BOOKMAKERS' COMMITTEE RESPONSE

TO THE SUBMISSION OF

BRITISH HORSERACING

IN RESPECT OF THE

50^{TH} ANNUAL HORSERACE BETTING LEVY SCHEME

1 EXECUTIVE SUMMARY

Introduction and Overview

1.1 The Bookmakers' Committee has reviewed the submission of British horseracing provided to the Levy Board in March 2010.

1.2 In short, the Bookmakers' Committee strongly rejects Racing's claim for £130 million to £150 million from the 50th Levy Scheme.

1.3 The Bookmakers' Committee rejects the notion that the Levy is intended to create a target yield. It is a mechanism that is designed to vary according to the performance of bookmaking. Any departure from that is a matter for a change in the statute and for Parliament to decide.

1.4 The Bookmakers' Committee also rejects the starting points and the methodology by which Racing's position has been reached. Far from adopting an approach based on rigorous analysis and supported by evidence, Racing's submission is based on flawed methodology and uses hypothetical assumptions to produce an unrealistic result.

1.5 Racing's submission fails to set out its needs, instead, setting out its aspirations. It fails to refer to income streams received from bookmakers other than the Levy and yet seeks to expand the scope of the statute to cover products not contemplated by Parliament at the time the subsidy was created.

1.6 Racing's submission does not present a business case that might have justified what is being sought, nor does it provide transparency on the costs incurred by Racing and the value of other income streams both now and in the future.

1.7 Racing's submission seeks to maintain a form of status quo for Racing (other than to establish a quantum from bookmakers) at a time when all other businesses are having to review and amend their operations to reflect the reality of the economic challenges faced in the UK and abroad.

1.8 The Bookmakers' Committee believes it is time that Racing undertook such a review and considered the rationalisation of its costs.

The Levy Mechanism

1.9 Racing's submission sets out an assessment of what it deems a 'reasonable' Levy yield and then seeks to present a mechanism which will achieve this yield. It is totally inappropriate to reverse engineer a result in this way, artificially creating arguments to support an enormous increase in levy monies to which the racing industry seems to believe it is entitled. A mechanism whether it be statutory or otherwise cannot support an argument to establish a target yield. This is a significant flaw in Racing's principal argument.

1.10 The amount generated by the Levy is not, and cannot be, fixed. Nor can it be placed within a bounded range. This is because it is entirely dependent upon the profitability of British horserace betting activity. This profitability in turn depends on

British horseracing's popularity with the betting consumer, the public's desire to spend its leisure pound in this way and the results of races.

1.11 It must be remembered that the Levy is not a payment for a British horseracing product and by statute remains unrelated to any perceived commercial value of horseracing to bookmakers. The payment is a long-established compensation mechanism and it is therefore inappropriate for Racing to found its submissions on a framework that seeks to reflect a commercial relationship. It is not what the statute or Parliament envisaged.

1.12 Until the Levy is replaced by a commercial mechanism, it must be taken for what it is: a compensatory mechanism, defined by statute, to make up for the anticipated reduction in gate receipts following deregulation in the 1960s. As a subsidy it is important that it is not transformed into something other than Parliament intended, especially given its impact on a range of internationally competitive businesses.

Current Market Conditions and the Bookmakers' Capacity to Pay

1.13 It is unrealistic to suggest, as Racing does, that against a market background where bookmakers' turnover and profit is significantly down, the amount of money transferred by statute from bookmakers to Racing via the Levy should nonetheless increase.

1.14 Betting on British horseracing is at an all-time low (and declining faster than ever), with the total costs of providing betting on British horseracing now at a commercially unsustainable level. British horseracing is reaching a "tipping point" with regard to its profitability and therefore its viability for betting shop operators. Racing cannot reasonably expect bookmakers to shoulder the burden of the Levy, even at current rates, without the risk of significant shop closures and job losses.

1.15 In the work undertaken by LECG in support of Racing's submission, there is no real assessment of the capacity of bookmakers to pay the sum of monies requested by Racing and there is no attempt to incorporate the most recent financial information in relation to the current financial performance of bookmakers.

1.16 The Bookmakers' Committee rejects the LECG assertion that:

'*the 2009 figures....are likely to be distorted by adverse conditions in the economy as a whole*".

1.17 The point of the Levy is that in the absence of commercial sustainability, it should balance the needs of Racing with the capacity of bookmakers to pay. As such, the decision to choose information on bookmakers' financial performance selectively and ignore current market conditions presents a false picture and biased estimate of the Levy.

1.18 The continuing decline in the popularity of betting on British horseracing, the cost of providing live TV pictures, other relevant costs in LBOs and the economic impact of the downturn is central to the estimate of the Levy and key to the balancing exercise that requires the Levy mechanism to take into account all prevailing economic, fiscal and social circumstances.

The Starting Point

1.19 Racing has chosen to base its main arguments on 2 points of reference:

1.19.1 the 2002 Determination of the 41st Levy Scheme; and

1.19.2 a secondary element within the 2002 Determination, which we consider Racing has materially misinterpreted.

1.20 Racing's choice of both of its points of reference is illogical and unreasonable.

1.21 First, the circumstances and context surrounding the 50th Levy Scheme differ markedly from that of the determination of the 41st Levy Scheme in 2002 and any decisions made at that time are of limited relevance to the current environment.

1.22 As regards the second point of reference, in her determination, the Secretary of State identified first the mechanism to be utilised. The potential yield was a secondary reference and was introduced only as a consequence of the principal decision. The reference used by Racing fails to show its true context: estimates of the potential yield resulting from the determined mechanism were recognised as a) secondary to the establishment of the scheme and b) dependent on the profitability of bookmakers.

1.23 If Racing had wished to base its argument around a scheme determined by Government, it seems obtuse that they ignored the determination of the 47th Levy Scheme which is the last time Government determined what was an appropriate mechanism. That determination would have provided Racing with the most recent and relevant evidence of Government thinking, missed by its use of the determination of the 41st Levy Scheme.

1.24 Similar economic, fiscal and social circumstances to those which currently exist would be more accurately reflected had a starting point of the 47th Levy Scheme been selected. The 47th Levy Scheme was referred for determination primarily because of a disagreement over whether the capacity of bookmakers to pay levy had been or would be reduced by the considerable increase in the cost of acquiring live TV coverage of horseracing. An offset of the incremental costs was proposed but not accepted.

1.25 The Minister accepted that an argument could be put forward:

'that bookmakers subscriptions to the new service constitute a commercially-based flow of money to racing'

and further stated:

'I therefore accept that it may have a material effect both on bookmakers' ability to pay and on the needs of racing'.

1.26 At the time, it was said that, because the extra cost was not known, the impact could not be adequately assessed and the Minister stated that:

'In time its full economic impact on bookmakers, racecourses and on horseracing generally may become clearer.'

1.27 We are of the view that the situation is now clearer: the increasing transfer of funds from bookmakers to Racing via TV picture rights should be fully taken into account in any approach to agree or determine the Levy. This element has been ignored in the submission by Racing to the HBLB completely.

1.28 Even if the 41st Levy Scheme is used a reference point, the context surrounding the 50th Levy Scheme differs from that of the 41st Levy Scheme in that:

1.28.1 there is acceleration in the decline in betting shop customers betting on British horseracing, resulting in an absolute fall in bookmakers' revenue from betting on British horseracing from 2008 to 2009; and

1.28.2 TV picture rights payments for British horseracing and the amount received by racecourses are at an unsustainably high level, with the prospect of further substantial increases expected before the start of the 50th Levy Scheme; and

1.28.3 poor economic conditions exist resulting in:

(a) already reduced disposable income for the consumer, and

(b) a budget that included VAT of 20% from 4th January 2011 further restricting consumer spending and increasing bookmakers' costs (including TV picture rights) that are subject to VAT (Betting is an exempt supply for VAT purposes and as such an increase in input VAT rates represents a direct increase in costs).

1.29 The net effect of these factors is

1.29.1 turnover reducing by 6.8%.[1]

1.29.2 gross win reducing by 18.6%.[2]

The Needs of Racing

1.30 Racing is rapidly moving to a commercial basis for its funding by increasing its charges for TV picture rights and therefore cannot reasonably expect Levy payments to increase.

1.31 We are of the view that the principle articulated in the last determination should now apply; far from any increase, the Levy ought to take into account the receipts from TV picture rights and be reduced, to ensure that the overall costs to bookmakers are reasonable, if bookmakers are to continue to view betting on British horseracing as a viable business opportunity.

1.32 For FY06/07-09/10 Racing received from betting £565M via Levy and TV picture rights, but excluding sponsorship.[3]

---

[1] Memo to ABB Industry Model Steering group, RS business Modelling, 7th June 2010.
[2] Ibid.

1.33 Racing argues at several points in its submission that it is not getting its 'fair share'. This is absolutely wrong; Racing is getting its fair share and more.

1.34 Racing's needs can and ought to be met from all its income sources, not just levy. Racing must look at the entirety of the flows of funding it receives and organise itself to deliver the funding where it is most needed.

1.35 The introduction since 2007 of upstream competition for the TV picture rights for British horseracing, without the ability to compete downstream (because both TV services were acknowledged to be 'must haves' by the High Court Judge asked to consider the issue), has led to the unsustainably high level of funds transferred from bookmakers to Racing; a sport which is fast losing its relevance to betting consumers.

1.36 Racing has continued to receive unsustainably high levels of revenue from bookmakers via the Levy and TV picture rights despite the falling value of betting on British horseracing. It is wrong to assume that income from the Levy, TV rights and sponsorship should be treated as separate, just because one is a statutory payment, another, the result of a commercial relationship and the third is a 'discretionary' spend. All this income comes from the same source and bookmakers' total contribution to Racing does not justify a Levy at current levels, let alone at the levels which Racing claims that it needs.

Lack of Evidence and Flawed Methodology

1.37 In order to assist it in addressing the issues raised by Racing and its economists LECG, the Bookmakers' Committee instructed Ernst & Young and London Economics, to provide expert economic advice. Both Ernst & Young and London Economics have raised significant concerns about the lack of evidence and the frequent use of hypothetical assumptions in both the LECG report and the Submission, the fundamental flaws in methodology and the number of serious analytical weaknesses.

1.38 Ernst & Young conclude[4]:

1.38.1 The Racing report argues for a substantial increase in the Levy yield despite acknowledging that betting on British horseracing has been in decline and that the funding contribution to Racing from other sources has been increasing.

1.38.2 Evidence on the increasing costs of racing is unconvincing and is based on a hypothetical model rather than actual numbers.

1.38.3 Racing's submission cannot be considered as a document using an evidence based approach.

1.38.4 This approach is based on assumptions which in its opinion are questionable.

[3] Satellite Information Services Ltd & HBLB.
[4] Ernst & Young, 'Critique of the Submission of British Horseracing', 3 August 2010.

1.38.5 The analysis is invalidated by not using the actual movement in the costs of horseracing.

1.38.6 This approach makes broad hypothetical assumptions about benefits to betting which might have increased since 2002 without any supporting evidence.

1.39 London Economics conclude[5]:

1.39.1 The suggestion that the economic and financial performance of the largest three bookmakers is representative of all bookmakers continues to be a serious weakness of the LECG analysis.

1.39.2 The marginal and non-standard approach adopted by LECG could result in the estimation of a Levy which renders betting operators unprofitable.

1.39.3 An estimate of the Levy of approximately £51 million once opportunity costs have been incorporated rather than the estimate of £120-£150 million presented by LECG.

1.39.4 Fundamentally, given the significant methodological weaknesses associated with the LECG analysis, the Horserace Betting Levy Board should treat any assessment of the potential Levy based on the LECG analysis with extreme caution.

Ultra Vires and Structural Deficiencies

1.40 Notwithstanding the Bookmakers' Committee's overall concerns about the nature and scope of Racing's submission, its flawed calculation mechanism and the methodology with which Racing seeks to drive a coach and horses through the purpose behind the Levy is itself flawed, the Bookmakers' Committee also considers it necessary to comment in this response on what Racing describes as 'options', by which the 50th Levy Scheme can deliver a reasonable return. Racing believes that a number of issues which it describes as 'structural deficiencies' should be taken into account in determining the Levy. Racing's submission and the issues of overseas horseracing, thresholds, exchange betting, off-shoring and the relationship between British horseracing and other betting shop products are as irrelevant as they are inappropriate. They are currently outside the scope of the statute and should play no part in the HBLB's deliberations. The revised process[6] was supposed to short-circuit some of these periodic and repetitious debates.

1.41 Without prejudice to that primary point, in any event, as London Economics points out in its report, Racing's arguments in this regard are entirely untenable and appear to be included in an attempt to make their baseline commercial bargaining solution more palatable.

1.42 Racing fails to acknowledge the link between the halving of the threshold and the discontinuation of the levy on foreign racing as part of the 42nd Levy Scheme.

---

[5] London Economics, 'An Assessment of the Economic Arguments Presented in Relation to the Setting of the 50th Levy Scheme', August 2010.
[6] Altered in April 2009 for the 50th Levy Scheme.

1.43 International comparisons presented in the submission are not valid or reasonable as the structure of revenues differs significantly by country. The international comparison therefore cannot be used to validate the arguments put forward in the submission without a detailed analysis, contrary to what is stated by Racing.[7]

1.44 No credible argument has been made to remove, reduce or re-structure the relief afforded to protect lower profitability shops via the use of thresholds. No justification exists to do so.

1.45 The BHA is of the view that the contribution to the Levy currently made by betting exchanges is insufficient to reflect fairly the volume of British horseracing business which takes place within the exchange market. The Bookmakers' Committee does not wish to pre-empt the consultation recently initiated by the HBLB and as such considers it appropriate not to comment further on the matter at this time.

1.46 Bookmakers operating from overseas being able to offer bets on British horseracing to customers is a subject beyond the scope of the statute and out-with the Levy.

1.47 Racing provides no evidence of the supposed relationship between British horseracing, gaming machines, virtual racing or indeed, any available betting product. There is no relevance or relationship that Racing could substantiate. The Bookmakers' Committee believes that the Levy applies only to non-overseas bookmakers and only then on their British horserace betting business.

Conclusion

1.48 Racing is, in the eyes of many including the Bookmakers' Committee, unfairly protected from the realities of a free market environment by a subsidy that is outdated and which interferes with competition to the detriment of both betting customers, bookmakers and ultimately the long-term health of the horseracing industry.

1.49 All parties should work together to find a replacement for the Levy which allows Racing and Betting to work commercially and effectively, and to take the burden away from Government over the next 3 years.

[7] Racing submission Page 7, Paragraph 2.

2 INTRODUCTION

2.1 The Bookmakers’ Committee wishes to re-iterate its recognition of the Board’s efforts in attempting to modernise the Levy process and generate more time for a decision to be reached internally, with a view to avoiding the necessity for a determination to be made by the Secretary of State.

2.2 As the Board is aware, the Bookmakers’ Committee submitted its recommendations for the 50th Levy Scheme, per its statutory responsibility, much earlier in the year than has previously been the norm and acknowledges that a determination by Government would be unhelpful for both the betting and racing industries.

2.3 In order to assist the Board by addressing the issues raised by Racing and in the spirit of co-operation, the Bookmakers’ Committee welcomes the opportunity to comment.

2.4 The Levy is not a payment for the British horseracing product and is unrelated to any perceived commercial value of British horseracing to bookmakers. That consideration is therefore irrelevant to the key drivers behind an agreement or determination of any particular Levy scheme; the key drivers being the capacity of bookmakers to pay on the one hand and the needs of Racing for Levy funds to be applied as defined in the relevant legislation on the other.

2.5 It is not therefore reasonable for Racing to make its submission based on a framework that reflects a commercial relationship. The Levy is not a commercial relationship, it is a statutory mechanism. As such, for Racing to attempt to argue its ‘needs’ by utilising a commercial framework is, from the outset, fundamentally flawed.

