50TH HORSERACE BETTING LEVY SCHEME
RACING'S CRITIQUE OF THE LONDON ECONOMICS REPORT FOR THE BOOKMAKERS' COMMITTEE

This note summarises Racing's comments on the London Economics ("LE") report 'An assessment of economic arguments presented in relation to the setting of the 50th Horserace Betting Levy' for the Bookmakers' Committee ("BC") (dated August 2010) (the "Report").

1. Racing recognises the test for the Levy agreed as part of the new process

2. Racing has provided this market approach method to consider how the Horserace Betting Levy may be determined in a market context applying commercial principles.

3. LE's attempted criticisms are mainly the same as they put forward in 2008 in relation to the 47th Scheme, and rejected by Racing (through an LECG paper, which will be supplied separately to the Deloitte Chatel team), with detailed reasons, at the time. LE has failed to respond to that paper.

4. This market approach continues to support fully Racing's case when updated to include 2009 financial data and the outturn from the 48th Scheme.

5. LE's closing hypothesis that Racing actually makes a negative marginal contribution to betting operators is simply not credible and undermines their entire analysis.

6. LE's criticism of the use of financial data from the Big Three contradicts with the approach of Ernst and Young in their work for the Bookmakers' Committee.

7. In the paper ATTACHED at Appendix A, our same expert team, albeit now having moved from LECG to Berkeley Research Group, has provided a summary response to LE's renewed criticism (sections 1-3) with additional detail if needed (sections 4-7) and remains available to discuss any of the underlying principles of their work

8. Therefore, nothing in the LE report changes Racing's position in relation to our Submission

3 September 2010

Economic Assistance in the Determination of the 50th Horseracing Levy

Response to London Economics Report to Bookmakers' Committee, August 2010

Berkeley Research Group (BRG)

3 September 2010

Objective

1. London Economics (LE) has commented on LECG's analysis of the Horseracing Levy as it might be determined in a commercial framework, in its August 2010 report to the Bookmakers' Committee of the Horserace Betting Levy Board.[1] London Economics criticised the LECG analysis in a number of ways and suggested adjustments to the commercial model that it claims would reduce the Levy. Its main criticisms were:

   a) Representativeness of the largest three bookmakers – an analysis based on the performance of the major bookmakers is not representative of all bookmaking operators.

   b) Opportunity Costs – the LECG analysis ignored the cost of capital involved in racing betting operations and used a non-standard approach for evaluating betting's options and calculating the Levy. If the opportunity cost of capital were included then by LE's figures this would reduce the Levy significantly.

   c) Ability to pay – using 2008 figures as the basis for the LECG analysis overstates the impact of racing on betting revenues compared to 2009 figures, when there were less favourable conditions for the Bookmakers.

   d) Convoyed sales – LECG overstated the loss of other product sales in LBOs if racing were withdrawn, and that substitution of other betting opportunities would make up for all but a small portion of the lost racing business.

2. The authors of the LECG reports now work through Berkeley Research Group (BRG), an economic consultancy, and respond to the LE comments here.[2] The responses are first summarised then discussed in more detail.

Response Summary

3. We reject the LE criticisms for the following reasons:

   - LE has not responded to the detailed comments LECG made on the previous LE report in 2008, which address most of the issues LE now raises again.
   - LECG chose to use data from the "top three" bookmakers as this was the only data available at the detail level needed to make the analysis practicable.
   - LE's proposed inclusion of the opportunity cost of capital is not appropriate for the commercial bargaining model used by LECG. If capital costs were included the 25:75 split in favour of Betting might change to a more equal 50:50 split, raising the Levy.

