5 January 2010

Payout Ratio of Regulated Firms

A report for Gilbert + Tobin

NERA
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Project Team

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1. Introduction

Our names are Brendan Quach and Simon Wheatley and we are consultants with a firm of expert economists, NERA Economic Consulting (NERA). A copy of our curricula vitae is attached at Appendix A.

We have been asked by Gilbert + Tobin, on behalf of ETSA Utilities, to prepare an expert report on certain matters arising in the context of the Australian Energy Regulator's (AER's) draft decision on ETSA Utilities' 2010-1 to 2014-15 regulatory proposal. The specific matter that we have been asked by Gilbert + Tobin to address concerns the reasonableness of the assumption by the AER that all dividends are paid out in a 1-5 year period when determining the value of imputations credits (ie, 'Gamma'). Attached at Appendix B are the instructions we received from Gilbert + Tobin for this assignment.

The opinions in this report are our own and we take full responsibility for them. We have read the Guidelines for Expert Witnesses in Proceedings of the Federal Court of Australia and confirm that we have made all inquiries that we believe are desirable and no matters of significance which we regard as relevant have, to the best of our knowledge, been withheld.

2. Payout Ratio of an Average Firm in the Market

In July 2009 ETSA Utilities submitted a proposal to the Australian Energy Regulator (AER) for the regulatory control period 1 July 2010 to 30 June 2015. In November 2009 the AER issued a draft decision on the proposal (the "draft decision"). The draft decision states that the AER will set the payout ratio used to calculate gamma equal to one.[1] Australian regulators use gamma to determine the proportion of company income tax that does not need to be included in a regulated firm's annual revenue requirement due to the benefit shareholders receive from the imputation tax system. The payout ratio is the fraction of imputation credits created that are distributed to shareholders.

We show below that statistics that the Australian Taxation Office (ATO) reports indicate that it is not reasonable for the payout ratio to be set to one. Instead, we show that the figure of 71 percent that Hathaway and Officer (2004) compute provides a more reasonable estimate of the ratio.[2]

2.1. Overview

The AER notes correctly in its recent draft decision that the payout ratio depends on:

- the fraction of imputation credits created each year that are distributed in the year in which they are created; and
- the value of imputation credits that are not immediately distributed, but are retained within the firm for a period of time.

Firms may not immediately distribute franking credits that are created because they wish to retain earnings to finance new investment.

The AER uses two arguments to suggest that the payout ratio be set to one – one theoretical and the other empirical. The theoretical argument is that an assumption of a payout ratio of one is consistent with standard valuation practice in a classical tax environment. For example, Handley states that the assumption is consistent with[3]:

> the standard WACC valuation framework (within a classical tax environment) due to Miller and Modigliani (1961), and which underlies standard valuation practices such as that formulated by McKinsey & Company, Inc. (2005) and Stewart (1991).

Handley correctly states that the standard valuation practice in a classical tax environment is to make the simplifying assumption that all free cash flows are distributed.[4] This assumption

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1 AER, *South Australia: Draft distribution determination 2010–11 to 2014–15*, 25 November 2009, page 259.

2 Hathaway, N. and R. Officer, *The Value of Imputation Tax Credits*, Working Paper, 2 November 2004.

3 John C Handley, A Note on the Valuation of Imputation Credits: Report for the Australian Energy Regulator, 12 November 2008, page 5.

4 Miller and Modigliani assume an ideal economy characterised by no transaction costs, no tax differentials between distributed and undistributed profits or between dividends and capital gains, no information asymmetries, competitive price-taking, and rational behaviour.

is reasonable if retained free cash flows can be reinvested at the firm's cost of capital. This is because, under a classical tax system, if a firm reinvests retained free cash flows at a rate of return equal to the cost of capital, the firm's value will be independent of whether free cash flows are distributed or retained.