2.6 The Bookmakers Committee has great sympathy with Racing's plight and we recognise its desire to fund a thriving sport. However, with the unsustainably high level of funding transferring from Betting to Racing (despite its reducing relevance to betting consumers in the UK, and despite the worst economic situation for a generation), Racing needs to look at the flows of that funding in its entirety and organise itself appropriately, to deliver the funding where it is most needed. Racing cannot reasonably expect to continue to increase the funds received from TV pictures and also retain the same level of Levy.

2.7 The time has come for all stakeholders to accept and address the reality of:

2.7.1 the declining popularity of betting on British horseracing, and

2.7.2 the unsustainably high level of funds transferring from Betting to Racing.

Only then will we be able to work together on a commercial solution which ensures a strong racing product / industry, a reversal in the declining betting trends and an appropriate funding mechanism.

2.8 In setting out its position within its submission, Racing appears to adopt contradictory and conflicting positions. Racing indicates that they are committed to a process of negotiation to arrive at what they term a ‘reasonable amount’, whilst at the same time setting out what that ‘reasonable amount’ is.

2.9 Further, Racing states that it is not possible for the Bookmakers' Committee to suggest a scheme which addresses the needs of Racing until it is aware of Racing's needs and yet Racing has obviously seen fit to arrive at what it terms a 'reasonable amount' without appropriately addressing the issue of bookmakers' capacity to pay.

2.10 Racing chooses to highlight that the relative contribution of the betting industry has decreased since the early 2000's, whereas there are higher payments from owners and other racing consumers (for example race goers, media right's consumers and sponsors). It fails to acknowledge that, using Racing's own figures, over the same period bookmakers' contributions to Racing increased by 33% from £120M to £160M. Further it fails to acknowledge that perhaps the most significant of major sponsor of British horseracing is the betting industry.

2.11 Racing argues at several points in the document that it is not getting its 'fair share'. We contend that this is absolutely wrong; Racing is getting its fair share and more.

2.12 The 'fair share' element is generated through a gross profits system which reflects the attractiveness to betting consumers in a free market where they can choose to place bets on a variety of interests; the 'more' element can be attributed to the excessive additional TV picture rights payments Racing receives following the competition for rights that accompanied the introduction of TurfTV in 2008.

2.13 'Market share' is however a different matter and the market share (the popularity of British horseracing with betting consumers) is in decline, continuing the trend of the past 10 years. The racing authorities are not only aware of the causative issues behind this but have driven the policies behind them despite the negative effect on bookmakers' income from British horseracing and thus Racing's income from the Levy (examples include accepting sponsorship from non-Levy generative bookmakers; 48 hour declarations; streaming of pictures via the internet; and the saturation of accessible TV channels by racing coverage). All of these detract from betting consumers betting in the most significant Levy generative areas, LBOs.

2.14 Interestingly, Racing attributes the prolonged period of substantial growth in profits for the betting industry to liberalisation of the market, including extended opening hours and the relaxation of advertising restrictions, as well as product diversification. It does not attribute any of that to a contribution from Racing.

2.15 One of the areas upon which Racing appears fixated is that in its opinion, racehorse owners are effectively funding the sport. This would seem to be absolutely correct. Racehorse ownership is not a profession for the owners but exactly what they state, a sport, and in that regard, little different from for example golf, sailing and a plethora of other activities. Golfers would not expect any of their annual outlays to be paid for by somebody else and it is difficult to see why Racing should feel it should not be the case for racehorse owners.

2.16 There is a specific reason why bookmakers contribute to Racing via the Levy, which seems to have been forgotten by Racing; it is a replacement for the anticipated reduction of racecourse gate receipts following the liberalisation of the betting market through the introduction of off-course LBOs in 1963.

2.17 In this, and other areas, Racing does appear to question the law as it pertains to the Horserace Betting Levy and the legal basis for the stance adopted by the Bookmakers' Committee on disputed points. The Bookmakers' Committee maintains its previously stated (and in some cases argued) positions and believes that, should it be necessary for a court to determine the rights or wrongs of a particular issue, it would prevail.

2.18 The Bookmakers' Committee considers the Levy to be an anachronism in that it no longer truly satisfies the purpose of its creation (compensation for reduced attendances in light of the legalisation of LBOs) and is seen as a method of transfer of funds from Betting to Racing. The circumstances and context in which it was created are no longer relevant, and the advancement of technology and changing demographic interests render it unable to undertake the role for which it was intended. It is no longer fit for purpose and consideration must now be given by government to either restoring its relevance or ending it.

2.19 A replacement for the Levy should allow Racing and Betting to work commercially and effectively, and take the burden away from Government over next 3 years. To be successful, it will require engagement and support from all interested parties.

2.20 Racing is, in the eyes of many, an industry unfairly protected from the realities of a free market environment by a subsidy that is outdated and detrimental to both betting consumers and bookmakers.

3 A ‘REASONABLE LEVY YIELD BASED ON THE 2002 DETERMINATION’

3.1 Racing bases its economic argument in Section 3 of its submission under the heading:

‘Reasonable Levy Yield based on the 2002 Determination.’

3.2 By doing so, Racing’s argument is fundamentally flawed from the outset and the economic modelling applied thereafter, in itself highly questionable, (as shall be demonstrated in Sections 4 & 5) renders its arguments without practical value in respect of the 50th Levy Scheme.

What is ‘Reasonable’

3.3 Racing’s submission states that the Levy should be calculated as a reasonable amount but no formal definition is provided of what is meant by reasonable.

The Use of Yield (vice Mechanism)

3.4 The language of the statute instituting the Levy sets out the mechanism by which a Levy is to be devised and created. It does not refer to a certain sum being paid from bookmaking to Racing, and from the outset recognises the fluctuating fortunes of competitive markets by reference to the fact that it needs to reflect the capacity of bookmakers to pay.

3.5 By definition, such a mechanism whether it be statutory or otherwise does not support an argument to establish a target yield.

3.6 It is the role of the Levy Board not to fix the amount of levy paid each year by bookmakers but, if possible, to reach agreement with the Bookmakers’ Committee on the rates, terms, conditions and definitions to be applied during the following years’ Levy scheme.

3.7 This was re-iterated by the Levy Board executive in papers to the Board as recently as 24th June 2010.

‘The Levy is not a target figure, however useful that may be, it is a mechanism based on gross profits.’

3.8 It is therefore irrational for Racing to establish what it perceives as a ‘reasonable’ yield and then artificially create an argument to support it. The amount generated by the Levy is not and cannot be ‘fixed’, nor can it be placed within a bounded range, because it is entirely dependent upon the profitability of British horseracing. This in turn depends on its popularity with the betting public and also, results.

3.9 From the outset of its submission Racing is fixated, incorrectly, on yield:

‘...to arrive at what the amount should be’

occurs as early as page1, line 5 of the Racing submission. This is either to entirely misunderstand the Levy process and its methodology, or it is a deliberate attempt to mislead.

The Use of the 2002 Determination as a Reference Point

3.10 Racing has chosen to base its main arguments on 2 highly questionable points of reference:

3.10.1 The 2002 Determination; and

3.10.2 A misinterpreted secondary element within the 2002 Determination.

3.11 Racing's choice of both of its points of reference is illogical, except possibly for the fact that it is perhaps the only starting point from which to build an argument to support the identification and achievement of a 'target yield', however tenuous.

3.12 When seeking guidance in respect of an annually occurring event, and in line with normal business practice, it is more usual for interested parties to use as their reference point the most recent (and therefore most relevant) evidence. When attempting to establish a basis for discussion, negotiation of a new scheme, or during a determination in respect of the Horserace Betting Levy, it would therefore be reasonable to refer to either the last agreed scheme or the last determined scheme.

3.13 If Racing's intent was to use a determination as opposed to an agreed scheme as its reference point, the 47th scheme would be more appropriate.

3.14 Of note on the issue of recency and relevance, for Racing to utilise as its apparent end point of 2008 is also questionable. To ignore 2009 data is to ignore the effect of the continued decline of popularity with betting consumers of British horseracing and the most significant economic downturn for a generation.

3.15 It appears however, that Racing has ignored the determination of the 47th Levy Scheme in order to avoid addressing the issues associated with the introduction of TurfTV, the resultant significant increase in costs to bookmakers, the financial benefit gained by Racing (in particular racecourses) and the comments made by the Minister during his determination.

3.16 In its reference to the 2002 Determination, Racing compounds the flaws in its argument by ignoring the Secretary of State's principal ruling, relying on misplaced and unsubstantiated assumptions in respect of what it (Racing) considers was her intent. To concentrate on and emphasise what is a secondary element of the 2002 determination can only be interpreted to have been chosen as a means of supporting Racings already weak argument.

3.17 Racings stated justification for using this particular determination is that:

'...we have identified one occasion on which a reasonable amount has been identified. By definition, a Secretary of State's determination is reasonable. In 2002 the then Secretary of State did so, identifying a range of £90-£105M as the yield from the 41st scheme which she determined'

and that:

'In other words, having conducted an investigation based around needs and capacity to pay, the Secretary of State considered it reasonable that the 2002/03 levy amount would be in that range.'

3.18 Racing's perception of what was actually said and the ease with which they appear to have interpreted not only the intent of the Secretary of State but also the manner in which they have tried to manipulate its interpretation by others is disingenuous at best.

3.19 Hansard records the Secretary of State's determination as follows:
'In all the circumstances, ***I am therefore minded to determine the 41st scheme on the basis of off-course bookmakers paying an average of 9 per cent. of their gross profits on horseracing betting.*** *(As on-course bookmakers will not be directly affected by the tax changes I am minded to continue the flat fee arrangements of the 40th levy scheme). My officials will be working with the Levy Board so that the details of the scheme can be confirmed and promulgated in time for it to take effect from 1 April.*

As to the sale of picture and data rights, it must be a cause of considerable disappointment that a full measure of agreement on the commercial terms which should apply has not yet been reached. Against this background of uncertainty and outstanding legal disputes I do not feel able to accept the Bookmakers' Committee argument that the 41st scheme should require only a nominal contribution from bookmakers from 1 May 2002. I have, however, taken account of the commitment from the British horseracing Board that any payments in respect of licences to use pictures or data which are purchased by that date will be offset against levy payments which the bookmakers concerned are liable to make thereafter.

As a result of these uncertainties ***it is hard to forecast how much the 41st scheme, determined in this way, will yield; but, on the basis of forecasts previously provided by the betting industry, it would be in a range from £90 million to £105 million in 2002–03. A lower yield would reflect a lower level of profits.*** *The scheme should enable both the betting and racing industries as well as punters themselves to share in the benefits flowing from the new tax regime; and enable the Levy Board to meet its own liabilities.'*

3.20 It is of paramount importance to note that in her determination the Secretary of State identified first the mechanism to be utilised; the potential yield was secondary and a consequence of the principal decision.

3.21 It does not follow therefore, and it is illogical to argue, that the Secretary of State considered it reasonable that the 2002/3 Levy amount would be in that range.

3.22 Estimates of the potential yield resulting from the determined mechanism were recognised as;

3.22.1 secondary to the establishment of the scheme; and

3.22.2 dependent on the profitability of bookmakers.

3.23 Racing's report does at one point reference 'enhanced LBO picture rights' concentrating on the 'most quoted example' of SIS, but only introduces the subject in order to discount it as irrelevant stating that the effect of both SIS and TurfTV contracts in respect of the 50th Levy Scheme will be limited.

3.24 What Racing chooses to ignore in its entirety is the massive and immediate 46%[8] increase in direct costs that followed the introduction of TurfTV, the huge injection of capital to Racing that followed from bookmakers (the same, single and tied source as Levy contributions) and most importantly the comments of the Minister in his 47th determination relating to the potential for it to be considered at another time.

3.25 Racing's decision to bypass the 47th Levy Scheme Determination removes it from having to address the single biggest issue in respect of the transference of funds to British horseracing from bookmakers; the additional £18M (2009/10) per annum received by Racing (racecourses) since 2008 following the introduction of TurfTV at an estimated additional cost to bookmakers of £29.4M[9] per annum (2009/10).

3.26 The 47th Levy Scheme was referred for determination primarily because of disagreement over whether the capacity of bookmakers to pay levy had been or would be reduced by the considerable increase in the cost of acquiring live TV coverage of British horseracing. An offset of the incremental costs was proposed but not accepted.

3.27 During the determination of the 47th Levy Scheme, the Minister accepted that an argument could be put forward

'that bookmakers subscriptions to the new service constitute a commercially-based flow of money to racing'

and further stated

'I therefore accept that it may have a material effect both on bookmakers' ability to pay and on the needs of racing'.

3.28 At the time, it was said that, because the extra cost was not known, the impact could not be adequately assessed and the Minister stated that

'In time its full economic impact on bookmakers, racecourses and on horseracing generally may become clearer.'

3.29 This impact is now clear and is addressed in the Bookmakers' Committee recommendations for the 50th Annual Horserace Betting Levy Scheme. It is clearly the case that the increasing transfer of funds from bookmakers to Racing via media rights should be fully taken into account in any approach to agree or determine the Levy.

3.30 The introduction since 2007 of upstream competition for the TV picture rights for British horseracing without the ability to compete downstream (because both TV services are 'must haves') has led to the unsustainably high transfer of funds from Betting to Racing, on a 'product' which is fast losing its relevance to betting consumers.

---

[8] FY07/08 (£38.4M) to FY08/09 (£56.2M).
[9] Includes VAT. Some VAT is recoverable by some operators.

3.31 Whilst there has been *upstream* competition for these rights, there is no effective *downstream* competition in the supply of the pictures to betting shops as the rights are controlled by individual companies - pictures from 31 of the 59 British racecourses can only be bought from TrufTV and the remainder (28) can only be bought from SIS. Accordingly, betting shop operators cannot effectively use competition of supply to negotiate commercially favourable costs.

3.32 In the past there was clearly an acceptance from all parties that levy and picture rights costs went hand-in-hand in assessing the overall transfer of funding from bookmakers to Racing, and that it was sensible to ensure picture costs were affordable so that racing could be promoted effectively in betting shops in order to maximise betting shop customer participation in betting on British horseracing (i.e. maintaining its betting market share) and therefore to maximise Levy returns. However, the emergence of upstream competition and fragmentation of supply of pictures has over-ridden this approach and distorted the way in which funds transfer from Betting to Racing.

3.33 This has resulted in a situation where costs for picture rights to show British horseracing in betting shops have increased by 64%.[10]

3.34 It is important to state, therefore, that the Levy (which, in the context of the overall transferring of funds from Betting to Racing, is misguidedly the subject of most of the media focus and the attention of the racing industry) is of reducing significance in respect of the transfer of funds from Betting to Racing.

3.35 The increasing picture costs have been introduced into the market at a time when betting on British horseracing continues to decline, indeed it is declining at a faster rate than ever, constituting just 43% of over the counter (excluding machines) betting shop profits for the 48th Levy Scheme (2009/10) compared to 49% for the 43rd Levy Scheme (2004/5).

3.36 Its popularity as a betting medium is in decline in common with the experience of horseracing around the world. British horseracing suffered specifically from the impact of a 'closedown' from the foot and mouth epidemic[11] in 2000/01 (which led to a complete shutdown of British horseracing on 28th February 2001, during which time betting customers bet on other things and in some cases, never returned). Most recently, its popularity has suffered from the introduction by some of its own stakeholders (certain groups of racecourses) of upstream competition in picture rights to LBOs. This has directly led to:

3.36.1 a reduction in the number of outlets showing pictures from all British racecourses (approximately 5 months in 2007 when less than circa 30% of all UK LBOs carried pictures from the 31 TurfTV courses; and

3.36.2 the inevitable "filling in" of product gaps by SIS and TurfTV (i.e. gaps where they are not carrying rights to the live racing at particular times) which led to a 'crowding out' of coverage of British horseracing in betting shops, and difficulties in presenting it as prominently as before upstream rights existed.

[10] FY07/08 (£38.4M) to FY09/10 (£63.2M).
[11] The only practical recent example of a complete and lengthy shutdown of British horseracing.

Both of these factors have inevitably reduced popularity of betting on British horseracing, reducing Levy yields accordingly.

