I sat back and rather enjoyed the exchange between my learned friend and the Court below, because it was really something the Court raised rather than our raising it, but what I think the Court was concerned about was that, oh sorry I've missed a stage out. In the High Court the spreadsheet only was looked at I would suggest by anyone at the hearing itself. It suddenly became, there it is, we're all looking at it, and my learned friend using all his natural astuteness leapt on with glee and said well there you are, they've used a cost of equity rate and that's what led to the argument you have before you today in which the Court of Appeal also had before it, namely that in fact, in fact Fonterra did use a cost of equity rate and that now is his answer to our argument that Fonterra used the WACC and therefore that's the end of the

Tipping J He's gone from a default case to a

Farmer A Regulation 9(1) case, yes exactly.

Tipping J Yes.

Farmer And so I think, I'm speculating to some extent, but what it seemed to me reading the judgment in the Court of Appeal on this point and being there at the time, what the President, or not the President I'm sorry, the

Judge presiding, Justice Hammond was concerned about was that and he does and it is referred to in the judgment, was that the Court was in the end having to grapple with these very complex sort of notions of cost of equity and cost of debt and WACC and how it all interrelated with each other and relying only on evidence in the case of Professor Officer, that was led or filed really in relation to how the Commission had pleaded the case in the first place and none of it was ever cross-examined on and so the Court was left with this feeling well maybe we should just let this thing evolve and if there's a problem well they can go back and amend the Regulation to whatever. So I'm just explaining it as I see it. I'm not really trying to press the point one way or the other.

Elias CJ So the argument that Fonterra had used, inequity, cost of capital was opportunistic really and it may be that it would have been better to deal with the thing straight up as indeed the counter-claim had dealt with it?

Farmer Yes and I should go back a bit. We actually before we even got into the High Court hearing, we actually applied to strike the counter-claim out and we failed. That was heard by Justice Gendall.

Elias CJ Oh yes.

Farmer And we said it wasn't appropriate to have a counter-claim of that kind but if the claim by the Commission was, as it was at that time, that somehow the Commission was, sorry that Fonterra had used the wrong rate and therefore hadn't used a cost of capital rate at all, well then Fonterra, sorry the Commission, the appropriate course was the Commission should say alright well now we're going to exercise our Regulation 9(2) power and do it and we could then challenge that, it's right to do that and there would have been a whole, we would have had difference evidence that probably would have come out at that point. Now Justice Gendall took a rather very pragmatic view, he said well we're here and we're here and we're here so let's stay here, let's get on with it.

Elias CJ But if it's been addressed as a matter of statutory interpretation what's the impediment to the matter having been on the counter claim?

Farmer I think it's fine to be dealing with it as a matter of statutory interpretation on my learned friend's first argument, what does cost of capital mean relevantly here? Does it mean is a WACC a cost of capital within the context in which it's used here? We're here to argue that, but when he perhaps then brings in this what Your Honours call the opportunistic second argument which is that Fonterra used the cost of equity, what you don't really have is expert commentary on the part that that figure in the spreadsheet plays in the overall analysis, and I

Elias CJ Isn't it apparent on the report?

Farmer — Well I'll do my best to say what part I think it plays in and in particular that feeds into the question that Your Honour Justice Blanchard raised, which we say with respect is critical which is why are we actually valuing the total enterprise, the total enterprise and I think when you ask that question and then look at it you see why, and the other question that was asked I think came from Justice Tipping was why are we bothered with debt at all and the answer is that debt is highly relevant to the determination of the cost of equity because you can't determine properly the cost of equity in the case of a company that in fact borrows money as part of its capital raising without having a look to see what the impact of the debt and the level of debt is on the return of equity that is appropriate to the shareholders. So I'll go over that and I'll go over it very shortly.

Blanchard J — Just Before you do though and coming back to this question of the declaration, and I appreciate that this rather starting things at the wrong end. If we did get to a point of considering a declaration are you saying that it would be better just to leave the matter for a default situation rather than to make a declaration which identified the cost of equity capital that Fonterra says that it has used?

Farmer — Yes I think we are because I think in effect what the Court, if the result of this hearing was that the matter was sort of at large then no doubt the Commission would purport to exercise its 9(2) powers and it would undertake an exercise and we would have, I think we would have different evidence, we'd have fuller evidence from valuers, because

Blanchard J — So you'd actually want the opportunity to come back in at that point?

Farmer — Well yes and if you look, and just even looking at what happens under 9(2), 9(2) or rather 9(3) says that when the Commission sets a discount rate it must have regard to whatever relevant information is used by Fonterra in calculating the price of a co-operative share and secondly is made available to the Commission. Now having regard to whatever relevant information is used by Fonterra, would enable among other things us to call evidence perhaps from Standard & Poors to explain rather more fully, not only as to what's been used in calculating the price but why and how, and what's lacking at the moment in the evidence here is that sort of fuller explanation of how the whole thing actually works. Now I'm going to do my best to explain to you how it works, but I have no more expertise or authority, probably less, than my learned friend has to give you that explanation and so you're left in a rather invidious position

Tipping J — Mr Farmer what if one was of the view, and I emphasise this is hypothetical, that the discount rate used by a new co-op in calculating it must be the same as the cost of capital rate and that we were of the view that that was the equity capital rate. Surely there's no more to be said.

Farmer	Well my concern Your Honour is that we're dealing here with concepts that really require a lot more expert opinion
Tipping J	Was this point made in the Court of Appeal? I mean we're here almost on a rather unsatisfactory basis if that's the case. I thought that everybody was satisfied that all the evidence was before the Court that should be before the Court.
Farmer	Well I've explained to Your Honour how this developed and we've not been the appellant at any stage in this case.
Tipping J	But I don't read anything in the papers that suggests, maybe I've missed it, that really the Court's hands are somewhat tied because of lack of evidence.
Farmer	Well that is exactly the concern that was expressed by the Court of Appeal, that they were nervous about giving what was called a powerful far reaching declaration that would effectively bind into the future and that would have a major impact on the way in which Fonterra valued its share price for the future.
Tipping J	But apparently according to Mr Goddard this point was raised by the Court not by your client.
Farmer	The point about the declaration.
Tipping J	No the point about what you might call the difficulties of doing what the, the point raised as to what the Court of Appeal's concern was. They raised that apparently off their own notion, not at the invitation or is that wrong?
Farmer	They raised it. My learned friend stood up for the appellant at the beginning of the hearing thinking he had the 15 minutes silence rule and the point was raised immediately by the Judge presiding and there was, I don't think my learned friend spoke for 15 minutes. So the point was, your right, the point was put on the table by the Court.
Tipping J	Well assuming one were of the view that as a matter of statutory interpretation in the context or forgetting the context, that that's what cost of capital rate means in this Regulation, what more evidence is going to eliminate?
Elias CJ	As a matter of statutory interpretation it just can't be necessary. It might be that there shouldn't be anything like a declaration that the rate should have been 8.5% or something like that but the bare explanation of whether cost of capital rate is equity capital or not I can't see that that's a problem at all.
Farmer	Well what you have in para.16 of the pleading is what Fonterra claimed and that's attacked by the Commission and if Fonterra was wrong well

then that's one thing but then in 17 what you've got is a positive claim by the Commission that the only other rate that is available is a cost of equity rate which is sort of like begging a number of questions about exactly what the cost of equity rate is and how it's arrived at and so forth.

Elias CJ But that's for another argument.

Farmer Yes, that may well be.

Tipping J Well this isn't a brilliantly drafted piece of pleading if I may be allowed to say so

Farmer You can say so Your Honour.

Tipping J But the declaration they seek is that the interpretation that they set out in para.17 above is correct. Now that's what they're seeking and that is an interpretation declaration, awkwardly expressed as it is, it seems to me to be clear enough they're asking the Court to say that the true construction of that Regulation is that its equity capital.

Farmer Yes, well that's certainly right and the Court of Appeal was unhappy about it.

Tipping J Well I can't see why they were unhappy about it, if that's the construction of the Regulations, so be it.

Farmer Well I'm just really standing here in an Amicus role Your Honour.

Tipping J Well you're doing a great job Mr Farmer in that Amicus role.

Anderson J It's because he's so used to it.

Elias CJ The Registrar might be terrified to hear that. He might think he might have to meet your fees Mr Farmer.

Farmer No, no, that was a very cruel comment made by His Honour in the Court below about senior counsel fees in these sorts of cases.

Blanchard J Yes, yes I thought you'd be hurt.