[1] London Economics (2010), "An assessment of economic arguments presented in relation to the setting of the 50th Horserace Betting Levy: Final Report for the Bookmakers' Committee of the Horserace Betting Levy Board", August 2010. Responding to: LECG (2010), "Setting the 50th Horserace Betting Levy: An Economic Analysis", 9 March 2010

[2] http://www.brg-expert.com/

- Alternatively, any levy that allowed Betting to just break even once the opportunity cost of capital was accounted for might be deemed reasonable and appropriate.
- The bargaining model used by LECG is a standard approach in valuing many commercial IP rights. LE's cost of capital approach is most appropriate for analysing investment projects and regulation, which is not what the LECG analysis is trying to do.
- LE significantly overestimates the opportunity cost of employed capital that might be freed up if horseracing were withdrawn from Betting. When corrected the opportunity "carrying cost of capital" would be a small fraction of LE's figures.
- LECG used 2008 data as it believed this represented the average position over a few years more accurately than 2009, an exceptionally poor year for Betting. Using 2009 figures would not reduce the Levy rate appreciably. A recalculated Levy range would be £108-£130m, or £138-161m including convoyed sales. Part of the reduction is accounted for by offshore moves, value which would not be lost under a commercial arrangement.
- LE makes an unsubstantiated and one-sided assertion that there would be no convoyed sales loss to other betting if racing were withdrawn, rather the opposite, and substitution would minimise the impact on Betting. LECG believes there would likely be a net loss of other betting, though does not rely on this for its main Levy analysis.
- The unreasonableness of LE's analysis is indicated in its estimates of the marginal contribution of British Horseracing when opportunity costs of capital and 60% substitution of racing betting into other products are included in the model, in the Bookmakers' Committee submission. This results in a negative marginal contribution, implying that racing is loss making for Betting, which defies reason.

Response Details

4. The comments that LE make are virtually unchanged from those it made in January 2008 on the original 2007 LECG 47th Levy report.[3] LECG prepared a detailed response to LE's previous comments in 2008 which was made available to the Bookmakers' Committee and referred to in the summary response in LECG's 2010 report.[4] The only substantial new LE comments are on LECG's use of 2008 data and some further detail on convoyed sales arguments.
5. Our main concerns with LE's current comments are summarised as follows:
   a) LE appears not to have responded at all to the detailed comments LECG made on the previous LE report in 2008 and available to LE. These comments address most of the issues LE now repeats, in particular the inclusion of cost of capital in the LECG model, the use of top three data and the treatment of convoyed sales.
   b) LECG chose to use data from the "top three" bookmakers as this was the only data readily available at the detail level needed for the analysis. Also these represent

[3] London Economics (2008), "Economic Assistance in the Determination of the 47th Horseracing Levy: Final Report for Bookmakers' Committee of the Horserace Betting Levy Board", January 2008, 32 pp. Responding to: LECG (2007), "Setting the Horserace Betting Levy – Analysis and Commentary", 26 November 2007.

[4] LECG (2008) "Economic Assistance in the Determination of the 47th Horseracing Levy: Response to London Economics, January 2008", 27 October 2008.

about three quarters of the betting receipts.[5] While the many small Bookmakers are an important part of the industry, data are generally not available and their inclusion is unlikely to have a major impact on an analysis based on average returns over the industry.

c) LE's proposed inclusion of opportunity cost of capital is not appropriate for the commercial bargaining model used by LECG, which is based on **accounting** profits and implicitly allows for capital and other risk in using a 25:75 split of available profits between licensor and licensee.[6] One of the main reasons the split is 75% in favour of the licensee is to allow for the capital risk being taken in comparison with other investment opportunities.[7]

d) If capital costs were explicitly included in the analysis (which we explain below is a difficult task) then the rationale for the 25:75 split disappears. Basic economic models of bargaining would suggest a more equal 50:50 split might be more appropriate, but one could just as well argue that any levy amount that enabled the betting industry to earn economic profits should be acceptable to Betting.[8] LE inconsistently mixes a project appraisal model with a bargaining model.

e) The bargaining model used by LECG is a fully standard approach in determining the value of many IP rights, despite LE's claims. [9] It is not the only method that might be used, but is widely used in areas such as determining reasonable patent

[5] "[T]here are now five major players accounting for around 80% of revenues." William Hill, Annual Report 2009, p. 14.