However, Australia does not operate under a classical tax system. Instead, Australia has an imputation tax system where the payout policy of a firm can affect its value. Postponing the distribution of free cash flows and the franking credits attached to them will reduce the value of the credits because retained credits cannot be invested by a firm to generate future revenues. Moreover, using retained earnings to finance new investment can lead to a build up of unpaid credits (see Dempsey and Partington (2007)).[5] This might suggest that a firm should raise new equity and pay a franked dividend sufficient to empty its franking account instead of using retained earnings to finance new investment.

While investors can use imputation credits to lower the taxes that they must pay, though, they will typically face taxes on the dividends that they receive. Whether the firm should use retained earnings to finance new investment or raise new equity will depend on the magnitude of the costs and benefits to shareholders associated with paying out dividends, issuing imputation credits and reducing agency costs by disgorging free cash flows.

The idea that equity owners will place a lower value on retained credits than those that are distributed immediately is explicitly acknowledged by Handley in footnote 9 of his report:[6]

> There will, of course, be some time value loss associated with the retention of credits, however, subject to the franking rules, firms may choose to distribute retained credits at will – including by way of special dividend and share buy-back arrangements. So whilst the current value of a retained credit ultimately depends on the expectation of when it is paid out, it is suggested here that the most appropriate assumption for valuation purposes is the one which is consistent with the standard cost of capital formulae i.e. assume a full distribution of free cash flow and therefore assume a full distribution of imputation credits. In contrast, the current approach reflected in equation (1) implicitly assumes retained imputation credits have zero value.

As Handley makes clear, the value of retained credits will be determined by:

- the rate at which a payout of credits in the future should be discounted (the discount rate); and
- the period over which credits are likely to be retained (the retention period).

The AER argues that the discount rate will lie between the risk-free rate and the cost of equity. Like Officer (2009), however, we view this argument as incorrect.[7] The use of the risk-free rate would only be appropriate if it were known with certainty that retained

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[5] Dempsey, Michael and Partington, Graham, *Cost of capital equations under the Australian imputation tax system*, Accounting and Finance Vol 48 No 3, September 2008, page 445.

[6] John C Handley, A Note on the Valuation of Imputation Credits: Report for the Australian Energy Regulator, 12 November 2008, footnote 9, page 5.

[7] Officer, R.R., Estimating the distribution rate of imputation tax credits: Questions raised by ETSA's advisers, 23 June 2009, page 5.

imputation credits were to be paid out and known with certainty the dates on which the credits were to be distributed.

Retained franking credits can only be distributed when they are attached to dividends. The amount and timing of future dividend payments, though, are uncertain. Since retained credits can only be distributed when attached to dividends, they should be discounted at the same rate one would use to discount dividends. The rate at which dividends should be discounted is the cost of equity.

For how long firms retain imputation credits is an empirical matter. The AER states in its draft decision that it is:[8]

> unaware of any empirical analysis that specifically explores the issue

but nevertheless concludes that:

> it is reasonable to assume a retention period of one to five years.

With this assumption and a discount rate that lies between the risk-free rate and the cost of equity, the AER shows that the value of a retained credit is between 70 per cent and 90 per cent of the value of an immediately distributed credit.[9] The AER then argues that if 71 per cent of credits are distributed immediately while the remaining 29 per cent are distributed within five years, the effective payout ratio must lie between 0.91 and 0.98. The AER concludes that this range is not significantly below one.

2.2. Evidence from the ATO

This section shows that the AER assumption that 71 per cent of franking credits are distributed immediately while the remaining 29 per cent are distributed within five years is not consistent with the evidence that the ATO provides. If the AER's assumption is correct (ie, 71 per cent of credits are distributed in the year they are created and retained credits are distributed within five years), one should observe a ratio of credits distributed to credits created each year that is substantially above 71 per cent. The time series of imputation credits created in Australia over the last 11 years indicate that, for the AER retention assumption to be correct, one should observe a ratio of credits distributed to credits created each year that on average lies between 89 per cent and 97 per cent. Instead the ATO data indicates that the ratio is on average 68 per cent.

