50th Horserace Betting Levy Scheme

Submission of British Horseracing

March 2010

CONTENTS

This submission is made by all constituents of British Horseracing ("Racing") as represented by the Horsemen's Group (itself made up of breeders, jockeys, owners, stable staff and trainers) and racecourses in relation to the 50th Horserace Betting Levy Scheme (2011/12). It is presented by Racing's representatives on the Horserace Betting Levy Board, namely the Chairmen of the British Horseracing Authority, the Horsemen's Group and the Racecourse Association.

This document is structured as follows:

1 EXECUTIVE SUMMARY

A. Overview

"The horserace betting Levy system was introduced in 1961. It is a mechanism for transferring funds from the business of betting on horseraces to "horseracing" in a broad sense" (Home Office, 1999).

That remains the case today and Racing welcomes the new process heralded by the Levy Board's letter to the Secretary of State in April 2009 to arrive at what the amount should be. That amount has to be reasonable, and Racing is committed to a process of negotiation, overseen by the Levy Board Independents, to arrive at that reasonable amount. Racing's goal is simply this: to establish a reasonable yield to Racing from the Levy for the 50th Scheme. This submission sets out Racing's assessment of what would amount to a reasonable yield.

Once that amount is established, which we consider is best seen as a range, Racing is committed to working with the Levy Board and Betting to establish a Scheme which is designed to have a good prospect of achieving it as a "target yield".

Under the new process, "any matter that is relevant in the circumstances at [the] time…should be taken into account."

This is a task that we believe requires an evidence based approach based on rigorous analysis, and the few "fixed points" that exist over the history of the Levy. We have adopted a number of different approaches:

- An approach which considers Racing's reasonable needs, the Betting industry's reasonable capacity to pay and the wider economic, fiscal and social circumstances as may relate to Betting and Racing;
- An approach based on generally accepted economic theory and detailed analysis of the financial returns from fixtures, whilst also taking into account racecourses' financial performance and the level of contributions emanating from racehorse owners.

We have adopted a conservative approach throughout.

We have also analysed international comparisons between Britain and other major racing nations as a validating exercise, and to compare with the returns from Betting to Racing deemed to be 'reasonable' in other major racing nations.

Taking into account all relevant circumstances, Racing believes that the reasonable return from Betting in the course of the 50th Scheme should be between **£130m** and **£150m**.

B. Funding of Racing

The table below illustrates how the funding structure of Racing has shifted since the early 2000's, including a reduction in the relative contribution of the Betting industry in contrast to the much higher payments from owners and Racing's other consumers (i.e. racegoers, non-betting media rights customers and sponsors etc.).

In this report we draw analogies between now and 2002, this being the year in which the Secretary of State last determined what range of values would represent a reasonable return.

The c.25% fixture expansion which has occurred since 2002 has been largely funded by Racing's participants, despite being, in large part, driven by the requirements of the Betting industry. With the majority of the additional fixtures being staged at All Weather racecourses, the fixture expansion has been achieved using the most efficient means available to Racing.

Financial contribution to British Racing - 2002, 2005 and 2008							
	2002		2005		2008		Growth 2002-08
Group	**£m**	**%**	**£m**	**%**	**£m**	**%**	**£m**
Betting industry	120	19%	152	17%	160	15%	40
Racing consumers	197	31%	301	35%	404	39%	207
Owners - net training costs	125	20%	200	23%	275	26%	150
Owners - breeding operations costs	191	30%	217	25%	207	20%	16
Total	**633**		**870**		**1046**		
Source: Economic Impact of British Racing (2006 and 2009 Deloitte reports); KPMG; BHA estimates							

- The most striking aspect of the split of expenditure is the very substantial increase in contribution to British Racing of owners. Net training fees alone are estimated to have grown by £150m between 2002 and 2008, as a consequence of higher training costs and, importantly, marked falls in real terms in average prize money levels. These higher training costs are largely reflecting higher costs of goods and services, and do not reflect an internal "profit".
- Betting's contribution represents payments to the Levy, LBO picture rights and race sponsorship payments.
- For many class of races, the actual prize money being offered in 2010 is below that offered for the same races in 2002, which is both unfair and also importantly acts as a major deterrent for existing owners to stay in the sport, and to new owners to enter the sport.
- When combined with the costs of breeding horses (which owners typically bear through horse purchases) investment from owners totalled almost £500m in 2008.
- The majority of this expenditure is injected into the rural economy and is vital in supporting tens of thousands of jobs. Prize money is also distributed to trainers and their staff, so it is not only an indirect factor in encouraging or discouraging owners, it also has a direct impact on pay levels for the workforce.
- The majority of Racing consumer spending is at racecourses. However, the substantial associated costs mean that racecourses' profits remain at modest levels. Aggregate racecourse profits in 2008 were substantially lower than in 2002.
- Racecourses' profits are estimated to have declined by a further 5-10% in 2009 and the outlook for 2010 and 2011 remains challenging. We have taken full account of all racecourse income streams. Increased returns from media rights contracts for LBO pictures already negotiated are believed not to apply until 2012 fixtures at the earliest, and hence are largely not relevant in the 50th Levy Scheme consideration.
- The proportion of Racing's funding which comes from the Betting industry has declined from 19% in 2002, to 15% in 2008 and is almost certain to have fallen further in 2009. This is despite the Betting industry's much enhanced capacity to pay.

C. Betting's Increased Capacity to Pay

- The Betting industry has experienced a period of sustained and rapid growth driven by deregulation, product diversification and the introduction of gross profits tax. By illustration the pre tax and interest profits of the "Big 3" Betting operators (William Hill, Ladbrokes and Coral) increased from less than £250m to over £750m between 2001 and 2008.
- The recession has seen declines in profits in 2009, but profit levels are still markedly higher than in 2002, and the Betting industry's confidence in the medium term health of the market is seen in the continued investment they are making.
- British Racing remains by some margin the largest sport for British betting operators. Since 2003/04 the Betting industry's gross win from British Racing has consistently been over £1bn, reaching a high of £1.2bn in 2007/08.
- The decline in the gross win from British Racing since 2007/08, and hence payments to Racing through the Levy, is a reflection of major structural defects of recent Levy schemes. Betting on Racing remains as popular as ever but significant leakages have occurred through exchanges and offshoring amongst other factors. The termination of Levy contributions from betting on all racing in LBOs has a negative impact. The continued existence of LBO thresholds under a gross profits Levy regime has also unfairly reduced the amount of Levy.
- British Racing has consistently met the Betting industry's need for additional product by expanding the fixture list and in slots to suit the Betting industry, notably winter evenings. Whilst the betting opportunities provided by the additional fixtures are intended to increase betting operation profits on Racing, it is clear the fixtures are also intended to increase profits on other products available in betting shops, particularly FOBTs/gaming machines. Racing does not benefit from these profits but bears the full cost of the expansion. Furthermore, the development and promotion of these other products has deflected betting away from Racing.

D. Quantifying a reasonable return and target Levy yield

In seeking to assess a reasonable return, taking into account all relevant factors, we have considered various methodologies, with a range emanating from each of these approaches as follows:

REASONABLE LEVY YIELDS		
	Method	**2011/12 reasonable return**
1.	**Racing's Needs** A cost focused approach based on conservative estimate of the incremental costs to Racing since the 2002 Determination of a reasonable range of £90-£105m.	£133-152m
2.	**Reasonable Share of Benefits** Starting with the 2002 Determination, consider a fair apportionment of the benefits of the substantial fixture expansion between Racing and Betting.	£128-149m
3.	**Market approach** An economic model which mirrors negotiations widely used for specialised assets for which there are unique users and suppliers.	£121-151m (£154-184m including convoyed sales)
Result	**Reasonable Levy Yield**	**£130-150m**

Based on these approaches, and validated by the international comparisons set out in section 4, we believe that the reasonable return from Betting in the course of the 50th Scheme is between **£130m** and **£150m**.

E. Racing's Needs Approach

- Our first approach starts with the 2002 Determination, this being the last time a comprehensive determination concluded what a reasonable return should be. In reaching her decision the then Secretary of State, Tessa Jowell, considered it reasonable that the 2002/03 Levy amount should be in the £90-105m range.
- While a Determination of the 47th Levy Scheme did of course take place in 2007/08, the result was not the setting of a new Scheme, but a rollover of existing arrangements to be accompanied by a full review of a number of issues surrounding the Levy, and a modernisation of its processes. The modernisation that has led to the new timetable and Racing submitting its proposals first will allow for many of the largely unresolved issues to be dealt with in the forthcoming negotiations.
- In this approach, we take the £90-105m range and evaluate how Racing's Needs have increased since 2002/03 by considering the impact of inflation, fixture expansion and related costs and demands on racecourses/central funding and the horsemen. The table below summarises the results of each of these factors.

Racing's Needs

£'m	Lower	Upper
2002/03 target yield	90.0	105.0
Less 2002/03 integrity costs	(16.2)	(16.2)
2002/03 target yield excluding integrity	73.8	88.8
Current integrity costs (2009/10)	25.0	25.0
Additional Fixtures		
Racecourse losses (1)	5.5	5.5
Owners' transport costs	6.5	6.5
Inflation (2)	22.2	26.3
TOTAL	**133.0**	**152.1**

Notes:

(1) Includes an estimated £4m of additional overheads and a requirement for reasonable return on capital. Excludes integrity costs of extra fixtures to avoid double counting

(2) Actual RPI to 2010 has been applied to the 2002/03 target yield (excluding integrity), thereafter forecast inflation has applied to all costs

Source: BHA analysis

Racing has experienced significant inflation since 2002/03

- Many of Racing's largest costs such as utilities, transport, equine costs etc, have experienced high inflation rates over the period. We have taken a conservative approach by using RPI which in aggregate was 25% between 2002/03-2009/10. We have used the general economic consensus on forecast inflation rates to adjust upwards to 2011/12.

The continued standards of regulation and integrity of British Racing is paramount but has an associated cost

- Centrally funded regulatory and integrity costs (including the provision of raceday officials, a comprehensive programme of Equine Welfare, doping control, an integrity services team, a comprehensive head office function to deal with the licensing of the sports participants and all racecourses, and disciplinary processes enforcing the Rules of Racing) have increased from £16.2m in 2002/03 to £25m in 2009/10. This is primarily as a consequence of the substantial fixture expansion and the increasingly complex betting environment in which Racing operates (including the emergence of betting exchanges).
- Operational efficiencies in regulation and integrity provision have been introduced by the industry, which have reduced the cost per fixture, and Racing continues to work to introduce further efficiencies wherever possible. However, as is generally accepted within the Levy Board's own policy objectives and across Government, there can be no compromise from the existing highest standards of regulation and integrity. Hence the scope for significant further cost reductions is limited.

The Betting industry must contribute reasonably to Racing's costs of fixture expansion

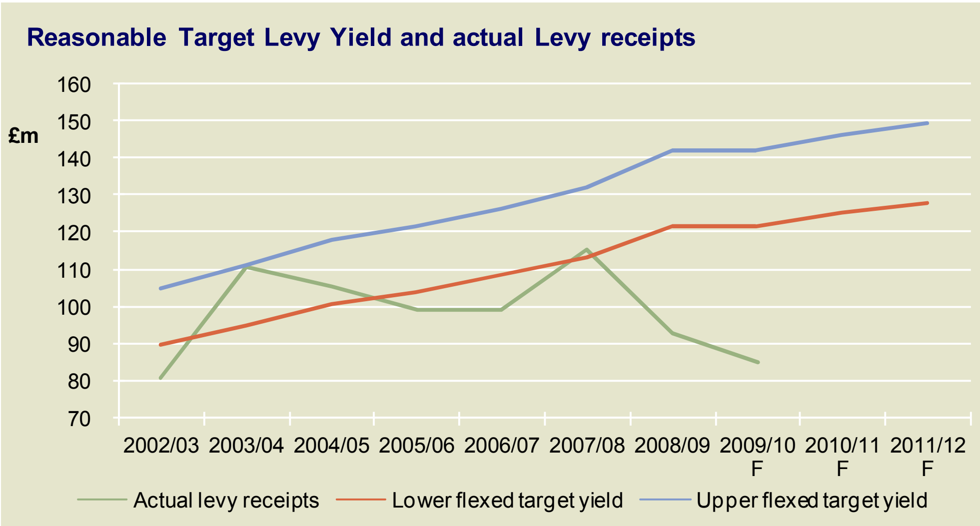
- In order to establish the minimum payment that is required from the Betting industry through the Levy for Racing to put on the additional fixtures, put on at Betting's request, namely BHA leasehold fixtures, we have considered racecourses' raceday losses, excluding all amounts paid to the racecourse by the Levy Board. By excluding these amounts but giving full credit for other revenues including LBO picture payments, we arrive at a loss before central support. It is reasonable to expect Betting, through the Levy, to at least make good the losses arising from these fixtures.
- Our analysis estimates that this pre Levy support raceday loss is £6m for the 2009 leasehold fixtures.
- In addition we conservatively estimate that the additional overheads created, forgone non-raceday revenue and the incorporation of a fair, but modest, return from these fixtures results in a further £4m funding requirement.
- We have deducted the £4.5m integrity costs (funded by the Levy) from this total to remove double counting, which results in a net cost of these additional fixtures of £5.5m.

Owners' costs - a modest but fair funding solution that will benefit all parties

- We have already highlighted the £150m increase in net owners' expenditure on training costs since 2002. The expansion of the fixture list has been an important factor. However, for this methodology we have only considered the most direct cost, namely transport costs, incurred by owners to bring their horses to these additional fixtures.
- We propose owners' estimated transport costs of £6.5m for these additional fixtures should be funded through an increased Levy yield. The use of this funding will help rebalance the current unsustainable cost versus reward equation.

F. Reasonable Share of Benefit – a fair apportionment of the benefits of fixture expansion

- This approach is related to the Racing's Needs approach in that it starts with the 2002 Determination's specified range and adjusts for inflation.
- It differs in that rather than purely focusing on Racing's incremental costs it considers a fair apportionment of the benefits of the substantial fixture expansion between the Racing and Betting industries.
- Our methodology recognises that there is not a linear relationship between the increase in the size of the fixture list and total betting turnover on British Racing, primarily due to the substitution effect (being punters transferring some of their stakes on existing Racing to new additional fixtures) which we have conservatively estimated as 50%. In practice we consider it likely to be significantly lower than 50%, particularly given the establishment of many fixtures in new time slots.



Source: HBLB; BHA Analysis

- The chart above shows the result of the 2002/03 range adjusted for inflation and additional fixtures, together with the actual Levy receipts to 2008/09 (and forecast for 2009/10). It illustrates how that in real terms successive Levy schemes since 2004/05 have failed to generate sufficient Levy receipts to keep pace with even the lower limit of the specified range of the 41st Scheme.
- This approach illustrates that while it is recognised the reasonable Levy yield for 2011/12 represents a substantial uplift from current levels, this is due to Racing receiving amounts considerably below what it should have on a reasonable basis for many years.

G. Market Approach

This approach provides a generally accepted test of what a reasonable return should be in the operation of a market. We have therefore carried out an analysis based on general economic theory employed in negotiations and valuation exercises for the purposes of tribunals etc, to consider how the Levy might be determined in a market context. The model mirrors negotiations widely used for specialised assets, often involving intellectual property, for which there are unique users and suppliers.

In this approach, parties are taken to enter hypothetical negotiations and make initial offers of the maximum or minimum Levy prices they could possibly accept. They negotiate an agreed Levy price within this price range, depending on their relative bargaining power, needs and capacities. The key features of the model include:

- The "upper bound" of the range would be the maximum Levy that Betting might be prepared to pay for access to Racing for Betting purposes. It represents the profits betting would lose if British Racing was withdrawn.
- The "lower bound" of the range is the minimum Levy that Racing might be prepared to accept to supply an acceptable quantity and quality of Racing product. The lower bound has been derived from an analysis of how many leasehold fixtures would be withdrawn by Racing given step reductions in the headline Levy rate, and how low the Levy could be reduced before Betting's lost profits from the withdrawn fixtures exceed its Levy savings on the remaining fixtures.
- These extreme "walk away" positions define the bounds of the negotiations.
- The analysis computes a price between the two extremes where the parties might agree to share the "surplus" (the difference between the upper and lower bounds), depending on their relative bargaining strength and other considerations.
- Having calculated the upper and lower bounds, it is conservatively assumed that Racing retains only 25% of the difference (which might actually be higher in commercial situations).

The economic model estimates that a negotiation would likely result in an agreed price of £121-151m, excluding the impact of "convoyed sales".

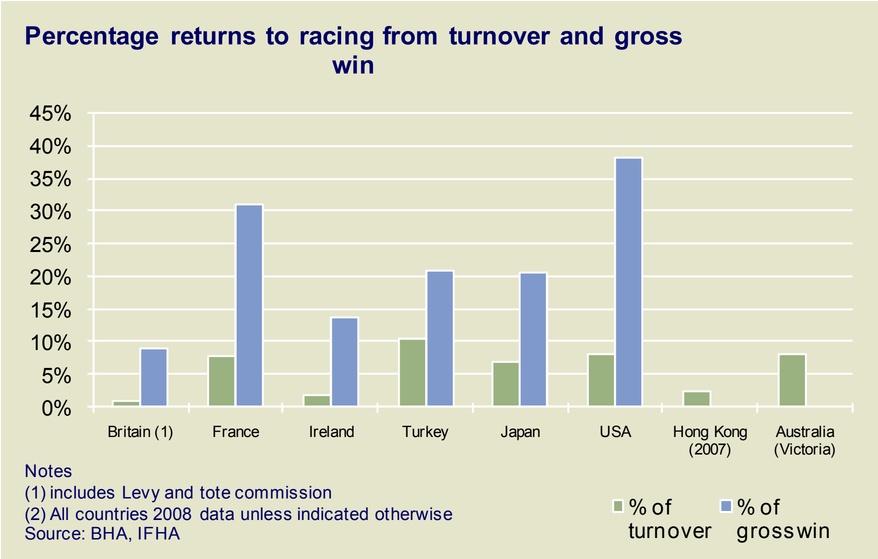
The "convoyed sales" aspect recognises that Racing contributes to the sales of other products in the LBOs, notably FOBTs. When LBO earnings from "convoyed" sales are added this increases the range to £154-184m.

H. International comparisons starkly illustrate the chronic underfunding of British Racing by Betting

Even in countries where there is a cultural, social and legal antipathy towards betting, Racing and the economic and social good that it creates, particularly in the rural sector is recognised, as is its inherent value as a betting product. Systems have therefore been put in place to enable Racing to be funded by Betting.