3.37 In previous years, there would have been no question that betting shop operators would want / need to show pictures from all British horseracing in order to maintain a competitive and sustainable business, but with reducing relevance, the popularity of British horseracing at an all-time low (and declining faster than ever), and with the total costs of providing betting on British horseracing unsustainably high (picture costs and Levy combined), British horseracing is rapidly approaching a "tipping point" with regard to its profitability and viability for betting shop operators; indeed some would say we are already there.

3.38 Unless the total costs of providing British horseracing can properly reflect its value to betting shop operators, it is logical to assume that some operators will stop taking pictures to ensure profitability. Whilst this will clearly lead to some fall in betting on British horseracing for individual operators choosing that route, the circa 60%[12,13] substitution to other products seen during the foot and mouth epidemic (2000/01), plus the huge reduction in costs, would more than compensate and ensure that the residual betting on British horseracing remained profitable.

3.39 In considering the 50th scheme, therefore, betting operators' Capacity to Pay needs to take into account the overall, and unsustainable transfer of funds from Betting to Racing, on a product which is fast losing its relevance to UK betting consumers. Far from any increase, the Levy needs to be reduced to ensure that the overall costs to bookmakers can continue to make betting on British racing viable. The Secretary of State accepted in the determination of the 47th scheme that (his quotes re costs of pictures being valid[14,15]), those costs have now crystallised and there can now be no assessment of bookmakers' capacity to pay which does not take into account the overall costs.

3.40 Racing’s choice to base its submission on the 2002 Determination, the secondary reference made by the Secretary of State, the use of target yield and what it perceives as reasonable, serves only to undermine the arguments presented by Racing.

---

[12] Lond on Economics, ‘Economic Assistance in the Determination of the 47th Horseracing Levy’ January 2008 (P, 18)
[13] Figure 5, ‘Product Crossover’ shows that 61% of horseracing customers already bet on other products and can therefore reasonably be expected to substitute betting on other products for horseracing if horseracing did not take place.
[14] *‘I therefore accept that it may have a material effect both on bookmakers’ capacity to pay and on the needs of racing’.*
[15] *‘In time its full economic impact on bookmakers, racecourses and on horseracing generally may become clearer.’*

4 ECONOMIC ANALYSIS OF RACING'S SUBMISSION – ERNST & YOUNG[16]

Executive Summary

4.1 The Racing report argues for a substantial increase in the Levy yield despite acknowledging that betting on British horseracing has been in decline and that the funding contribution to Racing from other sources has been increasing. Evidence on the increasing costs of racing is unconvincing and is based on a hypothetical model rather than actual numbers.

4.2 The report uses three approaches to quantify the Levy based on:

4.2.1 Racing's needs.

4.2.2 A reasonable share of the benefits.

4.2.3 A market approach.

4.3 The Racing's needs approach assumes that the although only a consequence of the principal ruling, the 2002 estimated yield represented a fair share of Racing's costs and then makes a number of assumptions to take account of subsequent changes to needs. It arbitrarily assumes that the Levy was intended to cover 100% of regulation and integrity costs and applies an actual cost increase (of 54%) to these. It then applies an RPI inflation factor to the remainder of the Levy, without any evidence that this reflects cost changes. It also allocates all losses associated with additional fixtures (together with an overheads and return uplift) to the Levy plus owners transport costs associated with the additional fixtures. There is no clear demonstration that this represents a fair increase in the funding needs of Racing taking account of changes in costs and non-Levy sources of funding.

4.4 The reasonable share of benefits approach is even more theoretical. It assumes that the 2002 estimated yield was a fair share of the benefits to Betting. It then assumes, without any supporting evidence, that the benefits to Betting have increased in line with inflation and the increase in the number of fixtures, with the latter effect adjusted by a 50% substitution factor. This produces benefits growth lines that bear no relation to the actual increases in gross win or profits from British horseracing, which are less theoretical indicators of the change in benefits to Betting.

4.5 The market approach uses a recognised model based on bargaining power. The key parameters in this model are upper and lower bounds based on assuming that all bargaining power is either with Racing or Betting respectively. A point between these two extremes is then chosen based on the balance of bargaining power. The approach as applied could be improved by first optimising the number of fixtures and then fully considering the costs of both Betting and Racing. It is likely that the lower bound at least would be brought down by these refinements.

[16] In preparing its response to Racing's submission, the Bookmakers' Committee sought the assistance of the independent consultants Ernst & Young. Their key conclusions are summarised in Section 4. Ernst & Young, 'Critique of the Submission of British Horseracing', 3 August 2010.

General issues

4.6 According to the HBLB the following issues should be considered when establishing a reasonable Levy yield to Racing:

4.6.1 Betting's reasonable capacity to pay

4.6.2 Racing's reasonable needs

4.6.3 All prevailing economic, fiscal and social circumstances as may relate to Betting and Racing

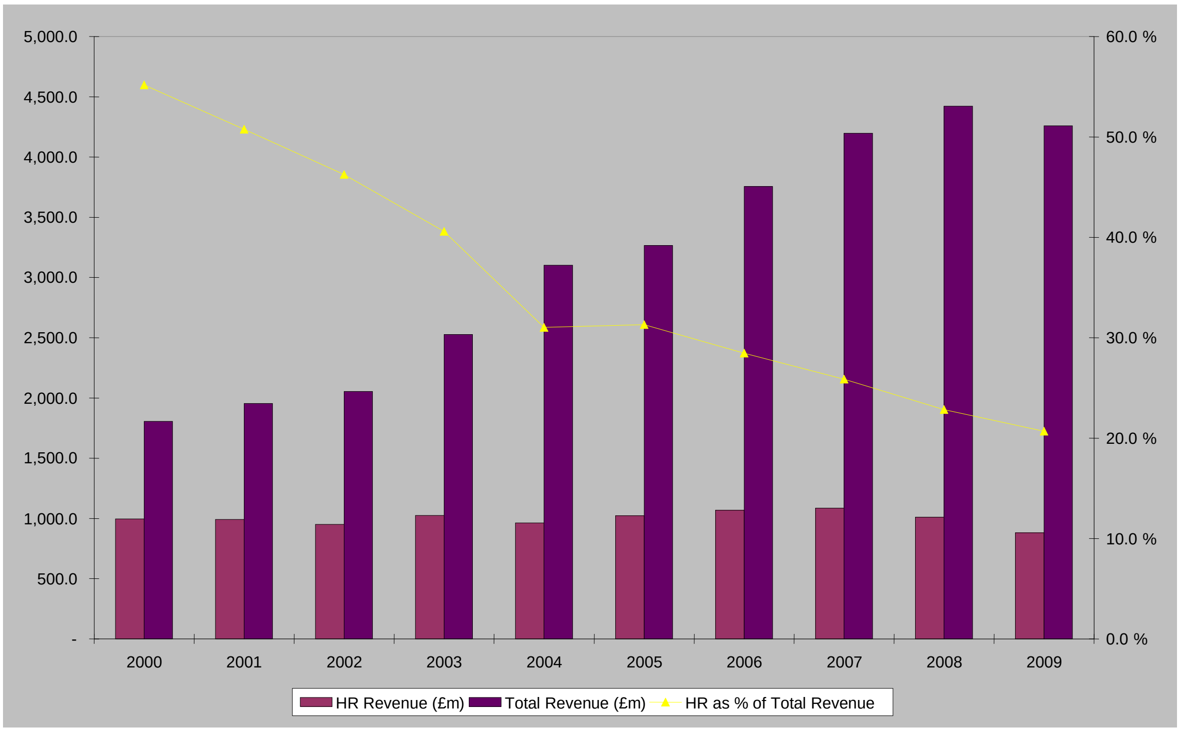
4.7 The submission of Racing deals primarily with Racing's needs. The impact of economic, fiscal and social circumstances is essentially ignored in the submission. The economic and fiscal circumstances have had a recent impact on the turnover and profits of Betting and therefore on Betting's reasonable capacity to pay and should be taken into account when determining the Levy.

4.8 In addition, there is increasing competition for consumers' spending not only with many new products within the gaming industry but also other types of leisure activities. Participation in betting on British horseracing and betting on horses in general may be losing its attraction, which should be assessed by analysing market trends over a longer period of time.

4.9 Racing's submission discusses the pre-eminence of British racing as being the aim of the Levy. However, the numbers on horserace betting suggest that racing is now a mature industry which is in decline. It is not the responsibility of Betting to subsidise a declining industry purely using arguments of its pre-eminence.

4.10 Contrary to Racing's statement that betting on racing is as popular as ever, **Figure 1** shows that the share of British horseracing betting revenues has been consistently decreasing whereas new businesses created by bookmakers and unrelated to British horseracing have been growing strongly. In 2009 British horseracing betting represented only 20.7% of bookmakers' revenue, compared with 55.2% in 2000.

Figure 1 Share of Horseracing Betting Revenue in Bookmakers' Total Revenue.



4.11 Racing's submission states that the Levy should be calculated as a reasonable amount but no formal definition is provided of what is meant by reasonable.

4.12 The submission of Racing proposes three different approaches to calculate the reasonable amount in 2010. Moreover, Racing states that under the new process of setting the Levy "any matter that is relevant in the circumstances at [the] time…should be taken into account", which requires an evidence based approach based on rigorous analysis.[17] It is the view of Ernst & Young that Racing's submission cannot be considered as a document using evidence based approach.

Racing Needs Approach

4.13 The Racing needs approach starts with the 2002 Determination.

4.14 This approach is based on assumptions which in our opinion are questionable. The first inherent assumption is that the 2002 assumed yield was correct. Obviously, if the starting point for Racing's calculation is wrong, the final result will be also incorrect.

4.15 Second, Racing states that it has experienced significant cost inflation since 2002/03. It is suggested that the numbers from 2002/03 should be adjusted to 2009/10 using Retail Price Index (RPI), which changed by 25% since 2002/03. Racing states that this is a conservative estimate of the inflation of the costs of horseracing, but provides no evidence to support this.

4.16 Clearly, one needs to use a discount factor to compare money between different time periods. The question, however, is which discount factor is most suitable to compare expenditures in the horseracing industry over time. The submission

[17] Racing submission Page 1, Section A, Paragraphs 4-5.

suggests using RPI as a discount factor which may not be the right approach because RPI includes mortgage interest payments that are irrelevant for the changes in the costs of the horseracing industry. Between years 2002/03 and 2008/09 the RPI index increased by 23.5%. If mortgage interest payments are excluded, then the increase is reduced to 16.5%. Furthermore, the measure now used as a target by the Bank of England is the Consumer Price Index (CPI), which increased by 12.1% between years 2002-03 and 2008-09. Another possible choice of discount factor is GDP deflator which is a measure of the level of prices of all new, domestically produced, final goods and services in an economy. Depending on the discount factor used, the present value of 2002/03 Levy may differ significantly.

4.17 In any case, it is not clear why a hypothetical inflation factor has to be applied to actual costs at all. The analysis is invalidated by not using the actual movement in the costs of horseracing.

4.18 In addition to the general inflation adjustment, Racing states that there was an increase in centrally funded regulatory and integrity costs which have increased from £16.2m in 2002/03 to £25m in 2009/10 as a consequence of fixture expansion primarily and the increasingly complex betting environment.[18] This represents a 54% increase which by far exceeds the rate of inflation. There is no discussion, however, in the submission of what is meant by increasingly complex betting environment and how this may increase the regulatory and integrity costs.

4.19 The analysis here is inconsistent in applying an actual cost increase to integrity (perhaps because it is higher than RPI?) and RPI to the rest (perhaps because the actual increase has been less than RPI?).

4.20 Racing states that efficiencies in regulatory and integrity provision have been introduced by the industry which resulted in a reduction in the cost per fixture. The scope for further significant cost reductions is however seen as limited. These statements are again not supported by evidence. There are no details provided about the actions which were undertaken to control costs. Also, Racing does not show statistics to support the statement that costs per fixture decreased. However, even if these costs decreased, it cannot be taken as evidence of efficiencies. It may be expected that regulatory and integrity costs per fixture decreased because they represent, in fact, fixed costs which are not related directly to the number of fixtures and hence decrease if calculated per fixture.

4.21 The calculation also assumes that integrity costs should be fully covered by betting, even though the 2002/03 assumed yield covers only a share of Racing's overall needs. It seems that this assumption that Betting should bear 100% of the integrity costs but only a share of other costs is designed to maximise the Levy increase and has no other reasonable basis.

4.22 The approach also adds in the estimated losses from additional fixtures that have been "required from the Betting industry". If the calculation of these losses is correct, then there is a rationale for arguing that this is an addition to the needs of Racing that has been imposed by Betting but only if Betting has truly required these fixtures. There is no evidence that such additional fixtures were 'required by the

[18] Racing submission Page 5, Bullet 1.

Betting industry'; in point of fact, HBLB records provide evidence of completely the opposite view as follows

'The Chairman of the Bookmakers' Committee confirmed the unconditionality of the offer [in relation to the 49th Levy Scheme] in that it was not based on a finite number of fixtures'[19]

Additional fixtures were created to maximise the yield and bookmakers have no power over the number of fixtures. There is, however, an additional estimate of £4m for additional overheads created, forgone non-race day revenue and an additional return which seems difficult to justify. If this is taken out the incremental contribution of the additional fixtures is £1.5m instead of the £5.5m quoted.

4.23 What Racing fails to reference in its submission is the undertaking provided by the BHB to the OFT in 2004, in respect of fixtures. Following the notification by the BHB and the Jockey Club of their governing agreements, OFT concerns about lack of competition in racing were addressed by the BHB agreeing to enter into certain commitments. These included a commitment to expand the fixture list by approximately 30% to a provisional target of 1500 fixtures by January 2006.

4.24 Racing states that additional fixtures are intended to increase betting operation profits on racing but also are intended to increase profits on other products available in betting shops, particularly FOBTs/gaming machines. Moreover, Racing states that it does not benefit from these profits but bears the full cost of the expansion, while the development and promotion of these other products has deflected betting away from racing.[20] These statements are not supported by evidence and it seems just as likely that improvements in the consumer offer in betting shops has increased betting on horseracing beyond what it would have been otherwise.

4.25 It is also proposed that owners' estimated transport costs of £6.5m for additional fixtures should be added to the Levy. Given that these costs have been willingly accepted by owners it is not clear what the justification is for this.

4.26 The levy on bookmakers is a result of the inability of Racing to generate sufficient revenues in a commercial setting to cover their own costs. The Levy currently corrects this form of market failure. Rather than attempting to seek the maximum settlement possible from bookmakers, the racing industry needs to define and agree their residual financial needs (by assessing the costs associated with the realistic needs of Racing and alternative commercial revenue streams), at which point the ability of bookmakers to subsidise racing activity should be considered in reaching an agreement acceptable to both parties.

4.27 Finally, the approach fails to address Racing's real needs by only focusing on theoretical cost increases and losses incurred on additional fixtures. To fully reflect needs it should also take account of other sources of funding (for example consumers) which are shown by the report to have been increasing rapidly. A full and detailed profit and loss account for Racing is needed to provide full quantification of needs and to demonstrate the size of the funding gap.

---

[19] HBLB 'Minutes of the 569th Meeting' held on 18th March 2009.
[20] Racing submission Page 3, Bullet 5.

Reasonable Share of Benefit Approach

4.28 The reasonable share of benefit approach again starts with the range assumed in the 2002 Determination, which in the first step is adjusted by RPI of 27%. In the second step a pro-rata fixtures increment is calculated using the rate by which fixtures increased between 2002/03 and 2009/10. In the third step, the fixtures increment is reduced using a substitution effect of 50%. In our view, this approach does not reflect the benefit to Betting as it uses a number of arbitrary assumptions about how that benefit has moved over time, none of which is supported by evidence.

4.29 It is assumed that the 2002 range reflects a reasonable share of the benefits of horseracing to the betting industry. It is then assumed that these benefits have moved subsequently in line with RPI. There is no evidence to support this. Indeed, gross win and profits from horseracing have not increased with inflation and could be said to give better indications of how the benefit to betting has changed over time.