[6] This rule of thumb is often accredited to Robert Goldscheider, an American licensing expert, who in the 1950s observed that the industry norm for royalty rates used in licensing technology in the electronics industry was for the licensor to obtain about 25% of the accounting profits from the sale of products using the licensed technology. Goldscheider argued that such a split of profits reflected the balance of risks (including capital risks) between licensor and licensee. In the context of an industry such as Bookmaking where fixed assets are a small proportion of the overall asset base of bookmakers, such a split might be overly generous. Goldscheider, Robert, John Jarosz and Carla S. Mulhern (2002), "Use of the 25 percent rule in valuing IP", *Les Nouvelles: Journal of the International Licensing Executives Society*, Volume XXXVII, No.4, December 2002.

[7] "Richard Razgaitis has identified 6 reasons for why a 25/75 (starting) split makes sense. First, "that's the way it is." Numerous licensors and licensees have agreed to a 25/75 split. It is, according to him, the industry norm. Second, typically 75 per cent of the work needed to develop and commercialize a product must be done by the licensee. **Third, "he who has the gold makes the rules." Licensees have considerable leverage because of the numerous investment alternatives open to them.** Fourth, a 3-times payback ratio is common. Such is obtained by a licensee retaining 75 per cent of the return by investing 25 per cent. Fifth, technology is the first of the 4 required steps of commercialization. The others are making the product manufacturable, actually manufacturing it and selling it. Finally, the ratio of R&D to profits is often in the range of 25 to 33 per cent." Goldscheider *et al*. (2002), *supra*. [emphasis added].

[8] In the absence of other influences, the Nash bargaining solution between equally placed players is an equal 50:50 split of the available money profit. e.g., Nash, John (1950), "The Bargaining Problem". *Econometrica*, 18 (2): 155–162.

[9] For instance, the Georgia-Pacific Factors that are used by U.S. courts in adjudicating reasonable royalty cases specifically suggest that the royalty rates should reflect the outcomes of a hypothetical bargaining situation. See, for example, the discussion contained in chapter 9 of Parr, Russell L. and Gordon V. Smith*, Intellectual Property: Licensing and Joint Venture Profit Strategies* (John Wiley and Sons, 2004).

royalties. These are routinely estimated in litigation and other areas based on hypothetical negotiations between buyer and seller with a share of available profits split between the parties. By contrast, the WACC cost of capital approach discussed by LE, and referred to in the HM Treasury Green Book, is most appropriate for investment project analysis and regulation, using discounted cash flow (DCF) analysis, where the main questions are whether a project can earn the cost of its investment and so justify itself.[10] LE's views may be the "standard approach" for "regulators throughout the world when they determine prices or revenues in regulated industries" but that is not what the LECG commercial analysis is trying to model. Few licensing negotiators would even have heard of the HM Treasury Green Book, but most would have heard of the 25 percent rule.

f) The practicality of the 25 percent rule is highlighted by the difficulties one would face in using fancier approaches that explicitly estimate "opportunity costs." For instance, LE significantly overestimates the opportunity cost of employed capital that might be freed up if racing were withdrawn from betting. Measuring "tied-up" capital is fraught with difficulties. Indeed LE's difficulty in making a convincing estimate of this opportunity cost illustrates why the bargaining model and 25:75 split are used in practice. Capital is defined as a combination of debt and equity. In its former analysis, which seems to be repeated here, LE uses "non-current liabilities" of the Bookmakers as a measure of capital that needs to earn a return (unpaid principal and interest on long-term debt). It allocates the WACC "cost" of this capital to racing based on racing's share of OTC business. This debt is an accumulation from past investments and only a small portion of this capital might be freed up if racing were withdrawn – possibly only that associated with some part of the land and buildings value of the shops and any physical assets that might be redeployed. LE also repeats its previous oversight in allocating the capital cost on the basis of racing's share of OTC business rather than all betting business. With these corrections the opportunity "Carrying Cost of Capital" included by LE would be a small fraction of LE's figures. The opportunity cost in LE's Table 3, by analogy with LECG's 2008 reply analysis, might shrink from £121.7m to about £4m.[11]