International comparisons validate the results of our previous methodologies, as showing that levels of funding in Britain, which has developed the most liberal approach to betting and gaming, are not at reasonable levels. It also shows that the returns from Betting to Racing deemed as reasonable in other major racing nations far exceed the return to British Racing via the current Levy mechanism:

- The equivalent to 1% of betting turnover paid to Racing in Britain compares to a more typical range of 8-12%.
- The 10% levy on gross profits on British Racing is again significantly less than in other countries which typically have returns in the 20-35% range.



This shows British Racing is at a serious disadvantage, as further evidenced by increasing numbers of owners relocating their horses overseas. As horseracing becomes increasingly global, this position threatens the long term health of the Racing industry in this country.

I. Options by which the 50th Scheme can deliver a reasonable return

It is not the purpose of this submission to propose the detailed design of the 50th Levy Scheme to achieve what is considered to be the reasonable return, and therefore a target Levy yield. The design of the Scheme must follow after the reasonable return has been established. Indeed, it is a matter for the Bookmakers' Committee to propose and the Levy Board to agree a Scheme that will deliver a reasonable yield to Racing, particularly bearing in mind the fact that Racing does not have the detailed information on which to make detailed proposals.

However, in considering the Scheme's design, we believe both the Bookmakers' Committee and the Board should take into account the various structural deficiencies that exist within the current Scheme.

The suggestions listed below are not intended to be exhaustive:

- **Overseas horseracing** - in our view, the Levy on overseas horseracing should properly now be reintroduced for the 50th Scheme. There is nothing in the Levy legislation which limits the Levy to revenues in relation to British horseracing and, indeed, there is clear historical precedent for our position.
- **Thresholds -** are a historical anomaly and we suggest they are removed from the 50th Scheme. In principle, there is no proper place for a Thresholds System in any Scheme where LBO contributions are calculated by reference to gross profit. However, provided that a reasonable return is established and a Scheme designed to target this yield, Racing would fully support initiatives within Betting to establish relief from Levy payments to the very smallest operators who run just a handful of LBOs if this were to encourage and protect consumer choice.
- **Betting on exchanges -** we consider there are two key issues that need to be considered in relation to Betting Exchanges for the 50th Scheme to determine how the exchanges pay a fair return to Racing, through the Levy:

- Firstly, whilst betting exchanges and traditional bookmakers are “bookmakers” for Levy purposes, they perform very different roles and derive their income from betting on Racing in different ways, and there is, therefore, no reason why they should be subject to the same treatment within the Levy Scheme.
- Secondly, it seems certain that there are many exchange customers who are acting as "bookmakers" within the Levy legislation and, therefore, have an obligation to pay the Levy as such under both the 48th and 49th Schemes. Any design of the 50th Scheme should facilitate the efficient collection of Levy from these individuals.

- **Offshoring -** the Levy was designed to capture all British betting activity on Racing; the fact that some companies have set up telephone call centres or websites offshore to carry out the same activity should not alter their obligation to pay the Levy.
- **“Relates to” Test –** Racing is entitled to receive the Levy in respect of any area of betting operator business that “relates to betting” on horseracing. This means that Racing should be entitled to receive a level of return referable to FOBTs, ‘Virtual Racing’, and other revenue streams where that revenue can reasonably be said to “relate to”. We believe the Levy Board should request specific information from Betting that would quantify such relationships.

2 INTRODUCTION

2.1 A new Scheme

SUMMARY

- **Racing welcomes the new process heralded by the Levy Board's letter to the Secretary of State in April 2009 to arrive at what the amount should be. That amount has to be reasonable, and Racing is committed to a process of negotiation, overseen by the Levy Board Independents, to arrive at that reasonable amount.**
- **Racing's goal is simply this: to establish a reasonable yield to Racing from the Levy for the 50th Scheme. This submission sets out Racing's assessment of what would amount to a reasonable yield.**
- **Once that reasonable amount is established, which we consider is best seen as a range, Racing is committed to working with the Levy Board and Betting to establishing a Scheme which is designed to have a good prospect of achieving it as a target.**

The new process

Racing welcomes the decision by the Levy Board to introduce a new process for conducting our annual Levy negotiation, as set out in its letter of 30 April 2009 to the Minister for Sport. The Levy Board can be assured that Racing is fully committed to this process.

We believe that the Levy Board's process is a significant step forward from that adopted in earlier years. This is because:

1. Previously, waiting for the Bookmakers' Committee recommendation has left insufficient time for Racing and Betting to reach a negotiated solution with sight of all necessary information.
2. 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 (as outlined in this submission).
3. In the past, the timing of the process has prevented the Levy Board from gathering information on key issues which it would need in order to properly assess the reasonable return and therefore target Levy yield.

A key benefit of the revised process is that the Levy Board now has the time and opportunity to seek information from the gambling operators at an early stage to fully address the issues raised by Racing. We hope that the Levy Board and the Bookmakers' Committee will embrace this opportunity, and that the process outlined in the Levy Board's letter to the Minister for Sport of 30 April 2009 will result in a recommendation from the Bookmakers' Committee which reflects a thorough prior discussion and negotiation on all relevant issues, without the need for determination.

What should be considered when establishing a reasonable Levy yield to Racing?

Our goal in making this submission is simple: to establish what should be the reasonable yield to Racing from the 50th Scheme. Our view is that the scheme should be structured so as to deliver a yield to Racing of between £130m and £150m[1].

In reaching this view, we have applied the test (which we wholly endorse) set out by the Levy Board in its letter to the Secretary of State of 30 April 2009:

"The baseline for any Levy negotiation has always been, and is, that any matter that is relevant in the circumstances at that time under the provisions of the 1963 Act, should be taken into account, giving such weight to any such matter(s) as is appropriate, which may include the following:

a) All prevailing economic, fiscal and social circumstances as may relate to Betting and Racing;

b) Betting's reasonable capacity to pay; and

c) Racing's reasonable needs".

We will not, in this document, make lengthy legal submissions regarding this test (although we can do so on request). For the moment, we would simply make the following points:

- First, when considering the needs of Racing, it is not enough to consider what is required to prevent a "spiral of decline" in Racing - it is necessary to establish what is necessary to ensure the pre-eminence of the Racing industry, since this is the stated purpose of the Levy legislation. When introducing the Levy in 1961, the then Home Secretary (Mr R Butler) stressed that "*The justification for it is the need to provide the machinery by which a great national sport and a national industry can be prevented from getting into trouble or declining. If, as a result of the [1961 Act], public support for horseracing can be maintained and increased, that purpose will be further advanced by the [Act]. In my view, it is in the national interest that our prestige and, indeed, our* ***pre-eminence*** *in the breeding and racing of bloodstock should be maintained. I believe that this [Act] will help to maintain it.*"
- Second, a full consideration of the indirect social, cultural and economic benefits of supporting horseracing through the Levy is imperative to setting a reasonable Levy. We explore these benefits in detail in section 2.2.

[1] We also set out our suggestions as to how the 50th Scheme may be managed to deliver this yield. However, we would stress Racing is not primarily concerned with how the Scheme is managed, but rather that the yield required by Racing is achieved.

- Third, when considering the gambling operators' capacity to pay, it is necessary to consider the whole of the bookmakers' businesses. This requires an assessment of the wider revenues from the bookmakers' entire operation (i.e. including revenues made from gaming machines (including those previously known as FOBTs).[2]

- Fourth, we would ask the Levy Board to note that the British Betting industry has enjoyed a prolonged period of substantial growth in profits. This is primarily due to:

    - Further liberalisation of the betting market including extended LBO opening hours and relaxation of advertising restrictions; and

    - Product diversification – including from sports betting, online offerings and FOBTs.

- The table below illustrates this growth by comparing the pre tax and interest profits of the “Big 3” betting operators (arising from their British focused operations) in 2001 to the most recently available information (2008 or 2009).

Big Three Bookmakers :
British Earnings before Interest and Tax

£m	**2001**	**2008**	**2009**
Coral (1)	26	192	n/a
Ladbrokes (2)	99	296	227
William Hill (3)	112	279	258
Total	237	767	n/a

Notes

(1) 2008 excludes Gala Bingo and Gala Casinos, pro-rates the Group's admin costs and operating income -excludes £159m exceptional costs

(2) 2008 and 2009 excludes other European Retail and discontinued operations, includes high rollers, 2001 excludes Vernons

(3) - excludes exceptional items including £88m profit in 2008

Source: Company Financial Statements

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[2] It is important to note that this is a distinct issue from the consideration of what constitutes leviable income. Bookmakers' income is leviable "in respect of so much of the business of the bookmaker as relates to … betting transactions [on horse races]". However, the consideration of "capacity to pay" is not limited by those words, and Lord Pannick has advised Racing that a broader investigation of income when considering capacity to pay is entirely reasonable.

The Bookmakers' Committee asserts that: it would be "*an error of law and also irrational for the amount of the Levy to be based in any way on … non-British racing or from other sports or gambling (such as FOBTs)*". This is legally incorrect, and Racing strongly disagrees. On the contrary, Racing would submit that it would be irrational if the Secretary of State was barred from taking account of income from sources other than bets placed on horseracing when it considers the capacity of betting operators to pay the Levy. This would, for example, enable the betting industry to use racing product as a "loss leader" from which it derives no direct profit, yet increases profit from other activities such as FOBTs, without any obligation to pay the Levy.

Separately, please also note that the Bookmakers' Committee have previously, and wrongly, conflated the questions of “capacity to pay" and “what constitutes the pool of leviable income”. The latter is defined, in section 27(2)(a) of the 1963 Act, by reference to parts of the bookmakers' business that "relate to" bets on horse racing. The concept of "capacity to pay" is not limited in this way. The issue of what constitutes leviable income in Section 5.

Profits increased by over £500m between 2001 (being the year when gross profits tax was introduced) and 2008. While the Big 3 have taken an increasing share of the market over that time through organic growth and acquisitions, the underlying growth has still been remarkable.

The total profits before tax and interest of the British retail market in 2008 was estimated as being £0.8bn[3] which given the relative size of retail and remote betting (telephone and online (British operators)) means it is likely the equivalent profit for the industry was over £1bn.

The declines experienced in 2009 are a product of the deep economic recession, with the industry proving less resilient than in previous, less severe, downturns. Nonetheless aggregate profits remain very substantially higher than in 2001.

It is Racing's case that Racing has suffered a decline in return from Betting to unreasonable levels due to structural reasons i.e. the inability of the 1963 Act mechanic to adapt and apply as intended to current market conditions (including offshoring and exchanges).

- Fifth, gambling operators, of course, also benefit economically from a healthy horseracing industry, and by the existence of the fixtures supported by the Levy. The opening hours of licensed bookmakers' offices are, in large part, dictated by Racing's fixture schedule.
- Sixth, the substantial growth in betting on alternative products such as FOBTs and Virtual Racing, has undoubtedly deflected betting on Racing; this being further evidence of why the existing Levy mechanism has failed to deliver the return for Racing that had been anticipated by the Minister when it was introduced.

The importance of Racing to the Betting industry is covered in more detail in section 2.2.4 below.

[3] The Full Picture: An Economic Impact of the British Betting Industry (2010 Deloitte)

2.2 Racing's economic and social importance

SUMMARY

- **Racing is a deeply engrained and important part of Britain's sporting and cultural life, and makes a major contribution to the economy and society as a whole.**
- **Racing employs thousands of people across Britain. It requires sufficient funding to enable it to retain this position.**
- **Racehorse owners and Racing consumers currently fund 85% of Racing's costs, with owners injecting £0.5bn in 2008. Their net training expenditure alone has grown by £150m since 2002, in part due to actual declines in prize money levels.**
- **In 2008 Betting contributed 15% of Racing's income down from 19% in 2002, and is almost certain to have fallen further in 2009.**
- **Racing remains the core product of the British Betting industry but structural deficiencies in the current Levy scheme have resulted in reduced payments to Racing.**

2.2.1 Overview

During the course of 2009, Racing commissioned the Sports Business Group at Deloitte to update the previous 2006 Economic Impact report, and Business in the Community to measure the extensive community links and contribution Racing makes to British life, with the result being "Racing Together - Horseracing and the Community".

The two reports were launched in summer 2009 and should be viewed in tandem.

In this section we draw on both reports to illustrate Racing's economic and social impact. In the interests of brevity we have kept this section brief. Readers can refer to the both reports for a more comprehensive discussion of the issues.

The table below sets out key measures of Racing.

KEY MEASURES OF RACING – 2008	
Total economic impact of British Racing	£3.39bn
Core British Racing industry expenditure	£1.05bn
British Racing's tax contribution	£325m
Core industry employment (FTE)	18,600
British betting industry's gross win on British Racing	£1.05bn
Average no of horses in training (1)	14,869 (2)
Number of owners (1)	9,011 (2)
Total racecourse attendances (m) (1)	5.7 (2)

Notes
(1) 2009 figures

Source: Economic Impact of British Racing (Deloitte 2009), BHA, Weatherbys

- The core Racing industry generated expenditure of over £1.05bn in 2008. This core expenditure in turn generated a further £2.34bn of indirect and induced expenditure, giving a total economic impact of £3.39bn.

- The core industry supports 18,600 employees (FTEs). In total there are over 100,000 direct, indirect and associated jobs within British Racing, including a proportion of those employed in Betting. Racing's employees are hugely dedicated to the sport, and many of them work for relatively low wages.
- Racing contributes over £325m in taxation – comprising betting duty, employment taxes and corporation tax.
- Racing remains by some margin the most popular sport for people to bet on in Britain.
- On average over 14,800 horses were in training in 2009, with an estimated 24,000 horses in training at some point. Thoroughbreds are located right across the country.
- There were over 9,000 registered owners, but in total over 40,000 people are estimated to have some interest in racehorse ownership. We discuss their invaluable and increasingly disproportionate contribution shortly.

The Economic Impact study focused on the period up to 2008. Many of the metrics in the report have since declined, largely as a result of the deteriorating economic situation.

2.2.2 Racing is in the fabric of British Society

Britain's 60 racecourses are located across the length and breadth of the country, and are typically at the heart of local communities.

Racing Together highlighted just some of the valuable contributions, often unheralded, Racing makes to local communities.

By a variety of key measures - including industry expenditure, racecourse attendances, employment, taxation generated and capital expenditure - Racing is the nation's clear biggest sport after football.

Racing's major festivals are ingrained in the country's sporting calendar, and through the Grand National, Racing has one of a handful of truly annual national events.

Racing matters to many thousands of people across Britain. It requires sufficient funding to enable it to retain this position.

2.2.3 Funding of British Racing

The table below illustrates how the funding of Racing has shifted since the start of the last decade, including a reduction in relative contribution of the Betting industry in contrast to the much higher payments from owners and Racing consumers:

Financial contribution to British Racing - 2002, 2005 and 2008

	2002		2005		2008		Growth 2002-08
Group	**£m**	**%**	**£m**	**%**	**£m**	**%**	**£m**
Betting industry	120	19%	152	17%	160	15%	40
Racing consumers	197	31%	301	35%	404	39%	207
Owners - net training costs	125	20%	200	23%	275	26%	150
Owners - breeding operations costs	191	30%	217	25%	207	20%	16
Total	**633**		**870**		**1046**		

Source: Economic Impact of British Racing (2006 and 2009 Deloitte reports); KPMG; BHA estimates

Owners' increasing contribution and poor returns

The most striking aspect of the split of expenditure is the very substantial increase in contribution of owners to British Racing. Net training fees alone are estimated to 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) and, importantly, marked falls in real terms in average prize money levels.

When combined with the costs of breeding horses (which they typically bear through horse purchases) their investment totalled almost £0.5bn in 2008 (46% of total funding).

The table below compares the minimum race values of a variety of race types between 2002 and 2010 and illustrates the extent of the decline in prize money levels over this period.

Selected Minimum Race Values – 2002 v 2010

Race Type	2002	2010	+/(-) %
Flat (handicaps)			
0 to 90	£10,000	£10,500	+5%
0 to 75	£3,900	£3,600	-8%
0 to 60	£3,200	£2,600	-19%
Maidens	£5,700	£3,600	-37%
Chases (handicaps)			
0 to 130	£9,000	£9,000	+0%
0 to 115	£5,750	£4,800	-17%
0 to 95	£3,400	£2,900	-15%
Hurdles (handicaps)			
0 to 130	£7,400	£7,200	-3%
0 to 115	£4,500	£4,000	-11%
0 to 95	£2,500	£2,600	+4%

The fact that horses are regularly competing for less prize money than in 2002 provides stark evidence of Racing's underfunding, acting as a major deterrent for existing owners to stay in the sport and new owners to enter the sport.

A large majority of this expenditure is injected into the rural economy and supports not only thousands of direct jobs in training yards and stud farms, but also jobs across the many sectors which rely on Racing for much of their income. The continuation of the current industry scale is dependent on the willingness, and ability, of owners to sustain current levels of investment. The decline in stable staff employees in 2009 from a modest fall in horses in training illustrates how vulnerable the industry is to this funding. Racing is an increasingly important part of the rural economy given declines in many other agricultural industries.

Racecourses' modest profits despite increasing revenues

British Racing, primarily but not exclusively the racecourses, has been successful in developing a broad range of revenue streams to compensate for the relative lack of betting contribution as well as making full use of their assets (see section 4 for the contrast with many of Britain's major international competitors). Racing's consumers spent £404m in direct expenditure alone on Racing in 2008. However, in Section 3.2.4 we set out that due to the high associated costs, racecourses profits are modest and have declined since 2002.

Betting's declining contribution to Racing

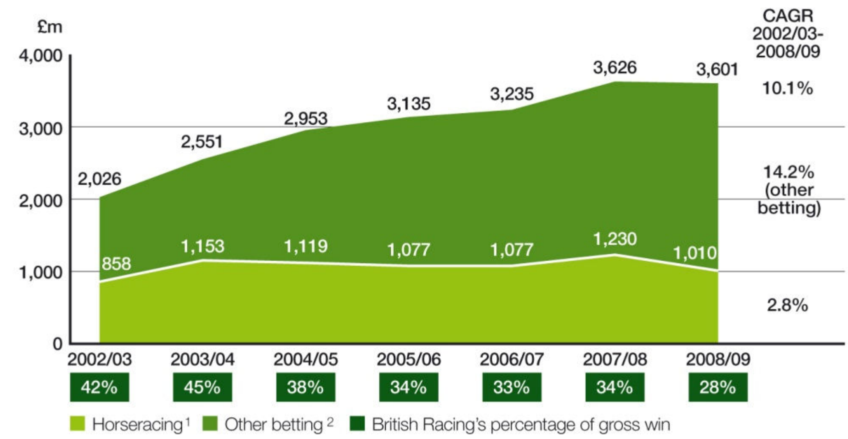
The net expenditure (i.e. betting operators' gross win) of punters on British Racing has been over £1bn per year since 2003/04, however the structure of the industry means that only an estimated £99m was directly paid to Racing through the Levy for 2008 (calendar year).