The AER assumes that firms distribute 71 per cent of franking credits immediately and then distribute the remaining 29 per cent after either one year or five years. In making this assumption the AER does not rely on any empirical evidence. Instead, the AER makes the following statements:[10]

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[8] AER, *South Australia: Draft distribution determination 2010–11 to 2014–15*, 25 November 2009, page 257.

[9] AER, Electricity transmission and distribution network service providers – *Review of the weighted average cost of capital (WACC) parameter*s: Final Decision, May 2009, page 419.

[10] AER, *Electricity transmission and distribution network service providers – Review of the weighted average cost of capital (WACC) parameters: Final Decision*, May 2009, page 418.

> …NERA's suggestion [that firms do not distribute some credits] implies that a stock of potentially valuable imputation credits builds up within the firm, never to be released to shareholders. In the AER's view, this suggestion is implausible, as a rational shareholder base would demand that retained credits be paid out.
>
> [T]he average firm in the Australian market will rationally seek to distribute its retained credits as quickly as possible through whatever means are available, so as to meet shareholder demands.

These arguments rely on the idea that the market places a value on imputation credits and that retained credits can be distributed at low cost. This is because if the market places a zero value on credits distributed, firms will face no incentive to distribute retained credits. Also if the costs of distributing retained credits are sufficiently high, firms will not distribute retained credits even if the market places a value on them. To assess whether it is reasonable to assume that firms retain credits for at most five years, in what follows we examine data from the ATO on the credits created and distributed each year.

To determine whether the AER assumption is reasonable we examine tax statistics that the ATO provides from 1996/1997 to 2006/2007. Table 1 shows for these years the credits created and the credits distributed. The credits created are net taxes taken from Company Tax: Table 6 of the ATO's Taxation Statistics for 2006-07. Credits distributed are net taxes less the change in the franking account balance adjusted for changes between 2001-02 and 2002-03 in the way the ATO reports franking account balances.[11]

The table also shows the credits that would need to have been distributed if companies had followed the advice of the AER and had distributed 71 per cent of the credits they had created immediately and the remaining 29 per cent after either one year or five years. For example, in 1997/98 the AER's one-year retention policy would mean that:[12]

- 71 per cent of imputation credits created in 1997/98 would be distributed (ie, 14,740.3 million = 0.71 × 20,761 million); plus
- 29 per cent of imputation credits retained from 1996/97 would also be distributed (ie, 5,396.3 million = 0.29 × 18,608 million).

In total imputation credits with a face value of 20,137 million dollars would have needed to have been distributed in 1997/98 (ie, 20,137 million = 14,740.3 million + 5,396.3 million). If firms had followed the AER one-year retention strategy, then the ATO tax statistics would show that 97 per cent of credits created over the 1996/97 to 2006/07 period would have been distributed. On the other hand, if firms had followed the AER five-year retention strategy, 89 per cent of credits created would have been distributed.

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[11] The ATO reports franking account balances in the years up to and including 2001-02 as the amount of dividends that could have been franked (ie, a Class C franking balance of $100 in 2001-02 means that $42.86 in imputation credits could have been distributed). From 2002-03 the franking account balances reported by the ATO indicate the amount of imputation credits that could have been distributed (ie, a Class C franking balance of $100 means that $100 in imputation credits could have been distributed).

[12] Table 10.6 of the AER, *Electricity transmission and distribution network service providers – Review of the weighted average cost of capital (WACC) parameters: Final Decision*, May 2009, page 419, calculated the value of imputation credits where 71 per cent are distributed in the year they are created and retained credits (ie, the remaining 29 per cent) are held by the company for either one or five years.

However, the actual proportion of credits created that were distributed on average from 1997 through 2007 is 68 percent. In other words, the AER assumption of a one or five year retention policy is contradicted by the ATO data. The data do not support an assumption that firms quickly pass on all of the credits that they generate.