4.30 The hypothetical inflation-based increase in benefits is then further adjusted to reflect the growth in the numbers of fixtures. There is recognition that not all of this growth would flow through in benefits to Betting in the form of gross win or profits. For this reason an arbitrary 50% substitution factor is applied. No analysis is presented to demonstrate that benefits to Betting would increase in line with fixtures or that the 50% substitution can be justified.

4.31 If, by contrast, the assumption of this approach was that benefits to Betting would follow costs to Racing, then it is not clear why this approach differs from the previous one in not considering integrity costs separately. In any case, no evidence is presented to suggest that costs to Racing and benefits to Betting would increase by the same percentage over time. Indeed, it is the divergence of these that leads to disagreement on the level of the Levy.

4.32 If, however, the intention is that this is a cost based approach, then there is also a problem with the treatment of the additional fixtures. This approach inherently assumes that the average cost per fixture is constant, a statement which in fact is contradicted in Racing's submission because Racing states that the costs per fixture have decreased.

4.33 The costs of Racing may be in general separated into fixed costs and variable costs. The first ones are not dependent on the number of fixtures, such as costs related to maintenance to infrastructure, partly integrity costs, etc. The variable costs change with the number of fixtures. It is likely that they increase in the number of fixtures in a constant manner, i.e., the incremental costs are constant. A straightforward multiplication of the 2002/03 target Levy by the pro-rata fixtures increment ignores the presence of substantial fixed costs.

4.34 Again, contradicting the computation method, Racing states that there is a non-linear relationship between the size of the fixture list and total betting turnover on British racing, which is primarily due to the substitution effect which is assumed to be 50%. According to Racing the substitution effect may be also less than 50%, given the establishment of many fixtures in new time slots. Hence, Racing states that 50% represents a conservative approach which is clearly a subjective opinion.

4.35 The discussion in Racing's submission as to how an increase in the number of fixtures contributes to the revenues and profits of betting is very weak. There is no evidence on the relationship between these two and the magnitude of substitution effect which is simply assumed. Moreover, contrary to what Racing states, the 50% substitution effect is not applied to the benefits but to the cost basis of Racing.

4.36 In summary, this approach makes broad hypothetical assumptions about how benefits to Betting might have increased since 2002 without any supporting evidence.

Market Approach

4.37 The market model based on bargaining between Racing and Betting assumes the following:

4.37.1 a market based Levy is agreed in negotiations between Racing and Betting; and

4.37.2 Racing retains only 25% of the difference between minimum and maximum points

4.38 The Levy range suggested by the market approach on the basis of LBO earnings, excluding exchanges, telephone and internet, is in the range of £121-151m. When LBO earnings from sales of FOBT and other betting are added this increases the target range to £154-184m.

4.39 There are certain concerns with respect to the applicability of the bargaining model presented by Racing to the Levy negotiations and to the way the critical input values are determined in this framework. First, the model defines two extreme situations. The lower bound is defined as the minimum amount of money Racing will accept not to close down. The upper bound is defined as the maximum amount of money Racing may demand from betting industry, for which the latter will still be willing to provide horserace betting in their shops. Essentially, these are two extreme values for the Levy between which there is cooperation between Racing and Betting. There is no cooperation for the Levy set beyond these values. This case may be considered a standard bargaining situation between two parties. Obviously, the main challenges are determination of the extreme values for the Levy and how the bargaining powers are distributed among parties.

4.40 To find the lower and upper bounds the revenues and costs structure of both Racing and Betting needs to be analysed in detail. As discussed in the previous section, Racing's costs can be divided into fixed costs and variable costs, where fixed costs are not dependent on the number of fixtures and variable costs change with the number of fixtures. The revenues of Racing, which include contributions of consumers and owners, depend on the number of fixtures, but since these revenues do not fully cover the cost of fixtures we may essentially refer to net costs of fixtures meaning the difference between revenues and costs. On the other hand, the costs of betting are independent of the number of fixtures while Betting's revenues increase with the number of fixtures.

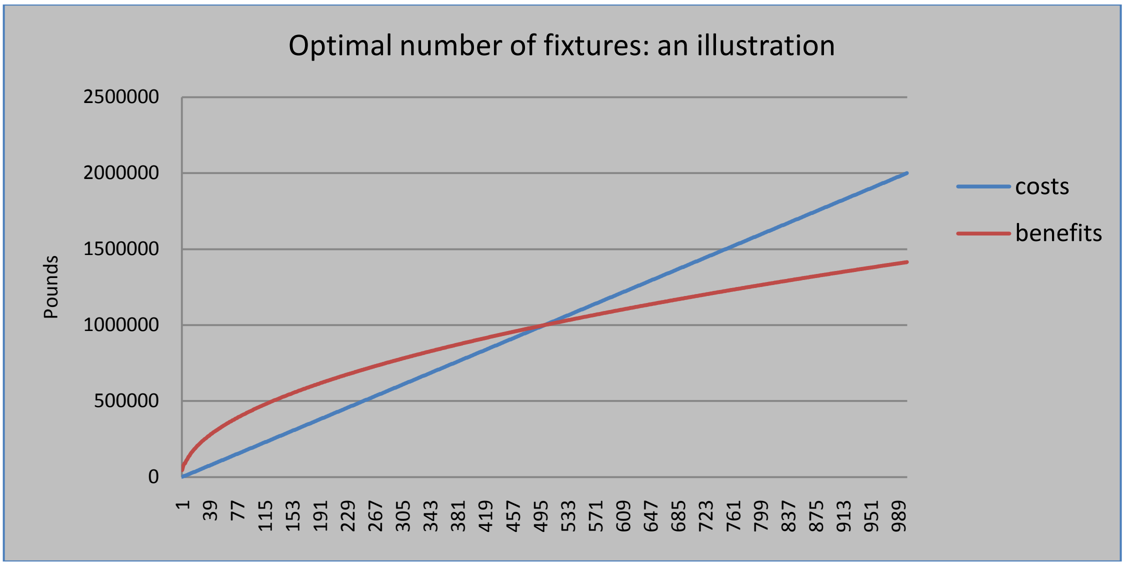
4.41 Having all the revenues and costs of Racing and Betting, the appropriate procedure to find the lower and upper bounds can be described as follows. Depending on who has the bargaining power in the extreme situations, either Racing or Betting will get all the profits. Hence, both parties are interested in maximizing the profits of Racing and Betting jointly; i.e., first they want to maximise the size of the pie and then decide how to share it. We may therefore treat all the costs and benefits of Racing and Betting as inputs into profit-maximization.

4.42 It may be expected that there are diminishing benefits from an increase in the number of fixtures to Betting and Racing. The first fixture certainly generates the greatest revenues for Betting and Racing with decreasing benefits from additional ones. The reason for this is as follows. The number of betting consumers is limited and their bids are distributed across all the fixtures. Adding one more fixture will make some of them switch and bet on the new fixture. The average number of betting consumers per fixture will decrease. Moreover, it is likely that each additional fixture attracts a smaller number of betting consumers because of less convenient timing. Hence, the number of betting consumers betting on new fixtures will certainly decrease and so will the incremental benefit from additional fixtures. Also, total racecourse attendance cannot grow linearly with the number of fixtures.

4.43 On the other hand, as discussed earlier, the incremental cost of fixtures is likely to be constant or maybe even increases. Hence, the expansion in the number of fixtures at some point of time becomes economically inefficient. One can potentially find the economically efficient number of fixtures, i.e., a number of fixtures for which the benefit is no smaller than the cost.

4.44 **Figure 2** below illustrates a hypothetical dependence between the number of fixtures, and their incremental costs and benefits. It is assumed that the incremental benefits of fixtures are diminishing while the incremental costs of fixtures are constant. The crossing point of the benefits and costs curves represents the economically optimal number of fixtures. We use the simple economic framework discussed above to state that the lower bound in the submission is not defined correctly.

<u>Figure 2</u> Optimal Number of Fixtures: An Illustration.



4.45 To find the lower bound one needs to estimate the minimum reasonable size of racing, which obviously depends on the number of fixtures. Assuming that Betting has the whole bargaining power it would make Racing choose optimally the number of fixtures shown by the cross section of the benefit and cost curves, where the cost curve represents a share of costs covered by Betting. If Betting covered full costs of additional fixtures the line would be shifted upwards resulting in a smaller number of fixtures. After choosing the optimal number of fixtures Betting would pay to Racing its share to cover the remaining fixed and variable costs, so that Racing does not close down.

4.46 The following information is needed to determine the lower bound:

4.46.1 fixed costs of Betting and Racing

4.46.2 incremental cost of additional fixtures to Betting and Racing

4.46.3 incremental benefits of additional fixtures to Betting and Racing

4.46.4 the share of costs paid by Betting in dependence on the number of fixtures (it may be constant in the number of fixtures)

4.47 The determination of the lower bound in the submission is not based on the information listed above and is therefore not theoretically valid. Moreover, if Betting would demand that Racing reduces the number of fixtures from the current level, the lower bound could be significantly lower than suggested by Racing.

4.48 On the other hand, the upper bound is determined assuming that Racing has the whole bargaining power. The question in this case is, however, whether indeed Racing follows profit-maximization as its objective.

4.49 If Racing maximizes profits, it would choose the same number of fixtures as Betting in the previous case, because at this level profits for both Racing and Betting are maximised. Betting would be requested to pay all the profits related to horseracing betting in the Levy.

4.50 However, it may be the case that Racing does not maximize profits but, for instance, sets a number of fixtures demanded by horse owners. In this case the number of fixtures would be bigger, including fixtures which bring losses for Betting. The chosen number of fixtures would be to the right of the intersection point at the level, at which Betting’s profits related to horseracing betting cover all the costs of additional fixtures. A number of fixtures determined in this way will be inefficient from the economic point of view.

4.51 To find the upper bound one needs the same information as for the lower bound. The upper bound determination depends critically on the number of fixtures and whether different betting products are considered to be complements or substitutes to British horseracing betting.

4.52 Once the lower and upper bounds are defined, one can make an assumption about the bargaining powers of both parties. Racing assumes that the bargaining power is on the side of betting industry which can demand 75% of the difference between the lower and upper bounds. This is clearly an arbitrary assumption which seems to be chosen to keep the Levy within a certain range consistently with the other two methods proposed in the submission.

4.53 Following the reasoning of the bargaining model Betting has two ways of influencing the level of the Levy – by determining the optimal number of fixtures and through the bargaining power itself. The determination of the number of fixtures is ignored in the framework proposed by Racing. In effect, the Levy may be at a much lower level than argued by Racing in the submission.

Increase in the Costs of Racing

4.54 Racing states that its costs, and in particular training costs, have increased significantly over time. Moreover, Racing claims that they have introduced efficiency measures to control costs, but there are no details provided about the actions which were undertaken. There is no analysis of the key cost drivers such as the number of employees, horses, etc. Without a thorough analysis of trends in costs any statements of Racing about efficiencies are not substantiated.

4.55 It may be the case that an increase in Racing's costs does not add any value to the betting industry at all. This increase may be due to inefficiencies on the cost side. For instance, an increase in training costs may be due to a lack of ability of Racing to negotiate prices or because of the uncompetitive structure of the training industry, which is able to impose price increases to the detriment of Racing. The submission states that higher training costs are largely reflecting higher costs of goods and services and do not reflect an internal "profit", but this statement is not supported by evidence. It is questionable why Betting should cover any inefficiencies of Racing.

4.56 Racing illustrates financial contributions to British racing in 2002, 2005 and 2008 stating that there was a very substantial increase in the contribution to British racing by owners.[21] For the reason stated above, the analysis of costs in absolute terms may be misleading and cannot be used directly to claim an increase in contributions. The fact that net training costs increased does not necessarily imply that the "reasonable" needs of racing increased. In fact the willingness of owners to continue to finance the majority of their costs acts as a reduction in the needs of funding from elsewhere including the Levy.

4.57 According to Racing, the financial contributions of owners to British racing increased substantially between 2002 and 2008. However, as illustrated in table on page 2, this contribution in percentage terms decreased from 50% to 46%. On the other hand, the contribution of the betting industry decreased from 19% to 15% and the contribution of racing consumers increased from 31% to 39%. The contribution of the betting industry increased from £120m in 2002 to £160m in 2008 which represents an increase by about 33%. At the same time the contributions of owners increased by 53% and the contribution of Racing's consumers by 105%. Hence, it is the consumers who are most increasing their share of racing costs rather than horse owners.

4.58 Racing states that there was a decrease in Racing's contribution despite enhanced bookmakers' capacity to pay.[22] However, in the submission there is no discussion or

[21] Racing submission Page 2, Table.
[22] Racing submission Page 2, final bullet.

calculation of the capacity to pay which would take revenues and costs related to horserace betting as a basis.

4.59 Moreover, Racing states that prize money decreased over time, which supposedly acts as a deterrent for existing owners to stay in the sport.[23] But according to the same report, fixtures have been on the increase, and according to the BHA, the number of horses in training rose by 12.5% from 2003 to 2009. This clearly contradicts the statement that there is a deterrent effect of prizes and requires a more detailed analysis to draw sound conclusions. In fact, the reduction in prize money combined with the increase in owners financial contribution suggests that the need for funding from the Levy could be reducing, although this can only be confirmed with a full picture of the costs and sources of funding of racing, something which is not provided by the submission.

4.60 According to Racing, horse owners cover a significant share of the costs which is seen as unfair. However, as pointed out by OCP[24], owners keep horses for pleasure and generally expect to incur losses doing so. Only a quarter of British training costs are recovered in prize money, and the pattern is repeated all over the world (except possibly in Hong Kong).

4.61 Racing states that the majority of expenditure is injected into the rural economy and is vital in supporting tens of thousands of jobs. Clearly, job creation is an important argument for any type of investment. However, it cannot be by itself a justification that the money is spent in the best way possible. In fact, more jobs could be created if money were spent differently. For instance, money spent on training could be used for a different purpose creating jobs in other industries which are no less valuable. We have also discussed in the previous section the issue of the economically inefficient number of fixtures, which may also be seen as money lost. The fact that a significant share of costs is covered by owners by choice cannot be taken by itself as an argument that costs need to be rebalanced.

4.62 Racing states that net training fees alone have grown by £150m between 2002 and 2008 as a consequence of higher training costs (due to increases in the cost of wages, feed, bedding and transport). On the other hand average prize money levels decreased. There is no detailed information provided which would support the analysis of trends in costs and assess possible reasons for these changes. Moreover, the fact that average prize money decreased may be due to an increase in the number of fixtures which as discussed earlier may not bring much benefit to the betting industry.

4.63 A more relevant figure to owners is prize money and costs per horse, not average prize money per race. As the average number of runners per race has decreased, an owner is more likely to win prize money. In addition, the likelihood of an owner winning prize money is directly proportional to the number of races; more races result in an increased chance of winning.

---

[23] Racing submission Page 2, Bullet 3.
[24] Organisation Consulting Partnership, Report to the Department of Culture Media and Sport, '47th Horserace Betting Levy Scheme, 21st January 2008

Betting's increased capacity to pay

4.64 Racing makes statements about an increase in pre tax and interest profits of the "Big 3" betting operators (William Hill, Ladbrokes and Coral) between 2002 and 2009, on which basis it claims an increase in Levy contributions. Moreover, Racing states that the betting industry has confidence in the medium term health of the market which is proved by the continued investments made. However, the investments made are certainly not related to betting on horses and, on the contrary, this indicates that the industry believes there are higher returns to investments in other market segments. The investment by itself represents no proof that the betting industry believes in the future of racing.

4.65 Racing acknowledges that there is a decrease in the betting industry's gross win from British racing and hence payments to Racing through the Levy, which it subscribes to leakages through exchanges and off shoring, termination of Levy contributions from Betting on all racing in LBOs and continued existence of LBO thresholds under the gross profits levy regime.[25] Although some of these 'leakages' present reasonable theoretical hypotheses for the decline in gross win from British racing, others do not. For example, 'LBO thresholds' is not a reasonable hypothesis for the decline in gross win, though it is for the decline in levy. However, it is important to note that the extent to which each may have contributed remains unproven. The reduction in interest in racing relative to other forms of betting could be just as great a driver of the change. This effect, together with some of the leakages mentioned, reduces gross win for those companies funding the Levy and is thus an argument for a lower capacity to pay and hence a reduction in the Levy.