Farmer Precisely, because there's a lot more pleasant ways of earning fees than doing this sort of work.

Tipping J Well I couldn't work out whether you were the hen or the fox Mr Farmer.

Farmer Well that's a sort of interesting digression, I did have some notes prepared and I'll hand those up at some point but I thought it would be much more useful if I just try and grapple with this question of why is

debt relevant and why do you value the total enterprise? Why is that necessary? But before doing that, because my learned friend took you through the statutes, there are a couple of provisions that he either didn't mention or perhaps passed over rather quickly and I just want to refer to them and then I'll come back to them later. Section 108 of the Act is very important in relation to this contestability same price argument and what that says is that shareholding farmers, and that's referring to Fonterra's shareholding farmers, are entitled to allocate to independent processors up to 20% of their weekly production throughout the season, so it is open to independent processors to go directly to any Fonterra farmer and say I would like to do a deal with you where you supply me up to 20% of your weekly production, and there are very good reasons why they might want to do that and I'll come to that just in a second because the other provision I wanted to show you that is also relevant to that is Regulation 8(1) which I'm sure my learned friend referred to but I don't know that he dwelt on it. Regulation 8(1) – in relation to default milk price, default milk I'm sorry, in relation to default milk provides that Fonterra and an independent processor may agree a price for the supply of raw milk. So the so-called default milk price is very much exactly that. It's a default or a backstop in case the independent processor

Tipping J But it's a discipline.

Farmer Well it may be a discipline on Fonterra but can you go back to s.108, because if the independent processors are unhappy with Fonterra, either because they can't negotiate an agreed price under Regulation 8(1) that they like all because the default milk price isn't something they like either, there is as I say absolutely no reason why they can't go to any farmer they like, whether a member of Fonterra or not, and do a deal with them. Now why would

Anderson J A farmer might be reluctant to do that sort of deal because it could lead to a compulsory sell back of some shares.

Farmer In terms of the quantity, the volume, yes they might, they might, but it depends on what the deal is that's being offered and it's important, my learned friend was asked the question I think well what is the price that is paid by Fonterra for milk? And he rather with respect to him sort of went down another track by referring you to transport costs and having the reasonable costs in the Commission had there been debate about it and the Commission had had to agree, had set a regional average price and so forth. But with milk it's different. First of all it's important to note this, there is no uniform milk price that is paid. The price varies literally from day-to-day and at the end of the season it's averaged and the price varies because of demand and the demand is something that's driven by global markets, not by New Zealand markets, whatever the figure is, 98% of Fonterra's milk is one form or another exported – milk powder I suppose primarily, and so over the course of a whole season that price may go up or it may go down and so the problem with

the whole default milk price if the independent processor wants to ride on that, the independent processor says well I'm not going to agree with Fonterra on a price at all, I'll just go for the default milk price. The problem with that is that that isn't calculated till the end of the season and it's based as we've seen on determining looking at the revenues earned and all those other things and then calculating the share price which is based on the performance of Fonterra over the year, and so in a situation for example where over the course of a year the price of milk went down fairly dramatically on global markets, well then, maybe I've got it the wrong way around, I never know, but if it went the wrong way or whatever it is then at the end of the year

Blanchard J You'd have to pay more than you were anticipating at the point when you bought.

Farmer Yes exactly and

Blanchard J Do you pay some instalment?

Farmer Yes, yes you do. And the farmers are paid in instalments as well and then there's the washup at the end of the year based on the averaging. But my point is simply this that in running a business certainty and stability are incredibly important in terms of getting your costs fixed so that you can then calculate your margins and do all the rest of it and market your product at a price that is based on a degree of certainty about the cost that you're having to pay for the components, so there's a real incentive on milk processors to achieve certainty by contract, a contractual price over the course of the year and so that's why in fact the largest independent milk processor which is Open Country Cheese has, and I'll show the evidence in a moment, has increasingly moved away from Fonterra towards dealing directly with farmers contracting with them relying no doubt on s.108. Now I'll give that reference. It's in our casebook, Fonterra casebook

Blanchard J Mr Farmer what's the relevance of this to the question we have to determine? It's good jury stuff but

Farmer No, no, what the relevance is because my learned friend is presenting this case to you in terms of his purpose argument as if this was a Telecom case where you can't compete unless you get an access price from Telecom, and my point is that when you're interpreting these Regulations and the statute and looking at the sort of broad concepts like efficiency and contestability, you don't need to strain the meaning of Regulation 9(1) in the way my learned friend would make you do it in order to be absolutely sure that there's no margin somewhere hidden there, because at the end of the day you don't need access to this default milk and in fact the access regime so-called is very much a backstop. It is a very small quantity of the milk that Fonterra has. It's something like 3% of the milk that Fonterra obtains from farmers that is subject to this regulatory regime.

Anderson J	Is that the 400 million litres is it?
Farmer	400 million litres out of 13.1 billion litres.
McGrath J	Includes the export market of course doesn't it?
Farmer	Oh yes it does, but by taking a s.108 my point has been that it is not as I say a Telecom situation where you have to deal with Telecom.
Tipping J	Are you saying there's enough contestability without having to strain s.9(1).
Farmer	Exactly, and that's the only point I make about it and so that makes much more defensible the fact that you have in Regulation 9(1) a maybe rough and ready, and I think the Court of Appeal might have used the word 'arbitrary' mechanism for dealing with this simply. It may not be perfect, it may not be perfect in the sense that there may be some margins of sense in there somewhere or other but the good thing about it is that you don't have the kind of disputes that according to the Court of Appeal make the senior bar wealthy.
Anderson J	But you wouldn't have disputes if it was interpreted as equity capital would you?
Farmer	Well maybe not, not you wouldn't that's right, but the point is that
Elias CJ	And it wouldn't be arbitrary either. I don't really understand the point made that it's rough and ready and arbitrary, I mean if the interpretation is as Mr Goddard has contended for it makes sense.
Farmer	And if it says we contend for and for reasons I'll go into now, it makes sense as well. The point is though that what the Regulation doesn't require is an exercise to be done year after year after year to determine what is the optimum method that can be used best further efficiency, contestability, competitively, whatever.
Elias CJ	But if it's a fixed meaning then it applies equally under Regulation 2, whereas on your contention Regulation 1 could yield a vastly different result from a determination of the Commission and that seems rather odd.
Farmer	Well that has yet to be test of course as to whether the Commission can do what it likes under Regulation 9(2) and the reason I show you
Elias CJ	Well I would, I would have thought that it can't because Mr Goddard's argument must cut both ways but my point is that there is symmetry if you read, and certainty, if you read the two parts of the Regulation in the way that Mr Goddard contends for. On your interpretation there would be lack of symmetry.

Farmer I'm sorry Your Honour if I

Elias CJ Well it would be at the option, Regulation 9(1) would make it at the option of Fonterra what type of cost of capital it was relying on which could be vastly different from an equity cost of capital.

Farmer Well first of all that's subject to all the constraints that Fonterra itself is under the Constitutional provisions that you were shown, namely that the Fonterra Board can't do what it likes. It's bound by what the valuer puts up to him and the valuer is appointed independently by the Shareholders Council, so that's why they chose a reputable valuer such Standard & Poors who do that and the only discretion that the Fonterra Board has is within that range of 7 and a half percent on either side of the meaning.

Elias CJ Well I don't think it's necessary to attribute the choice to the Board, it's just that on two interpretations, unless it has a fixed meaning such as Mr Goddard contends for, you could

Farmer Or the one I contend for?

Elias CJ Well no because your contention is that there are a range of meanings. You don't say that the only possibly meaning is WACC, you say that if Fonterra used WACC that's the appropriate one, but if you're in the real default situation of the Commission deciding to do it then it's perfectly able to go to an equity cost of capital rather than WACC and that's where the dissonance is set up.

Farmer Well with respect Your Honour I would not agree that it's perfectly able to go under 9(2) to an equity rate because the Commission is also constrained and it's constrained by those factors in 9(3) and there would be in our submission, we would be able to have a similar argument albeit on different evidence

Elias CJ But that's all about information. That's the information

Farmer No, no, the first part is, well yes but they are powerful factors and one question would be if the Commission simply ignored what Fonterra did in calculating the price of a co-operative share, then that would lead into arguments about whether you've got inconsistency between the equity, or the value of the share on the one hand and the value or the price of the milk on the other because the backing out thing that my learned friend talked about, that whole issue would come up again but in a different way.

Anderson J Could Fonterra sensibly use only a cost of debt capital?