Table 1. ATO statistics

		Credits distributed		
			AER assumption	
Year	Credits created	Actual	1-year policy	5-year policy
1996-97	18,608	12,470		
1997-98	20,761	15,767	20,137	
1998-99	22,543	17,512	22,026	
1999-00	28,462	18,094	26,746	
2000-01	27,099	24,238	27,495	
2001-02	27,843	12,841	27,627	25,165
2002-03	31,034	10,944	30,108	28,055
2003-04	36,042	28,345	34,589	32,127
2004-05	41,346	28,437	39,808	37,610
2005-06	48,652	35,893	46,533	42,402
2006-07	58,189	42,340	55,423	49,389
Mean proportion distributed		68%	97%	89%

Credits are in millions of dollars. Proportion distributed in any given year is the ratio of credits distributed in the year to credits created in the year.

Another way of looking at the ATO data is to ask what proportion of credits must have been distributed immediately and what proportion of credits must have been retained for either one or five years to match on average the actual distribution policy one observes. The answer is that there exists no one-year strategy that will match on average the policy one observes, but if firms were to distribute 17 per cent of credits created immediately and 83 per cent after five years, one can match on average the actual distribution policy one observes. The impact of discounting on the 83 per cent of credits held for five years, though, is to substantially reduce their value. For example, if the cost of equity is 11.04 per cent per annum (which is one of the AER's assumptions), the present value of 17 cents of credits distributed immediately together with 83 cents retained for five years is just 66 cents.

2.3. Conclusion

The AER in its draft decision stated that for the purposes of calculating the value of gamma it would assume that all imputation credits would be distributed in the year they are created (ie, a payout ratio of one). A payout ratio of one was deemed reasonable by the AER on the basis of its analysis of the time value loss associated with retaining credits. In the absence of any empirical evidence the AER assumed that 71 per cent of credits are immediately distributed while credits retained are held by an average firm for one to five years.

This report has considered the reasonableness of this assumption by analysing the ATO annual tax statistics. Our analysis of the level of credits created and retained by Australian companies demonstrates that the AER's assumption that credits are retained for between one and five years is not supported by the ATO data. The AER's retention assumption would require one to observe a ratio of credits distributed to credits created on average of between 89 per cent and 97 per cent. Instead the ATO data shows that the average ratio of credits distributed to credits created is 68 per cent over the last 11 years that data are reported.

Appendix A. Curricula Vitae

A.1. Simon Wheatley

Simon Wheatley is a special consultant for NERA Economic Consulting. From 2008 to 2009 he worked as a quantitative analyst for the Victorian Funds Management Corporation. From 2001 to 2008 he was a Professor of Finance at the University of Melbourne. Before joining the University of Melbourne, he held positions at the Universities of British Columbia, Chicago, New South Wales and Washington. His research has appeared in, among other journals, the Journal of Finance, the Journal of Financial Economics and the Journal of Monetary Economics. He has also refereed papers for every major journal in Finance. He has a PhD in Finance from the University of Rochester, a Master's degree in Economics from Simon Fraser University and an Honours degree in Economics from Aberdeen University.

Employment

- Special Consultant, NERA Economic Consulting, 2009-
- Quantitative Analyst, Victorian Funds Management Corporation, 2008-2009
- Adjunct, Melbourne Business School, 2008
- Professor, Department of Finance, University of Melbourne, 2001-2008
- Associate Professor, Department of Finance, University of Melbourne, 1999-2001
- Associate Professor, Australian Graduate School of Management, 1994-1999
- Visiting Assistant Professor, Graduate School of Business, University of Chicago, 1993-1994
- Visiting Assistant Professor, Faculty of Commerce, University of British Columbia, 1986
- Assistant Professor, Graduate School of Business, University of Washington, 1984-1993