4.66 The costs of the betting industry have steadily increased in the past years reducing bookmakers' capacity to pay, where, as discussed in the previous sections the capacity to pay should be computed using revenues from Betting on horses only. The betting industry has been forced to offset cost increases with efficiencies. Additional efficiencies have been provided by consolidation of bookmakers. A suggested increase in the levy on gross profits does not provide incentives to reduce the costs further.

4.67 As stated by the HBLB, Levy yield should take into account all prevailing economic, fiscal and social circumstances as may relate to Betting and Racing. Economic and fiscal circumstances changed drastically in the last two years having an impact on bookmakers' capacity to pay.

[25] Racing submission Page 3, Bullet 4.

5 ECONOMIC ANALYSIS OF RACING'S SUBMISSION - LONDON ECONOMICS[26]

5.1 A number of the specific recommendations that were made in previous London Economics' research should have been incorporated into the most recent LECG analysis; failure to do continues to leave the LECG paper methodologically flawed.

5.2 Given the significant methodological weaknesses associated with the LECG analysis, the Horserace Betting Levy Board should treat any assessment of the potential Levy based on the LECG analysis with extreme caution.

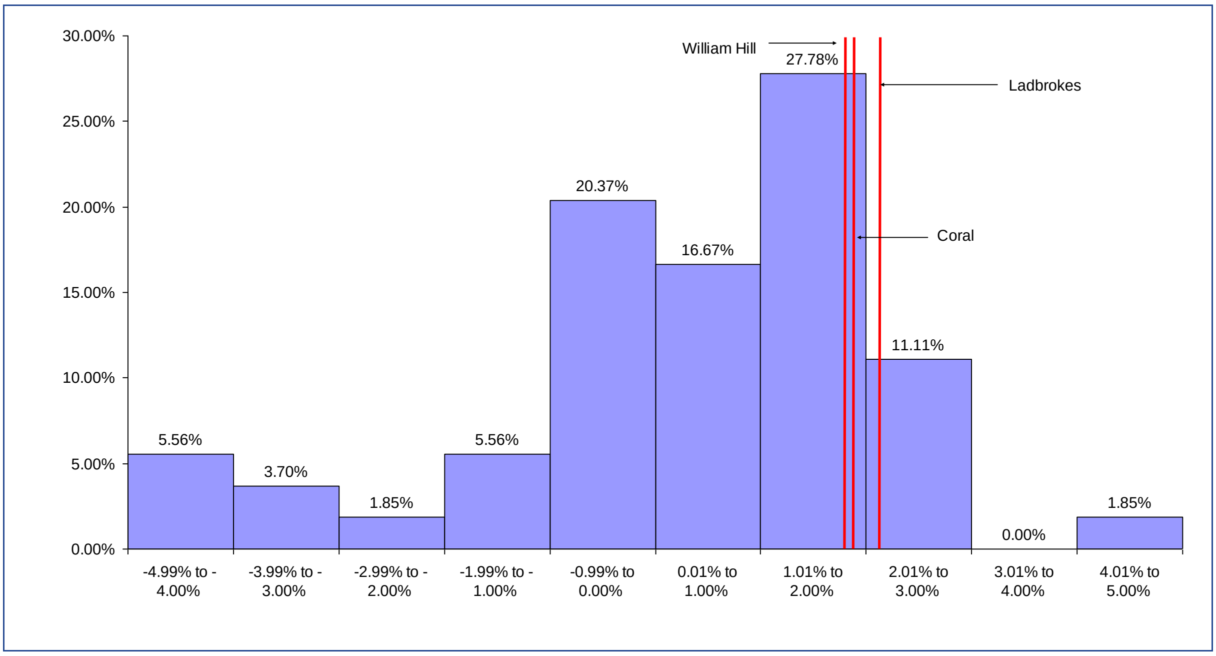
Representativeness of the 'Big 3' Bookmakers

5.3 The suggestion that the economic and financial performance of the largest three bookmakers is representative of all bookmakers continues to be a serious weakness of the LECG analysis. In particular, two of the three firms (Ladbrokes and William Hill) are constituents of the FTSE 250 indicating that they are two of the largest 250 firms incorporated in the UK by market capitalisation. At the other extreme, there are approximately 450-500 single operator betting offices and 80-100 bookmakers operating just two LBOs. To suggest that the cost structure and financial performance of some of the largest companies in the country is representative of 500 micro-sized operations is a significant weakness of the LECG analysis.

5.4 London Economics analysis of recently collected survey data covering 74% of LBOs indicates the average profitability (as a proportion of gross income) of bookmakers *not* amongst the 5 largest operators stands at approximately 7.4% compared to more than 20% for the largest bookmakers. This has a significant impact on any modelling results generated.

[26] In preparing its response to Racing's submission, the Bookmakers' Committee sought the assistance of the independent consultants London Economics. Their key conclusions are summarised in Section 5. London Economics, 'An Assessment of the Economic Arguments Presented in Relation to the Setting of the 50th Levy Scheme', August 2010.

Figure 3 Profit Margin as a Proportion of Turnover for the Largest Three Bookmakers 2004-2005.



Source: London Economics "Economic Assistance in the Determination of the 47th Horseracing Levy - Final Report for the Bookmakers' Committee of the Horserace Betting Levy Board", January 2008

5.5 **Figure 3** clearly illustrates the lack of representativeness of the analysis undertaken by LECG and as such it overstates the estimate of the levy determined as part of their commercial bargaining solution.

5.6 LECG claims that the largest three bookmakers were representative of the all bookmakers because there was no suitable data to suggest otherwise. London Economics used publicly available information from Companies House to generate a dataset containing financial information on the operators of approximately 8,500 LBOs into their analysis and were amazed by the suggestion that there was a lack of data. Bookmakers are very different in their physical and financial characteristics and different policy measures will have a differential impact on bookmakers depending on their size.

5.7 London Economics have assessed detailed income and expenditure data provided by the Association of British Bookmakers covering 74% of the LBO estate in 2009. The information collected covers 83% of the LBOs owned by the 5 largest bookmakers and approximately 22% of independent or single shop operators. The analysis indicates that the average profitability of LBOs varies significantly depending on the size of the LBO; smaller LBOs are significantly less profitable compared to larger LBOs, irrespective of the owner. The average profitability (profit before interest and tax as a proportion of total income) ranged between 2.1% for large independent bookmakers to approximately 35% for those very large LBOs owned by the biggest 5 operators. (**Table 1)**

Table 1 Profit as a Proportion of Turnover by LBO Size (2009).

	Top 5 bookmaker							
	Very Small	Small	Medium	Large	Very Large	Small Independent	Large Independent	Single Shop Operator
Profitability	7.9%	17.3%	24.1%	30.0 %	35.7%	17.7%	2.1%	14.4%

Source: London Economics analysis of Association of British Bookmakers data (2009) collected by Ray Stone Consulting Ltd

5.8 On average, the profit rate achieved by the 5 largest bookmakers stands at 23.9%, while the average profit rate posted by the owners of independent LBOs (large and small operators combined) stands at 6.8%, and the profitability as a proportion of gross income achieved by single shop operators stands at 14.4%.

5.9 These analyses clearly illustrate the variation in profitability and other financial outcomes achieved by bookmakers, which is especially important given the impact of the recession on the bookmaking industry and the severity of the recession on small bookmakers. The LECG suggestion that because there is no suitable data (which we disagree with), the largest three bookmakers must be representative of all bookmakers is ungrounded in theory, and suggests that they do not accept the concept or existence of economies of scale in the bookmaking industry.

Opportunity Costs

5.10 In any analysis assessing the costs and benefits associated with a particular option, both the direct and indirect costs associated the course of action should be considered. By ignoring the cost of capital in their analysis, LECG seriously understates the costs incurred by betting operators. The marginal and non-standard approach adopted by LECG could result in the estimation of a levy which renders betting operators unprofitable. This is because the analysis does not take a holistic view of all the costs that betting operators incur.

5.11 To provide an appropriate quantity and quality of betting opportunities to its customers, bookmakers incur significant capital expenditure in relation to the purchase, upkeep and improvement of its LBOs. This capital expenditure is generally financed through a combination of debt and equity (including retained earnings), and both the debt and the equity have to be remunerated at a normal rate of return, otherwise neither investors nor lenders would be willing to provide funds to the bookmakers. The cost of the remuneration of the debt and equity has to be taken into account in assessing the economic viability of a business and is recognised by regulators throughout the world when they determine prices or revenues in regulated industries.

5.12 The analysis undertaken by LECG has repeatedly ignored the opportunity costs incurred by bookmakers and suggests that their inclusion is ‘incorrect in theory’. London Economics analysis is based on the HM Treasury Green Book, which offers best-practice guidance in relation to appraisal and evaluation in the United Kingdom. Any sensible model considering the costs and benefits associated with a particular business action will take account of the cost of capital. Ignoring the cost of capital would result in grossly misleading results and, possibly, in bankruptcy.

5.13 London Economics replicated the modelling undertaken by LECG and modelled the Weighted Average Cost of Capital (WACC) or the cost of financing long-term debt and equity for the three major high street bookmakers (William Hill, Ladbrokes and Coral in 2008), and combined this with information in relation to their long-term debt and equity finance. Using the identical assumptions presented by LECG in relation to the contribution of British horseracing to gross win, this analysis suggests that once the cost of capital is incorporated into the modelling, the total costs associated with the provision of British horseracing are approximately 25% higher than suggested by LECG. This is presented in **Table 2**.

Table 2 Betting Upper Bound - Marginal Contribution of Racing to GB Retail – Replication of LECG Analysis with Introduction of Opportunity Costs.

	LE Analysis				LECG Analysis	
	Ladbrokes	William Hill	Coral	Aggregate	Aggregate	
	2008	2008	2008	2008	2008	2007
OTC Gross Win	487.8	519.6	359.7*	1367.1	1,367.2	1,342.0
FOBT Gross win	286.1	318.3	310.1	914.5	820.1	716.2
Total GB Retail Gross Win	773.9	837.9	669.8~	2281.6	2,187.3	2,058.4
Retail operating Profit (%)	187.9	240.1	192.0~	620.0	25.9%	27.2%
Share Racing in OTC (default %)	44%	44%	44%	44%	44%	45%
Racing gross win (a)	214.6	228.6	158.3	601.5	601.6	604.0
- GPT	-32.2	-34.3	-23.7	-90.2	-150.6§	-151.0§
- Levy	-21.5	-22.9	-15.8	-60.2		
- TV Costs (est) (b)	-17.9	-19.5	-13.6	-51.1	-50.7	-26.7
- Staff Costs (est) (c)	-90.8	-82.8	-70.6	-244.2	-244.7	-231.4
Opportunity Costs	-36.5	-64.8	-20.4	-121.7		
Total racing marginal costs	-198.8	-224.3	-144.2	-567.3	- 446.0	-409.1
Racing Marginal Contribution (Profit)	15.8	4.3	14.1	34.2	155.6	194.9
Racing Marginal Contribution (No Levy)	37.3	27.2	29.9	94.3	215.7	255.3
Contribution of racing % racing gross win	7.4%	1.9%	8.9%	5.7%	25.9%	32.3%
Equivalent Levy (d)	17.4%	11.9%	18.9%	15.7%	35.9%	42.3%
Upper Bound bargaining solution	**11.8%**	**10.5%**	**12.2%**	**11.4%**	**16.5%**	**18.1%**
Upper Bound Levy				£104.4	£150.5	£165.8

Note: *In this analysis, we have been able to access information financial information at a suitably disaggregated level for Ladbrokes and William Hill; however, the equivalent information has not been available for Coral. In particular, we have been unable to gather information on OTC gross win of FOBT gross win and have inserted estimates of these measures as balancing items to derive the equivalent aggregate measure of OTC and FOBT gross win as presented by LECG. ~ Calculation based on previous assumptions. §GPT and levy combined

(a) Racing gross win = OTC gross win x default percentage (44%) – Assumption in LECG analysis. (b) TV Direct costs saved due to rights costs and other operating costs (£8,500 per shop) – Assumption in LECG analysis. (c) Staff costs saved estimated pro rata in proportion of racing gross win in total OTC gross win – Assumption in LECG analysis. (d) "Equivalent Levy" is the pre-levy profit contribution- and the upper bound for bargaining. It is equivalent to the maximum levy bookmakers would be prepared to pay as a proportion of racing gross win such that they would be indifferent between paying this amount and having the entire racing product removed.

The Weighted Average Cost of Capital (WACC) is used in finance to measure a firm's cost of capital. The total capital for a firm is the value of its equity (for a firm without outstanding warrants and options, this is the same as the company's market capitalisation) plus the cost of its debt. The "equity" in the debt to equity ratio is the market value of all equity, not just shareholders equity on the balance sheet. The WACC is calculated as follows WACC = (1 - debt to capital ratio) * cost of equity + debt to capital ratio * cost of debt. Information from Bloomberg suggests that the WACC for Ladbrokes stands at 10.31% compared to 11.31% for William Hills. We have assumed an average WACC of 8.63% for Coral, which is the average across a number of listed firms in the leisure and gaming industries. We have assumed that the non-current liabilities for Coral are represented by company non-current liabilities (not Group).

Source: London Economics' analysis and LECG report 'Setting the 50th Horserace Betting Levy - an Economic Analysis', March 2010

5.14 The incorporation of opportunity costs (the cost of capital) into the commercial bargaining solution presented by LECG results in a reduction in the estimate of the modelled Levy to approximately 11.4% compared to the current Levy rate of 10% and the estimates presented by LECG (upper bound of 16.5%). This illustrates how important it is in any modelling approach to consider all the costs associated with the generation of the various income streams and not just those that relate to the day-to-day operation of the business.

Capacity to Pay

5.15 In the work undertaken by LECG, there is no real assessment of the capacity of bookmakers to pay for the estimated Levy and there is no attempt to incorporate the most recent information in relation to the current financial performance of bookmakers. London Economics refute totally the LECG assertion that

"*the 2009 figures....are likely to be distorted by adverse conditions in the economy as a whole*".

The entire point of the is that in the absence of commercial sustainability, the Levy should balance the needs of Racing with the capacity of bookmakers to pay, and as such, the decision to choose information on bookmakers' financial performance selectively is unhelpful in presenting an unbiased estimate of the Levy.

5.16 Total OTC gross win in 2009 was approximately 12.4% lower for Ladbrokes compared to 2008 (£420.9 million compared to £480.7 million in 2008), while the equivalent downturn in betting activity for William Hill was approximately 11.6% (£459.9 million compared to £519.6 million in 2008). The economic impact of the downturn is central to the estimation of the Levy.

5.17 With this in mind, rather than using information from 2008, if the LECG analysis is updated to reflect the financial outcomes in 2009, a number of outcomes are startling. Compared to 2007 (and the model prediction of 11.0%), betting stakes amongst these bookmakers were approximately 10.4% lower in 2009 compared to 2007.

5.18 Basing any assessment of the Levy on 2009 numbers rather than 2008 (incorporating the declining HBLB default percentage) reduces the LECG 'like-for-like' upper bound estimate of the Levy from 16.5% by approximately 2 percentage points. Once the analysis is also adjusted for the opportunity cost of capital, the equivalent upper bound for the Levy falls into the range of 9.8% and 12.8% for the largest three bookmaking firms.

5.19 Basing any assessment of the Levy on 2009 numbers rather than 2008 and adjusting the analysis for the opportunity cost of capital, the lack of representativeness of the largest 3 bookmakers and the weak profitability across the remainder of the sector, the 'like for like' equivalent upper-bound for the Levy falls to 10.1%.

5.20 In the work presented by LECG, a lower-bound estimate of the Levy is estimated to be approximately 6.4%. Combining a more conservative lower-bound estimate of 7.5% to reflect some of the additional costs of British horseracing with the upper-bound estimate presented here (10.1%) and the 25:75 split of economic surplus adopted in the LECG report, a more appropriate estimate of the Levy should be in the region of 8.3% to 8.5%. This equates to an estimate of the Levy of approximately £51 million once opportunity costs have been incorporated rather than the estimate of £120-£150 million presented by LECG.