Farmer No it couldn't and if I could go now into an explanation of why it couldn't

Tipping J Could I just before you do

Farmer Sorry and that leads into the total enterprise question.

Tipping J I'd be grateful for that help too but just before we leave this relationship between 9(1) and 9(2) that the Chief Justice has just been discussing, I have wondered whether part of the trouble is that in Regulation 9(2) the indefinite article is used, a cost of capital rate, whereas I rather think what they mean is that if a new co-op doesn't use the cost of capital rate referred to in para.1, the Commission must and I think the indefinite article tends to skew one's thinking away from the fact that it is a specific cost of capital rate that's been referred to in 9(1) and it's the same one that's been referred to 9(2) and its substitute is called, and it's the opposite side of the same coin, the discount rate. That's how I would be inclined subject to any further help counsel can give to read these two together as they're obviously meant to as it were march together.

Blanchard J It has to say a because it wouldn't make sense

Tipping J Exactly, it has to say a but really it's referring to the one that's the appropriate one, in 9(1).

Farmer Yes I think the reality is Your Honour that because the time these Regulations were drafted it was known that there was going to be no price fixed in the first year by way of a calculation because it was just done as an agreement, that 9(2) was really directed to that first year and thereafter because Fonterra necessarily does have to every year calculate a cost of capital rate which it has to publish under Regulation 14 that the regime forever would be a Regulation 9(1) regime.

Tipping J But what I'm really into this maybe wrongly is that reading the two together they are referring to a particular cost of capital rate, namely the one appropriate to the exercise that's being undertaken. They're not referring to a range which is then driven off which one your client happens to pick as the appropriate one.

Farmer Well that's what my learned friend's putting to us.

Tipping J Well I'm putting it to you too because frankly that seems to me to be the natural reading of these two provisions together.

Farmer Well the underlying premise of that with respect seems to be that really debt plays no part in determining cost of capital. That cost of capital for the purpose of valuing shares, and my learned friend emphasises that purpose necessarily can only mean cost of equity capital and I want to now show you how when enterprises are valued that even when the cost of equity is looked at and the required return of equity investors is calculated, debt plays an enormous role in that calculation

and that's why you end up ultimately with a WACC-type bottom line which the valuers then use to calculate the total enterprise value, and certainly yes if you then want to determine what's the net value of the shares then you can if you like deduct the debt, but can I just take you, perhaps take you now back into the Standard & Poors document but as a preliminary to that in the same volume which is volume 3 on the case on appeal, at tab 40, there's a leading text that was annexed to somebody's affidavit, I don't know whether if was Professor Officer or Professor Bowman, it doesn't matter, it's before the Court and it's Corporate Finance by Ross, Westerfield and Jaffe and the relevant chapter, chapter 12, Risk, Return and Capital Budgeting and I promise I won't, no I won't take you in any of the mathematics on the first page but I'll have to do it briefly on the second page. You can be assured I'll be the first to get lost in it. But at the foot of the first page you will see the sentence 'when firms finance with both debt and equity, the discount rate to use is the project's overall cost of capital. The overall cost of capital is a weighted average of the cost of debt and the cost of equity' and the distinction is drawn which I'll come to

Tipping J But this can't relate to use for what purpose, determining the enterprise value?

Farmer That's right.

Tipping J Yes.

Farmer And so there's a distinction drawn between when you're valuing a company. Between companies that have no debt, companies that have all debt and companies that have a mixture of debt and equity and most companies of course are companies that have a mixture of debt and equity and the debt to equity ration is a critical factor in the valuation of companies and of course that's why companies in particular, and certainly listed companies, analysts are always extremely interested in the debt to equity ratio when they value the company. So that's the starting point, then you'll see there's a heading *The Cost of Equity Capital* and then on the next page, halfway down *The Cost of Capital with Debt*.

Tipping J The pages don't seem to run on.

Farmer No they don't.

Tipping J On the hand the firm can invest

Farmer No they don't. It does from my purpose doesn't matter because I didn't want it to.

Elias CJ Comprehension is not required.

Farmer No it's not required on the first half of the next page. If I can take you down about two thirds of the way down the page just before the first mathematical formula you will see a sentence 'if a firm uses both debt and equity, and Fonterra certainly is in that category, the cost of capital is a weighted average of each. This works out to be' and then there's a formula. 'The weights in the formula are respectively the proportion of total value represented by the equity and the proportion of total value represented by debt'. So the greater the debt the less the value of the equity, and then it carries on. 'This is only natural. If the firm had issued no debt and was therefore an all-equity firm, its average cost of capital would equal its cost of equity' because the two things are effectively the same. 'At the other extreme if the firm had issued so much debt that its equity was valueless, it would be an all-debt firm and its average cost of capital would be its cost of debt'. And then over the page, I think it is, yes literally yes it is over the page, 'assembling these results we get the average cost of capital for the firm after tax' and then there's a formula. 'Because the average cost of capital is a weighting of its cost of equity and its cost of debt, it is usually referred to as the weighted average cost of capital and from now on we will use this term'. So that's fairly basic but necessary understanding that you need to have I think and if I now take you into the Standard & Poors document, same volume actually, volume 3, tab 25, and my learned friend

Tipping J Tab 5?

Farmer Tab, sorry, no it's tab 25. My learned friend took you through some of this but I want to actually focus a bit more closely on it. So on page 379 of the case under the heading *Weighted Average Cost of Capital* it begins. '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 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, which is equity and interest-bearing debt', so the whole point is that it's artificial when you're dealing with a company that got both equity and debt, to simply divorce one from the other because the overall capital needs of the company consist of both of those types of capital and so they have to be considered together and that

Elias CJ Well that's obvious in terms of valuing the enterprise, but you're going to go on to say

Farmer You need to persist with me Your Honour and humour me why I go through this because it's, wait till we get to the end and then

Elias CJ That will be exciting.

Blanchard J You'll tell us when we've got there?

Farmer I will, I will. So it then continues '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' and then you have various terms that are then described. My learned friend I think took you briefly through those 'weighted average cost of capital is cost of debt, that's Kd times the percentage, d% is really the cost of having that amount of debt and then the same exercise in the case of the equity capital that is invested in the company. Then over the page what Standard & Poors then did was to look at two things in turn. The first is what is the rate of return that's required on the debt capital? And then secondly what is the rate of return that is required on equity capital? And the first of those things is quite simple, as they say at the top of the page, 'the rate of return on debt capital is the rate a prudent investor would require on interest-bearing debt', so you can work that out by reference to bonds or bank rates or whatever, and they rate on that. Where it gets much more complex is when you look at what is the rate of return that an equity investor would require in relation to this kind of company that raises capital both in the form of debt and equity? And to determine that they use here, and there's no dispute I wouldn't have thought with the orthodoxy of this, they use a Capital Asset Pricing Model, CAPM, as it's called and why they're doing this is they wanted to find out what is the required rate of return that an equity investor needs if he's going to invest in this type of company, and that involves a whole lot of horrific things, and you'll see them listed in the formula that's below. You have risk free rates of return, you have Betas or systematic risk for this type of equity investment, market risk premiums and all the rest of it, and if you read through, and I won't, but if you read through the discussion that then follows about Beta, Beta is certainly looking at the type or the level of risk for this type of equity investment. A company like Fonterra, and that requires all sorts of comparisons to be made between Fonterra and other similar companies, not only nationally but globally and then if you go over the page it then follows an investigate or an exercise that takes you back into debt so I'll read that bit at the top of the page. 'Betas as reported in public sources are levered which means they reflect the added risk to equity investors associated with debt financing in the capital structure of the subject company'. So if I can just stop there. If this company had no debt, terrific, then we can immediately probably stop the exercise at that point and ask the question well what is the required rate of return for a company that has no debt and it's going to be probably lower than would be the case of a company that does have a reasonable proportion of debt. So that is a necessary inquiry that has to be made in determining the required rate of return for an equity investor, and then it continues on if I can read 'to derive a Beta applicable to Fonterra of a Fonterra business unit based on identified public companies' and then there's a list of them at the end, 'the reported levered betas must first be unlevered and then

relevered at assumed optimal or indicated industry debt to total capital levels'. So you do this exercise looking at the optimal debt to equity ratio for this type of company and you then have a formula that tells you how you do it and you'll see in that formula D over E, and D over E is identified just below that as debt to market value of equity ratio of the subject company.

Tipping J Is this any more complicated than saying that an equity investor with a highly geared company will require a greater return because of the greater risk?

Farmer Yes well certainly, that's exactly right.