Once the amounts paid by the Betting industry for LBO picture rights, on-course betting commission and sponsorship are added to the Levy, £160m was paid to Racing; representing 15% of Racing's funding, Betting's proportion has declined markedly from 2002 and is almost certain to have fallen further in 2009.

In addition to the Levy mechanism, the Horserace Totalisator Board (the Tote) also exists for the good of Racing. Established in 1928, the modern day organisation is split between a pool betting and fixed odds business, the latter comprising over 500 Licensed Betting Offices plus remote betting operations. Its contribution to Racing is made up of Levy payments, commissions directly to racecourses relative to on-course Tote betting, and donations and sponsorship. This amounts to some £84m over the last four years, with the total contribution in 2009 being £19.1m. The Tote therefore provides approximately 12% of Betting's contribution to Racing despite representing around only 6% of industry gross win.

2.2.4 Racing at the heart of the British Betting industry

British Betting Industry Gross win by type



Note 1: British Racing gross win includes betting exchange commissions, typically 1.5-5%, on winning bets and which has grown from £23m in 2002/03 to £76m in 2008/09.
Note 2: Excludes online casino and poker and offshore sportsbook.

Source: HM Revenue and Customs; Company/group financial statements; Deloitte analysis.

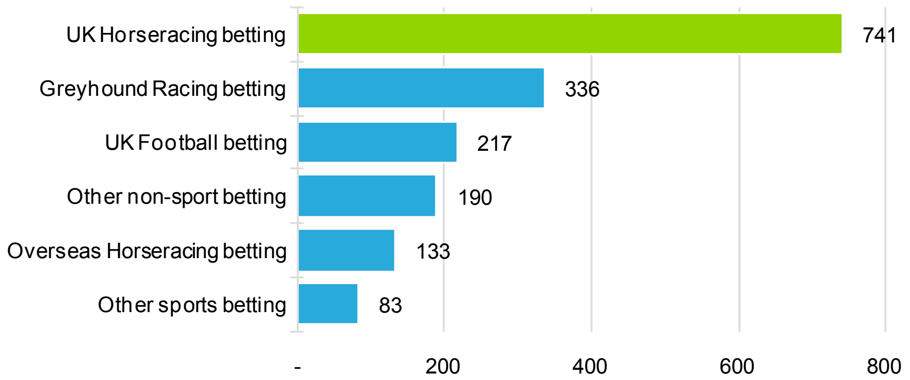
The graph above sets out the estimated total gross win of betting operators from British Racing and total from all betting, together with British Racing's percentage of total gross win from 2002/03 to the present.

Key aspects include:

- Since 2003/04 the betting industry's gross win from British Racing has consistently been over £1bn, reaching a high of £1.2bn in 2007/08.
- £5.5bn of gross win from British Racing has been earned by British betting operators in the last five years of which £513m was paid to Racing via the Levy. This represents 9.3% of the total, and illustrates the impact of thresholds on the Levy yield.

The emergence of FOBTs since 2002 has contributed significantly to British Racing's proportion of total gross win declining from 42% to 28%. Nonetheless, British Racing remains the biggest sport by some distance for betting operators, as illustrated by the chart below which breaks down LBO gross win excluding machines.

Composition of Betting Shop gross win (exc. machines) (£m), 2008



Source: ABB report 2009, Reproduced from Deloitte "The Full Picture" report, 2010

- The gross win from British Betting in 2008 was £741m compared to the next biggest betting on greyhounds of £336m and football of £217m.
- British Racing is the clear preference for punters, but significant amounts are also bet on overseas racing – in 2008 the gross win in LBOs from overseas racing was £133m.

British Racing is typically the anchor product that attracts customers to the shops who will then often bet on other products including FOBTs, and we believe that the Levy Board should request full information to allow the extent of the current relationship to be assessed.

The value of British Racing to retail betting is also illustrated in the higher picture rights agreements recently entered into with some of the racecourses by both SIS and Turf TV.

The gross win figures do not incorporate the gross win earned by offshore betting operators who take bets from British bettors, which has been progressively increasing as more operators move their sports book offshore. This major trend was not anticipated at the time of the 2002 determination. The move of William Hill and Ladbrokes internet operations offshore (amongst others) in 2009 has reduced onshore gross win and hence Levy payments further. The Levy Board estimated that the associated loss from William Hill and Ladbrokes alone was in excess of £4m per year.

The development of betting exchanges since 2001 has had a huge impact on the British betting industry. The £3.6bn gross win set out above in 2008/09 includes only the commission earned by exchanges. The analysis of the betting industry that led to the establishment of gross profits as the basis for assessing both Levy and betting duty took no account of the prospect of such a fundamental change in the market. Further, since that time, there has been no retrospective analysis to establish whether the growth of exchanges has intervened to disrupt the sharing between Betting and Racing of the proceeds of the growth in betting activity forecast upon the introduction of the gross profit mechanisms. Betting exchanges have also facilitated individuals operating as bookmakers (as defined in the Levy legislation and a different issue to whether they require a licence under the Gambling Act) but being able to avoid their statutory obligation to pay Levy. The current Levy scheme does not properly deal with these structural issues.

3 ALTERNATIVE APPROACHES TO DETERMINING THE REASONABLE RETURN TO RACING FROM THE 50TH SCHEME

3.1 Introduction

SUMMARY

- **We have considered various methodologies to assess what would represent a reasonable outcome to the 50th Levy Scheme.**
- **Methodology 1: Racing's Needs – updates the 2002 Determination to take account of inflation, the additional product that Racing now provides and other relevant factors.**
- **Methodology 2: Reasonable Share of Benefits – again starting with the 2002 Determination specified Levy Yield, calculates a reasonable apportionment of the benefits of the subsequent fixture expansion between Racing and Betting.**
- **Methodology 3: Market approach – considers how the Levy might be determined in a market context applying commercial principles through independent economic analysis.**
- **THESE VARIOUS APPROACHES IDENTIFY THAT A REASONABLE RETURN TO RACING VIA THE 50th LEVY SCHEME IS BETWEEN <u>£130M and £150M</u>.**

The establishment of a reasonable return requires consideration of all relevant issues: including the reasonable needs of Racing, the reasonable capacity to pay of the bookmakers and all prevailing economic, fiscal and social circumstances as may relate to Betting and Racing.

This is, by its nature, a challenging task requiring rigorous analysis of all relevant issues. Racing has therefore sought to identify methodologies and approaches by which the reasonable level of return might be assessed, and look forward to negotiation and discussion which we hope to end with an agreed target return.

In doing so, 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.

<u>Methodology 1: Racing's Needs</u>

<u>Adjusting the last "reasonable" scheme determined by a Secretary of State by reference to Racing's updated circumstances.</u>

We have taken as our starting point the Scheme determined by the Secretary of State on the last occasion a new Scheme was created by that means. This was in 2002, when Tessa Jowell determined the 41st Scheme[4].

When announcing her decision the Secretary of State stated that the 41st Scheme "*could yield a figure in the region of £90m to £105m*", and went on to say "t*his scheme should enable both the betting and racing industries as well as punters themselves to share in the benefits from the new tax regime*".

<u>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.</u>

[4] The 47th Scheme, determined by Gerry Sutcliffe, was simply a "roll over" of the 46th Scheme.

This provides a basis which is, by definition, reasonable.

We have therefore updated the 2002 determination to take proper account of how the needs of Racing, and the other relevant circumstances, have changed since that time. In particular we have considered:

- The effects of inflation experienced over the period to 2009/10, and forecast to 2011/12;
- The increased integrity costs of the industry due to the increasingly complex betting environment including the development of betting exchanges; and
- The incremental costs experienced by the racecourses and horsemen arising from the substantial expansion of the fixture list, taking into account other revenues generated from the expansion.

This needs-based approach does not therefore take into account the substantial benefits the Betting industry has accrued from this fixture expansion.

Methodology 2: A Reasonable Share of Benefit to Racing

This approach is related to the Racing's Needs approach in that it starts with the 2002 Determination specified Levy Yield, adjusted for inflation, and then considers a fair apportionment of the benefits of the substantial fixture expansion between the Racing and Betting industries.

In order to flex the 41st Levy Scheme range for the fixture expansion, we have taken what is a very conservative approach. Our methodology recognises that there is not a linear relationship between the increase in the size of the fixture list and total betting turnover and/or profit on British Racing, primarily due to the substitution effect.

The substitution effect in this context refers to the situation whereby some punters, being given a greater number of British races to bet on, fund these bets from a combination of higher overall stakes, but augmented by some reductions/transferred stakes from existing races.

We have prudently used a substitution rate of 50%, although we consider it to be significantly lower. If it were any higher, there would have been little reason for the betting industry to request additional fixtures.

Methodology 3: Market Approach

This approach uses economic analysis to consider how the Horserace Betting Levy might be determined in a market context applying commercial principles. It develops an economic framework for the Levy, and uses this to derive a range of possible Levy prices. The analysis has been performed by the independent economists, LECG.

3.2 Comparison of the Racing industry in 2002 and 2009

SUMMARY

- **The fixture list has expanded by over 20%, the majority of which are betting-focused fixtures. Racing has consistently met the betting industry's demand for new fixtures.**
- **Racecourse profits are already substantially lower in 2009 than 2002 and they face a challenging short to medium term outlook given economic conditions.**
- **Racehorse owners' funding of the sport has increased by £150m since 2002.**
- **Betting on Racing is as popular as ever but structural weaknesses (movements offshore, lower margins, exchanges, thresholds) have negatively impacted Levy yield.**

Before we discuss the results of the various methodologies we have used to establish a reasonable return, and therefore a target Levy yield for the 50th Scheme, we set out some of what we see as the context by briefly examining major changes in the Racing and Betting industries since 2002. We have chosen this year, 2002, because it represents the majority of the 2002/03 Levy Scheme hence shows the state of the respective industries at the time of the 41st Scheme Determination. The table below sets out key metrics:

Racing and Betting industry Metrics	2002	2008	2009	Growth 2002-08	Growth 2002-09
Racecourses					
Fixtures staged	1158	1423	1426	23%	23%
Aggregrate (adjusted) pre-tax profits (1)	44	19	n/a	-57%	n/a
Owners					
Owners' net expenditure on training horses	125	275	n/a	120%	n/a
Betting					
British betting operators' gross win (2)	2026	3601	n/a	78%	n/a
Gross win from British racing (2)	858	1050	n/a	22%	n/a
Levy (2)	79.9	93	85	16%	6%

Source: BHA, Weatherbys, Economic Impact of British Racing (Deloitte - 2009)

Notes

(1) Adjusted for levy capital grants capitalised

(2) Based on fiscal year of next year e.g. 2008 represents year ended March 2009, 2009/10 HBLB forecast

The gross win on British Racing has been impacted during this period by a number of leakages, including the increasing number of operators setting up telephone call centres and/or websites offshore.

3.2.1 Expanded fixture list

The marked expansion of the fixture list since 2002 has been the most important change to the Racing industry over this period.

The expansion was substantially in response to demand from betting operators for British Racing "product".

Part 1 of the British Horseracing Board's Racing Review, published in April 2003, noted that bookmakers had clearly identified times when they wanted more British Racing product and that over 20% of that required product was not being supplied. At that time there were 303 occasions in the bookmakers' criteria for paying for pictures for licensed betting offices when one of these requirements was not met. This meant that Racing was failing to meet over 20% of the Betting industry's demand. The initial fixture expansion filled a significant proportion of these gaps.

The 2005 Gambling Act meant that from 1 September 2007 LBOs were permitted to open in the evening between September and March, thereby allowing year-round evening opening. This extended opening resulted in greater demand still from the Betting industry for additional fixtures, as an anchor for LBO business in fulfilling their "primary purpose" under the legislation as betting operators, despite FOBT business being a significant focus during the new opening hours. Racing again answered this request, with over 100 winter evening fixtures programmed annually since.

British Racing has therefore consistently met the request for additional product by expanding the fixture list as quickly as possible within the bounds of the horse population and Racing's overall infrastructure. Moreover, with the majority of the additional fixtures being staged at All Weather racecourses, the fixture expansion has been achieved using the most efficient means available to Racing.

Whilst the betting opportunities provided by the additional fixtures are intended to increase betting operation profits on Racing, an additional (if not the primary) aim for Betting is to increase profits on other products available in betting shops. Racing has not benefited from these profits but bears the full cost of the expansion.

In creating these additional fixtures Racing was aware that in the majority of cases admission-related revenues and sponsorship/corporate revenues were likely to be limited (as seen in our discussion of the relative profitability of these fixtures in Section 3.3.5) but anticipated a reasonable allocation of the profits derived from the extra fixtures between Racing and the Betting industry.

3.2.2 Betting industry's financial performance

We have already set out the very significant growth in the Betting industry's revenues and profits over the 2002-8 period in Section 2. However it is in Racing's view particularly significant to contrast this growth in Betting's revenue and profits with the falling profits of racecourses and marked increase in contribution to the support of owners which we discuss below, both in relative and absolute terms.

3.2.3 Owners and horses

Owners were, of course, already important funders of the sport in 2002 but their contribution has increased dramatically with a c.£150m increase in net expenditure on training costs between 2002 and 2008. This increase has been through a combination of expansion of the horse population and rises in average training costs. Owners' contributions to prize money have increased as racecourses seek to maintain prize money levels. Indeed, these contributions have risen by 48% since 2005.

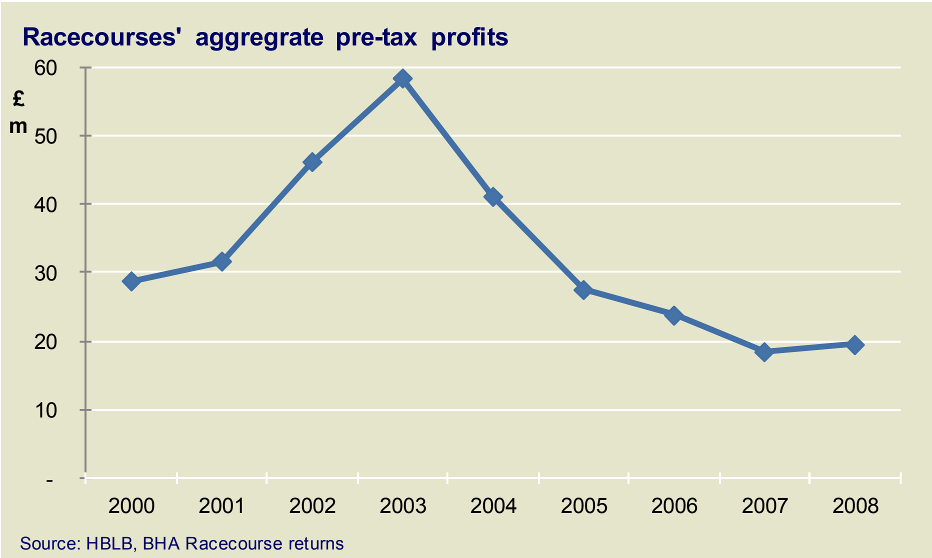
The 2009 falls in average horses in training and owners risks becoming much more pronounced if the current poor returns to owners are not redressed. Prior to the recession, the steady period of economic growth in Britain acted to, in part, compensate for the inadequate returns – effectively masking the structural weaknesses in the funding of the industry. However, the economic deterioration means that the industry no longer has this cushion, with owners increasingly vulnerable to the ongoing challenging outlook for economic recovery.

The reductions in British prize money in 2010, and potentially beyond, driven by lower Levy returns, can only add to this vulnerability.

The marked increase in owners' funding of the industry contrasts with the much more modest British Betting industry contribution, given the Levy has increased by only £13m between 2002/03 and 2008/09 and based on current HBLB forecasts will fall back to a level only £5m higher than 2002/03 in 2009/10. As set out in Section 2.2.3, even when all other payments from the Betting industry to Racing are included the contribution only increased from £115m in 2002 to £149m in 2005 and thereafter to £160m in 2008.

3.2.4 Racecourses' financial performance

The chart below sets out the aggregated pre-tax profits of the UK's racecourses from 2000 to 2008. The pre-tax profits shown have been adjusted to more accurately reflect the underlying profits of the racecourses given differing treatment of capital credits.



The graph illustrates some key points:

- Racecourses' pre-tax profits, which include current revenues from picture rights deals, have been <u>lower</u> than the 2002 levels since 2004 with profits in 2008 more than £25m lower than in 2002. Racecourses' profits are therefore significantly lower than when the 2002 determination occurred.
- Appendix One sets out the major positive and negative factors to impact on racecourses' profits over the period. In aggregate these factors have resulted in profitability declining over the period.

- The fall in profits has occurred despite fixture expansion, illustrating that racecourses have benefited much less than Betting from these fixtures.

The very significant, but temporary, boost to profits as a result of the commencement of the “attheraces” contract in 2001, and its subsequent termination in 2004, is the biggest single factor affecting profits. Most importantly, the Secretary of State’s Determination in 2002 leading to an anticipated yield of £90-£105m Levy was made with knowledge of the then assumed long-term marked increase to profitability the attheraces contract meant for the racecourses.

With a number of Britain’s racecourses being not-for-profit organisations[5], the majority of racecourse profits over the period have been used to part fund the racecourses’ investment in facilities by over £600m between 2003 and 2008.

Aggregated dividends to shareholders in all British racecourses over this period were less than £10m.

This investment in facilities has meant the net debt of racecourses has markedly increased despite pre-tax profits.

3.2.5 Challenging outlook for racecourse profitability

Given the current economic climate and the slow recovery rates forecast by government it will be a major challenge for racecourses to even maintain the 2009 levels of revenues and profits, indeed further declines are the more probable scenario. The specific factors below are particularly relevant:

- The sporting corporate hospitality market is expected to have a particularly slow recovery;
- Increased consumer demands for value for money, given the extremely competitive leisure market, resulting in over 80% of racecourses freezing, or reducing, ticket prices for 2010;
- Sponsorship values for all but premium sporting properties continue to be under great pressure. Indeed even many of Racing’s top races face challenges in just maintaining existing sponsorship values;
- Non-raceday business is subject to reduced customer budgets (notably public sector) and increased price competition between all conference venues; and
- It will be increasingly difficult for racecourses to identify further cost efficiencies given the reductions already made in 2008-09.

The most significant potential boost to racecourse profits – higher LBO picture revenue - is discussed below.

[5] Most notably Jockey Club Racecourses which owns 14 racecourses and pays no dividend to its owner, the Jockey Club, with its profits re-invested in the sport primarily through investment in improved facilities and prize money levels. A number of independent racecourses, including York Racecourses, are effectively owned by the local community and hence do not pursue profit maximisation.