A Commercial Bargaining Solution

5.21 LECG suggested that London Economics displayed a fundamental lack of understanding of the commercial bargaining model and that the approach adopted by LECG was a common approach in economic literature. There was also a suggestion that the outcomes generated by the commercial bargaining model were generous to bookmakers given the LECG assumption that the bookmaking industry was able to capture 75% of the 'surplus' associated with the horseracing product compared to 25% for the horseracing industry.

5.22 The approach adopted by LECG is by no means standard in economic literature. In addition to the fact entirely different methodological approaches have been considered for assessing the upper-bound and lower-bound of the bargaining solution, there are also issues in relation to whether all the costs of doing business have been included in the LECG analysis. The LECG approach considers only operating expenditures and as such, takes account of only part of the overall costs of bookmakers and is very misleading.

5.23 As previously, London Economics has attempted to replicate the modelling approach adopted by LECG to illustrate that the continued omissions in their model have a significant impact on the appropriate Levy that might be determined. This 'like-for-like' approach also allows London Economics to illustrate that the use of more recent financial information (from 2009 rather than 2008), reflecting the extent of the economic downturn on bookmakers, and the deterioration in the capacity of bookmakers to subsidise Racing, significantly affects the estimated size of the final Levy under the LECG approach.

Data Availability

5.24 It is vitally important to note that the estimates of the potential levy contribution produced by LECG are based on financial information from 2008, when the true impact of the global recession had not fully impacted the financial performance of bookmakers. Even partial information from 2009 illustrates the significant deterioration in the financial performance across the sector as well as the disproportionately large impact of the recession on the smallest bookmaking operators and the smallest LBOs operated by the largest bookmaking firms.

5.25 For these reasons, it is crucial throughout any estimation of the Levy that both the most up to date and extensive information is used in any analysis rather than selecting the most convenient data. London Economics do not understand why the work undertaken by LECG did not incorporate more recent financial information where it was available and fundamentally disagree with the assertion that '*the 2009 figures....are likely to be distorted by adverse conditions in the economy as a whole*'.

5.26 Betting on British horseracing has declined in recent years and as such, there has been a significant deterioration in the contribution of horseracing to the turnover and profitability of bookmakers. For the 43rd Levy Scheme (in 2004/05) the default percentage was calculated as 49%, which compares to the HBLB default percentage of just 43% calculated for the 48th Levy Scheme (2009/10)[27]. Ignoring

[27] Default percentages are calculated by Calendar Year. The default percentage for the 48th Levy Scheme (Apr 09-Mar10) used data for the period 1 Jan – 31 Dec 2009.

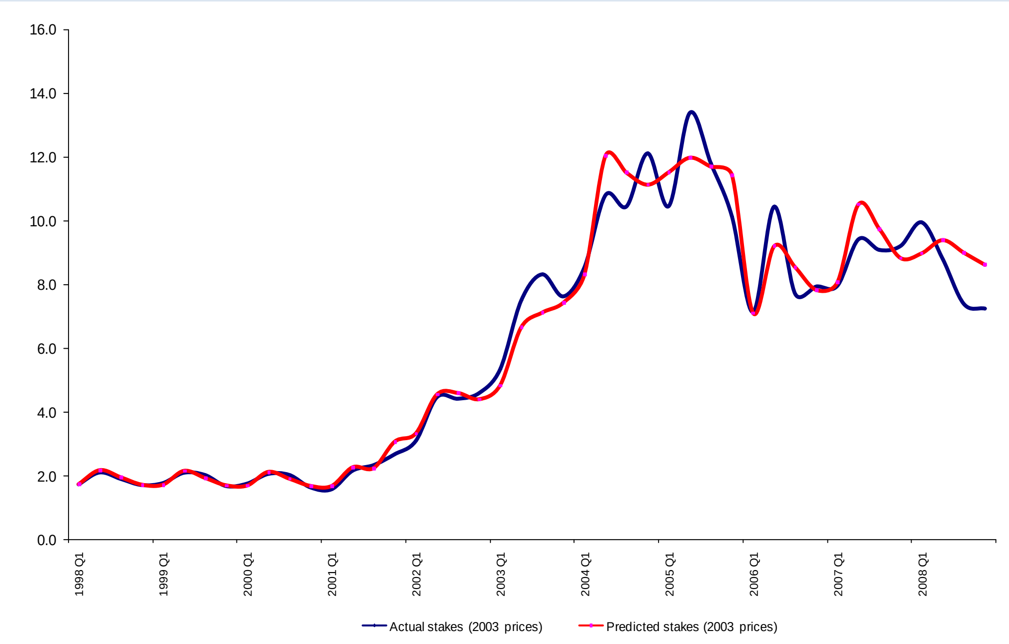
the most recent financial information available unnecessarily reduces the ability to discern the emerging and longer term trends in both the Racing and bookmaking industries.

5.27 The decision to choose information on bookmakers' financial performance selectively is unhelpful in presenting an unbiased estimate of the Levy.

<u>Figure 4</u> The Relationship Between Actual and Predicted Stakes Against UK GDP.

The relationship between actual and predicted betting stakes against UK GDP

Previous work undertaken by London Economics has illustrated the likely impact of the economic downturn on betting activity and illustrates the sensitivity of betting to the position in the economic cycle. In particular, an analysis undertaken for the Association of British Bookmakers presented to HM Treasury at the start of the current economic downturn (presented below) illustrates that for every 1% change in the level of GDP, a resulting 4.3% change in the value of betting stakes would be expected. The economic slowdown and the resulting impact on betting activity and operating profitability are reflected in the most recent financial information presented by the major bookmakers.



Note: London Economics' analysis based on HM Revenue and Customs annual and quarterly data

Source: London Economics on behalf of the Association of British Bookmakers, March 2009

Using this model establishing the relationship between economic growth and betting stakes (and information on the average of the independent economic forecasts for UK GDP available at that time (February 2009), the analysis indicates that, as a result of the economic downturn, betting stakes would be expected to be approximately **11.0%** lower in 2009 than in 2007.

Note that this model considers betting stakes as a whole and not those specifically related to UK horseracing. Given the longer term decline in the popularity of horseracing, any economic recovery may not be translated into an equivalent recovery in betting on UK horseracing.

Industry Analysis

5.28 The analysis undertaken by LECG is based on information relating to the 'Big 3' bookmakers in the UK. It is incorrect to believe that these firms are representative of the industry more generally. **Table 3** illustrates the variation in the average rate of profitability across the industry. **Table 4** illustrates the likely upper limit of the Levy if the entire betting industry were considered instead of just the 'Big 3'.

Table 3 Betting Upper Bound - Marginal Contribution of Racing to GB Retail – Replication of LECG Analysis with Introduction of Opportunity Costs and Updated Financial Data.

	LE Analysis				LECG Analysis	
	Ladbrokes	William Hill	Coral	Aggregate	Aggregate	
	2009	2009	2009	2009	2008	2007
OTC Gross Win	427.4	459.1	316.5	1,203.0	1,367.2	1,342.0
FOBT Gross win	282.5	343.5	321.2	947.2	820.1	716.2
Total GB Retail Gross Win	709.9	802.6	628.5~	2,141.0	2,187.3	2,058.4
Retail operating Profit (%)	134.5	202.7	151.3~	488.5	25.9%	27.2%
Share Racing in OTC (default %)	43%	43%	43%	43%	44%	45%
Racing gross win	183.8	197.4	136.1	517.3	601.6	604.0
- GPT	-27.6	-29.6	-20.4	-77.6	-150.6§	-151.0§
- Levy	-16.5	-17.8	-12.2	-46.6		
- TV Costs (est)	-17.8	-19.9	-13.3	-51.0	-50.7	-26.7
- Staff Costs (est)	-85.7	-81.4	-68.0	-235.2	-244.7	-231.4
Opportunity Costs	-37.4	-26.9	-20.4	-84.7		
Total racing marginal costs	-184.2	-175.0	-134.4	-493.6	- 446.0	-409.1
Racing Marginal Contribution (Profit)	-0.4	22.4	1.7	23.7	155.6	194.9
Racing Marginal Contribution (No Levy)	**16.1**	**40.2**	**14.0**	**70.3**	215.7	255.3
Contribution of racing % racing gross win	-0.2%	11.3%	1.3%	4.6%	25.9%	32.3%
Equivalent Levy	9.8%	21.3%	11.3%	14.6%	35.9%	42.3%
Upper Bound bargaining solution	**9.9%**	**12.8%**	**10.3%**	**11.1%**	**16.5%**	**18.1%**
Upper Bound Levy				£87.6	£150.5	£165.8

Note: ~ Calculation based on previous assumptions. §GPT and Levy combined

(a) Racing gross win = OTC gross win x default percentage (43%)

(b) TV Direct costs saved due to rights costs and other operating costs (£8,500 per shop) – Assumption in LECG analysis

(c) Staff costs saved estimated pro rata in proportion of racing gross win in total OTC gross win – Assumption in LECG analysis

(d) "Equivalent Levy" is the pre-levy profit contribution- and the upper bound for bargaining. It is equivalent to the maximum levy bookmakers would be prepared to pay as a proportion of racing gross win such that they would be indifferent between paying this amount and having the entire racing product removed.

(e) We have refined the assumption in relation to the effective levy. Specifically, the estimate of the effective levy for 2009 is 9% rather than the 10% used in the LECG analysis. The impact of this amendment is to increase the upper bound bargaining solution than would otherwise be the case by approximately 0.2 percentage points

Information on the 2009 financial performance for Coral is unavailable at this stage. Therefore, we have calculated the reduction in turnover, gross win and profitability between 2008 and 2009 for William Hill and Ladbrokes (for whom information is available) and applied these annual changes to the 2008 information for Coral. This is a reasonable estimate given the fact that we would anticipate that Coral is relatively similar to the other 2 bookmaking firms and we would not have expected the economic downturn to have impacted Coral disproportionately relative to the other firms.

Source: London Economics' analysis and LECG 'Setting the 50th Horserace Betting Levy - an Economic Analysis', March 2010

Table 4 Betting Upper Bound - Marginal Contribution of Racing to GB Retail – Replication of LECG Analysis with Introduction of Opportunity Costs and Updated Financial Data.

	LE Analysis			LECG Analysis	
	Industry Total	Non Top 3	Top 3	Aggregate	
	2009	2009	2009	2008	2007
OTC Gross Win	1,535.7	332.7	1,203.0	1,367.2	1,342.0
FOBT Gross win	1,195.5	248.3	947.2	820.1	716.2
Share Racing in OTC (default %)	43%	43%	43%	44%	45%
Racing gross win	660.4	143.1	517.3	601.6	604.0
- GPT	-99.1	21.5	-77.6	-150.6§	-151.0§
- Levy	-59.4	12.9	-46.6		
- TV Costs (est)	-72.3	-21.3	-51.0	-50.7	-26.7
- Staff Costs (est)	-294.6	-59.6	-235.2	-244.7	-231.4
Opportunity Costs	-118.1	-34.8	-84.7		
Total racing marginal costs	-643.5	-149.9	-493.6	- 446.0	-409.1
Racing Marginal Contribution (Profit)	16.9	-6.9	23.7	155.6	194.9
Racing Marginal Contribution (No Levy)	**76.3**	**6.0**	**70.3**	215.7	255.3
Contribution of racing % racing gross win	2.6%	-4.8%	4.6%	25.9%	32.3%
Equivalent Levy	12.5%	5.2%	14.6%	35.9%	42.3%
Upper Bound bargaining solution	**10.6%**	**8.8%**	**11.1%**	**16.5%**	**18.1%**
Upper Bound Levy	£70.3	£12.6	£57.7	£150.5	£165.8

Note: ~ Calculation based on previous assumptions. §GPT and Levy combined
(a) Racing gross win = OTC gross win x default percentage (43%)
(b) TV Direct costs saved due to rights costs and other operating costs (£8,500 per shop) – Assumption in LECG analysis
(c) Staff costs saved estimated pro rata in proportion of racing gross win in total OTC gross win – Assumption in LECG analysis
(d) "Equivalent Levy" is the pre-Levy profit contribution- and the upper bound for bargaining. It is equivalent to the maximum levy bookmakers would be prepared to pay as a proportion of racing gross win such that they would be indifferent between paying this amount and having the entire racing product removed.
(e) We have refined the assumption in relation to the effective Levy. Specifically, the estimate of the effective levy for 2009 is 9% rather than the 10% used in the LECG analysis. The impact of this amendment is to increase the upper bound bargaining solution than would otherwise be the case by approximately 0.2 percentage points
Information on the 2009 financial performance for Coral is unavailable at this stage. Therefore, we have calculated the reduction in turnover, gross win and profitability between 2008 and 2009 for William Hill and Ladbrokes (for whom information is available) and applied these annual changes to the 2008 information for Coral. This is a reasonable estimate given the fact that we would anticipate that Coral is relatively similar to the other 2 bookmaking firms and we would not have expected the economic downturn to have impacted Coral disproportionately relative to the other firms.
Source: London Economics' analysis and LECG 'Setting the 50th Horserace Betting Levy - an Economic Analysis', March 2010

5.29 Based on the financial information provided by LECG in relation to the 3 largest bookmakers, and combined with grossed-up survey data covering 74% of all Licensed Betting Operators from the Association of British Bookmakers, the analysis illustrates relatively poor profitability of British horseracing amongst smaller bookmakers. In particular, using an identical methodological approach as that adopted by LECG and assuming (conservatively) that small operators have the same cost of capital as larger operators, the analysis estimates that the marginal contribution of British horseracing amongst smaller operators is negative. In addition, the analysis shows that the upper bound bargaining solution for firms not in the top 3 to be approximately **8.8%** compared to an estimate of 11.1% for the three largest betting operators. For the industry as a whole, the upper bound bargaining solution stands at 10.6%, which is 0.5 percentage points lower than the estimate generated when considering only the largest 3 firms.

Splitting the Surplus Between Racing and Bookmaking Under a Bargaining Solution

5.30 LECG assert that Racing's true bargaining position should reflect in part the fact that Racing are owners of the intellectual property rights, and as such there is every likelihood that in a real life commercial bargaining scenario, Racing would be able to capture a greater proportion of the economic surplus generated by the two industries than that assumed in the modelling exercise. We do not accept that this is the case. The bargaining positions of the various stakeholders reflect wider commercial considerations such as the capacity of bookmakers to pay the levy and the alternative betting opportunities that would be available to bookmakers. Most importantly, the apparent strength of bookmakers' bargaining position reflects the fact that the racing industry has been unable to secure its own commercial sustainability and as such, bookmakers are the only compulsory purchasers of the racing product. It is important to note that the value of the intellectual property is determined by what operators are willing to pay. There is no commercial bidding war for the IPR associated with racing product and the fact that the Levy is statutory implies that in the absence of a levy, under a true commercial bargaining outcome, the split in surplus between bookmakers and the racing industry might be even wider.

A Commercial Outcome

5.31 In the work presented by LECG, based on an assessment of the economic costs and benefits associated with the provision of 207 leasehold fixtures, a lower-bound estimate of the Levy is estimated to be approximately 6.4%. This reflects the break-even point at which the provision of these fixtures becomes just profitable to the industry and is one extremity of the bargaining outcome.[28] Combining this lower-bound estimate with the upper-bound estimate presented here and the split of economic surplus adopted in the LECG report, a more appropriate estimate of the Levy should be in the region of 8.3% to 8.5%[29] rather than the current levy rate of 10% and less than half that estimated by LECG in their analysis. This equates to an estimate of the Levy of approximately £51 million once opportunity costs have been incorporated rather than the estimate of £120-£150 million presented by LECG.