Tipping J But it all ends up by being a factor that's fed into the equity investor's rate of return.

Farmer What I'm saying Your Honour is this is all leading to a value of the enterprise and the question was asked why do you need to value the enterprise, and the question was asked also why be bothering about debt when we can somehow take a shortcut through.

Tipping J Well I can understand how the level will influence the rate of return that the prudent equity investor would wish to obtain. If it's that point I'm immediately and totally

Blanchard J To be fair to Mr Farmer I don't think he's finished going through this.

Elias CJ No.

Tipping J Well I'm just trying to see where it's all heading.

Blanchard J I would like to go slowly through it. It would help me because I'm the slow sort of animal in these areas.

Tipping J Well we can refresh ourselves.

Elias CJ You carry on with it Mr Farmer but perhaps it might be sensible to take the lunch adjournment now. Is that as good a place in this

Farmer Yes, no it's good, it's probably worth contemplating over the lunch hour.

Tipping J I'm very anxious to hear more. I'd just quite like to know where we are going as we go along but perhaps that

Blanchard J It takes all the fun out of it.

Elias CJ Right, thank you very much.

1.01pm	Court Adjourned
2.16pm	Court Resumed

Elias CJ Yes Mr Farmer

Farmer If Your Honours please, we were going through the Standard & Poors report which is volume 3, tab 25 and just to recap very very briefly, on page 379 they embarked on their explanation of weighted average cost of capital and what its function was in valuing the company and in particular stated that what they would set out to do was to ascertain an appropriate rate of return on debt capital, that's the top of page 380 and then the more difficult exercise of determining the required return on equity using the capital asset pricing model and considering in that respect elements of risk for the company, appropriate Beta figures, leveraged and then releveraged and so on to take account of the debt financing that existed in the company and looking also at the top of page 381 at optimal or indicated industry debt to total capital levels. So you have this debt to equity ratio which is very important in coming to an assessment of the return on equity that an equity investor would require. That whole exercise which is then undertaken as you'll see in the middle of age 381 is a check used against what's called 'typical proportions of interest bearing debt' preferred equity, common equity of publicly traded companies in similar lines of business as Fonterra. So there's that fed into the exercise and then the matter is also looked at from a global or international context which you'll see referred to at the foot of the page under the heading *Global Considerations*. The sentence begins 'whilst the cost of capital is constituted from both the cost of equity and cost of debt, it is the estimation of the cost of equity which causes difficulties in the international context' and they go on to say that 'for that reason we've had to adjust the CAPM framework to take account of those global difficulties. The key point there I do want to emphasise is the statement 'the cost of capital is constituted from both the cost of equity and the cost of debt' and so what we're looking at here quite clearly is the cost of capital to the company and it's from that the cost of debt and equity capital to the company. That cost is calculated by Standard & Poors in this case as the weighted average cost of capital as being 8.5% and you'll see that later in their report. And from that of course they then value the company as a total enterprise and from that they obtain the share price which is then just simply a matter of simple deduction of the amount of debt from the total enterprise value, or company value, and dividing that total equity by the number of shares. So that I think explains the whole process and what I want to do now is go back to Regulation 9(1) because it's our submission that it is inescapable that in arriving at the share price Fonterra through its valuer used WACC, the weighted average cost of capital. It is an inescapable fact that they used WACC and when you actually look at the wording of Regulation 9(1), I want to, although we've looked at it many times, the key words in our submission are that the discount rate that is used in calculating the annualised share

value must be the same as the cost of capital rate used, and that must mean used in fact, by Fonterra in calculating the share price, and in our submission that envisages one rate, not three, they only used one rate in calculating the share price. They may have in arriving at the rate that they used fed components into it, but those components were, just as I hate to use this cake

Elias CJ Cooking

Farmer But they got gobbled up or mixed up or assimilated into the final product which was the rate that was used, which was a weighted average cost of capital that was used directly to determine the enterprise value from which as I say the simple deduction and division is then able to be made to give you the share price. So there can't be three rates from which you can choose. There can only be one rate and so the only issue that can then arise, the only answer that the Commission can give to what is a factual conclusion that I've just stated is that the term 'cost of capital' must be in this context, can only be, can only be interpreted as cost of equity capital, so that WACC cannot be regarded as a cost of capital rate at all, and that must be at the end of the day the only argument that's available to the Commission. And our response to that, we really can do no better than to adopt what the almost forgotten man in this case, which is the Judge in the High Court, Justice MacKenzie, his analysis, and I'd like to take you through it because it puts if I may say so with respect, as succinctly as it can be put, the reasons why the argument for the Commission should not be accepted. So if you go to volume 1, tab 9 and he happily also takes you through in a summary way and in a way that's probably more clear than I've done it, the Standard & Poors analysis and how it fits in to this whole exercise. So if you go to page 57 of the case and in para.41 he refers to what he calls a brief description of the valuation method adopted by the Standard & Poors and in 42 he says 'the valuer adopted the approach of determining an enterprise value for Fonterra', so that's what they actually did. 'It did that by calculating separate enterprise values for the main business units and combing those to produce a total enterprise value. Those enterprise values were calculated using the discounted cash flow methodology as its primary approach and the capitalisation of earnings valuation methodology or market approach as its supporting approach or cross-check'. So that's the checking by reference to listed companies and globally. 'To convert the enterprise value into a share value, the following steps were necessary', and there was then the deduction from the enterprise value of the debt and then the division of what was left by the number of shares to produce a value per share.

'43. Calculating the enterprise value by the DCF method involves forecasting future cash flows of the enterprise. Those projected future cash flows and the residual values of the assets producing them at the end of the forecast period, are converted to their net present value equivalent. That conversion involves the choice of a rate of return or

discount rate'. So to get to a net present value you have to have a discount rate. 'In this part of its methodology, Standard & Poor's adopted the weighted average cost of capital rate as the appropriate discount rate' and then he sets out how Standard & Poors described WACC which was the beginning in fact of that part of the report that we've taken you to so I won't read it again. Para.44 'Standard & Poors describe in some details 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 & Poors described this in this way' and there's the references to proportions of debt, equity and so on. Companies in similar lines of business. Para.45 'For that typical capital structure, rates of return are attributed to the debt and equity components', and we saw how that was done. 'The rate of return on debt capital stated by Standard & Poors to be the rate a prudent debt investor would require'. The rate of return on equity capital determined using CAPM. Those rates of return are then applied to the typical capital structure on a weighted basis to produce WACC'. And then he says in 46 'The essential question in this proceeding is whether the WACC rate used by Standard & Poors 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"' and they are the words that I put emphasis on when I took you back to Regulation 9(1). His Honour then said 'Two points should first be noted about the word "used" in that term. The first is that the WACC rate is used by Standard & Poors for the purpose of fixing a fair value range for the shares within which range the actual fair value is set by Fonterra. On a strict view it could be argued that no cost of capital rate is used by Fonterra when the sole function of Fonterra is to fix a point'. That point was raised this morning that because it's the valuer and not Fonterra that's doing the exercise, whether it might be said that there was not rate of any description used and he goes on to reject that view of it. At the top of the next page he says 'Accordingly I consider that Regulation 9(1) is properly to be understood as meaning that if the valuer uses a cost of capital rate in calculating the fair value range, Fonterra uses that cost of capital rate when it adopts a point value within the range. Neither party suggested that that was not the approach that should be followed'.

Anderson J Well when the Judge says in para.47 Mr Farmer after 'I don't think that approach is appropriate. The basic concept was in place when the Regulations were promulgated', was it in place by virtue of the Constitution or how was it in place?

Farmer The Act was passed before

Anderson J The Act was passed five weeks before the readings.

Farmer That's right, and schedule 1 sets out what has to be in the Constitution.

Anderson J Yes, thank you.