Education

Ph.D., University of Rochester, USA, 1986; Major area: Finance; Minor area: Applied statistics; Thesis topic: Some tests of international equity market integration; Dissertation committee: Charles I. Plosser (chairman), Peter Garber, Clifford W. Smith, Rene M. Stulz

M.A., Economics, Simon Fraser University, Canada, 1979

M.A., Economics, Aberdeen University, Scotland, 1977

Selected Publications

- Do measures of investor sentiment predict returns? (with Robert Neal), 1998, *Journal of Financial and Quantitative Analysis* 33, 523-547.
- International investment restrictions and closed-end country fund prices, (with Catherine Bonser-Neal, Greggory Brauer, and Robert Neal), 1990, *Journal of Finance* 45, 523-547

(reprinted in International Capital Markets Volume III, 2003, G. Andrew Karolyi and Rene M. Stulz, editors, Edward Elgar Publishing, Cheltenham, Glos).

- A critique of latent variable tests of asset pricing models, 1989, *Journal of Financial Economics* 21, 177-212.
- Some tests of international equity market integration, 1988, *Journal of Financial Economics* 21, 177-212 (reprinted in International Capital Markets Volume I, 2003, G. Andrew Karolyi and Rene M. Stulz, editors, Edward Elgar Publishing, Cheltenham, Glos).
- Some tests of the consumption-based asset pricing model, 1988, *Journal of Monetary Economics* 22, 193-215.

Refereeing experience

Referee for Accounting and Finance, the Australian Journal of Management, Economic Letters, Financial Analysts Journal, Financial Management, Journal of Accounting and Economics, Journal of Business, Journal of Empirical Finance, Journal of Finance, Journal of Financial and Quantitative Analysis, Journal of Financial Economics, Journal of Futures Markets, Journal of International Economics, Journal of International Money and Finance, Journal of Money, Credit, and Banking, Journal of Monetary Economics, Management Science, National Science Foundation, Pacific-Basin Finance Journal, and the Review of Financial Studies.

Program Committee for the Western Finance Association in 1989 and 2000.

Teaching awards

MBA Professor of the Quarter, Summer 1991, University of Washington

Honours

Elected a member of Beta Gamma Sigma, June 1986.

Fellowships

Earhart Foundation Award, 1982-1983

University of Rochester Fellowship, 1979-1984

Simon Fraser University Fellowship, 1979

A.2. Brendan Quach

Brendan Quach is a Senior Consultant at NERA with ten years experience as an economist, specialising in network economics and competition policy in Australia, New Zealand and Asia Pacific. Since joining NERA in 2001, Brendan has advised clients on the application of competition policy in Australia, in such industries as aviation, airports, electricity, rail and natural gas. Brendan specialises in regulatory and financial modelling and the cost of capital for network businesses. Prior to joining NERA, Brendan worked at the Australian Chamber of Commerce and Industry, advising on a number of business issues including tax policy, national wage claims and small business reforms.

Education

1991-1995 — **AUSTRALIAN NATIONAL UNIVERSITY**
Bachelor of Economics.
(High Second Class Honours)

1991-1997 — **AUSTRALIAN NATIONAL UNIVERSITY**
Bachelor of Laws.

Career Details

2001 - — **NERA ECONOMIC CONSULTING**
Economist, Sydney

1998-1999 — **AUSTRALIAN CHAMBER OF COMMERCE AND INDUSTRY**
Economist, Canberra

1996 — **AUSTRALIAN BUREAU OF STATISTICS**
Research Officer, Canberra

Project Experience

Regulatory and Financial Analysis

2009 — **Jemena - Gas Distribution**
Cost of Equity
Co-authored a report on the application of a domestic version of the Fama-French three-factor model to estimate the cost of equity for regulated gas distribution businesses. The report examined whether the Fama-French three-factor model met the dual requirements of the National Gas Code to provide an accurate estimate of the cost of equity and be a well accepted financial model. Using Australian financial data, the report also provided a current estimate of the cost of equity for Jemena.