[28] Note that London Economics were unable to replicate the analysis presented by LECG due to the lack of data availability. Independent of this, we fundamentally question the use of two entirely different methodological approached for estimating the upper and lower bounds in a commercial bargaining setting. We also point out that even though the point of break-even is characterised by a 6.4% implied levy, LECG appear to ignore this estimate indicating that a 10% rate is preferable; however, provide no evidence why an alternative un-modelled estimate might be preferable.

[29] A lower-bound of 7.5% has been assumed to derive this estimate

6 INTERNATIONAL COMPARISONS

6.1 Racing's submission argues that

'international comparisons starkly illustrate the chronic underfunding of British Racing by the Betting'.

The Bookmakers' Committee considers that the international comparisons presented in the submission are not reasonable, as the structure of revenues differs significantly by country. The international comparison therefore cannot be used to validate the arguments put forward in the submission without a detailed analysis, contrary to what is stated by Racing.[30]

6.2 There are several different ways in which a racing industry can be managed and run according to the customs and practices which have developed in each particular location and, certainly in two cases, to meet specific political requirements.

6.3 Few, if any, reflect the way in which Racing is currently organised and financed in Great Britain which has also developed in its own way over a long period.

6.4 State controlled betting monopolies are a common feature.

6.5 A further common thread running through the world of racing is a single central governing body, either at national or state level, which receives and distributes funding from a variety of sources ranging from direct government grants, payments from pari-mutuel operators and bookmakers and royalties from the sale of media rights or, often, from all three. In some cases, the central governing body also regulates racing; in others, the regulator is separate from but usually funded by the governing body.

6.6 For example, the French market cannot be used as a comparison because it has not historically possessed a competitive racing betting industry. Betting on racing has historically been provided by PMU, which is a state monopoly. Therefore, it has not had the pressure of competitors on its margins and can afford to finance racing on a larger basis. Racing in France is a net source of fiscal income, where the Government enjoys a 16% tax take from the PMU system. Pool take-outs are typically much higher than the margins earned by fixed odds bookmakers so there is less money returned to the betting consumer. Thus, as a generalisation, pools offer poorer value to betting consumers.

6.7 The submission states that the British and Irish markets have similar betting industries and British owners make the biggest contribution to racing in Europe. This statement is inconsistent with evidence in the submission because, according to the table in Appendix Two, Irish owners finance 67% of the racing industry whereas British ones only finance 33%.

6.8 Racing in the United States takes place within 38 separate states, all of which operate autonomously but under overarching federal legislation dating back to 1978.

---

[30] Racing submission Page 7, Paragraph 2.

6.9 In Australia the sport is run on a quasi-commercial basis, which succeeds because the states have granted pool monopolies to the privately run totalisators (known as TABs) and because off-track fixed odds betting is illegal except via telephone and the internet, which is itself already regarded as posing such a threat to racing's income that interstate and international betting have been banned in three Australian states.

6.10 Various governments have taken the decision either to be the source of racing's income or to supplement it by hypothecation of some or all of their betting tax take or by operating or granting a pari-mutuel monopoly for the benefit of horseracing. Furthermore, tote monopolies abroad inject large subsidies into racing which enable overseas betting consumers to go racing cheaply by comparison to the United Kingdom.

- Racing's submission attempts to offer a number of options by which, what it considers a reasonable return can be delivered. Racing is of the opinion that there are various structural deficiencies that exist within the levy scheme which prevent the level of income it seeks being achieved.

- In Sections 7-11of this submission, the Bookmakers' Committee addresses these issues in turn, concluding in each case that Racing's "options" are misguided and misplaced.

7 OVERSEAS RACING

7.1 In its submission Racing again raises the issue of a levy payable on foreign racing. With effect from the 42nd Levy Scheme, such bets were deemed not to be leviable. The levy on foreign racing was discontinued following an agreement with the then BHB that the threshold should be halved from £150,000 to £75,000.

7.2 Racing fails to acknowledge the link between the halving of the threshold and the discontinuation of the levy on foreign racing as part of the 42nd Levy Scheme.

7.3 As Racing notes in its submission, levy did used to be payable on such races and that situation prevailed up to and including the 41st Levy Scheme (2002/03). That was the first scheme to be based on gross profits rather than turnover and was the result of a determination by the Secretary of State. Part of her decision was to set the threshold for the 41st scheme at and above which the headline levy rate of 10% was payable; she set the figure at £150,000.

7.4 That was also a time of transition to the British Horseracing Board licensing system and, as part of that process, the terms and conditions of the 42nd scheme were designed by agreement to 'mirror' the terms and conditions of the BHB's licensing scheme. Clearly the BHB had no rights over foreign racing and thus no basis upon which to claim a licence payment associated with it. Levy on foreign racing was therefore discontinued because foreign racing was beyond the jurisdiction of the licence and there was thus no right to income from this source.

7.5 However, in recognition of this, the threshold above which the headline 10% rate applied was halved to £75,000 under the 42nd Levy Scheme; this agreement was the result of negotiations between the bookmaker trade associations and the BHB management.

7.6 Inter alia, the evidence of these negotiations lies in the preamble to the Committee's Recommendations for the 42nd Levy Scheme:

7.6.1 'In formulating its recommendations for the 42nd Levy Scheme, the Bookmakers' Committee welcomes the opportunity to propose a scheme which it believes should remain in place, subject to annual review, until the end of the statutory Levy system. Following the announcement made by the Minister for Sport on 17th April 2002[31], the Committee expects that this period will extend for a minimum of two years, thus covering the 43rd Levy Scheme ending 31st March 2005. However, the Committee accepts that the statutory mechanism may continue beyond that date, depending upon the availability of time in the Government's programme in which to bring forward the necessary legislation.'

7.6.2 'Furthermore, the Committee welcomes the high degree of stability which this interim period will allow and during which a smooth and orderly transition can take place between the current statutory scheme and the full non-statutory commercial mechanism which is expected to follow it. It is grateful to the Government and the Horserace Betting Levy Board for facilitating the conditions in which the framework of these recommendations could be

[31] DCMS News Release 71/2002 dated 17th April 2002

established and in which meaningful and ultimately successful negotiations with the British Horseracing Board (BHB) were able to take place.'

7.7 As with the reduction of the threshold, at no point in the discussions around the 42nd Levy Scheme was the exclusion of foreign racing questioned. The mechanism suggested by the Committee at the time was that foreign racing be "zero-rated" for the purposes of the Levy. However, subsequent legal advice received by the Board during the formal drafting of the 42nd scheme recommended that this should be amended such that the scheme referred only to British horseracing business. That has been the position ever since.

7.8 Further evidence lies in the Chairman's Statement on page 7 of the Board's 2001/02 Annual Report where he makes the point, in the context of the awaited submission from the Bookmakers' Committee on the 42nd scheme, which was to reflect the commercial data rights agreement, that:

'I understand that it will include a negotiated reduction in the turnover threshold at which the full 10% of gross profits is paid, which should add about £10 million to the Levy next year. However, the downside is that the commercial deal makes no allowance for payments by British bookmakers on bets taken on overseas horseracing. Not only is it worth about £5 million a year but it has always provided a source of alternative income during periods of lengthy abandonments. If you add to this the decision to base the sale of pictures to betting shops on a fixture basis, with no payments for abandonments, then it will inevitably lead to less financial stability in Levy income, with a consequent knock-on effect for racing'.

7.9 It is obvious from the Chairman's prescient comments that there was a link established between thresholds and levy on foreign racing and that it was as the result of negotiations between the bookmakers and the BHB. Also obvious, was his recognition that picture rights payments were relevant to the discussion. He also warned of a potential knock-on effect for Racing.

7.10 Yet more evidence that the current position arose from a negotiated settlement appears in the Chief Executive's Report in the 2002/03 HBLB Annual Report. Referring to the terms of the 42nd Levy Scheme, the CEO observes that:

"They are based, for the first time, on the gross profits of bookmakers arising from betting on British horseracing, as compared with all, including overseas, horseracing, and involve a gross profits based contribution from on-course bookmakers. The terms reflect, to a material extent, the terms agreed between the BHB and the bookmakers for the supply of pre-race data".

7.11 Further evidence is provided during 2003 in a letter from the then Chairman of The Bookmakers' Committee, Mr Warwick Bartlett to the HBLB Chairman in which he stated:

'There is not now, nor in our view has there ever been, any justification for a statutory levy on foreign horseracing. One of the few benefits to emerge from the political decision to end the levy and replace it with a commercial agreement was that there was no argument which could be tabled by the BHB in support of such a charge and it was therefore dropped. As you know, the bookmakers agreed to a

50% reduction in the threshold, from £150K to £75K, by way of compensation and that was reflected in the levy.'

and that

'In respect of foreign racing, the exemption was fully agreed by the Bookmakers' Committee, the BHB and the Levy Board. In our view, this request is no more than an attempt to renege on an agreement reached voluntarily by all the parties involved because, for reasons which are clear to all, levy income has not yet met the aspirations of the BHB Chairman.'

and that

'I am authorised to advise you that the Committee will reject any attempt to reintroduce a charge which it has never believed to be justified and which was waived by mutual consent.'

This is further reinforced in a letter to Mr Peter Savill, BHB Chairman:

'The BHB representatives on the Levy Board will be aware that, each year and for many years, the Bookmakers' Committee has argued at the Annual Strategy Review that foreign racing should be exempt from the levy. It did so because there is no moral or commercial reason why British racing should enjoy the benefit of a product which it does not stage nor to which it makes any contribution at all and which is, in any case, paid for at source by the betting industry. However, this view was not shared by a majority on the Board so foreign racing remained leviable until the 42nd scheme, when it was, quite correctly, exempted for reasons to which I will return.

He further stated:

'However you will doubtless recall that, because the BHB had no claim to any percentage of the income from foreign racing, it was agreed that the threshold at and above which the charge on British horseracing gross profits would be a flat 10% was reduced from £150K under the 41st Levy to £75K under the 42nd as a compensatory payment. You may be assured that, had your representatives pressed for the retention of the levy on foreign racing in the 42nd scheme, as you state, then the Bookmakers' Committee would have insisted on the retention of the £150K threshold.'

7.12 Racing states correctly that no distinction is drawn in the 1963 Act between betting transactions on races which take place in Great Britain or elsewhere. However, when the Act was drafted, there was no racing available to British betting consumers at that time except that which took place in Great Britain, nor was it envisaged by legislators that it would be; Hansard makes no reference to any discussion on such a possibility. It is not, therefore, surprising that the Act draws no distinction between something which existed at the time it was drafted and something which did not. Furthermore, as the Board acknowledges on its website, the original purpose of establishing the Levy was to provide a means of compensating racecourses for the loss of attendance which was anticipated when the LBOs were legalised in 1961. This clearly has nothing whatsoever to do with racing which takes place overseas, then or now, and, in our view, effectively confirms what the legislators of the day had in mind.

7.13 What the will of Parliament at the time actually was, we shall never know because of course foreign racing as an issue did not feature in the debate. In the absence of any agreement for the 50th Levy Scheme, it seems likely that the courts would have to decide on the scope of the Act in this respect should any party wish to progress the matter that far.

7.14 The associated issue of the threshold would have to be addressed if there were to be a change in the current position. The threshold was halved under the 42nd scheme to compensate for loss of levy from this source and, if overseas racing was once again to become ‘leviable’ the balance would have to be restored (see ‘Gross Profits Thresholds’).

8 GROSS PROFITS THRESHOLDS

8.1 The 41st Levy Scheme was unique in that, following the change in the structure of general betting duty in October 2001, the Committee's recommendation that the 41st Levy Scheme (and by implication any that might follow it) should be based on bookmakers' gross profits rather than on turnover was accepted by the Government in its determination of the scheme.

8.2 No credible argument has been made to remove, reduce or re-structure the relief afforded to protect lower profitability shops via the use of thresholds and no justification exists to do so.

8.3 There has always been a mechanism built into the Levy to enable bookmakers to be divided into different categories for the purposes of assessing their liability to pay the Levy. It is a fundamental feature of the statute and the responsibility for recommending the different rates, categories and definitions for each Levy scheme remains with the Bookmakers' Committee. Before the change in the basis of assessment from turnover to gross profits occurred, bookmakers paid a Fixed Fee per shop which, under the 40th Levy Scheme, amounted to £705. They then paid nothing on (under the 40th scheme) the first £337,673 of horseracing turnover, a figure called the Fixed Fee Slice and adjusted annually for inflation at RPI. Turnover above that figure was then levied at a rate of just under 2.5%.

8.4 As part of the determination of the 41st Levy Scheme and in seeking to replicate this mechanism under the gross profits regime, the Secretary of State introduced a threshold figure below which the headline rate of levy on gross profit should be abated pro-rata. This figure was set at £150,000 which was calculated to provide a broadly equivalent measure of relief to that hitherto available under the Fixed Fee/Slice mechanism. The purpose of it was, and remains, to provide for lower payments for the less profitable shops to help them to stay in business in competition to the bigger and more profitable emporia, both for reasons of customer choice and also to maintain as uniform a legal presence on the high street and in rural areas as possible, to discourage illegal betting. For reasons which have been discussed in 'Overseas Racing', that threshold figure was halved under the 42nd scheme (2003/04), reset at £80,000 in 2006/07 and subsequently adjusted for inflation. It is also worth pointing out in this context that, when the then BHB was negotiating the Licence mechanism with bookmakers, it recognised and agreed to the principle of the threshold, albeit at the lower level described above.

8.5 The Committee has little doubt that the requirement of the Act that there should be 'categories', requires the Committee to make relief for small bookmakers, whether through thresholds or some equivalent mechanism. Every Levy scheme to date has made such provision to a significant extent, usually, as in the 2002 Determination, at a level considerably higher than that prevailing in the 49th Levy Scheme or in our proposals for the 50th Levy Scheme.

8.6 The need for thresholds is illustrated in the report by London Economics based on the methodology employed by LECG for Racing's submission. In Table 4 this methodology calculates an upper bound levy rate for non Top 3 bookmakers of **8.8%** compared to 11.1% for Top 3 bookmakers.

8.7 An advantage of the threshold system is that it incentivises Racing to become more attractive to betting consumers, because the marginal rate of levy is in excess of the headline rate. This is because increasing a shop's gross profit from horseracing will increase the rate payable.

8.8 In the OCP report dated 21st January 2008, commissioned by the Minister to assist him in the determination of the 47th scheme, there was clear recognition of the importance of the threshold system:

'*We therefore suggest that the threshold be indexed for inflation and, if a lower levy yield is adopted, consideration be given to increasing the threshold by an appropriate amount as opposed to each basis point reduction in the rate.'*

It also stated

'Restoration of the real 2002-3 value of the threshold would be consistent with the 2002-3 determination. It would take into account the capacity to pay of each bookmaker considered separately. It would almost certainly prevent the closure of a number of small shops, probably preserving betting shop facilities in some areas where they would otherwise cease.'

8.9 The threshold for the 41st Levy Scheme was set by the Minister at £150,000. That rate would now be £190,118.[32]

8.10 LBOs generate approximately 70% of the total levy achieved under each scheme. Those shops currently in business are now contributing to Racing, if more were to close due to a reduction or removal of the threshold, the burden of supporting British horseracing would fall on the remaining shops, which would in turn make even more shops uneconomic. If, an attempt to make-up for the levy lost due to closures were imposed upon the LBOs remaining, the result would be a downward spiral of diminishing return for the Levy. It is without doubt that such actions would have significant effect.

8.11 In addition, the Bookmakers' Committee wishes to highlight the extremely difficult trading conditions currently experienced by bookmakers which alone could lead to significant shop closures with the obvious 'knock-on' effect to the Levy. Should however, profitability on British Horserace betting business be further eroded through for example, changes to thresholds the effect would be to accelerate and increase the number of shop closures. If this were to occur, the effect on bookmakers and as a consequence, the Levy, could be very serious indeed.

8.12 It is of note that the proposed increase in threshold to £123,000 contained in the Bookmakers' Committee recommendations for the 50th Levy Scheme is aimed at recouping a fraction of the extra funds now transferred from bookmakers to British horseracing in a way that is equitable across the LBO estate.