Farmer Para.48 'the second point is that the WACC rate is used by the valuer in the calculation of an enterprise value for Fonterra as a step in the process of setting the fair value range. To convert that enterprise value into a value per share, the further steps described in para.42 are necessary', and that's just the deduction of the level of debt and then the division by the number of shares. A fairly mechanical sort of exercise. 'The amount of debt in Fonterra's actual capital structure must be deducted from the enterprise value and the resultant balance divided by the number of shares'. So there's no judgment being brought to bear at that point. It is as I say a purely arithmetical exercise. 'It will be necessary to return to this point but for present purposes it suffices to say that I do not consider that the fact that those further steps are involved means that the WACC rate is no used in the calculation of the share price for the purposes of Regulation 9(1)'. So what he's really saying is that for him the critical final step in determining the total enterprise value was the use of WACC and then the rest of it was as I've described it just pure arithmetic. So he then says in 49 'Accordingly, the essential question is whether the WACC rate is a cost of capital rate within the meaning of Regulation 9(1)', so that's the point of law as it were that the Commission has really raised. 50 'Fonterra's approach to the interpretation of Regulation 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 Regulation 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 Regulation 9. Fonterra submits that the term "cost of capital" can refer to both equity capital and debt capital. Professor Bowman deposes that a number of standard textbooks use the term "capital" in a way which is consistent with referring to both equity and debt financing. Accordingly Fonterra submits that Fonterra has through Standard & Poors used a weighted average cost of capital in determining its share price that a WACC is within the ordinary and natural meaning of the term "cost of capital rate" and that Regulation 9(1) accordingly applies to make that WACC rate the discount rate in calculating the annualised share value'. Now I'll just stop there for a moment. I won't take you to Professor Bowman's affidavit but he does list a huge number of economical financial economic texts in which cost of capital is interpreted as being commonly regarded as being weighted average cost of capital. The basis of that obviously being that most companies raise capital by both borrowing and obtaining equity and so when thinking of cost of capital it is naturally correct to think of both debt and equity and if you're valuing up to average them. At 52 His Honour says 'in this proceeding, as in the retention proceeding, the

Commission submits that a purposive approach to the Regulations requires a different outcome. The essence of the Commission's contention is that the purpose of the annualised share value component in the Regulation 8(6) formula is to isolate the return on capital component in the bundled payment to suppliers. The capital, for that purpose, is equity capital. A WACC which involves both debt and equity components is not the Commission submits an appropriate rate to determine the return to shareholders'. And then there's a reference to Professor Officer's evidence who says that you have to attribute or give cost of capital a meaning within the particular context in which its been used in and there's no particular dispute with that as a general proposition. His Honour describes that a bit further though saying 'in essence the Commission's approach to interpretation involves inserting the word 'equity' in the phrase "the cost of capital rate used by Fonterra" so that it becomes "the cost of equity capital rate used by Fonterra"'. That would of course if I can just pause there, that would actually take you right back down into the Standard & Poors spreadsheets from which you pluck it out, to use my learned friend's term, because that would be the only place where you would find a cost of equity capital rate being prescribed, so that would direct you to doing the exercise quite differently. Doing it at a much earlier stage of the valuation process than is being done on our approach which is to take the final product of the valuation exercise, namely the weighted average cost of capital, and then regard that as being the determinant of total enterprise value and hence of share price.

Anderson J	It's an argument that draws the distinction isn't it between used and calculated?
Farmer	Yes.
Anderson J	That they calculated the cost of equity capital in order to ascertain the weighted average cost of capital and it's the weighted average cost of capital that they actually used.
Farmer	They used, yes Your Honour with respect I would accept that. So just going back then to where I was. That analysis the Commission submits that that's reading equity into the phrase leads to one of two possible outcomes, (a) since WACC has been used in calculating the price of a Fonterra share no cost of capital rate has been used by Fonterra or (b) the relevant for Regulation 9(1) is the cost of equity capital used by Standard & Poors, its calculations of the WACC, so there's the word 'calculation' actually used Your Honour. His Honour responds to that by saying first of all he says 'again the starting point must be the words themselves'. And my learned friend I think in his written submissions and certainly in discussions that he and I have had over recent days, cavils a little bit with that starting point and says' well really statutory interpretation is one fluid exercise and which context and purpose and so on are all considered and you ascertain the meaning of words from that and with respect to him I don't disagree with him but he's reading

rather too much I would have thought into the use of the term 'starting point'. I don't with respect the Judge was seeking to break this up into a series of quite discrete exercises. What he said was and Justice Hammond, who my learned friend cites in his written outline said much the same thing, the primacy that words, well I've forgotten how he put it, that words constitute the primacy of any interpretation but they must of course be interpreted according to the overall purpose of the legislative instrument. His Honour continued 'do the words in Regulation 9(1), read in their context', so he is reading them in the context, 'require to be read as referring to a cost of equity capital rate, to the exclusion of the use of a WACC rate'? Because remember there's only one rate on his approach and we respectfully agree with him, and so do you have to exclude WACC. You can only have cost of equity, so that's the question that he poses and what he then goes on to do is to look at Regulation 9(1) and contrasting it with Regulation 9(2) and the rest of it

Elias CJ What do you say the distinction is between the discount rates set under Regulation 9(1) and 9(2) because I can't see that there's any sense in having a different rate? If you're talking about a matter of meaning here.

Farmer I think the way I'd answer it is this that 9(1) talks about is equating the cost of capital rate for this purpose with that in fact used by Fonterra, so it's looking at comparing what was done in relation to setting the share price and saying you must do the same thing whereas Regulation

Elias CJ Well what's the rationale for it? Can you explain what possible policy reason would there be for a difference?

Farmer Between 9(1) and 9(2). What I said I think this morning was that 9(2) was probably very much intended as a one-off exercise at the very beginning of Fonterra's existence in a situation where it was known that the share price had not been calculated by any valuation process because it had been agreed as a result of political negotiation, and so that's why 9(2) uses the word 'set' rather than 'use'. The Commission must 'set' a discount rate because there was nothing to compare it with, to equate it with. When that was over, year one, then Fonterra thereafter had to every year under the statute it has to calculate a share price and determine a share price and so the permanent machinery is really the 9(1) machinery where the intention was that the rate used for determining the share price would be assimilated to the rate that was used here under the Regulation, so the two parts of the Regulation are performing quite different function (a) as I say being a one-off historical exercise in all likelihood and the other one being a continuing exercise so that's how I would respond to that Your Honour.

Tipping J But are they not both looking for the same conceptual exercise? That's the point I have difficulty with.

Elias CJ That's the point I was trying to

Tipping J Albeit they may have had different focuses.

Elias CJ Well they were temporarily different on the answer that you've given but shouldn't they be directed at the same thing, that is the share value?

Farmer Yes, yes, certainly.

Elias CJ So why would the calculation be different.

Farmer Well

Elias CJ You're just saying it has to be an available cost of capital rate?

Farmer Yes I'm saying that if in fact Fonterra through it's valuers used a weighted average cost of capital rate in valuing the shares, that is the end of the story. If the Commission when it in a default scenario, whether it's just at the beginning or whether some years down the track for some reason or other, the Fonterra Board doesn't do its job and doesn't value the shares, although it's hard to see, or if they value them in some way where they're not using a cost of capital rate, it's almost inconceivable to see how that could be. Then the Commission has got a regulatory function of setting a discount rate but when doing that of course under 9(3) as I pointed out earlier, it must have regard to what Fonterra has done in calculating the price of a share, presumably in the past. So I don't know that I can take that much further and I don't think the point Your Honour raises, if there is some sort of asymmetry there, then it's asymmetry that is a problem for just as much my learned friend as it is for me.

Tipping J But I have difficulty understanding what the relevant distinction was. The Judge says in his para.53 'In considering the context, the distinction between the two discount rates is important'. Now what in your submission is the relevant distinction?

Farmer I in fact wasn't going to read you that bit because I don't regard it as a necessary part of my analysis.

Tipping J I see.

Elias CJ I thought you were telling us this was a succinct summary and you couldn't do better than

Farmer I couldn't but that is a diversion. That's a diversion. You don't need to go there believe me.

Elias CJ Put square brackets around that part. It seems to be very important to the Judge's reasoning.

Farmer With respect it's a factor he takes into account and really what he's saying is that in the one case under 9(1) the valuer, I think what he's saying is this that under 9(1) the valuer is valuing the share price of the shares. He's not concerned in the least about the price of raw milk. He's not even interested. He doesn't even know about raw milk, so he's only concerned with what is the appropriate rate to use for valuing the shares. Whereas by contrast the Commission under 9(2) has got nothing to do with setting a share price or a share value. That's not its job' its job is to fix the default price of milk, so in that sense they're doing two different things and what 9(1) is saying is that when Fonterra comes to fix the default milk price it must use the rate that the valuer used in valuing the shares.

Tipping J But both of these approaches are directed towards putting an arithmetical value on analysed share value for the purposes of the formula in 8(6), and each is equally directed towards calculating annualised share values.

Farmer Yes.

Tipping J Indirectly they lead to cost of milk I agree but I can't quite understand the force of the distinction you make between (1) is directed to share value and (2) directed to milk.