2009 **WA Gas Networks - Gas Distribution**
Cost of Equity
Co-authored a report that examined a range of financial models that could be used to estimate the cost of equity for a gas distribution business. The report computed estimates of the cost of equity of a gas distribution business using the Sharpe Lintner CAPM, Black CAPM, Fama-French three-factor model and Fama-French two-factor model. The report examined both domestic and international data.

2009 **Clayton Utz - Gas Distribution**
Cost of Equity
Co-authored a report on alternative financial models for estimating the cost of equity. The report examined the implication of estimating the cost of equity of a gas distribution business using the Sharpe Lintner CAPM, Black CAPM and Fama-French models. The report examined both domestic and international data.

2008 **Joint Industry Associations - APIA, ENA and Grid Australia**
Weighted Average Cost of Capital
Assisted in the drafting of the Joint Industry Associations submission to the Australian Energy Regulator's weighted average cost of capital review. The submission examined the current market evidence on the cost of capital for Australian regulated electricity transmission and distribution businesses.

2008 **Joint Industry Associations - APIA, ENA and Grid Australia**
Weighted Average Cost of Capital
Expert report for the Joint Industry Associations on the value of imputation credits. The expert report was attached to their submission to the Australian Energy Regulator's weighted average cost of capital review. The report examined the current evidence on the market value of imputation credits (gamma) created by Australian regulated electricity transmission and distribution businesses.

2007 **Energy Trade Associations - APIA, ENA and Grid Australia**
Weighted Average Cost of Capital
Expert reports submitted to the Victorian Essential Services Commission evaluating its draft decision to set the equity beta at 0.7, and its methodology for determining the appropriate real risk free rate of interest, for the purpose of determining the allowed rate of return for gas distribution businesses.

2006 **Office of the Tasmanian Energy Regulator**
Implications of the pre-tax or post-tax WACC
Provided a report to OTTER on the potential implications of changing from a pre-tax to a post-tax regulatory framework.

2005 **Queensland Rail, Australia**
Weighted Average Cost of Capital
Provided a report for Queensland Rail on the appropriate weighted average cost of capital for its regulated below rail activities.

2004 **Prime Infrastructure, Australia**
Weighted Average Cost of Capital
Provided a report for Prime Infrastructure on the appropriate weighted average cost of capital for its regulated activities (coal shipping terminal).

2002 **Rail Infrastructure Corporation (RIC), Australia**
Review of the Cost of Capital Model
Provided advice to RIC and assisted in drafting RIC's submission to the Australian Competition and Consumer Commission (ACCC) on the appropriate cost of capital. This included building a post-tax revenue model of RIC's revenues in the regulatory period.

2002 **Essential Services Commission of South Australia**
Review Model to Estimating Energy Costs
Reviewed and critiqued a model for estimating retail electricity costs for retail customers in South Australia for 2002-2003.

2002 **Integral Energy, Australia**
Provided Advice on the Cost of Capital for the 2004 – 2008 Distribution Network Review
Provided analysis and strategic advice to Integral Energy on the possible methodologies that IPART may use to calculate the cost of capital in the next regulatory period.

2001 **TransGrid, Australia**
Advice on ACCC's Powerlink WACC decision
Provided a report critically appraising the ACCC's decision regarding Powerlink's weighted average cost of capital (WACC).

Appendix B. Brief of NERA – Distribution Rate

B.1. Background

The Australian Energy Regulator (**AER**) is currently considering ETSA's Regulatory Proposal for 2010-2015, and has published its Draft Determination on 25 November. As part of this process, the AER must determine an appropriate return on capital, which is a function of (inter alia) the valuation of dividend imputation credits.

The imputation credit factor (or gamma) is the product of the value of imputation taxation credits created as a proportion of their face value and the proportion of imputation credits that can be distributed. The value of franking credits is estimated using the following formula:

$$\gamma = F.\theta$$

where F is the payout ratio and θ (theta) is value of imputation credits.