3.2.6 Enhanced LBO picture rights deals fall outside 2011

One revenue stream which is currently forecast to increase is licence fees payable to racecourses for the provision of pictures to third party businesses whose business includes the provision of content services to betting operators (namely SIS and Turf TV). The announcement of Arena Leisure plc's improved contract with SIS in August 2009 is the most quoted example. However, this contract is not due to start until 1 January 2012[6]. Furthermore the sizeable number of fixtures staged by Arena Leisure means it has considerable strategic value to SIS given the competition between SIS and Turf TV. It is therefore highly likely that a significant premium was paid to Arena Leisure and that comparable contracts are unlikely to be offered to other racecourses.

The existing LBO contracts for SIS and Turf TV do not expire until 31 December 2011 and 31 December 2012 respectively. Hence the subsequent Turf TV contracts fall completely outside the 2011/12 Levy Scheme and only three months of the new SIS contracts fall into the Levy period.

[6] Arena Leisure announced the 5 year contract with SIS commencing on 1 January 2012 was estimated to be worth £105m, hence £21m per year, which compared to SIS revenue of c.£10m per year under the current contract.

3.3 Reasonable Levy Yield based on Racing's Needs

SUMMARY

The Racing's Needs approach results in a Reasonable Levy Yield of £133-£152m

Key factors being:

- **Racing's cost inflation alone is conservatively estimated at 25% to 2009/10 based just on RPI.**
- **Racing's regulation and integrity costs have increased from £16m in 2002 to £25m in 2009 driven largely by fixture expansion and an increasingly complex betting environment. Any compromise of British Racing's existing high integrity standards would reduce confidence in the product and have a detrimental impact on its attractiveness as a betting medium.**
- **The additional fixtures (based on 2008 BHA Leasehold fixtures) are, in aggregate, loss-making before Levy distributions. Racing must be properly recompensed for staging these fixtures.**
- **The horsemen have incurred very significant extra costs from fixture expansion. It is reasonable, as a minimum, for owners' transport costs to additional fixtures to be supported, particularly as these fixtures can only offer relatively low levels of prize money.**

3.3.1 Overview of calculated Reasonable Levy Yield

Having set out the context of the changes in the Racing and Betting industries since 2002, we now turn to quantifying a reasonable Levy Yield based on Racing's Needs.

This approach estimates a Levy Yield for the 2011/12 Levy Scheme by focusing on the incremental costs experienced by Racing to enable the expansion of the fixture list. It does not therefore directly consider the substantial benefits the Betting industry has accrued from this expansion, which are discussed later under the Reasonable Share of Benefits and the Market Approach methodologies.

The table below sets out the build-up of the required Levy range based on the 41st Levy Scheme range of £90-105m by:

- Inflating for RPI;
- Additional regulatory and integrity costs arising from fixture expansion and the increasingly complex and diverse betting industry - notably the emergence of betting exchanges;
- Net cost to Racing of the additional fixtures; and
- Owners' transport costs to the additional fixtures, which generally offer modest prize money.

The table below sets out how we have comes to the reasonable Levy Yield of £133-152m. Each item is discussed in turn below.

Racing's Needs

£m	RPI (1)	Predicted Levy range based on SOS's 2002/03 determination Lower	Upper
2002/03 target yield		90.0	105.0
Less 2002/03 integrity costs		(16.2)	(16.2)
2002/03 target yield excluding integrity		73.8	88.8
2003/04	3.1%	76.1	91.5
2004/05	2.6%	78.1	93.9
2005/06	3.2%	80.6	96.9
2006/07	2.4%	82.5	99.2
2007/08	4.8%	86.4	104.0
2008/09	3.8%	89.7	107.9
2009/10	(0.4)%	89.4	107.5
Current integrity costs		**25.0**	**25.0**
Additional Fixtures			
Estimated raceday loss excluding Levy distributions for additional fixtures		6.0	6.0
Additional overheads/need for appropriate return		4.0	4.0
Remove double counting of integrity costs		(4.5)	(4.5)
Minimum contribution from the Levy to justify additional fixtures		**5.5**	**5.5**
Sub-total		**119.9**	**138.0**
Owners' transport costs for additional fixtures		6.5	6.5
Inflation to 2011/12	5.2%	6.6	7.6
TOTAL		**133.0**	**152.1**

Note (1): Inflation based on movement between RPI index for March of later year. 2009/10 based to January 2010, 2010/11 estimate. Fixtures are for calendar year of earlier year

Source: Racecourse Returns; BHA analysis

3.3.2 Inflationary aspects

The first stage of the Racing's Needs approach is to consider the significant amount of inflation in the UK economy from 2002 to the present.

The most appropriate inflation rate to apply for Racing is the Retail Price Index given the broad nature of costs that racecourses and other Racing bodies incur. Racing has invested £706m in capital expenditure to improve facilities between 2004 and 2008 alone, the large majority funded through commercial borrowing hence it is appropriate to use a Price Index, such as RPI, that reflects the cost of borrowing.

The cumulative RPI inflation rate over 2002/03-2009/10 is 25%, with annual rates set out in the table above.

In practice many of Racing's costs – including, transport, equine feeding costs, utilities etc - have experienced greater inflation than the 25% increase however this has not been incorporated into our analysis (e.g. gas 143% and electricity 89% inflation between 2002 and 2009).

We have excluded regulatory and integrity costs from this general inflationary uplift as there are very specific circumstances for these costs that require separate consideration (see below) and hence have deducted the £16.2m integrity costs in 2002 from the original £90-£105m range.

The forecast inflation rates used for 2010 onwards are based on the general consensus of economic forecasts hence we have assumed 2% inflation in 2010/11 which should also be considered in the in the context of the Bank of England's target inflation rate of 2% and their likely actions to deliver this target rate.

3.3.3 Increased regulatory and integrity costs

Strong integrity, regulatory and security measures are integral to protecting the reputation of British Racing as a sport attractive to participants and raceday consumers, and as a betting product.

Since 2002 Racing's regulatory and integrity efforts have been forced to respond to:

- a significant new challenge in monitoring betting activities and associated results of races, including the impact of the growth of betting exchanges; and
- expansion of the fixture list – including a high number of fixtures at the lower end of the quality spectrum and hence, all other things being equal, which are more vulnerable to attempts to distort the integrity of the sport.

One of the initial drivers of the increased investment in integrity was the major review in 2002 of the sport's integrity provision, which led to an overhaul of the (then Jockey Club's) Security Department. These changes included a significantly strengthened team including former senior police detectives, intelligence specialists and betting analysts; the introduction of sophisticated information technology and surveillance equipment; and intelligence links to the betting industry.

The betting environment has become even more complex since this review and hence Racing's integrity requirements have increased. The resulting cost increases are therefore a direct response to the challenges of the relationship between Racing and Betting. Moreover they operate to the direct benefit of the betting industry; greater investment in monitoring benefits the business, in particular of the exchange betting, which have also contributed valuable data.

In February 2010, the approach taken by the Authority in the regulation of sports betting was endorsed by the Report (made to the Minister for Sport) of the Sports Betting Integrity Panel, chaired by Rick Parry. The report recommends the creation of a pan-sports integrity unit, modelled upon the head office structure of the Authority's Integrity Services and Licensing department. The approach and resource has been endorsed as being the model, and therefore "reasonable".

Given the operational challenges set out above, Racing has had to face inevitable cost increases over the period under review. To simplify the analysis of those costs, we have compared only funding provided today directly by the Levy, and compared this on a like-for-like basis with 2002.

Care should taken to understand the scope of the costs being funded, as the words ‘integrity’, ‘regulatory’ and ‘security’ are often used interchangeably in relation to costs. As of today, the Levy Board funds the cost of racecourse camera patrol and photo finish services, plus approximately 96% of the Authority’s total regulatory spend. The Authority’s spend includes the provision of raceday officials to each fixture, comprehensive programmes of Equine Welfare and Doping Control, the integrity services team referred to above and in the Parry report, plus a comprehensive head office function to deal with the licensing of the sports participants and all racecourses, and disciplinary processes enforcing the Rules of Racing (themselves strengthened and which have led to higher costs of prosecution and enforcement).

Spending across all the areas of expenditure above has increased from £16 million in 2002 to £25 million in 2009. The increase is markedly higher (£4.8m) than the cumulative RPI over the period. Many of the reasons for the increase are set out above. Two further notable increases arose due to a step change in the cost of pension provision for the Authority’s regulatory staff (which had always been funded by the Levy), and the end of a long lease at Portman Square in 2004 which saw a rise in office costs in the move to a new location (151 Shaftesbury Avenue, which has since been vacated).

Operational efficiencies in integrity provision have been introduced by the industry, which have reduced the integrity cost per fixture, and the Authority continues to work with other Racing bodies to introduce further efficiencies wherever possible. However, there remains a priority commitment to the highest standards of regulation and integrity, hence the scope for significant further cost reductions is limited.

There are other costs of regulation and integrity that we have not analysed in this section. For example, the Levy Board used to fund the cost of starting stall provision at all flat fixtures, but chose to withdraw this funding in April 2004 in order to support prize money grants. However, this decision can be set against the Levy Board’s welcome decision to pick up the funding of the Authority’s regulatory head office costs in April 2006 as a direct result of the sport losing its significant commercial income streams from non-British bookmakers. There are also significant further regulatory costs borne by the racecourses, in the areas of medical and veterinary provision.

We are not requesting that the scope of regulatory and integrity costs funded by Betting through the Levy be increased; nor are we asking for Betting to contribute through the Levy to the significant governance and administration costs of the sport, these being borne entirely by other stakeholders; but taking all these costs together, which we consider to be reasonable, we consider the current absolute level of contribution by Betting to the funding of regulatory and integrity costs to be fair, and have therefore included £25m against this cost heading in our analysis of Racing’s Needs.

Racing will be delighted to disclose all information in relation to the regulatory and integrity costs subject to normal confidentially.

3.3.4 Cost of fixture expansion - racecourses

In order to establish the minimum payment that is required from the Betting Industry through the Levy for Racing putting on the additional fixtures, we have considered the following:

- The Raceday profit/(loss) excluding all amounts paid to the racecourse by the HBLB (primarily prize money grants, integrity grants and fixture incentives). By excluding these amounts but giving full credit for other revenues including LBO picture payments, we arrive at a loss before central support. It is reasonable to expect any Levy to at least make good the losses arising from these fixtures;

- The additional overheads created from the staging of these fixtures and therefore not captured in raceday profits;
- Consideration of forgone non-raceday revenue lost to some racecourses from staging these fixtures (conservative approach taken in this respect):
- Incorporation of a fair rate of return on these fixtures; and
- Removal of the integrity costs to avoid double counting given these have been dealt with already under total integrity costs.

3.3.5 Raceday losses from additional fixtures

Fixture list expansion has benefited the betting industry with much more modest benefits for Racing as seen by the contrast in very modest raceday profits from the additional fixtures discussed below with an estimated gross win of in excess of £100m from the additional fixtures.

The Raceday profit/(loss) impact of the expanded fixture list has been examined by analysing the performance of the BHA leasehold fixtures[7] for 2008 (being the latest year for which comprehensive data was available). Leasehold fixtures were first introduced in 2003 to enable fixture expansion. The raceday results are set out in the table below, together with the results of the other fixtures held at the racecourses staging leasehold fixtures to contrast the major differences in profitability.

Raceday profit/(loss) of 2008 Leasehold fixtures

£'000s	2008 Leasehold fixtures		2008 Other fixtures (2)
	Total	Average	Average
Number of fixtures (1)	207		668
Admission related revenue	2,667	13	44
SIS/LBO monies	5,975	29	30
Race sponsorship	645	3	9
Other revenue	485	2	8
Total revenue	**9,773**	**47**	**92**
Total prize money	(7,153)	(35)	(48)
Integrity costs	(3,693)	(18)	(18)
Other raceday operating costs	(5,040)	(24)	(30)
Total costs	**(15,885)**	**(77)**	**(96)**
Raceday loss before Levy distributions	**(6,113)**	**(30)**	**(4)**
Levy distributions	9,556	46	53
Raceday profit after Levy distributions	**3,444**	**17**	**49**

Note (1) The missing 63 fixtures of the planned 270 leasehold fixtures for 2008 are due to either the financial. Tinformation not being available (notably Great Leighs fixtures), abandonments and tw o Chester fixtures w hich are excluded due to being unrepresentative

Source: BHA racecourses returns - 2008

7 In addition to the leasehold fixtures, 40 self funding Enterprise fixtures are planned in 2010. These fixtures have been created primarily to enable racecourses to race in time slots attractive to racegoers but when the betting industry requirements are generally already considered adequately serviced. These have therefore not been included in the fixture expansion analysis although it should be noted that significant gross win will still be generated from these fixtures.

Key features of the fixtures:

- The leasehold fixtures are significantly less profitable than other fixtures – generating on average 65% less profit at £17,000 per fixture after Levy receipts.
- Excluding Levy distributions the fixtures lost on average £30,000, with very few fixtures achieving profits on this basis. Total direct losses to Racing therefore are over £6m from these 207 fixtures alone.
- The unattractive time slots for racegoers, corporate attendees and sponsors is illustrated in the much lower revenues from these sources for leasehold fixtures. Average admission related revenues were less than £13,000 for the leasehold fixtures compared to £44,000 for other fixtures.
- The integrity cost of operating each fixture is essentially the same hence it makes up a much higher proportion of total revenue.
- Racecourses have been successful in reducing other raceday expenditure but there are limits to further reductions.
- Total Levy distributions (prize money, integrity fees and fixture incentives) of £9.6m were paid to support 207 fixtures.
- The prize money paid to owners is on average approximately £5,000 per race staged, meaning the returns to owners even if they have a winner are extremely modest compared to training costs.
- A significant proportion of the fixtures take place at unsociable hours, particularly floodlit winter evening fixtures.

3.3.6 Quantification of 2008 raceday results for inclusion in a reasonable Levy Yield

It is prudently assumed the profitability of the leasehold fixtures in 2009 was broadly similar to those in 2008. However it is possible a further deterioration in profits has been experienced given pressure on ticket pricing, marked decrease in corporate business, poor attendances for low grade fixtures, and limited sponsor interest in such fixtures.

In order to estimate a 2009 cost we have therefore taken the average raceday loss before Levy distributions of £30,000 per fixture but adjusted it downwards to reflect the c.£5,000 per fixture of racecourses' executive contribution to prize money. We have excluded this to reflect the fact that the racecourses have chosen to add this prize money and therefore we have removed this cost.

The adjusted loss before Levy distributions that we have therefore multiplied by the 249 BHA leasehold fixtures is, therefore, £25,000, which results in a raceday loss of £6m.

It is therefore reasonable that as an absolute minimum the additional cost of the fixtures that the Levy should meet is £6m. However this in itself ignores an uplift that would be reasonable to reflect the need for a racecourses to cover overheads, generate a sufficient operating profit to fund new or repay the loans from past capital investment, and service debt charges, which we discuss below.

3.3.7 Increased racecourse overheads, opportunity cost of Racing and need for return

Given the physical constraints on turf racecourses to stage large volumes of additional fixtures, a large proportion of the newly created meetings have inevitably been programmed at All-Weather Track (AWT) racecourses. A large proportion of the overheads at these AWT racecourses arise as a direct consequence of staging these fixtures and it is reasonable to expect sufficient raceday profits to contribute to a substantial element of such costs.

For example a higher volume of fixtures reduces the life of the all weather surface at these courses. Replacing an all weather surface can cost approximately £1.5m which if done every five years means for a racecourse with 100 fixtures it effectively costs £3,000 per fixture for this element alone[8]. We have therefore incorporated an element of the respective racecourses' overheads to reflect the high proportion of leasehold fixtures.

For the racecourses where the additional fixtures make up a much less significant proportion of their total race programme the incremental impact on overheads will be lower. Nonetheless it is likely that additional costs will be created such as demands on management time and increased maintenance costs. An element of their overheads has therefore been included.

Many racecourses now have developed extensive non-raceday activities such as conference and banqueting. However typically racecourses are unable to pursue such activities on the days they stage Racing. There is therefore an opportunity cost involved in staging Racing which is not factored into the raceday profit and loss. We have therefore made a prudent estimate of this forgone income at applicable racecourses.

Racecourses are also entitled to require a reasonable return for the fixtures they stage; we have therefore assumed a very modest £5,000 profit per fixture is required.

In total we have included a very conservative £4m to cover these three aspects in our Levy Yield for this needs based approach.

3.3.8 Owners' costs of additional fixtures

We have already discussed how the absolute level of owners' contribution to the Racing industry has increased markedly since 2002, and that the proportion of their operating costs covered by prize money has fallen sharply.

Nonetheless for this methodology we have not sought to incorporate a wide definition of increased owners' costs which have arisen from the expanded fixtures list, but rather consider only the most direct cost being the transport costs incurred by owners to bring their horses to these fixtures. We have therefore been extremely conservative in this respect.

The potential returns for horses running in these fixtures are generally poor with average prize money of £5,000 per race. It is entirely possible for a horse to win four to five such races in a year yet still not cover training costs.

Furthermore, it is now common for a placed horse in a race at a leasehold fixture (indeed many other fixtures) to win insufficient prize money to cover transport costs. This is a poor incentive for owners to run their horses, and ultimately acts as disincentive for owners to remain in the sport. It is a significant factor in the remuneration of trainers and stable staff. This is amplified by the considerable anti-social nature of many such fixtures.

We therefore consider the cost versus reward balances for these fixtures to be unsustainable. As an absolute minimum we consider it is right and fair for owners' transport costs for horses to the additional fixtures to be met. Approximately 22,000 horses ran in BHA leasehold fixtures in 2009. The NTF estimate that the current average transport cost of a runner is £300, meaning the total cost is approximately £6.5m.

The support of transport costs is also likely to encourage more runners, thus reducing the number of races at low level fixtures with small fields which the Betting industry regularly cite as a reason for lower gross win.

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[8] A significant proportion of the fixture list expansion has taken place at racecourses with all weather facilities, including floodlit, in order to provide sufficient betting product at certain periods and times of the year, notably autumn and winter evening racing. Kempton has undergone a £18m redevelopment between 2004-06 to add a floodlit AW track to its existing turf track. In additional Great Leighs, with a reported cost of in excess of £20m, was also developed to stage AW fixtures. Such racecourse capital investment has already greatly benefited the Betting industry.

3.4 The Reasonable Share of Benefits approach

SUMMARY

The Reasonable Share of Benefits approach results in a Levy Yield of £128-£149m

This method demonstrates that the Levy has provided an inadequate return for the product supplied by Racing since 2004/05.