g) LECG used 2008 data for its main analysis as it believed this represented the average position of Racing and Betting more accurately than 2009, which has been acknowledged as an exceptionally poor year for Betting. The bargaining model requires that profits are estimated over more than a single year. 2008 was chosen as representative after reviewing trends in the data over a five year period. Also, data were less complete for 2009 in that data for Coral were not available at all, whereas they were available at a total revenue level for 2008. Sensitivity analysis has been performed comparing 2008 figures with best estimate 2009 figures. These show that the use of 2009 figures would change the minimum lower bound Levy rate by less than 1%. A recalculated Levy range would be £108-£130m, or £138-161m

[10] Often there may be a "hurdle rate" of return for a project; if the project earns a return higher than this it may be approved. In the current context this implies that any levy that allows Betting to earn positive profits is acceptable. LE could have performed a DCF analysis incorporating several years of projected data, and using an appropriate "hurdle rate". However, from an investment appraisal perspective, any levy rate that allowed for non-negative economic profit would make the investment worthwhile. This investment appraisal perspective is an entirely different one from the bargaining perspective, and the huge difficulties involved in identifying appropriate discount rates and opportunity costs mean that it is a much less practical method to apply to royalty negotiating situations.

[11] LECG (2008), Table 3, p.24.

including convoyed sales.[12] Part of the reduction is accounted for by offshore moves, value which would not be lost under a commercial arrangement.

h) LE scarcely justifies its assertion that there would be no convoyed sales loss of other betting if racing were withdrawn. On the contrary LE asserts that punters would substitute other betting opportunities for racing, so that non-racing betting would actually increase if racing were withdrawn. LE claims that an astonishing 60% of racing business would transfer to other products and the only loss would be those punters who only bet on horses, about 25% of all punters. This is an extreme interpretation. While it is clear that substitution between betting opportunities is a two way street, LE does not allow for the losses of other business from punters who bet primarily on horses but also on other betting and might not visit the LBOs, who value a range of choice, or who might still visit LBOs but less frequently and spend less. By contrast, LECG believes that on balance the net result would be a loss of other betting.

6. LE's main adjustments to the LECG figures stem from its inclusion of opportunity cost of capital in the analysis. If these "opportunity costs" of tied-up capital were included explicitly in the model (which is not the norm in licensing negotiations given the practical difficulties of identifying relevant capital) then the 25:75 split in favour of Betting would no longer make sense. LE also significantly overestimates the opportunity cost of capital that might be freed up if racing were withdrawn. It also takes an extreme and one-sided interpretation of the possible impact on convoyed sales of other betting products.

7. The unreasonableness of LE's position is indicated by Figure 8 "Marginal Contribution of British Horseracing to the 'Big 3' Retail Estates" in the Bookmakers' Committee submission.[13] This indicates that with the opportunity cost included and with a full 60% of racing business substituted into other products, despite using a lower figure for staff costs that would be saved if racing were withdrawn (20% versus 40% in LECG analysis), the marginal contribution of racing to Betting profits is a negative £1.7m. This indicates a small loss from racing betting and is only kept from being more negative by the staff cost assumption. This contradicts the facts that racing continues to be offered in LBOs and the Bookmakers consistently emphasize the key role of Racing in their retail business.

[12] This allows for actual 2009-10 48th Levy receipts of £75.4m and actual average Levy rate of 8.9%.

[13] Bookmakers' Committee (2010), "Recommendations for the 50th Annual Horserace Betting Levy Scheme", August 2010.