Please refer to the Draft Determination from pages 254 – 263 for the AER's consideration surrounding the estimation of the payout ratio.

B.2. Questions

ETSA Utilities would like you to examine the assumption that the AER and Handley have made that it is reasonable for the AER to assume all dividends are paid out in a 1-5 year period. Could you please analyse official tax statistics in this regard to consider the appropriateness of this assumption.

B.3. Guidelines in preparing your report

Attached are Expert Witness Guidelines issued by the Federal Court of Australia. Although this brief is not in the context of litigation, ETSA Utilities seeks a rigorously prepared independent view for use in the context of regulatory decision making and you are requested to follow the Guidelines to the extent reasonably possible in the context.

In particular, please:

- identify your relevant area of expertise and provide a curriculum vitae setting out the details of that expertise;
- only address matters that are within your expertise;
- where you have used factual or data inputs please identify those inputs and the sources;
- if you make assumptions, please identify them as such and confirm that they are in your opinion reasonable assumptions to make;
- if you undertake empirical work, please identify and explain the methods used by you in a manner that is accessible to a person not expert in your field;

- confirm that you have made all the inquiries that you believe are desirable and appropriate and that no matters of significance that you regard as relevant have, to your knowledge, been withheld from your report; and
- please do not provide legal advocacy or argument and please do not use an argumentative tone.

B.4. Attachment A: Expert Witness Guidelines issued by the Federal Court of Australia

B.4.1. General Duty to the Court[13]

An expert witness has an overriding duty to assist the Court on matters relevant to the expert's area of expertise.

An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential.[14]

An expert witness's paramount duty is to the Court and not to the person retaining the expert.

B.4.2. The Form of the Expert Evidence[15]

An expert's written report must give details of the expert's qualifications and of the literature or other material used in making the report.

All assumptions of fact made by the expert should be clearly and fully stated.

The report should identify and state the qualifications of each person who carried out any tests or experiments upon which the expert relied in compiling the report.

Where several opinions are provided in the report, the expert should summarise them.

The expert should give the reasons for each opinion.

At the end of the report the expert should declare that "[the expert] has made all the inquiries that [the expert] believes are desirable and appropriate and that no matters of significance that [the expert] regards as relevant have, to [the expert's] knowledge, been withheld from the Court."

There should be included in or attached to the report: (i) a statement of the questions or issues that the expert was asked to address; (ii) the factual premises upon which the report proceeds; and (iii) the documents and other materials that the expert has been instructed to consider.

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[13] See rule 35.3 Civil Procedure Rules (UK); see also Lord Woolf "Medics, Lawyers and the Courts" [1997] 16 CJQ 302 at 313

[14] See *Sampi v State of Western Australia* [2005] FCA 777 at [792]-[793], and *ACCC v Liquorland and Woolworths* [2006] FCA 826 at [836]-[842]

[15] See rule 35.10 Civil Procedure Rules (UK) and Practice Direction 35 – Experts and Assessors (UK); *HG v the Queen* (1999) 197 CLR 414 per Gleeson CJ at [39]-[43]; *Ocean Marine Mutual Insurance Association (Europe) OV v Jetopay Pty Ltd* [2000] FCA 1463 (FC) at [17]-[23]

If, after exchange of reports or at any other stage, an expert witness changes a material opinion, having read another expert's report or for any other reason, the change should be communicated in a timely manner (through legal representatives) to each party to whom the expert witness's report has been provided and, when appropriate, to the Court.[16]

If an expert's opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate without some qualification, that qualification must be stated in the report (see footnote 5).

The expert should make it clear when a particular question or issue falls outside the relevant field of expertise.

Where an expert's report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports.[17]

B.4.3. Experts' Conference

If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

[16] The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565

[17] The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565-566. See also Ormrod *"Scientific Evidence in Court"* [1968] Crim LR 240