Key factors being:

- **Racing's cost inflation alone is conservatively estimated at 25% to 2009/10.**
- **Fixture list expansion of 25% since 2002.**
- **A reasonable apportionment of the revenues arising from the additional fixtures incorporating an estimated betting substitution rate of 50% (which we consider a prudent estimate of betting substitution between fixtures given the high proportion of fixtures in new betting sessions).**

In Section 3.3.2 we set out the inflationary pressure on the Racing industry since 2002. This is the same starting point for a methodology which looks at the relative returns to Racing and Betting from the fixture list, particularly its growth since 2002. In the interests of brevity we do not repeat them here. We therefore turn to the other key factor in this approach - the expanded fixture list and the return that Racing could reasonably expect from these new fixtures.

3.4.1 Expanded fixture list

In order to flex the 41st Levy range for the fixture expansion we have taken a very conservative approach. Our methodology recognises that there is not a linear relationship between the increase in the size of the fixture list and total betting turnover on British Racing, primarily due to the "substitution" effect and the fact that some of the added fixtures are in less attractive time slots for betting than existing fixtures.

The substitution effect in this context refers to the situation whereby some punters, being given a greater number of British races to bet on, will fund these bets from a combination of higher overall stakes but augmented by some reductions/transferred stakes from existing races.

The greatest substitution effect is likely to occur if a fixture is added to a betting session with multiple existing fixtures, and conversely the lowest when a new fixture is added to a session with no pre-existing fixtures (e.g. winter evenings).

We do not take account in this methodology of any substitution between betting on Racing and other betting products (albeit in a wider context it is Racing's very firm view that this takes place).

We have assumed a 50% substitution rate[9]. However for the reasons stated below we consider this is likely to significantly overstate the amount of substitution actually occurring in line with our conservative approach. In determining the 50% substitution rate we have considered the following:

[9] For simplicity we have included in the substitution effect the relative unattractiveness of some fixtures for betting compared to existing (2002) fixtures.

- A significant number of the additional fixtures have been programmed in new betting sessions where no fixture existed in 2002 hence by definition no direct substitution can occur for those betting at the time of the race (i.e. rather than hours in advance). For example in 2009 there were over 100 winter evening fixtures in new betting sessions;
- With reference to indexed turnover figures from 2006, the Strategic Review of the Fixture List, published in 2008, showed that on average the gross win earned from each of the 161 extra fixtures staged in 2006 (excluding twilight fixtures) which had been added since 2002 was on average only 8% lower than the industry average. Estimated total gross win of over £100m was generated;
- Racing continues to be accommodating to the Betting industry's requests that fixtures are staged at times to maximise betting revenues. For example the cooperation through the Betting Patterns Working Party has resulted in the starting time for many of the 2009/10 winter evening fixtures has been brought forward by several hours to ensure continuous betting product is provided to the LBOs.

3.4.2 Resulting reasonable Levy yield

The table below shows how we have applied the inflation and fixture expansion methodology to derive a reasonable Levy Yield in 2011/12.

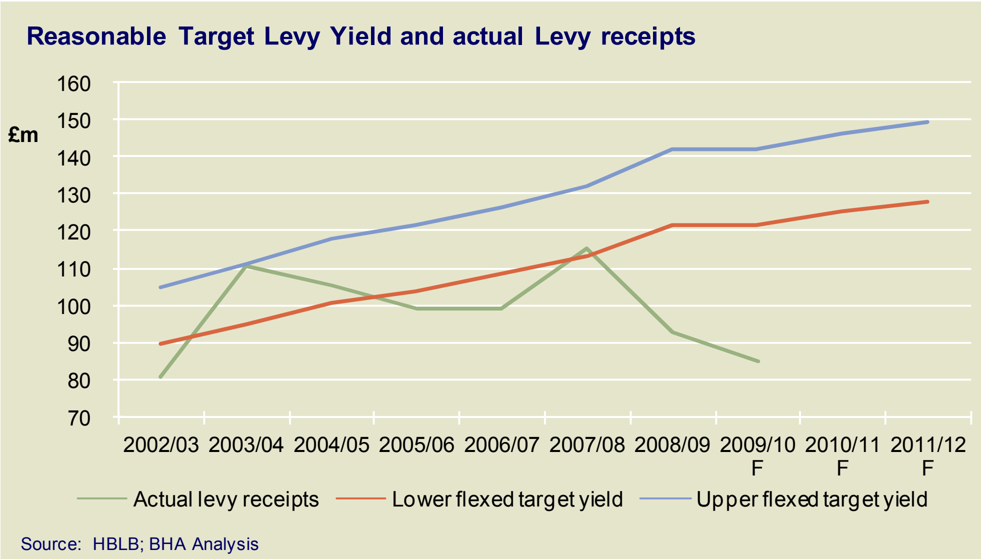
Stage	**Method (for any given year)**	**Application – 2011/12**	**Cumulative Result**
Base range	From 41st Levy	£90-105m	£90-105m
Adjust for inflation	Apply accumulated RPI over the period – actual to 2009, forecast 2010-2012	27% inflation to £90 -105m = £24-29m	£114-134m
Pro-rata fixtures - increment	Inflated range multiplied by 23.5% in increase in staged fixtures[10] between 2002-09	£114-134m x 23.5% = £27-31m	£141-165m
Less substitution effect	50% substitution used – considered to be a very conservative approach for reasons given above	(50%) x £27-31m = (£13-16m)	£128-149m
Reasonable value			**£128-149m**

Notes (1) For the purpose of the table only all numbers have been rounded to nearest whole number

[10] We have used staged fixtures rather than planned fixtures in acknowledgement that adverse weather conditions will result in a level of abandoned fixtures each year. While the BHA will stage some replacement fixtures if the level of abandonments is considered excess, staged fixtures will always be less than planned fixtures. We have assumed [70] abandonments for 2011/12 and assumed 1430 fixtures are staged.

The chart below shows the result of the 2002/03 range adjusted for inflation and additional fixtures, together with the actual Levy receipts to 2008/09 (and forecast for 2009/10).

The analysis illustrates how that in real terms successive Levy schemes since 2004/05 have failed to generate sufficient Levy income to keep pace with even the lower limit of the specified Levy Yield of the 41st Scheme (other than in 2007/08 which was aided by an exceptional "high roller" impact as per bookmaker statements).



3.5 Market approach

SUMMARY

The market approach results in a reasonable Levy yield of £121 - £151m

Key factors being:

- **The market based Levy is the price that might be agreed in market negotiations between Racing and Betting for a "right to access racing for betting purposes". The approach assumes that the parties make offers of the maximum (Betting) or minimum (Racing) Levy prices they might consider, and negotiate an agreed price within this range, depending on their relative bargaining power, needs and capacities.**
- **It is assumed conservatively that Racing retains only 25% of the difference between the minimum and maximum points, which might be higher in commercial situations.**
- **The total Levy figure is based on LBO earnings and applied to all the Levy, assuming the Levy is collected for all types of betting.**
- **When LBO earnings from "convoyed" sales of FOBTs and other betting products are added this increases the target range to £154-184m.**

3.5.1 Overview

Our economic analysis considers how the Horserace Betting Levy might be determined in a market context applying commercial principles. It develops an economic framework and uses this to derive a range of possible Levy prices.[11]

The approach estimates a Levy price from first principles, as a price that might be agreed in market negotiations between Racing and Betting for a "right to access racing for betting purposes". Other than the price mechanism, the Levy operation is assumed unchanged:

- The Levy is seen as an administrative arrangement for ensuring that an access right exists, is operated effectively and the costs and benefits are distributed in a mutually acceptable, fair and reasonable way.
- Racing and Betting negotiate as groups and the Levy agreement is available to all members of both groups on equivalent, non-exclusive terms.
- The Levy "access right" may differ from typical commercial access rights in important respects but the method of agreeing a price is based firmly on methods used in the market place. [12]

In the hypothetical negotiations, Betting and Racing make initial offers of the maximum or minimum Levy prices they could possibly accept. They then negotiate an agreed Levy price within this price range, depending on their relative bargaining power, needs and capacities.

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[11] The current model is based on the LECG analysis included in the BHA's 47th Levy submission in 2007. "Setting the Horserace Betting Levy – Analysis and Commentary", LECG, 26 November 2007.

[12] The market model overlaps many of the concepts in the actual Levy process. A traditional Levy determination as a balance between the needs of Racing and the capacity of Betting to pay for access to racing (possibly also allowing for other social aims), is consistent with the market model that compares Betting's demand for racing (and how much it is prepared to pay) with Racing's funding needed to provide racing for betting purposes (and how much it will accept). The market and Levy principles are not so far apart as might be imagined.

- The upper bound of the range is the maximum Levy that Betting might be prepared to pay for access to racing for betting purposes.
- The lower bound of the range is the minimum Levy that Racing might be prepared to accept to supply an acceptable quantity and quality of racing product.
- These extreme "walk away" positions define the bounds of the negotiations.
- The analysis computes a price between the two extremes where the parties might agree to share the "surplus" (the difference between the upper and lower bounds), depending on their relative bargaining strength and other considerations.
- It is conservatively assumed that Racing retains only 25% of the surplus, which might be higher in commercial situations.

This mirrors real-life negotiations widely used for specialised assets, such as a one-of-a-kind building or a right to use specialised intellectual property, for which there are unique users and suppliers (or both parties choose to negotiate as groups) and there is no readily identified price in a regularly functioning market. Similar economics techniques of "hypothetical negotiations" between willing buyer and seller are also used in litigation to determine a 'fair and reasonable' price for licensing proprietary technology or other intellectual property, where indeed they may be considered the leading approach.

The analysis is based primarily on data for the British retail business, which accounts for the bulk of the Levy. A similar analysis of Levy sources from other betting channels (exchanges, telephone and internet) shows that figures for the upper and lower bounds are likely to be similar to or higher than those for the retail business. Thus, the results for the LBOs are applied across the whole Levy. This assumes that the Levy amount applies to the items currently levied and that these levies can be collected (*e.g.*, including betting operations transferred offshore). The Levy amount does not address issues of applying the Levy to currently unlevied items, such as overseas racing.

Full details of the market approach are given in the LECG report attached as an Appendix to this Submission. The report also contains a review of the critiques of the market approach made by OCP and London Economics at the time of the 47th Levy Submission.

3.5.2 Upper bound

The upper bound for the negotiations is calculated from the accounting data for the GB retail business for the 'top 3' Bookmakers. It is assumed that these are representative of the GB retail business, accounting for about three quarters of GB retail total revenue.

- The upper bound is estimated by considering what profits Betting would lose in its retail business if GB horseracing were withdrawn, compared to its current profits. This is calculated from the loss of revenue minus the potential savings such as media and other operating costs that would not be incurred without horseracing. It is assumed that Betting would be able to continue in operation.
- The analysis differentiates between the short and long term impact depending on which of operating costs might be saved, giving a range for the upper bound. The short term impact on Betting profits is likely to be higher, as Betting will be more able to reconfigure its business in the long term.
- Conservatively, it is assumed that Betting would save its share of retail staff and other costs depending on racing's share of OTC gross win, with no share of costs borne by FOBTs.

A similar analysis of other Levy sources (exchanges, telephone and internet) shows that the equivalent upper bound is likely to be similar or higher than for the retail business, so that the results for LBOs are applied across the whole Levy.

The calculation of Betting's upper bound is shown in Table A1. This considers the direct effect of the loss of GB horseracing betting on Betting retail profits. We use 2008 figures as most representative of the current situation, since 2009 figures are not fully available and are likely to be distorted by adverse conditions in the economy as a whole. It is shown in the table that Racing's gross win for the top 3 in 2008 is estimated to be £601.6m. If racing were withdrawn it is assumed that LBOs would lose all this revenue (*i.e.*, on balance gross win from FOBTs and other OTC products are assumed unchanged). It is further estimated that the LBOs would be able to reduce costs by an estimated £445.8m, comprised of GPT and Levy, TV and a *pro rata* share of LBO staff costs, shared between racing and other OTC only. This is a conservative estimate since it assumes that Betting is able to reduce operating costs significantly and especially that FOBTs carry no staff or other operating costs. This implies a total marginal contribution of £155.8m, or 25.9% of racing gross win. Since this marginal contribution allows for a 10% Levy, the upper bound in the Levy negotiations would be 10% above this, at 35.9%. This is taken as the main value for the upper bound.

An even more conservative estimate for the Levy assumes that a *pro rata* share of *all* OTC operating/administration costs would be saved if racing were withdrawn. This leads to a 30.3% upper bound as the minimum value for the upper bound.

**Table A1: Betting upper bound –
Marginal contribution of Racing to GB Retail**

(£m) Top 3 Bookmakers	**2008**
OTC gross win	1,367.2
FOBT gross win	820.1
Total Retail gross win	2,187.3
Retail operating profit %	25.9%
Share racing in OTC	44%
Racing gross win [a]	601.6
– GPT + Levy	-150.4
– TV costs (est) [b]	-50.7
– Staff costs (est) [c]	-244.7
Total racing marginal cost	-445.8
Racing marginal contribution	155.8
Contribution as % racing gross win	25.9%
Equivalent Levy % [d]	**35.9%**
Equiv. Levy % (full cost allocation) [e]	35.9%
Equiv. Levy % (dir + full admin) [f]	**30.3%**

(Source: Bookmaker Annual Reports; HBLB Annual Report 2008/09; LECG analysis)

a Racing gross win = OTC gross win x default percentage (HBLB).

b TV direct costs saved due to rights costs and other operating costs (est. £8,500 per shop).

c Staff costs saved estimated from total retail staff costs allocated *pro rata* on proportion of racing in total OTC gross win (assumes no staff costs allocated to FOBTs).

d "Equivalent Levy" is the pre-Levy profit contribution, as the upper bound for bargaining.

e Contribution assuming all costs allocated to products (racing, FOBT, other) in proportion to gross win.

f Contribution allocating direct GPT and Levy costs to racing, remaining administration/other costs allocated to products (racing, FOBT, other) in proportion to gross win.

This defines an upper bound for the Levy of around 30% - 36%, equivalent to £278m - £329m when applied to the 2008 Levy total of £91.6m for all betting.

3.5.3 Lower bound

The lower bound considers the minimum Racing would accept to supply racing at a quantity and quality acceptable to Betting. Given that Betting continues to ask for more fixtures at the current Levy, the preferred benchmark is the minimum Racing would accept to maintain the current level of racing – meaning a full fixture list of races of a quality acceptable to both Racing and Betting. Since Racing is having difficulty funding this level of fixtures the preferred lower bound is the current Levy rate of 10%.

The analysis also considers this in more detail by asking whether at lower Levy rates Racing would need to reduce the number of fixtures, and how far Betting would want such reductions given that it would lose gross win on the lost fixtures. The analysis also considers whether other sources of funding, such as increased Racecourse media earnings, might reduce the minimum that Racing would need for the current quality and quantity of fixtures.

An analysis of the BHA leasehold fixtures, which have constituted the main increase in the fixture list since 2003, shows that it is not in Betting's interests to reduce the Levy rate significantly. Lower Levy revenues would result in fewer fixtures, and below a certain level the direct loss to Betting from the reduced betting on racing exceeds any Betting savings from reduced Levy costs for the remaining fixtures. Thus the lower bound might be a slightly reduced Levy compare to current level but Betting would not want any further reduction as it would lose more than it would gain.

This is illustrated in Table A2, which treats all the leasehold fixtures for which data are available as a "block" in which all fixtures are assumed the same. The first step calculates how far the Levy rate might be reduced before Racing would withdraw all the fixtures. Considering Racecourse earnings, the fixtures currently make a total Raceday loss of £6.1m, and receive £9.6m in Levy funding. The lowest the Levy funding could be reduced to before the all fixtures were loss making would be £6.1m. Assuming the Levy funding is proportional to the gross win generated by the fixtures, this implies the lowest Levy rate needed to run the fixtures would be 6.4% (*i.e.*, 10% x 6.1 / 9.6).

The second step calculates Betting earnings without the fixtures. With the same assumptions Betting would lose £105.8m of gross win if the leasehold fixtures were withdrawn (assuming no substitution into other racing fixtures). Assuming Betting could save the media costs for these fixtures and a portion of labour costs, its loss of profits on the lost leasehold fixtures would be £53.1m. This would be partly offset by a saving in Betting's Levy costs on the remaining fixtures of £29.2m. Combining these figures, this would leave Betting a net £23.9m worse off than it was before the Levy was reduced. As a result, Betting would not want to push the Levy so low that the leasehold fixtures were withdrawn. The lowest Betting would seek would be just above the breakeven point of 6.4%.

Table A2: Racing lower bound - Minimum Levy for leasehold fixtures (as a "block")	
£m	**Leasehold fixtures**
Number of leasehold fixtures (with data)	207
Racecourses:	
Levy/BHA distribution Racecourses	9.6
Implied gross win leasehold [a]	105.8
Raceday profit (loss) before Levy	-6.1
Levy for leasehold breakeven %	**6.4%**
Betting:	
Lost gross win (no substitution)	105.8
Lost profit (ex TV, part labour) post-Levy [b]	-53.1
Levy saving on remaining fixtures (new rate)	29.2
Net gain (loss) (ex TV, part labour)	**-23.9**

(Source: BHA Racecourse Returns (2008), LECG analysis)

[a] Gross win calculated from Levy distribution assuming 10% rate and an average 90.3% share of total Levy payments made to Racecourses (2008/09), for Levy contribution for prize money, integrity and other raceday costs (*i.e.*, approx. 9.6 x 10 / 90.3%).

[b] Cost reduction: save TV media rights and half labour costs *pro rata* on racing gross win

The "block" analysis is mainly for illustration, and our full "incremental" lower bound analysis considers the leasehold fixtures as a distribution, in which the fixtures have different earnings and gross wins, rather than as a block in which all fixtures are assumed to be the same. When allowance is made for these differences between fixtures, the "incremental" analysis shows that Betting would not reduce the Levy below about 8.7% (higher than the 6.4% in the "block" analysis) before it starts to lose more profit from the lost fixtures than it gains in reduced Levy on the remaining fixtures. Under other assumptions, including the possibility that some proportion of lost gross win on withdrawn fixtures might be substituted back to other racing, it is concluded that the lowest possible bound for the Levy at which Racing would supply a quantity and quality of racing that Betting would accept is at or above 7.5%.

A similar analysis of other Levy sources (exchanges, telephone and internet) shows that the equivalent lower bound is likely to be similar or higher than for the retail business, so that the results for LBOs are applied across the whole Levy.

The analysis also considers whether Racing might be able to find other sources of funding to maintain the same level of fixtures, such as Racecourse media earnings or increased funding from Owners or Trainers. It appears, as explained in greater detail in the full report, that the scope for supplementing income from other sources is too small to affect the result (See LECG report, section 5.3).

Based on these analyses, we define two figures for the lower bound: a minimum lower bound of 7.5% and a preferred lower bound of 10%, equivalent to £69m and £92m respectively based on the 2008 Levy total.