Farmer Because the point about (1) is that it's directed to share value and the rate that was used in determining the share value must be the same rate that is then used by Fonterra when it comes to the milk price exercise. So it's a purely factual exercise that they have to undertake. I want to go back to 55, which is why I said 53 and 54 are a bit of a diversion is because it's at 55 he really comes back to try and deal specifically with the Commission's argument, namely that cost of capital rate in Regulation 9(1) can only mean cost of equity capital. So what he says in 55, he says 'another point which is clear for Regulation 9(1) is that there can only be one cost of capital rate', no I've made that point already myself. Regulation 9(1) is not property to be interpreted in a way which would mean that there might be two or more rates which might meet the description 'the cost of capital rate'. Obviously I'm putting emphasis on the word 'the', because if so that would require a choice as to which cost of capital rate was to be used by Fonterra as the discount rate. Regulation 9(1) does not contemplate that possibility. That point is relevant to the possibility to which I have referred in para.52(b), and 52(b) was the Commission's argument that the relevant rate is the cost of equity capital, which is found in the spreadsheet.

Blanchard J Why does the Judge say 'which cost of capital rate was to be used by Fonterra'? That's not correct is it? No one was forcing Fonterra to use a particular rate.

Farmer No, no.

Blanchard J The question was whether they did use?

Farmer You're referring precisely Your Honour to where?

Blanchard J Para.55.

Farmer Yes, he's saying there as I understand it that

Blanchard J He's saying that because there might be two or more rates on the argument that he's rejecting, that would require a choice to be made as to which cost of capital rate was to be used by Fonterra. Well that's not correct. It might require a choice as to which cost of capital rate had been used by Fonterra.

Farmer Oh well I think yes.

Blanchard J And I just wondered whether that's leading astray.

Farmer Well possibly what he's saying Your Honour, I agree the wording is perhaps not as precise as it might be, but if Fonterra's task was to determine what rate was used in fact in calculating the share price, then that becomes quite a different exercise if there are actually more than one rate. If there were three rates as my learned friend would say that were used Fonterra then has some kind of decision to make about which it picks, and what the Judge is saying is that's not what is contemplated by Regulation 9(1) because

Blanchard J He is referring there to Regulation 15?

Farmer I don't think so Your Honour, 15?

Blanchard J The only time that Fonterra is forced to use a rate is when they have actually used one and then they have to notify it.

Farmer 16?

Blanchard J 16, yes.

Farmer Well they certainly do have to publish the rate they've used in calculating the share price and as my learned friend has acknowledged, the rate that is published has been the WACC, so I think Your Honour what the Judge is saying is in response to my learned friend's argument that there are these three rates to be discovered if you search through the spreadsheets. He's saying well it doesn't seem that the Regulation is contemplating that there will be more than one rate because if there were more than one rate Fonterra would have to make a choice and Regulation 9(1) does not on its face give Fonterra any choice. What it says is that you must use the same rate that was used in calculating the share price which assumes the premise there that there is only one rate that was used.

Tipping J	Would it be of assistance Mr Farmer if the Judge had said at the end of his first sentence of that paragraph 'there can only be one cost of capital rate which has been used'.
Farmer	That would clarify it, yes.
Anderson J	Really in the sense that used really indicates here the rate at which the projected cash flow was discounted.
Farmer	Yes.
Anderson J	And it was discounted by WACC.
Farmer	Yes, yes with respect I agree.
Elias CJ	Which is why really the appellant has to succeed in saying that in context the rate has to be the
Farmer	Cost of equity.
Elias CJ	Not WACC but the cost of equity. So really all of this three calculations used is a red herring really.
Farmer	Yes it is, it was a opportunistic, clever
Elias CJ	It was a convenient argument at the time.
Farmer	And I had the greatest of admiration for my friend at the time but in the cold light of day it
Elias CJ	Too nimble.
Farmer	It doesn't survive the months that have gone by since then. Anyway, so I'll just finish 56 because, and that's just about almost there, so His Honour said 'that interpretation involves the proposition that on the facts here there are three rates used', and he sets them out, and then at the top of the next page, 'and to identify the correct rate the word "equity" is to be understood as intended by the draftsman. This point is somewhat different from the more general submission that a rate used will qualify only if it is an equity rate. The interpretation currently under consideration would require two steps; the first the reading of the word "used" as covering both the rate actually used and the rates used in calculating that rate' which is the distinction Your Honour Justice Anderson raised a little while ago, and (b) 'the reading in of the word "equity" to Regulation 9(1). I do not consider that that interpretation is correct. The rate used as referred to in Regulation 9(1) is the rate which is actually used to calculate the enterprise value. A rate which is used as a component in calculating that rate is not "the rate used", so on the facts the rate used was WACC and no other rate.

The issue is whether WACC falls within the term "cost of capital rate" or not'. And if I take you over briefly to 61, he says there 'if the intention had been to exclude WACC as a discount rate for the purposes of Regulation 9(1) it might reasonably be expected that that intention will be clearly expressed. This is not a situation where it's necessary to apply the Regulation to a situation not specifically envisaged by the drafter. The inclusion in Regulation 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 and calculating a share price is to be excluded in the absence of express words to that effect', and I've said that we respectfully adopt that analysis. What I did have prepared as I mentioned were some notes and I've given my learned friend a copy of them. They don't really contain anything different from what I've already said, including on the question of contestability in level playing fields and all the rest of it and if it's convenient I might just hand the notes up and leave them with you as a record of our position today and I don't think it's really necessary for me to take you through them unless you want me to.

Elias CJ Yes, that will be fine thank you.

Farmer In that case those are our submissions if the Court pleases.

Elias CJ Yes Mr Goddard?

Goddard Thank you Your Honour. Just a couple of very quick points in reply. The first is the suggestion that the Commission's argument shifted. What I think emerged from the Court's questions to my learned friend and I'd like to make it very clear is that there has been no change at all in the interpretation argument that's been put forward, that was put forward in the pleading and advanced in the High Court and Court of Appeal. What did change is the realisation in the course of the High Court hearing that perhaps even on that interpretation, the cost of capital means, cost of relevant, cost of equity capital, perhaps even on that interpretation it was Regulation 9(1) that applied on the facts in 2002/03 that it wasn't a foregone conclusion that on that interpretation the Commission would have to undertake a valuation exercise under 9(2). That would depend on the factual question of whether a cost of equity capital had been used in calculating the share price by the valuer. It appeared from the material before the Court, both the spreadsheet to which I took the Court earlier and also Mr Stuart's evidence – that's in volume 2 of the case on appeal – the relevant passage is para.41 on page 110 that a cost of equity was used as part of the input into the derivation of the WACC, so perhaps that was a relevant cost of capital and 9(1) applied, but what I said to the High Court and the Court of Appeal is that it wasn't necessary to actually get into that question which was one of application of the Regulation. What the Commission was asking the Court to do was to interpret it to say whether cost of capital does indeed mean cost of equity capital here

in the expectation that the Commission could then apply that Regulation correctly interpreted to the facts in that year and subsequent years. That goes to a question, my second point, asked by His Honour Justice Blanchard what sort of declaration should be granted were the Court in agreement with the interpretation put forward by the Commission. And in my submission a declaration as to the meaning of the term 'cost of capital' along the lines set out in para.17 of the counter-claim, although I'm certainly open to more felicitous wording after its characterisation as clumsy and inelegant would be the appropriate declaration. It's not necessary in my submission to go on and make declarations as to whether or not in that year a cost of equity capital was in fact used or a declaration as to what that cost of equity capital was. The essential point in issue for that year and subsequent years is what does cost of capital mean and a declaration on that point will help Fonterra publish the correct figure under Regulation 16(4)(h) in all future years and will help every party concerned to apply the regulations going forward. The third point is my learned friend's suggestion that assessing the enterprise value was inescapable. My learned friend said it was inescapable that Fonterra would calculate it's enterprise value and that to do so it would use a WACC. I addressed earlier in my submissions the point that it's not inescapable, that there are ways of setting a share price which do not require an enterprise value. One would be to adopt a process of valuing the shares that didn't involve a discounted cash flow analysis at all. For example the market multiples approach that the valuer used as a cross-check, that doesn't involve a cost of capital at all and the valuer could have adopted that no cost of capital rate of any kind would have been used, no enterprise value that using a cost of capital rate would have emerged. But the other possibility, the one that I emphasised was that it would have been possible to value the equity capital alone carrying out a discounted cash flow analysis of the cash flows attributable to equity. Professor Officer explained that in his affidavit and in fact it's perhaps helpful to note that Mr Stuart, Fonterra's CFO, recognises that possibility in his evidence. Again I'm in volume of the case on appeal, under tab 11 at para.37 and following beginning at page 109 of the case on appeal. Mr Stuart notes that Standard & Poors used WACC and then goes on to say in the second sentence 'as noted previously, there are other theoretical ways to determine a fair value share range. One such method involves discounting cash flows less interest expense and financing costs, i.e. cash flows to equity holders, at the cost of equity. This provides an equity valuation from which the share value is derived. Under this approach no need to deduct the value of Fonterra's debt to derive the equity value. This is the approach adopted by the Commission in decision 501'. So you can do it without calculating enterprise value. Mr Stuart goes on to say 'contrary to the Commission's assertion in para.34, this is not the only available method and in fact is less common', so it is available, it's less common, but it's done - you don't have to do it. And then he goes to explain in the rest of para.38 and 39 how they lead to the same result. So it's not the case that it's inescapable that one would assess an