8.13 The levy yield from a closed shop is £0. Some of the business from that shop may move to another leviable shop but, especially where the shop is at some distance from the nearest competitor, it may be lost altogether if the customer stops betting, moves to an illegal operator, or to one that is based offshore.

[32] Source: Ernst & Young (as at May 2010)

9 BETTING EXCHANGES

9.1 The Horserace Betting Levy Board has initiated a consultation in respect of Betting Exchanges.

9.2 Whilst it notes that individual interested parties may wish to comment on Racing's submission, the Bookmakers' Committee does not wish to pre-empt the consultation and as such considers it appropriate not to comment further on the matter at this time.

10 OFFSHORE BOOKMAKERS

10.1 The Committee is aware that Racing is concerned by bookmakers operating from outside the United Kingdom being able to offer bets on British racing to customers without paying levy. Furthermore, it has signalled that it seeks some sort of restorative action through HBLB and DCMS.

10.2 This issue has nothing to do with the Levy.

10.3 The Government has no power to require companies outside its fiscal jurisdiction to pay taxes (and, by implication, levy) in the UK. The Gambling Act is specific in its definition of territoriality and thus the requirement to hold any form of operating licence issued by the Gambling Commission and still be able to advertise lawfully in the UK.

10.4 Gibraltar lies within the European Economic Area. Under Article 299(4) of the EEC Treaty, Gibraltar is defined as being within the European Union by virtue of being a European territory for whose external relations Britain is responsible. The Treaty of Rome applies to those European Territories for whose external relations a Member State is responsible, unless such a territory is specifically excluded; thus Gibraltar, although a separate jurisdiction from the UK, is regarded by the Commission and other Member States as part of both the EEA and the EU.

10.5 However, Article 28 of the 1971 UK Accession Treaty relieves Gibraltar from the common customs tariff, the common agricultural policy and the harmonisation of taxes, in particular VAT.

10.6 We recognise that such bookmakers are able to advertise their products within the UK by race sponsorship and by press and other PR and marketing media, thus promoting their businesses to the detriment of shore-based bookmakers who pay both general betting and levy – an advantage of around 25 pence in every £1.

10.7 It has been suggested that advertising restrictions should be applied against bookmakers who do not pay levy on some or all of their horserace betting business because it is being conducted from outside the UK jurisdiction. There can be no legal basis for this proposition as far as an EU state is concerned. Advertising can be restricted by the Government from non-EU states which are not recognised by the British Government by virtue of their inclusion on the White List.[33] However, advertising cross-border between EU States is permitted and thus any ban or restriction on such advertising would be illegal.

10.8 If the issue is to be addressed without a change in legislation, the onus must lie with those offering advertising and sponsorship opportunities to offshore bookmakers to consider whether it is in the long-term interests of British horseracing that they should do so. The Committee clearly has no power either to recommend that offshore bookmakers should pay levy or to recommend that any organisation should refuse sponsorship deals or advertising copy. These are matters for others to address.

[33] Currently Alderney, the Isle of Man, Tasmania and Antigua & Barbuda

10.9 Offshore bookmakers cite commercial imperatives as being the main drivers for their decision to re-locate. The costs of tax, regulation and sports levies, which they must pay whilst they operate within the UK's jurisdiction, are such as to render them uncompetitive with those other providers of on-line betting services who are located offshore, typically either in Gibraltar or Malta.

10.10 Offshore bookmakers aim to create competitive platforms for global growth in order to ensure that those businesses remained competitive for the longer term.

10.11 Some commentators have observed that, in exchange for changing the basis upon which general betting duty was changed from turnover to gross profits, the major bookmakers agreed in 2001 to repatriate their businesses from the offshore locations to which they had migrated. In the event, both William Hill and Ladbrokes did this in what was then a markedly different competitive environment, most notably, perhaps, it was before the emergence of betting exchanges as a major force in the market. Nevertheless, they are now being accused by some of reneging on that original deal.

10.12 It should, however, be remembered that the 'deal' in question had several components. As important as the one already mentioned was the condition that

'all should benefit from the change'

That included betting consumers, horseracing via the statutory levy and even greyhound racing through the voluntary levy.

10.13 The benefit to betting consumers became apparent immediately as the 9% deduction on all bets ceased to be charged on stakes with effect from 1st October 2002, the date of the change. The Horserace betting levy peaked at an increase of around 100% but has been on average around 60% higher than it was before the change to gross profits.

10.14 In addition to this, the Government of the day declared that its policy[34] was to create a framework in which it wanted:

'....to see a successful gambling industry; one that is able to respond rapidly and effectively to technological and customer-led developments in both the domestic and global market place, building on its existing reputation for quality and integrity, and in the process increasing its already important contribution to the UK economy.'

It was to achieve this by creating a framework in which there would be:

'....a system of law and regulation within which the gambling industry can flourish.....'

10.15 Unfortunately, despite encouragement and advice that these objectives would only be achieved under proportionate regulatory and fiscal regimes, the Government of the day delivered neither. It did not create an environment in which the industry could flourish because it imposed a costly and overstated regulatory structure and a fiscal regime which is so punitive to the remote betting/gaming provider that not one

[34] A Safe Bet for Success – DCMS – March 2002

overseas gaming or betting operator has relocated to the UK since the Gambling Act 2005 became law. Indeed, so anti-competitive is the tax regime for this type of operator that the current situation has arisen whereby two companies[35] who invested significant sums in the repatriation of their businesses in 2001 have now, reluctantly, reversed those decisions.

10.16 There can be no certainty about a hypothesis but it is logical to speculate that, had the Government of the day responded to the calls from the remote gambling community and others for a more competitive tax rate on this aspect of their businesses, then the developments that have now unfolded would probably not have occurred.

10.17 Whatever the views of Racing and the Levy Board might be, the situation has developed because those concerned could not retain the on-line sportsbook element of their businesses within the UK and remain competitive with other providers in the global market place. That they have been unable to do so is itself consequent upon a failure by the Government of the day to deliver on one of the key objectives upon which its whole policy of modernising Britain's gambling laws was predicated, specifically to create an environment in which the gambling industry 'could respond rapidly and effectively to technological and customer-led change in the global market place'.

10.18 That Racing, through the likely reduction in Levy yield, should feel the downside of this situation is an unfortunate but nevertheless inevitable consequence of this failure.

10.19 It is inconceivable that those bookmakers who remain onshore would be willing to make up any shortfall in levy which resulted from any one or more of their number moving offshore.

[35] William Hill & Ladbrokes

11 GAMING MACHINES, VIRTUAL RACING AND THE ‘RELATES TO’ TEST

11.1 It is stated in Racing’s submission that British horseracing is the ‘anchor product’ which attracts customers to the shops, who then go on to bet on other products etc. and that Racing is therefore entitled to receive the levy in respect of any area of a bookmakers business that relates to betting on horseracing. According to Racing this implies that Betting should pay a level of return referable to FOBTs [gaming machines], Virtual racing and other revenue streams where that revenue can reasonably be said to relate to horseracing. Moreover, Racing states that the Levy Board should request specific information from Betting that would quantify such a relationship.[36] The LECG modelling approach suggests that the levy collected should be increased by approximately £33 million to reflect customer betting activity on other sports and FOBTs [gaming machines].

11.2 Racing provides no evidence of the supposed relationship between British horseracing, gaming machines, virtual racing or indeed, any available betting product. There is simply no relevance or relationship that Racing could substantiate.

11.3 Racing states that all streams of betting revenues should be considered in the calculation of the Levy because they relate in some way to betting on horses. The critical issue therefore is to assess whether indeed there is any relationship between betting on horses and other betting products. The question is whether different betting products can be considered as complements or substitutes and whether more of the betting on other products can be attributed to horseracing than vice versa. The submission does not provide any evidence on this and it would require a substantial survey-based statistical exercise to establish any such linkages.

11.4 If different betting products are complements then an improvement in the attractiveness and quality of racing will stimulate consumers to use other betting products, in which case the arguments of Racing may have some validity, although this could be offset by increases in horseracing betting from the introduction of machines or increases in football betting, etc. If, on the other hand, betting on horses and other betting products are substitutes to each other, i.e., if consumers tend to use one product or another, then an improvement in the attractiveness and quality of racing will draw more people to betting on horses and the usage of other betting products will decrease. In such a case, there would be no apparent justification for the demands of Racing to include other betting products in the calculation of levy contributions.

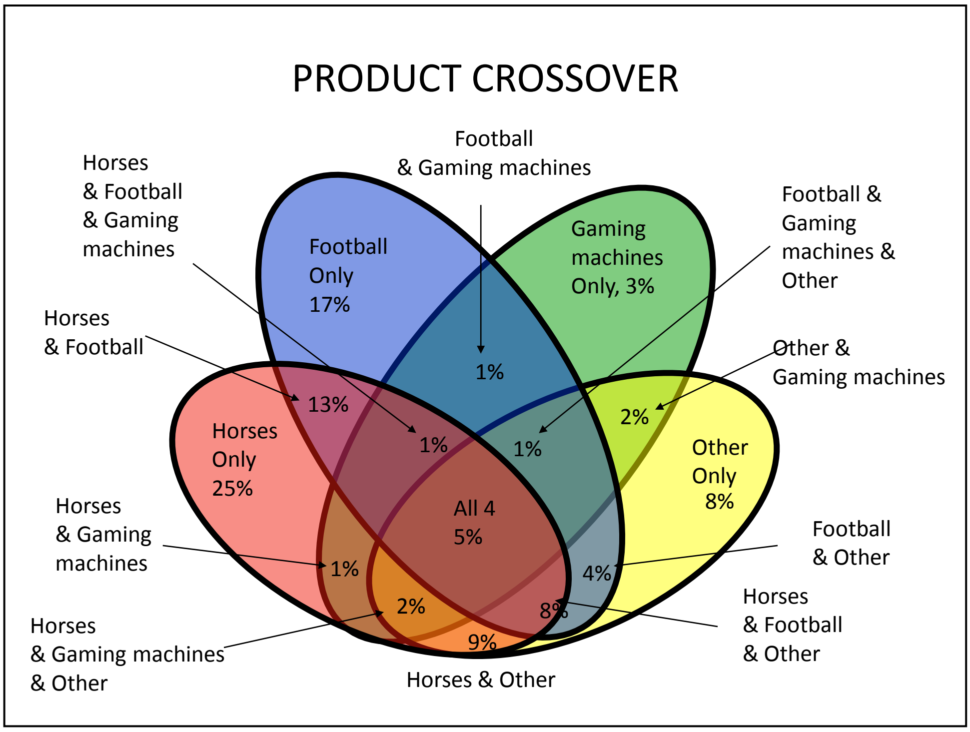
11.5 There is no evidence provided in the submission that horseracing helps to attract people to come into shops to use other products e.g. FOBTs, as stated on page 18 of the submission, for instance. Given this lack of evidence and the possibility that other forms of betting could just as easily be attracting people to bet on horseracing, it seems that the Levy should be calculated exclusively on the basis of revenues from betting on horses.

11.6 In terms of specific evidence from one of the largest three British bookmaking operators, the information presented in **Figure 5** suggests that out of the total number of betting shop customers, the proportion involved in horseracing in

[36] Racing submission Page 9, Last bullet.

some way stands at 64%. However, of these customers, approximately 25% are only involved in horseracing betting with the other 39% also involved in other forms of betting activity (football, gaming machines and other activities) and 36% of customers engage in betting activity that explicitly excludes horseracing betting. However, the analysis also suggests that of those betting shop customers involved in football betting (50% of all customers), 23% are involved in football betting (and not horserace betting), with 27% participating in both football and horserace betting. This crossover is replicated within other types of betting activity.

Figure 5 Product Crossover Within Betting Products.



11.7 Therefore it is clear that there is a two-way movement of betting activity across betting products and that the services provided by bookmakers facilitate customers whose primary betting activity is not horseracing to bet on horseracing and vice versa and the greater the extent of betting opportunities and platforms, the greater the extent of the substitution across activities.

11.8 Although it is the horseracing industry's contention that the Levy should be applicable to other betting activities resulting from horseracing activity, it is equally the case that the betting activity on British horseracing is a result of the betting activity by customers of other sports and events.

11.9 The evidence suggests that it is not the case that without British horseracing, bookmakers would cease to function. In reality, a significant proportion of customers do not currently bet on horseracing (and increasing amongst younger age groups), while a significant proportion would substitute into other betting products.

11.10 The logical conclusion of the horseracing industry's argument in relation to convoyed sales is that bookmakers should be *compensated* through a reduced levy for the increased betting on British horseracing they facilitate through the provision of wider betting services.

11.11 Applying the arguments of Racing that the Levy should be computed based on the revenues from all the betting products would in fact be very harmful for the future of the betting industry. As was the case of FOBTs, which generated significant revenues for the industry and gaming duty for the government, the development of new products is key for the future of this industry. If Betting were to pay the Levy on all their innovative activities, this would negatively affect their incentives to invest and develop new products.

11.12 The fact that new products may "deflect betting away from racing" cannot be used as a valid argument for increasing the Levy because innovation and new products are good for consumers and increase their satisfaction. At the end consumers choose how they want to spend their money and cannot be forced to bet on horseracing. The Levy should take into account how future streams of revenues in the betting industry will be affected by Racing's proposal.

11.13 The growth in revenues may also be attributed to capital investment in the improvement and relocation of betting shops. The incentive to invest in betting shops may be again taken away by having the Levy imposed on all betting products. Indeed, the growth of the betting industry could have been even bigger than it has been in the absence of the Levy.

11.14 The report of Racing acknowledges that an increase in profits results from factors which are not related to racing itself, such as:

11.14.1 Liberalisation of the betting market including extended LBO opening hours and relaxation of advertising restrictions

11.14.2 Product diversification – including sports betting, online offerings and FOBTs

11.15 Bookmakers accept that horserace betting does represent an important element of current revenue (approximately 44% according to LECG assumptions using 2008 information declining to 43% based on 2009 information) from total over the counter business (excluding machines); however, this does not necessarily reflect the contribution to profit, the role and contribution of other betting products, or the alternative means of betting currently available to betting consumers.

12 OTHER OBSERVATIONS

Reference Dates

12.1 The choice of 2002 as the keystone date for Racings submission has been discussed at length in Section 3. Notwithstanding this choice of reference point throughout its document Racing varies its point of reference to bolster the strength of the point it is trying to make.

12.2 On numerous occasions Racing's submission varies the point of reference for which the changes in industry statistics are calculated in order to strengthen its arguments. For instance:

12.2.1 Page 5: 2009 is used as the reference point to show losses in the horse racing industry, but year 2008 is used to discuss the profitability in horse betting industry. Using the same year for both would give a very different comparison.

12.2.2 Page 17: With the exclusion of 2007/08 which appears to be anomalous, Betting's gross win from British racing has been on a steady decline or at best flat since 2003/04. The graph conveniently takes in 2002/03 which is much lower.

12.2.3 Page 30: Only one year (2008) is used for analysing additional fixtures, without any consideration of trend. This undermines the robustness of this analysis.

Employment

12.3 Racing states that it provides '18, 600 (FTE) direct jobs' and '100, 000 direct, indirect and associated jobs within British racing',[37]although it provides no evidence for the claim and no definition is provided for 'associated'.

12.4 The betting industry directly supports 40,700 (FTE) jobs and indirectly supports circa 62, 300 jobs in areas such as IT, real estate and retail sectors.[38]

Taxation

12.5 Racing states that it 'contributes over £325M in taxation – comprising betting duty, employment taxes and corporation tax'.[39] Of note is the use of 'contributes' vice 'pays'. Betting duty is paid by bookmakers and its inclusion as a contribution by Racing is disingenuous at best.

12.6 The Gross Value Added taxation benefit generated by the betting industry is £700M (excluding VAT, which for the premises betting industry alone amounts to £209M.[40]

---

[37] Racing submission Page 15, Bullet 1.
[38] Deloitte 'The Full Picture, An Economic Impact of the British betting Industry', January 2010.
[39] Racing submission Page 15, Bullet 2.
[40] Deloitte 'The Full Picture, An Economic Impact of the British betting Industry', January 2010.