3.5.4 Share of surplus

The final stage of the negotiation model is the share of the surplus that goes to each party. It is usual in such models to assume that the relative bargaining power of the parties determines where between the two extremes a rate might be agreed.

- In the model we assume that the surplus (difference between upper and lower bounds) would be split in a 25/75 ratio (25% to Racing).
- The split is based typically on the share of risk or required investment borne by the parties, as well as other less definable aspects of bargaining power. A 25% split reflects "rules of thumb" sometimes used in other licensing contexts.
- This split is considered conservative and generous to Betting. The actual investment risk taken by the parties may be more balanced between Racing and Betting. In equivalent commercial negotiations Racing might achieve a higher share.[13]

Sensitivity analysis of the results show that there is only limited sensitivity of the Levy price to changes in the lower bound but greater sensitivity to changes in the split.

The results of the analysis are summarised in Table A3.

Table A3: Levy bargaining range – Racing betting only

Levy	Max lower bound %	Max lower bound £m*	Min lower bound %	Min lower bound £m
Maximum Upper bound:				
Upper bound (maximum Betting might pay)	35.9%	328.9	35.9%	328.9
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	**16.5%**	**150.9**	14.6%	133.7
Minimum Upper bound:				
Upper bound (maximum Betting might pay)	30.3%	277.5	30.3%	277.5
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	15.1%	138.1	**13.2%**	**120.9**
Current Levy (2008)	10.0%	91.6	10.0%	91.6

* Equivalent Levy amount applying Levy % to total Levy for all betting (£91.6m in 2008)

The main case is for a Betting upper bound of 35.9% and Racing lower bound of 10%, which leads to a Levy rate of 16.5%, equivalent to £150.9m based on the 2008 actual Levy amount. The lowest most conservative case is for a Betting upper bound of 30.3% and Racing lower bound is 7.5%, which leads to a Levy rate of 13.2%, equivalent to £120.9m. The total levy range would then be £121-151m.

[13] The theoretical "Nash Equilibrium" in bargaining games for similarly placed parties is a 50/50 ratio. The traditional "needs and capacity" Levy framework might imply a share between Racing and Betting in a ratio of 50/50, or possibly if between Racing, Betting and Society of 33/67.

3.5.5 "Convoyed" sales of other betting products

A further aspect of the economic model is the contribution of horseracing to sales of other products in the LBOs, called "convoyed" sales. The full contribution of horseracing to betting should also reflect the value derived from sales of other products in the LBOs that depend partly on racing as the anchor product that brings punters in. FOBTs in particular work as highly profitable filler products for punters whose primary object in visiting the LBOs may be horseracing betting. Racing remains the dominant LBO product and appears to be the main reason for most punters to visit an LBO. This means that withdrawing racing from LBOs is likely to have greater impact on LBO earnings than just the direct effect, and the upper bound should reflect that.

It is not a simple matter to estimate the "convoyed" sales of other products that would be lost if horseracing were withdrawn from LBOs. The analysis makes an estimate from the "diverted" horseracing betting gross win that is likely to have been displaced by new products, primarily FOBTs, and would be lost if horseracing were not available.

- It compares actual horseracing gross win against what this is likely to have been had horseracing betting grown in line with overall GDP growth, over the period since about 2003 when FOBTs and other new betting products became important.
- It assumes that these earnings would not occur if horseracing were not available in the LBOs, that the "primarily horseracing" business would be lost and with it the diverted sales of other products.[14]
- This would increase the maximum Betting would pay to retain horseracing. The incremental effect on the Levy is then calculated using this higher upper bound.

The effect is to add about a further 14% to the upper bound, or 3.6% to the Levy, equivalent to about £33m. The Levy range would then be £154-184m, measured between the minimum upper and lower bound assumptions (44.7%, 7.5%) and the maximum upper and lower bound assumptions (50.3%, 10%). The effect is shown in Table A4.

Table A4: Levy bargaining range – Including FOBT/Other betting sales

	Max lower bound		Min lower bound	
Levy	**%**	**£m**	**%**	**£m**
Maximum Upper bound:				
Upper bound (maximum Betting might pay)	50.3%	460.9	50.3%	460.9
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	**20.1%**	**183.9**	18.2%	166.8
Minimum Upper bound:				
Upper bound (maximum Betting might pay)	44.7%	409.6	44.7%	409.6
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	18.7%	171.1	**16.8%**	**153.9**
Current Levy (2008)	10.0%	91.6	10.0%	91.6

[14] This assumes that on balance the gross win for Other sports betting (and any convoyed sales associated with this) is unchanged by the withdrawal of horseracing.

3.5.6 Other betting platforms

Retail accounts for about 68% of the total Levy in 2008, with telephone at around 14%, internet at 7%, betting exchanges at 7% and other betting about 4%.

A similar analysis of telephone betting indicates that the upper bound for telephone might be around 45% for the main case in 2008. An analysis of betting exchanges indicates an upper bound of around 56%. It has not been possible to make estimates for internet betting. These upper bounds are similar to, or above, those used for the retail business (30% - 36%). A similar analysis of the lower bounds for the other platforms indicates that these are also likely to be similar to or higher than those for the retail business. Thus, the Levy rate for the retail business is applied across the whole Levy. The LBO implied rate may underestimate the Levy rate that might be agreed in a market context for these other platforms. This assumes that the Levy amount applies to the items currently levied and that these levies can be collected (*e.g.*, including betting operations transferred offshore).

The current analysis is based on 2008 data, before the move offshore by some telephone and internet betting operations. The Levy amount is thus the total that would be expected to be collected for all these platforms. The question of how to address leakages existing before 2008, and offshore moves since then, is not addressed in these figures.

3.5.7 Other critiques

The full LECG report also contains a review of the critiques of the market approach made by OCP and London Economics at the time of the 47th Levy Submission. The critiques are rejected.

4 INTERNATIONAL COMPARISONS

SUMMARY

- **The current mechanism for providing support from Betting to Racing means that British Racing is at a major competitive disadvantage against its international competitors.**
- **The returns from Betting to British Racing are far below that deemed as reasonable in other major racing nations.**
- **The equivalent to 1% of betting turnover paid to Racing in Britain compares to a more typical range of 8-12%.**
- **The 10% Levy on gross profits on British Racing is significantly less than in other countries which typically have returns in the 20-35% range.**
- **Betting's average contribution per runner is lower in Britain than all other major racing nations.**
- **Owners' costs recovery through prize money is by some margin the lowest of all major nations.**

4.1 Overview

In this section we compare and contrast key metrics and the funding of British Racing with a wide variety of racing nations. In particular, we focus on comparisons and lessons from France and Ireland.

The structure of racing and betting industries, and their relationship is very different across countries having typically evolved over many years, and is often subject to change given economic and regulatory flux. We do not therefore seek to derive a target yield from international comparisons.

However, despite the different structures of racing and betting across countries, there is one overriding principle: The relationship between racing and betting means that, in all countries, a structure exists under law to provide reasonable financial support from betting to racing.

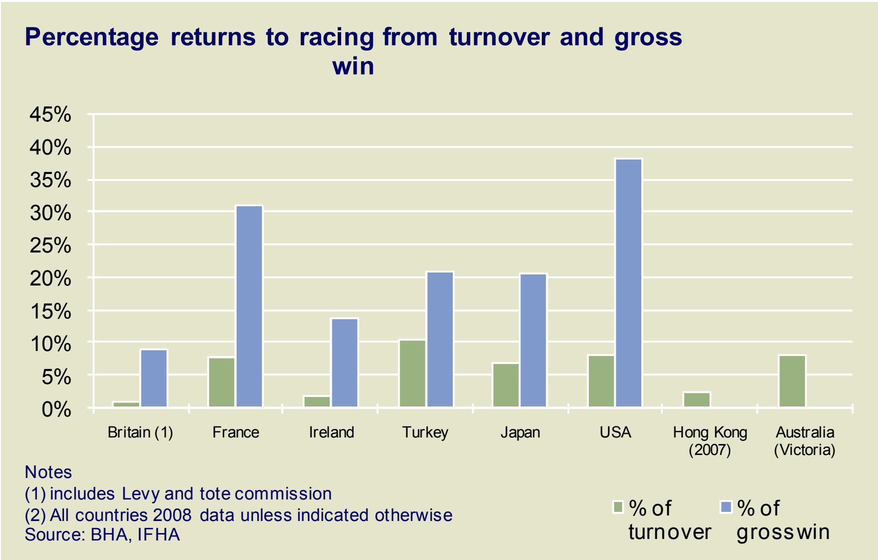
The analysis below shows that the returns in other major racing nations far exceed the return to British Racing. This approach is therefore presented so as to validate the Levy yields quantified by the three approaches set out above. There is no comment, however, on whether one system is better than another, or would be suited to another country.

It is also the case that Racing is a global sport, with increased competition between major racing nations, and, indeed, emerging racing countries. Competition occurs through a variety of channels but broadly centers on the ownership, breeding and location of the best horses.

Racing in Britain therefore cannot operate in a vacuum. What is happening in other countries can, and does, impact on the health of the sport in Britain. Britain has many advantages over other nations, however return levels are seriously behind other nations which represents a serious risk.

4.2 Contribution of the Betting industry to Racing in each country

The nature of the betting environment in each country varies with significant differences in terms of the models adopted and the amounts paid back to bettors. It is therefore instructive to consider the percentage of both turnover and gross win that is paid to Racing when comparing countries.



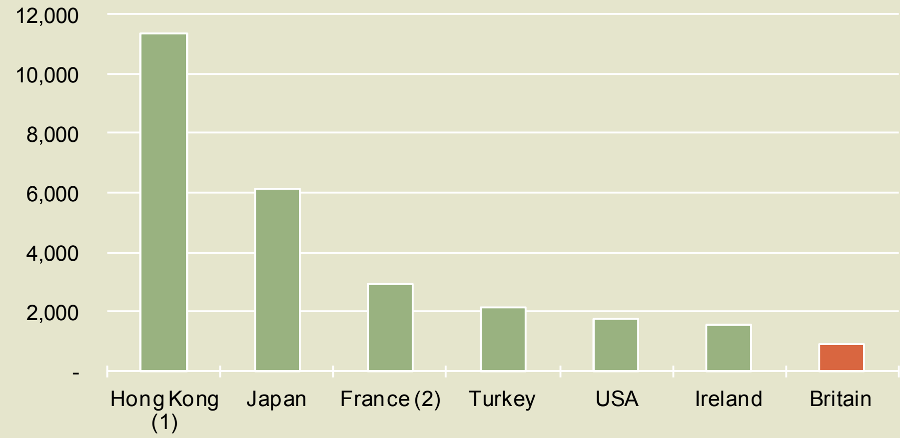
The chart above illustrates just how low the returns paid to British Racing are compared to other countries, specifically:

- The 1% of turnover paid to Racing in Britain compares to a more typical range of 8-12%.
- The 10% Levy on gross profits on British Racing (in reality nearer 9% due to the existence of thresholds) is again significantly less than in other countries which typically have returns in the 20-35% range.
- France – the pari-mutuel PMU is the monopoly provider of betting on racing in France. It delivered €743m returns to its racing industry in 2008 from a betting turnover significantly lower than that in Great Britain.
- Ireland – has a very similar betting market to the UK with the majority of betting taking place through commercial betting operators. The biggest difference being the lack of FOBTs in LBOs. The onshore bookmakers pay 1% of all betting turnover to the government in betting tax which is allocated to the Horse and Greyhound Fund which funds these two sports. However the government has historically topped up this fund due to the importance of racing in Ireland.
- Hong Kong – despite competition (much of it illegal betting) forcing the HK Jockey Club (which runs pool betting) to reduce take out rates, the amounts paid to racing are still much higher than Britain.

In Britain, additional amounts are paid for by operators for pictures supplied to LBOs and race sponsorship with amounts thereby transferring from Betting to Racing. These are discretionary spends for rights (content or association through sponsorship) which businesses chose make and are therefore different in nature. However, even when they are incorporated, the amount of turnover paid to Racing remains less than 1.5%

4.3 Britain's low betting contribution per runner

By taking the total amounts returned by the betting industry to racing in each country and dividing by the number of runners, the average level of betting support per runner can be shown. This method helps comparability given the different scale of the racing industry in each country.

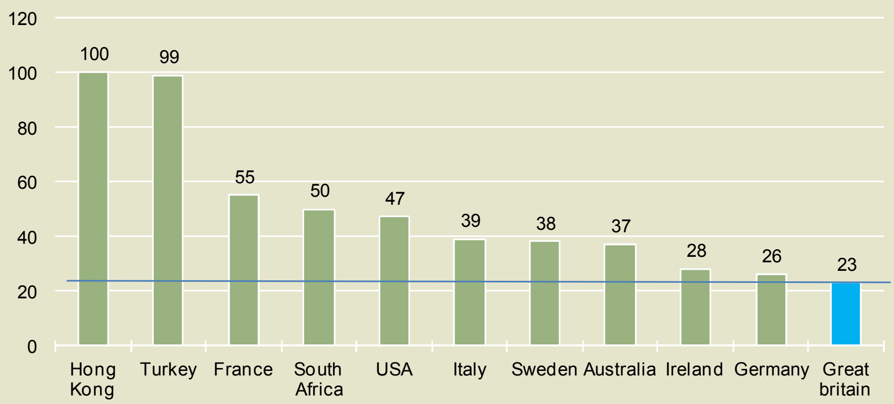


Notes (1) 2007 numbers, all others 2008, (2) Includes trotting.
Source IFHA

The analysis shows how the low return to British Racing translates to significantly lower support per runner. The £930 support per runner given to British Racing is much lower than the other European countries and a fraction of that in Asia.

4.4 Poor returns for British owners

Figures from the International Federation of Horseracing Authorities for 2008 show that the return to owners from prize money as a proportion of training costs in Britain was 23%, the lowest of all major racing nations. The graph below illustrates how poor Britain's recovery rate is compared to both its current major competitors but also a number of emerging European competitors.



Note: Dubai not shown in graph due to distorting the scale but was 160% in 20008.
Soutce: IFHA

4.5 Comparisons of the funding of British, Irish and French racing

More detailed analysis of the funding position and consequence of racing in Britain, France and Ireland is set out in Appendix Two. The key points to highlight are:

- British owners make the biggest financial contribution in European racing.
- The €743m the PMU distributes to racing allows it to support a much broader French range of activities, neither of which exist in Britain including
  - Significant breeders' premiums to support the large French breeding industry (encompassing thousands of jobs). This will be a factor in the 52% of British breeders surveyed by the TBA in 2009 who stated they would consider moving their broodmares to France.
  - Allowances paid to owners to support transport costs.
- The expenditure of owners is the key means by which the c.18,000 direct jobs in British Racing are supported – owners net £275m expenditure from training costs alone equates to over £15,000 per job.
- The decline in Irish racing in 2009 brought on by the recession has been exacerbated by the over reliance on owners and racing consumers compared to the betting industry (akin to Britain), with a resulting loss of an estimated 2,000 jobs. It is instructive to consider that two of the proposed responses to the funding challenges are to increase betting tax and address the severe leakage of betting revenue, hence taxation, to offshore betting companies.

5. OPTIONS FOR DESIGN OF THE 50TH LEVY SCHEME TO ACHIEVE THE REASONABLE RETURN AS A TARGET YIELD

SUMMARY

- **In considering the Scheme's design and with a view to delivering a reasonable yield, the Bookmakers' Committee and the Levy Board should take into account the various structural deficiencies that exist within the current Scheme. These include:**
- **Overseas horseracing – There is nothing in the legislation that limits the Scheme to British horseracing.**
- **Thresholds – There is no proper place for a Thresholds system in a Scheme calculated by reference to gross profit.**
- **Betting Exchanges – Given the fundamental differences between the traditional bookmakers model and the exchanges model, there is no reason why their treatment within the Scheme should be the same. In addition, there are exchange customers who are acting as "bookmakers" within the Levy legislation and therefore have an obligation to pay the Levy at the prevailing rate.**
- **Offshoring – The Levy was designed to capture all British betting activity on racing and the fact that some companies have moved parts of their business offshore should not alter their obligation to pay Levy.**
- **"Relates To" Test – Racing is entitled to receive the Levy in respect of any area of betting operator business that relates to betting on horseracing. This means that Racing should be entitled to receive income from revenue streams such as FOBTs and Virtual Racing where that revenue can reasonably be said to "relate to" horseracing.**

5.1 Introduction

As set out above, the primary objective of this document is to set out Racing's case on what the reasonable return should be from the 50th Scheme.

Once this is established the next task is to translate that into a "Target Yield", and to design a Scheme to achieve it. It is of course fully understood that the Scheme design will be aimed at achieving this target, as opposed to guaranteeing it.

The Scheme will need to be designed on the basis of the best possible information as to relevant turnover and profit within the relevant sectors of Betting, and based on the best possible assumptions as to how the Scheme can apply in law (for instance, with reference to what we say below as to Levy liability for offshore operators which Government is now considering how best to implement).

This section considers some of the structural issues, deficiencies and inefficiencies within recent Levy Schemes, which the Levy Board may wish to take into account when at the stage of analysing detailed proposals for the 50th Scheme and the ability of that Scheme to deliver the target yield and makes suggestions as to how these issues might be addressed.

5.2 Overseas (e.g. Irish, French, South African) racing

In our view, Levy on overseas horseracing should properly now be reintroduced for the 50th Scheme. There is nothing in the Levy legislation which limits the Levy to business that relates to British horseracing, we consider it to be Racing's legal entitlement to receive Levy in respect of so much of the business of a bookmaker as relates to all horse races.

The Levy is not a payment for "rights"; it is a general mechanism to transfer funds from Betting to Racing in a broad sense. To limit the application of the Levy to British Racing only limits the scope to achieve the target yield unnecessarily, and in doing so builds into the system disincentives to promote betting on British Racing, which is entirely contrary to the stated objectives of the HBLB.

There is clear historical precedent for Racing's position. Prior to the 42nd Scheme (2003/4), British bookmakers paid Levy in respect of all their business that related to horse races. No distinction was drawn as to whether these races were staged in Britain or overseas. Today, annual gross win from overseas racing in British LBOs is approximately £133m (Source: The Big Picture – 2010), plus an unknown additional gross win for British operators of remote platforms and betting exchanges.

Whilst there has been much discussion and debate as to why overseas racing was not levied directly as part of the 42nd and subsequent schemes, this is not relevant as each Scheme is to be addressed on its own as to its target yield and its structure.