enterprise value; it's not the case that it's inescapable that a WACC would be used. Mr Stuart has recognised the possibility that neither would be required. Professor Officer has explained why that's the case. A related point which my learned friend touched on really in referring to the High Court judgment, the Fonterra submission that it is consistent with valuation best practice to use WACC in the Regulation 9 context. In my submission that's not the case and there is absolutely no evidence to that effect. There is abundant evidence that using WACC to set the enterprise value and through that to calculate a share price is consistent with valuation best practice. That's not in question, but Professor Bowman nowhere suggested that it was consistent with good valuation practice to use WACC in the Regulation 9 context where one is calculating annualised share value. There's no evidence to that effect and that's for the obvious reason explained by Professor Officer that it is in fact completely inappropriate to do so. That leads into my last point which is the relationship between Regulation 9(1) and Regulation 9(2). In my submission the point made by Your Honour The Chief Justice in questions to my learned friend is exactly right, they should be consistent. They should be two paths to the same end. That end is getting a relevant discount rate to use in calculating the annualised share value, that's what we're trying to do, to get a relevant discount rate that can sensibly be used to calculate the annualised share value in accordance with the definition in Regulation 3. There's only one cost of capital rate that can sensibly be used in that way; that's the cost of equity capital rate

Tipping J	Is there any evidence specifically directed to that point about the correct approach to annualised share value in terms of that annuity exercise Mr Goddard, because that, and you're right I think, that is really the purpose of the whole exercise.

Goddard	It is, to get an annualised share value and really the whole of Professor Officer's evidence is directed at that question, that if one looks at 10.1 of his evidence which is under tab 14 in volume 2

Tipping J	Just excuse me a second.

Goddard	Sorry.

Tipping J	Tab 14

Goddard	Of volume 2 in the case on appeal.

Tipping J	Sorry, I didn't have the right volume. I had it a moment ago.

Anderson J	It's the pink one.

Tipping J	The pink one. My pink one's been covered up. Now tab 14, I'm so sorry Mr Goddard.

Goddard	Not at all Your Honour. This was really the question that Professor Officer was asked to address. Unlike Professor Bowman who was asked what meaning the phrase 'cost of capital' had in standard usage amongst financial economists and he collected a large number of textbooks in which was very reminiscent of the comment of Justice Hammond's about not making a fortress out of dictionaries.
Tipping J	You're sort of working the annuity backwards aren't you in a sense?
Goddard	That's exactly right. That's actually a very good way of thinking about it because if the share price was derived from a discounted cash flow analysis of expected cash flows then you have to use a discount rate to turn those future cash flows, the year-on-year payments in an NPV now. What Regulation 9(1) says is if you have to unravel that, if you have to turn the NPV now, which is the share price, back into an annual income stream use a corresponding discount rate, don't unwind it using a different rate from the one that was used to wind up those cash flows into a current share value, so this is exactly doing the NPV in reverse. What Professor Officer was asked to comment on was the meaning of the phrase 'as used in the Regulations and the implications of the goals for that meaning', and
Anderson J	It's rather novel to have expert evidence on the meaning on an enactment isn't it?
Goddard	Not unprecedented, I think is how I'd put it Your Honour and I
Anderson J	That's fortunate then. It's quite unorthodox.
Goddard	It's reasonably unusual but there are two Australian authorities in the casebook where that very issue has been grappled with.
Anderson J	They probably have different statutes in different states where you then receive expert evidence as a question of fact in the States.
Tipping J	Anyway I'd be interested to know what he said on this because it appears likely to me as being the fundamental starting point if you like.
Goddard	Yes, the question of whether expert evidence can be used to assist technical terms is dealt with in those cases and in my submission it can in exceptional circumstances be appropriate and helpful and that's why this is here, and those two cases are referred to in my written submissions and in the casebook. Going on if we come to page 9 of the affidavit, page 158 of the case on appeal, heading '*C3 The application of these principles to the present circumstances* – the principles being summarised at the top of page 9 that to give operational content to the phrase "the cost of capital" one needs to know the context in which the phrase is used. The appropriate capital can be identified and its costs determined'. '*C'* comes on to 'wholesale price of milk defined by this. By definition the "annualised share

value" will be the "perpetuity equivalent" for any single period and it goes on to explain that. 32, this is the key point 'Regulation 3(1) defines annualised share value as a "perpetual annuity", or perpetuity based on the value of the shares. This means by definition the appropriate cost of capital **has** to be that associated with the share value, including peak notes. There can be no other cost of capital when the perpetuity equivalent is derived from the share value and not from some other form of capital. The rate used cannot be WACC because, by definition, there is no debt in the share value, assuming the peak notes are a form of equity which is the case.

Blanchard J What are peak notes?

Goddard They are a form of subordinated debt which govern the right of suppliers to supply peak milk at the height of the season. They've been dispensed with since by Fonterra but at this time they were used to govern how peaky your supply was. It's much lower cost to have a very peaky milk supplier as an incentive to encourage people to flatten out their supply rate but you had to pay more if your supplier was peakier. I hope that's helpful. That's rather abbreviated.

Tipping J My brother's looking a bit peaky Mr Goddard.

Anderson J Can you help me with this Mr Goddard? It may have been touched on by Mr Farmer – it's a factual matter.

Goddard Your Honour.

Anderson J An independent processor can't come to an agreement over price but takes milk. The default price then applies, but that will always be fixed in arrears – up to a year in arrears or even more.

Goddard Yes.

Anderson J So is there some sort of provision payment?

Goddard Yes there is.

Anderson J Or else it's an incentive to settle the price.

Goddard Certainly if one could reach agreement in advance on a fixed price with Fonterra, and Fonterra is not obliged to do that. It could also say it will be a price determined after the event, then that would be an attraction. It's sometimes better to lock in a certain price rather than face the possibility of something lower or something higher, but where the default price applies then payments are made on a provisional basis by the independent processor and as a wash-up at the end of the season one would expect it to happen fairly shortly after the end of the season but of course litigation might

Anderson J What if the Commission had to fix it under 9(2).

Goddard Exactly Your Honour. That took some time and so it happened quite a while later.

Anderson J Thank you.

Goddard Coming back to Professor Officer at the top of page 10, 'there can only be one rate which gives the perpetuity arising from the share value and that is an equity cost of capital'. So that I think Your Honour goes squarely to the question 'is there any evidence that says "only one rate can sensibly be used"

Tipping J Well I was trying to do this backwards exercise if you like that drives off annualised share values definition and in a sense as you say it's the reverse, you've got the net present value, you've got to go back and I was wondering how that all fitted into the picture and this evidence is quite helpful from that point of view.

Goddard It's exactly on that, yes, it explains how you can take a set of cash flows into the future, use a discount rate to work out what the net present value of those is. If someone's gone through that process to set a share price and an appropriate discount rate is lurking within that, when you're working backwards for that NPV

Tipping J Is there any rejoinder, I know this is uncontroversial in a sense, but is there any rejoinder to that evidence from another witness?

Goddard No, no reply was filed by Professor Bowman to that. Mr Stuart files a very short reply affidavit. It's under tab 16 and didn't take issue with any of those propositions.

Tipping J The key to the Officer analysis in this respect seems to be the implicit reference from his description of annualised share value of the reference to dividends and that seems to be the way in which he explains that debt can therefore have no relevance. Is that approximately correct?

Goddard That's approximately correct. That's dealt with in 31, but 32

Tipping J He says that the annualised share value will be the perpetuity equivalent of the dividends received by shareholders and then he goes on to talk about that and then he carries on as per what you've read. But he then gives an explanation as I understand him, the crunch of which there is no debt in the share value and so on.