Legal analysis, backed by precedent, shows that overseas racing may be levied directly. The only consideration should be to construct a Scheme within the terms of the legislation that will deliver the reasonable Levy yield sought by Racing of £130-£150m, and we propose that there is benefit in setting a Scheme that does not distinguish between revenues from British and overseas racing. Such a proposal would remove a distinction which can lead to an incentive to promote betting on other Racing content. The removal of the distinction would act as an incentive to scheduling race times on a complementary basis with racing from other countries, ensuring maximum betting opportunities, as opposed to now, where British Racing return is incentivised by clashing. Racing and Betting would receive mutual benefit from the impact in British LBOs, with many British betting operators also benefiting from the improved service in their businesses around the world, specifically Northern Ireland and the Republic of Ireland. Further, British betting operators would have less of a cost-based incentive to promote overseas racing if Levy was paid on that product at the same rate as for British Racing.

5.3 Gross Profit Thresholds for abated rates of Levy payment by bookmakers operating Licensed Betting Offices ('Thresholds')

Thresholds, as they have operated since 2002, are an anomaly and are acting as a benefit to major bookmaking businesses in a way which was not intended, and are acting as a further disincentive to promoting betting on British horseracing. This is the subject of an ongoing review within the Levy Board.

It is our view that there is no proper place for a Thresholds system in any Scheme where LBO contributions are calculated by reference to gross profit; a gross profits Levy removes per se the possibility of Levy payable being anything other than proportionate, equitable and fairly reflecting the bookmakers' capacity to pay. Moreover, Thresholds create the possibility that betting operators may manage their businesses so as to deliberately minimise Levy yield - a practice which is inconsistent with the intentions of the legislation.

The Levy Board has conducted a review into both Thresholds and Levy incentivisation. We consider Levy incentivisation in a further section below. Both Racing and Betting have been able to contribute to the review, but it has not yet concluded. The terms of reference for the review were to assess:

a. The appropriateness of thresholds, within the meaning of the Act, for the 50th Levy Scheme and beyond.

b. An appropriate level of thresholds for each bookmaking constituency for the 50th Levy Scheme for consideration by the Bookmakers' Committee.

c. The viability of incentivising licensed betting operators paying Levy by means of marginal rates of Levy.

d. The relationship between thresholds and Levy incentivisation.

Thresholds were introduced by the Government as part of the determination of the 41st Levy Scheme (which changed the basis of the Levy from turnover to gross profit) to replicate the relief for "smaller bookmakers" that had arisen resulting from the turnover bandings, specifically those as set out in Schemes between 1988 and 2001. The ongoing review has uncovered the fact that the relief for smaller bookmakers had not been the original intention of the bandings, but they were more to provide confidentiality of data.

Recently, however, the Levy Board has promoted Thresholds as being for the benefit of smaller betting shop operators. In confirming the details of the 48th Levy Scheme on 3rd November 2008, the Levy Board announced the terms of next year's Scheme are based on those of the current Scheme with some important modifications, including that, to assist smaller betting shop operators, the threshold above which the full 10% of Gross Profits is payable will increase from £85,700 to £90,000.

Data from the 47th Scheme produced by the Levy Board for the ongoing review has shown the benefit of Thresholds has extended far beyond these smaller operators, in that:

1. over 4,800 LBOs paid Levy at less than the headline 10% rate
2. if all those LBOs had paid Levy at the full 10% rate, the 47th Levy yield would have been a minimum £7m higher (an 11% increase); and
3. some £5.2m of that increase in Levy payment (75% of the total increase) would have been paid by the five largest high street operators.

Unsubstantiated arguments have been put forward by the Bookmakers' Committee that a significant number of shops would close were Thresholds to be removed. Any loss of Levy in such a case would of course be limited by substitution of betting activity as punters moved to the nearest open shop, but in any event, the Bookmakers' Committee's assertion suggests that the Levy payment is such a material element of an LBOs cost base that an increased Levy payment would threaten its very viability.

It is contrary to two general statements that are also promoted repeatedly by bookmakers, namely that FOBT business is what makes LBOs profitable, and that British Racing betting is the core betting product

We disagree with the assertion made by representatives of the Bookmakers' Committee that ending thresholds in and of itself would lead to the closure of a significant number of shops., We ask that the Levy Board bear in mind the following information, produced for its own review, when considering this suggestion. Analysis of two betting operators and their results for the 47th Scheme showed that their Levy payments were 3.46% and 3.83% respectively of their total cost base. For the analysis, depreciation and profit of fixed asset disposals were excluded from costs; we propose that inclusion of depreciation charges would actually have been appropriate, which would have led to smaller percentages still being calculated;

Further, our own analysis of publicly available data from one of the "Big 3" shows that, in relation to LBO business only, in 2002 their Levy payment was 5% of total gross win and 7% of operating costs. In 2008, the Levy payment was 2% of total gross win and 3% of operating costs.

However, provided that a reasonable return is established and a Scheme designed to target this yield, Racing would fully support initiatives within Betting to establish relief from Levy payment to the very smallest betting operators who run just a handful of LBOs if this were to encourage and protect consumer choice. The Levy legislation allows for the inclusion of such a provision, as it allows bookmakers to be divided for the purposes of the Levy into different categories, and for the amount, if any, payable by way of Levy to be determined by reference to the category in which a bookmaker falls. We recognise though that such a proposal may create issues of competition law. As with all matters in this section, however, that should not be simply at the cost of Racing. It follows from the new approach to the Levy negotiation that the Target Yield should be set and a Scheme designed to achieve the level of contribution from each part of the betting sector that is considered appropriate in order to achieve the overall.

We would post two further reasons why the current Thresholds system is unreasonable and not fulfilling its original purpose and hence providing further reason for its removal:

(i) the move away from a "demand" test for the opening of new LBOs has raised the possibility of multiple LBOs operating in close proximity to each other, without a proportionate increase in total betting activity, leading to the consequence that there is a higher likelihood of each shop falling under the threshold and paying an abated rate of Levy and thereby reducing total yield. This would not have been the case under a turnover based Levy; and

(ii) we would want to remove any possibility that LBO operators could reduce the promotion of British Racing in their shops during a Levy period, and particularly towards the end of a period, in order to benefit to the maximum degree from the abated Levy rates on offer.

5.4 Betting on Exchanges

As stated above already, our primary concern is that any agreed Levy Scheme is designed to deliver the reasonable yield sought by Racing.

The detailed design of that Scheme is a matter for the Bookmakers' Committee to propose and the Levy Board to agree. The design of the 41st Scheme did not anticipate the success of the exchanges' high volume low margin betting business model in setting the headline 10% gross profits mechanism. Further, there has been no in-depth analysis since that time to establish whether the exchanges' model has impacted upon Racing's share of the growth in betting that was envisaged, and has taken place, since then. In September 2008, the Levy Board approved a motion to ask DCMS to review the whole mechanism by which betting exchanges pay Levy, and we would have expected such a review to consider these issues. No review has taken place, but Racing should not be disadvantaged because of this and we hope they will be addressed fully during the course of the negotiations of the 50th Scheme.

Specifically, we propose that both the Bookmakers' Committee and the Levy Board should take into account the two issues that we set out below when considering Scheme proposals in relation to betting on betting exchanges.

First, whilst both betting exchanges and traditional bookmakers are "bookmakers" within the terms of the Levy legislation and definition, they perform very different roles and derive their income from betting on Racing in very different ways.

So, betting exchanges do not take any risk and earn revenue through providing the platform through which their customers place and accept bets with each other. Traditional bookmaker operators take the risk of accepting bets and earn revenue through successfully managing their book of liabilities. Whilst exchange operators and traditional bookmaking operators are both "bookmakers" for Levy purposes within the 1963 Act definition, there is no reason why both should have to pay the same percentage of their respective horseracing profit (commission for exchanges and gross win for traditional bookmakers) or indeed for their Levy obligation to be based on their "gross profit" at all. For example, on-course bookmakers and spread betting companies are "bookmakers" who pay Levy on a different basis.

The 42nd Levy Scheme recommended by the Bookmakers' Committee, and approved by the Levy Board, required exchanges to pay Levy of 10% of their commission and, in addition, 10% of the gross win from the lay bets of their profitable layers. That Scheme was successfully judicially reviewed by a now defunct betting exchange, Sporting Options. However, it is important to note that the decision did not hold that calculating the Levy in this way was unreasonable per se, simply that there had been insufficient consultation with betting exchanges prior to that decision being taken. At that time, there was no betting exchange representative on the Bookmakers' Committee, and this has since been changed. However, ever since, the Bookmakers' Committee seems to have taken the view that exchanges are to pay Levy on the same 10% of gross win as traditional bookmakers, albeit on the exchanges' commission. No alternatives have been proposed. However, there is no barrier to the Bookmakers Committee doing so. Provided that the Bookmakers' Committee consults properly with the exchanges, we can see no reason why the Bookmakers' Committee should not be able validly to recommend a scheme which requires a greater contribution from betting exchange activity as part of delivering an increase in the total Levy yield.

Our second point is that it seems certain that there are many exchange customers who are acting as "bookmakers" within the Levy legislation and, therefore, have an obligation to pay the Levy which, in accordance with the 48th Scheme, would be at 10% of Gross Profits on their British Horseracing Betting Business. Any Scheme design should facilitate the efficient collection of Levy from these individuals.

The key legal issue in determining whether an exchange customer is a "bookmaker" within the Levy legislation is whether he is carrying on "the business of receiving or negotiating bets". Note that this is a completely separate issue to whether that same exchange customer requires a licence under the Gambling Act 2005.

There is little doubt that an exchange's customers are receiving or negotiating bets – the question is then whether there are customers who are doing so as a business. Given that, as an example, Betfair imposes additional charges on those of its customers who place more than 1,000 bets an hour, make more than 20 data requests per second and consistently make a profit, we are confident that a court would be satisfied that these people are not casual punters but instead are people who conduct their operations as a business.

We are of course aware that HM Treasury conducted a review of the tax treatment of betting exchanges in 2004/05. Indeed, Betfair were happy to share with us the bundle of documents they received in response to a Freedom of Information Act request which they had submitted in relation to that review.

On inspection of the documents, it is very clear that, even in 2004/05, the Treasury did not conclude that no users of a betting exchange were in business. The conclusion of the Treasury's review was that, for reasons of Government policy, it did not want to change the current tax laws in a way such that any betting exchange users would, in the future, be subject to taxes designed for them specifically. This is in no way relevant to the legal question as to whether certain users of betting exchanges are "bookmakers" who have a liability to pay the Levy.

5.5 Offshore bookmakers

The Levy was designed as a mechanism to ensure a transfer of funds from Betting to Racing in its broadest sense. The fact that technology has enabled developments in the manner in which such betting is offered to the consumer does not mean that Racing should be prejudiced – see above. Also, the Levy was intended to capture all British betting activity on Racing. The fact that some operators have set up telephone call centres and/or websites offshore to carry out the same activity should not alter the reasonable return to Racing. It is a glaring inadequacy of the current Scheme that Levy is not paid on at least £50m of gross win on British Racing generated for these offshore bookmakers by British punters. As above, the 50th Scheme, in delivering a reasonable target yield, will either have to take a view that offshore operators will be liable to pay Levy themselves, or design a Scheme that otherwise addresses the structural issue that to date has led to a direct reduction of Levy yield and is therefore unreasonable and unfair on Racing.

The Department for Culture, Media and Sport ("DCMS") announced on 7 January 2010 that it would shortly commence a consultation to consider how to implement new licence requirements for overseas online gambling firms who want to have a customer base in Great Britain. The Sports Minister Gerry Sutcliffe indicated that the Government will also be looking into ways to secure fair contributions from overseas licensed operators towards the costs of regulating gambling and the Levy. He noted on 7 January 2010 that "In terms of the Horserace Betting Levy, I remain firmly of the view that all operators taking bets on British races should pay their fair share. There is more to do but I am committed to making sure this happens."

Racing welcomed these announcements. As stated, Racing is not getting its "fair share" and the 50th Scheme is the process by which this can be rectified.

One route is for there to be a change in law to ensure that Levy is payable by all operators. Whilst working to achieve this, Racing should not carry the cost if for any reason this is not implemented. Racing also notes that a continued failure to address this and other (e.g. tax) structural issues has a considerable impact on competition between betting operators as regards online and other remote operations. One impact is that the Tote, who make a considerable contribution to Racing outside of the Levy, and who have so far decided to retain their remote businesses on shore, are at a considerable trading disadvantage, which may itself have a further negative impact on Racing.

For Betting to pay a reasonable return to Racing through the Levy, that return would in Racing's view be best shared by all operators. But, if the inadequacy of the current system is not addressed for the period of the 50th Scheme, this should not detract from a Scheme being set to deliver an intended target of £130-£150m.

We note also that the Bookmakers' Committee, representing as it does the interests only of operators contributing to the Levy, have a direct interest in securing contributions from all operators. Indeed, the Bookmakers' Committee could not be opposed to securing this, not least due to the increased contributions demand that this leakage will require of them.

We also note, separately, that a number of the major operators have located remote operations offshore and will be benefiting at a consolidated level from these moves.

We recognise the lead role that the Levy Board has taken in initiating the proposals to ensure that all bookmakers who target British punters contribute to the Levy. In October 2008 the Board proposed that DCMS should carry out a review of the legislative and regulatory framework to establish the means by which overseas operators offering a bet on British horseracing to customers in Britain are or could be subject to the Levy. Further, in April 2009 the Board wrote to Chris Bell of the Bookmakers' Committee setting out its support for a proposal to require off-shore operators carrying out bookmaking activities in Great Britain to pay the Levy. To quote: "There must be an unequivocal statement by the Levy Board in any release related to the next Levy Scheme that it is prioritising capturing Levy from offshore operators". Racing will continue to support the Levy Board in achieving this objective.

5.6 FOBTs, Virtual Racing and the "relates to" test:

Racing is entitled to receive the Levy "in respect of so much of the business [of betting operators] as relates to betting transactions on horse races".

This means that the Levy is payable in respect of more than simply business directly deriving from bets placed on horseracing. Provided a sufficient relationship can be established between any particular revenue stream and betting transactions on horse races, that revenue stream should be (indeed, would have to be in law) leviable. In particular, this means that Levy could be assessed on bookmakers' income from FOBTs, "Virtual Racing" and/or any other product, where that income can reasonably be said to "relate to" horseracing.

Section 27(2)(a) of the 1963 Act states that the Levy Scheme shall include provision "for securing that the Levy shall be payable only by a bookmaker who carries on his own account a business which includes the effecting of betting transactions on horse races, and only in respect of so much of the business of the bookmaker as relates to such betting transaction".

The words "in respect of" define the "pool" from which the Levy can be assessed (i.e. the "leviable" business of the bookmakers)[15]. Traditionally, Levy Schemes have limited the business which may be subject to Levy to amounts received in respect of bets placed on horseracing.

However, the words "relate to" are capable of capturing business other than bets placed on horse races (and assessed with respect to either turnover or gross win), provided that such business can be said to "relate to" betting transactions placed on horse races. The natural meaning of the words "relates to" is broader than "derives from"[16]. Lord Pannick has confirmed that in this context "relates to" means "have some connection with"[17]. In his advice to the Levy Board in respect of the last Scheme, Sir Phillip Otton agreed with this construction[18].

It follows that, in a determination, the Secretary of State is entitled to take the view that business may be subject to Levy even if it does not constitute betting transactions on horse races, provided that it relates to such transactions (in the sense that a connection can been drawn between the two revenue streams or elements of the bookmakers' business).

This will require detailed analysis in the course of the negotiations. However, Racing has made an initial assessment of the potential for such "convoyed sales" in the Market Approach methodology above.

Racing considers that such a relationship exists in relation to FOBTs and virtual racing games:

5.6.1 Gaming machines (including FOBTs)

The Gambling Commission's licensing criteria for LBOs state that gaming machines may be made available for use in licensed betting premises only at times when there are also sufficient facilities for betting available. Such facilities for betting must include the provision of information that enables the customer to access details of the events on which bets can be made and to be able to place those bets, obtain details of the outcome of the events, calculate the outcome of their bets and be paid or credited with any winnings.

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[15] The words do not define the income which is relevant to the bookmakers' capacity to pay, for which see paragraph 2.1.2 above.

[16] Contrary to the assertion of Mr De Haan QC on behalf of the Bookmakers Committee Appended to the Bookmakers' Committees' response to Otton I dated 21 October 2008

[17] Paragraph 23 of the Pannick Opinion.

[18] Paragraph 24 of Otton III.

By definition therefore bookmakers could earn no FOBT revenues from LBOs if there was no betting available, and as betting on Racing is the primary form of betting in LBOs, Racing is, therefore, directly responsible for bookmakers' FOBT earnings. In addition, evidence adduced by both Racing and Betting in the negotiations for the 49th Scheme demonstrated that the take up of gaming machines is significantly increased by punters drawn to betting offices to place bets on British horseracing (see, for example, the Bookmakers' Committee's Response to Otton I).

Sir Philip Otton concluded[19] in "Otton III" that the Secretary of State would face difficulty in assessing the relevant proportion of gross margin on gaming machines which "relates to" betting transaction on horse races, and that as a result he may elect not to exercise his discretion to assess a Levy on such an income.

We consider that the new process for the negotiation of the 50th Scheme removes this difficulty. And, as we state, Racing's case is that there is direct evidence that a significant connection does exist[20].

We look forward to the opportunity to address this issue which will entail consideration of information which Racing does not have at this stage. We would suggest that information to be provided and considered would include as a minimum the gross win from FOBTs secured by bookmakers on every day for the two years ending 31 March 2010, split between morning, afternoon and evening sessions. This would facilitate an analysis of how the level of FOBT earnings changes in relation to the various types of race meeting being staged.

This should lead to a Levy Scheme where the Levy percentage of Racing gross win is set in recognition of not just total Racing gross win but also by reference also to total FOBT gross win.

5.6.2 Virtual Racing

As above, where it can be established that there is a sufficient relationship between revenue generated from Virtual Racing and Racing, that revenue should also be leviable for all the reasons given at 4.2.1 above.

We consider there to be a direct relationship between horseracing and its virtual equivalent, and that a Levy on virtual horseracing is one source open to the Bookmakers' Committee and the Levy Board to achieve an overall reasonable yield. As noted above in relation to overseas racing, inclusion of Virtual Racing within the scope of the Levy would reduce the incentive for bookmakers to promote this product over British horseracing.

5.7 Levy Incentivisation

As we have set out in our submissions to the Thresholds Review group, we would be happy to consider any proposals from the Bookmakers' Committee that incentivised betting operators to increase their directly leviable business, be that British Racing, overseas racing, Virtual Racing etc.

Part of the incentive could be for betting operators to pay marginal rates of Levy on the additional leviable business generated. Any such proposal however would be subject to one key condition; that any incentives only became applicable once the upper bound of the agreed reasonable yield range had been achieved for the Scheme as a whole.

We note that previous Schemes contained incentivisation mechanisms.

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[19] At paragraph 22 of Otton III.