Goddard Yes

Tipping J It's a bit cryptic but

Goddard I think para.32 might be a little bit

Tipping J No, that's what I'm reading from.

Goddard Clearer though, because really what he's saying is that if it's a perpetuity based on the value of the shares, then by definition the appropriate cost of capital has to be that associated with shares. No other cost of capital as derived from the share value not some other form. Yes he's saying it's because there's not debt but that is I think in the context of an annualised value of the shares, not at all difficult or controversial.

Tipping J What I'm just leading up to Mr Goddard as to whether you can help, I felt some force in Mr Farmer's suggestion that you might have different discount rates for share valuation depending upon the amount of debt and the character of the debt so this idea that debt can have no influence on share value strikes me as being a bit too absolute.

Goddard I think Your Honour put it nicely in response to Mr Farmer if I may say so with respect, in saying of course there's more risk associated with equity in a highly-geared company and therefore the cost of equity will depend on the assumed debt equity mix, but that's not the same thing as saying that one has to do an enterprise value with a discount at WACC in order to work out what the value of the equity is, because just as you can do that, what Standard & Poors did, so too what you can do is say well for a company with a typical, and that's the approach Standard & Poors took, a typical mix of debt and equity in this business, what is the cost of equity, now let us discount the expected cash flows to equity holders at that cost of equity rate and so in some sense the process of identifying a relevant cost of equity rate has to be sensitive to the assumed or optimal mix of equity and debt for companies in that line of business, but it doesn't follow from that that the actual cost of debt of that company has any bearing at all on its actual cost of equity and it certainly doesn't follow from that, that in order to value the shares of the company you have to do an enterprise valuation using a WACC then back off the debt. Mr Stuart himself says no you don't have to do that, there's another way, that's the most common but there is another way.

Tipping J Yes I understand exactly what you're saying thank you.

Goddard Thank you Your Honour.

Elias CJ Mr Goddard just thinking of something that Mr Farmer said which is also picked up in that reply affidavit from Mr Stuart about it's the valuers who identify the cost of capital rate, I have a question as to what is the operative choice of the rate, because presumably Standard & Poors came up with the report but it just occurred to me that actually the identification of the cost of capital rate is in fact under Regulation 16. I'm not sure whether that's right as a matter of fact, I'm just

wondering what the, because it's that process which is a responsibility of the new co-op which I would have thought was the actual thing that identifies it.

Goddard I think the answer to that lies in two stages. The first is Your Honour's exactly right that under Regulation 16(4) it's Fonterra, the new co-op, that has to publish certain things for each season and what (H) says is 'the cost of capital rate used by new co-op in calculating the price of a co-operative share for that season, if any. If any is very important because of course there may not have been a cost of capital rate at all. Actually I'll come back to that as there's one relating point I do want to make in reply. But it is Fonterra's responsibility to identify that and publish it. That's not in my submission meant to involve any discretion or freedom of choice and that really comes back to the point that

Elias CJ But it wasn't, I might be quite wrong about this because I haven't looked at the report, in fact I'm not sure that we have the full report do we, the Standard & Poors report?

Goddard Even the Commission wasn't given the full report.

Elias CJ No, but do they identify the cost of capital rate?

Goddard That

Elias CJ Except by the calculations undertaken?

Goddard And that's something that we don't know for sure and that's one of the reasons why in my submission it's, it can't be determinative of whether or not it's in a particular report. The question is whether it's been used and what is reported, at their limit the report could just be a very short statement 'this is the share price' and then there are certain matters that need to be covered in terms of approach under the Constitution but how much detail goes into it? There's no obligation to provide a WACC for example either, is a matter for Standard & Poors, but of course it's always open to Fonterra to go back and say did you use a cost of equity capital rate, please tell us it? That's a factual enquiry, was it used and is a mechanism that can be used. I think it's a little unrealistic, probably it would be unrealistic for Fonterra to suggest that there will be a problem in getting the valuer to disclose the rates they had used, if in fact they adopted a discounted cash flow analysis, and if this Court declares that cost of capital means cost of equity capital with the result that Fonterra is required to publish each year a cost of equity capital figure if one has been used, then I think one can be absolutely confident that Fonterra can ask its valuer for that rate and than can then publish it, just as on my learned friend's approach Fonterra needs to ask the valuer what WACC rate it used and then publish that. There's no difference.

Elias CJ Just remind me, where is that Standard & Poors thing again?

Goddard It's under tab 25 of volume 2.

Elias CJ Yes thank you I don't need to detail you on that. I was just checking.

Goddard One of the reasons I'm a little bit diffident about saying what was and was not in the report is the fact that material was dripped fed to the Commission, so that for example although the first instalment of the report is under tab 25. Under tab 26 there's the letter I took the Court to earlier responding to a request for the complete copy saying no we won't give you that but here's some more material and there's an appendix 1 which has various tables in it, including various cost of equity and cost of debt figures and then there are the spreadsheets, including the spreadsheet to which I took the Court and I just don't know whether that was part of the report or not because it's not made clear in Fonterra's letter providing it to the Commission.

Elias CJ Well where do you derive your schedule into steps taken by the valuers?

Goddard From Mr Stuart's evidence.

Elias CJ I see, thank you.

Goddard And from tab 25, but mostly, yes, from Mr Stuart's evidence and tab 25 and that's all in there.

Elias CJ Yes.

Anderson J The rate that was in fact published is the WACC.

Goddard Was in fact published was the WACC but that in my submission just cannot be determinative of the question of what should have been published? The last point I wanted to make was just that at temporal 1 about 9(1) and 9(2), I think my learned friend is right to say that it was probably everyone's expectation at the time that the Regulations were made that Regulation 9(2) would apply for the first year because there was simply an agreed share price in that year, no calculation of it and that it was seen as likely that Regulation 9(1) would apply in subsequent years, but no one could know that for sure because of course the mechanism set up by the Constitution provided for in the Act was that the approach to setting the share price was to be determined by the valuer to be appointed by the Council and it was always open to the valuer to decide for example to adopt the market multiples approach which was the approach it adopted as a cross-check on discounted cash flow analysis, so while I think I agree with my learned friend that the timing process he describes was a likely one, it wasn't a certain one. What my friend sought to do with that was to say well look everyone expected 9(1) to apply in future years and what

Fonterra had to do, what it's valuer had to do was calculate an enterprise value using WACC and that takes me back to the earlier point I made in reply that in fact he didn't have to do an enterprise value at all, he didn't have to use WACC. There are a number of ways of approaching that calculation. Finally actually one more point that I should just deal with is the suggested distinction of His Honour Justice Anderson between inputs that are used in setting the share price and inputs that are used in a calculation. In my submission that distinction isn't robust in this context. It can't work for a number of reasons. Perhaps the most significant of which is the language of Regulation 9(1) which talks about the cost of capital rate used in calculating the price, so it is used in a calculation that is being referred to. That calculation has the various stages set out in my appendix 2. You could write it all as one great big equation and then every input would be used. Breaking it up into stages is a completely artificial process done simply for convenience because humans like to do one thing, then another, then another, but all the inputs are used in calculating

Anderson J There is only one rate that's applied?

Goddard No Your Honour, they are all applied but with different weightings, so the cost of equity capital rate is applied with a .6 weighting and the cost and the cost of debt with a .4 or whatever it is. They are all applied and that's really the point of the corrected page 29 that I handed up at the start of today. If you look at the last section there, this is the bit that has changed. I have clarified it to make precisely this point clearer.

McGrath J Sorry, what are you referring to now?

Goddard I'm referring to the single page, replacement page 29 that was attached to my notes, and it's that last paragraph and what I was trying to show here is that if you look at the process of calculating a share value and you try to run it together you can do it in two ways. The first line is to say well the share value is profits divided by WACC minus debt over the number of shares, so what have you used in calculating the share value, well you've used all the inputs that are in there, but you can rewrite that to incorporate previous steps in the equation in the form in the second line. It's profits over .6 times cost of equity capital plus 4 times cost of debt, minus debt over the number of shares. They're all used and it's just a question of how you write it down. It cannot in my submission be the case that what these Regulations refer to depends on how you write your formulae down and whether you write them in separate equations on separate lines or whether you write it out as one equation. Both are equally correct, both are equally appropriate. It just cannot be the case that is what's used depends on how you write it. Unless the Court has any questions.

Elias CJ No thank you Mr Goddard. Thank you counsel, we'll take time to consider our decision. Thank you very much for your assistance.

3.19pm Court Adjourned