[20] See further section 3.3 and 3.4 of Racing's submission to Sir Phillip Otton dated 25 October 2008 and section 2 of Racing's submission dated 28 October 2008 (which should properly have been dated 28 November 2008).

5.8 Other issues

In closing, we note two other issues which the Levy Board may wish to take into account when considering the design of any Scheme proposed by the Bookmakers' Committee. All are based around the ability of the Scheme design to go outside of the established gross profits mechanism.

First, and linked to our section on FOBTs above, we consider that Racing bears an unfair share of the revenue risk under the gross profits mechanism. This is because of the additional profits earned by Betting, convoyed sales, off the back of Racing being the primary betting activity. An additional consideration to recognising convoyed sales within the Levy Scheme design would be to agree a Scheme that earned different amounts for Racing in particular betting sessions when the risk sharing was most imbalanced, such as winter evenings.

Second, there is the historical precedent of Betting making separate Levy payments for a specific hypothecated purpose. In the 40th Scheme, Betting paid specific amounts to contribute to Racing's central marketing activity, and we propose that similar direct contributions be considered.

The Bookmakers' Committee is not fettered in any way from making specific Scheme proposals, outside of the established gross profits mechanism, in order to address these points.

Appendix One – Major Factors of Racecourse Profitability 2002-09

Positive impact	Negative impact
Higher LBO media payments In 2001 the LBO market was controlled by monopoly buyer SIS, with the value paid to racecourses being significantly lower than its true market value. Modest increases in subsequent SIS contracts occurred between 2002-2007, with a large proportion of the absolute increase being driven by fixture expansions. The introduction of competition to the market with the establishment of Turf TV in late 2007 has resulted in further increases in licence fees paid to racecourses.	**Loss of £30m p.a. attheraces contact** The contract commenced in October 2001, hence 2002 was therefore the first full year of its existence. The original attheraces media deal was a 10 year deal with minimum payments of £307m, over its duration, to the 49 participating racecourses – with the payment profile relatively smooth at c.£30m per year . The agreement was terminated in 2004 and meant racecourses lost £30m a year in revenue, with minimal associated direct costs, hence effectively £30m lost profits. While Racing UK and the new attheraces channel have resulted in revenue for racecourses this has been at substantially lower values.
Greater admission related revenue Total racecourse attendance in 2002 and 2009 were broadly similar despite the increase in fixtures. Higher ticket prices have therefore been the key driver in increased admission related revenue, enabled by the racecourses' investment in improved facilities.	**Lower terrestrial television media rights** The amounts paid by Channel 4 and BBC in media rights have declined markedly since 2002, indeed Channel 4 have been paid by Racing to continue coverage. The need for terrestrial coverage to showcase Racing for betting purposes has contributed to this decline.
Higher non raceday profits Racecourse continue to diversify their revenues by expanding their non raceday activities. However, while they have had success since 2002 the competitive nature of the market means that the levels of profits earned are still relatively small.	**Significant increases in operating expenditure** Racecourses have been negatively impacted by large increases in a variety of costs including integrity, maintenance and employee costs.
	Increased finance costs As a result of borrowing to fund the racecourses' substantial capital investment in improved equine and racegoer facilities. While improved racecourse facilities are generally expected to increase profits, in the short term the interest cost and repayment of loans often means the cashflows are negative in the short to medium term

Appendix Two: Comparisons of the funding of British, Irish and French racing

Funding of racing by sector

£m	Britain		France (all)		France (excluding trotting)		Ireland	
	£	%	£	%	£	%	£	%
Betting industry	160	19%	585	72%	293	79%	48	18%
Racing consumers/partners	404	48%	11	1%	6	1%	43	16%
Owners (net training costs)	275	33%	211	26%	73	20%	182	67%
	839		**807**		**372**		**273**	

Source: BHA:PMU:Dukes Report
Excludes breeding sector given lack of comparable information for France and Ireland
Notes: Based on £1:Euro 1.25
Betting industry - consisting of direct payments through the Levy,PMU, HRI (respectively) and also LBO pictures rights in Britain and Ireland
Racing consumers /partners – including the admission fees and raceday spend of racegoers, sponsorship and advertising and other commercial revenues generated by racecourses w hether related to racing or other activities. Ow ners (net training costs) – ow ners expenditure on keeping, training and running horses less prize money received. It does not include the costs of acquiring horses w hich w ill be significant.

- Payments arising from betting form the majority of funding for French racing. Owners still make a significant net contribution of over £200m but benefit from much greater prize money and premiums.
- British owners already make the biggest contribution to racing in Europe. It is therefore unrealistic to expect further support from the owners, to continue to compensate for lack of betting industry support.
- The lack of support from the betting sector has meant the burden on funding of racing has fallen on owners and racing consumers in Britain and Ireland. This has to date been sustained by the unprecedented period of economic prosperity since the late 1990’s but the current climate changes this. We briefly discuss below the situation in Ireland.
- British and Irish racecourses have been successful in developing diverse commercial revenues both raceday and in many case non-raceday which in part compensate for the lower betting revenues but there is a limit beyond which we consider it dangerous to assume this can continue if inadequate betting returns are paid to the sport.
- The expenditure of owners is the key means by which the c.18,000 direct jobs in British Racing are supported – owners’ net £275m expenditure from training costs alone equates to over £15,000 per job.

Comparison of the usage of Levy and PMU distributions to racing

The table below compares how funds generated by the PMU & HBLB are in turn applied in the racing industry.

Comparison of HBLB and PMU distributions to racing (2008)

£m	Great Britain	France (Including trotting)	Difference
Levy			
Prize money	59	305	(246)
Owners premiums/support	0	38	(38)
Breeders support	2	43	(41)
Integrity	25		
Other racecourse support (2)	7		
Other industry bodies support	4		
Administration costs	4	200	160
Other betting contributions	45		
	146	**585**	**(439)**

Source: PMU;IFHA:HBLB

Note PMU Euro distributions converted at £1:Euro1.25

The analysis highlights that:

- French owners and breeders premiums are designed to support domestic owners and breeders. There is minimal support in Great Britain. These premiums are considered a valuable tool to ensure the many thousands of jobs in the French breeding industry.
- The betting contribution to prize money in France represents over 95% of total prize money, with less than €5m in sponsorship and equivalent to racecourse prize money. British racecourses in contrast make up around 30% of prize money from executive contributions and sponsorship. It is clear British Racing is doing what it can to make up for insufficient betting support, but there is a limit to what more can be achieved.
- The £200m non-prize money payments to racing in France are used to cover a much broader variety of costs than in the Britain. In addition to funding the integrity functions, payments to racecourses and other bodies are made to cover marketing, administration, general operational costs etc. Such payments are required because of the lack of non betting revenues generated by the racing industry. In contrast the diversified revenue streams developed by British racecourses effectively fund the majority of these operations but we consider there is limited potential for further funding to compensate for inadequate betting returns.
- France has put in place a series of allowances to support owners' transport costs. Total allowances of €9.2m were paid in 2008, which based on the c.75,000 thoroughbred runners equates to an average of €121 per runner. The transport allowance is an example of the type of encouragement French racing offers to its owners to maintain, and indeed expand, their racing interests for the good of the whole sport. British Racing does not currently have sufficient funds to consider such schemes.

Lessons from Irish racing's decline

Irish racing is currently undergoing a painful adjustment caused by the deep recession experienced in the country. The downturn forced the government to reduce the amount by which it tops up the Horse and Greyhound Fund above what the bookmakers' contribute from the 1% tax on turnover. The reliance on owners and racing consumers, with limited betting industry support, has arguably exacerbated the situation given:

- Owners and hence horses in training have fallen markedly – with current owners down 9.5% but new owners by 28% meaning further major falls seem inevitable.
- At least 1,500 and up to 2,000 jobs are thought to have been lost already.

British Racing to date has been much more resilient but nonetheless it is instructive to witness what can occur. We would also point to two of the key proposed responses to deal with the funding crisis:

- Increase the betting tax from 1% to 1.5% or higher; and
- Address the very significant leakage of betting tax revenues arising from offshore internet operators who currently make no contribution for the Irish racing product they use.

Setting the 50th Horserace Betting Levy – An Economic Analysis

10 March 2010

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Contents

This report has been prepared as an independent review to help inform the British Horseracing Authority (BHA) in developing its position regarding the 50th Levy Scheme (2011/12). Assistance from the BHA and LECG staff members in preparing this report is gratefully acknowledged. The opinions expressed here are those of the author and should not be taken as the views of the BHA or any other organisation.

Abstract

This report presents an economic analysis of how the 50th Horserace Betting Levy might be determined in a market context applying commercial principles. It develops an economic framework for estimating a Levy price from first principles, as a price that might be agreed in hypothetical market negotiations between Racing and Betting for a "right to access racing for betting purposes". The parties make offers of the maximum (Betting) or minimum (Racing) Levy prices they might consider and negotiate an agreed price within this range, depending on their relative bargaining power, needs and capacities. In the main analysis it is estimated that considering just the direct contribution of racing to gross win would lead to a Levy in a range of approximately £121m - £151m. A full estimate including the additional contribution of racing to sales of other betting products would be £154m - £184m.

LECG

1 Executive Summary

Summary

The market approach results in a target Levy yield of £121-151m.

Key factors being:

- The market based Levy is the price that might be agreed in market negotiations between Racing and Betting for a "right to access racing for betting purposes". The approach assumes that the parties make offers of the maximum (Betting) or minimum (Racing) Levy prices they might consider, and negotiate an agreed price within this range, depending on their relative bargaining power, needs and capacities.
- It is assumed conservatively that Racing retains only 25% of the difference between the minimum and maximum points, which might be higher in commercial situations.
- The total Levy figure is based on LBO earnings and applied to all the Levy, assuming the Levy is collected for all types of betting.
- When LBO earnings from "convoyed" sales of FOBTs and other betting are added this increases the target range to £154-184m.

1.1. Overview

Our economic analysis considers how the Horserace Betting Levy might be determined in a market context applying commercial principles. It develops an economic framework and uses this to derive a range of possible Levy prices.[21]

The approach estimates a Levy price from first principles, as a price that might be agreed in market negotiations between Racing and Betting for a "right to access racing for betting purposes". Other than the price mechanism, the Levy operation is assumed unchanged:

- The Levy is seen as an administrative arrangement for ensuring that an access right exists, is operated effectively and the costs and benefits are distributed in a mutually acceptable, fair and reasonable way.
- Racing and Betting negotiate as groups and the Levy agreement is available to all members of both groups on equivalent, non-exclusive terms.
- The Levy "access right" may differ from typical commercial access rights in important respects but the method of agreeing a price is based firmly on methods used in the market place. [22]

In the hypothetical negotiations, Betting and Racing make initial offers of the maximum or minimum Levy prices they could possibly accept. They then negotiate an agreed Levy price within this price range, depending on their relative bargaining power, needs and capacities.

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[21] The current model is based on the LECG analysis included in the BHA's 47th Levy submission in 2007. "Setting the Horserace Betting Levy – Analysis and Commentary", LECG, 26 November 2007.

[22] The market model overlaps many of the concepts in the actual Levy process. A traditional Levy determination as a balance between the needs of Racing and the capacity of Betting to pay for access to racing (possibly also allowing for other social aims), is consistent with the market model that compares Betting's demand for racing (and how much it is prepared to pay) with Racing's funding needed to provide racing for betting purposes (and how much it will accept). The market and Levy principles are not so far apart as might be imagined.

- The upper bound of the range is the maximum Levy that Betting might be prepared to pay for access to racing for betting purposes.
- The lower bound of the range is the minimum Levy that Racing might be prepared to accept to supply an acceptable quantity and quality of racing product.
- These extreme “walk away” positions define the bounds of the negotiations.
- The analysis computes a price between the two extremes where the parties might agree to share the “surplus” (the difference between the upper and lower bounds), depending on their relative bargaining strength and other considerations.
- It is conservatively assumed that Racing retains only 25% of the surplus, which might be higher in commercial situations.

This mirrors real-life negotiations widely used for specialised assets, such as a one-of-a-kind building or a right to use specialised intellectual property, for which there are unique users and suppliers (or both parties choose to negotiate as groups) and there is no readily identified price in a regularly functioning market. Similar economics techniques of “hypothetical negotiations” between willing buyer and seller are also used in litigation to determine a ‘fair and reasonable’ price for licensing proprietary technology or other intellectual property, where indeed they may be considered the leading approach.

The analysis is based primarily on data for the British retail business, which accounts for the bulk of the Levy. A similar analysis of Levy sources from other betting channels (exchanges, telephone and internet) shows that figures for the upper and lower bounds are likely to be similar to or higher than those for the retail business. Thus, the results for the LBOs are applied across the whole Levy. This assumes that the Levy amount applies to the items currently levied and that these levies can be collected (*e.g.*, including betting operations transferred offshore). The Levy amount does not address issues of applying the Levy to currently unlevied items, such as overseas racing.

Full details of the market approach are given in the LECG report attached as an Appendix to this Submission. The report also contains a review of the critiques of the market approach made by OCP and London Economics at the time of the 47th Levy Submission.

1.2. Upper bound

The upper bound for the negotiations is calculated from the accounting data for the GB retail business for the ‘top 3’ Bookmakers. It is assumed that these are representative of the GB retail business, accounting for about three quarters of GB retail total revenue.

- The upper bound is estimated by considering what profits Betting would lose in its retail business if GB horseracing were withdrawn, compared to its current profits. This is calculated from the loss of revenue minus the potential savings such as media and other operating costs that would not be incurred without horseracing. It is assumed that Betting would be able to continue in operation.
- The analysis differentiates between the short and long term impact depending on which of operating costs might be saved, giving a range for the upper bound. The short term impact on Betting profits is likely to be higher, as Betting will be more able to reconfigure its business in the long term.
- Conservatively, it is assumed that Betting would save its share of retail staff and other costs depending on racing’s share of OTC gross win, with no share of costs borne by FOBTs.

A similar analysis of other Levy sources (exchanges, telephone and internet) shows that the equivalent upper bound is likely to be similar or higher than for the retail business, so that the results for LBOs are applied across the whole Levy.

The calculation of Betting's upper bound is shown in Table A1. This considers the direct effect of the loss of GB horseracing betting on Betting retail profits. We use 2008 figures as most representative of the current situation, since 2009 figures are not fully available and are likely to be distorted by adverse conditions in the economy as a whole. It is shown in the table that Racing gross win for the top 3 in 2008 is estimated to be £601.6m. If racing were withdrawn it is assumed that LBOs would lose all this revenue (*i.e.*, on balance gross win from FOBTs and other OTC products are assumed unchanged). It is further estimated that the LBOs would be able to reduce costs by an estimated £445.8m, comprised of GPT and Levy, TV and a *pro rata* share of LBO staff costs, shared between racing and other OTC only. This is a conservative estimate since it assumes that Betting is able to reduce operating costs significantly and especially that FOBTs carry no staff or other operating costs. This implies a total marginal contribution of £155.8m, or 25.9% of racing gross win. Since this marginal contribution allows for a 10% Levy, the upper bound in the Levy negotiations would be 10% above this, at 35.9%. This is taken as the main value for the upper bound.

An even more conservative estimate for the Levy assumes that a *pro rata* share of *all* OTC operating/ administration costs would be saved if racing were withdrawn. This leads to a 30.3% upper bound as the minimum value for the upper bound. (For further details see the LECG report in the Appendix).

Table A1: Betting upper bound –
Marginal contribution of Racing to GB Retail
(Top 3 Bookmakers)

(£m)	**2008**
OTC gross win	1,367.2
FOBT gross win	820.1
Total Retail gross win	2,187.3
Retail operating profit %	25.9%
Share racing in OTC	44%
Racing gross win [a]	601.6
– GPT + Levy	-150.4
– TV costs (est) [b]	-50.7
– Staff costs (est) [c]	-244.7
Total racing marginal cost	-445.8
Racing marginal contribution	155.8
Contribution as % racing gross win	25.9%
Equivalent Levy % [d]	**35.9%**
Equiv. Levy % (full cost allocation) [e]	35.9%
Equiv. Levy % (dir + full admin) [f]	**30.3%**

(Source: Bookmaker Annual Reports; HBLB Annual Report 2008/09; LECG analysis)

[a] Racing gross win = OTC gross win x default percentage (HBLB).

[b] TV direct costs saved due to rights costs and other operating costs (est. £8,500 per shop).

[c] Staff costs saved estimated from total retail staff costs allocated *pro rata* on proportion of racing in total OTC gross win (assumes no staff costs allocated to FOBTs).

[d] "Equivalent Levy" is the pre-Levy profit contribution, as the upper bound for bargaining.

[e] Contribution assuming all costs allocated to products (racing, FOBT, other) in proportion to gross win.

[f] Contribution allocating direct GPT and Levy costs to racing, remaining administration/other costs allocated to products (racing, FOBT, other) in proportion to gross win.

This defines an upper bound for the Levy of around 30% - 36%, equivalent to £278m - £329m when applied to the 2008 Levy total of £91.6m for all betting.

1.3. Lower bound

The lower bound considers the minimum Racing would accept to supply racing at a quantity and quality acceptable to Betting. Given that Betting continues to ask for more fixtures at the current Levy, the preferred benchmark is the minimum Racing would accept to maintain the current level of racing – meaning a full fixture list of races of a quality acceptable to both Racing and Betting. Since Racing is having difficulty funding this level of fixtures the preferred lower bound is the current Levy rate of 10%.

The analysis also considers this in more detail by asking whether at lower Levy rates Racing would need to reduce the number of fixtures, and how far Betting would want such reductions given that it would lose gross win on the lost fixtures. The analysis also considers whether other sources of funding, such as increased Racecourse media earnings, might reduce the minimum that Racing would need for the current quality and quantity of fixtures.

An analysis of the BHA leasehold fixtures, which have constituted the main increase in the fixture list since 2003, shows that it is not in Betting's interests to reduce the Levy rate significantly. Lower Levy revenues would result in fewer fixtures, and below a certain level the direct loss to Betting from the reduced racing betting exceeds any Betting savings from reduced Levy costs for the remaining fixtures. Thus the lower bound might be a slightly reduced Levy compare to current level but Betting would not want any further reduction as it would lose more than it would gain.

This is illustrated in Table A2, which treats all the leasehold fixtures for which data are available as a "block" in which all fixtures are assumed the same. The first step calculates how far the Levy rate might be reduced before Racing would withdraw all the fixtures. Considering Racecourse earnings, the fixtures currently make a total Raceday loss of £6.1m, and receive £9.6m in Levy funding. The lowest the Levy funding could be reduced to before the all fixtures were loss making would be £6.1m. Assuming the Levy funding is proportional to the gross win generated by the fixtures, this implies the lowest Levy rate needed to run the fixtures would be 6.4% (*i.e.*, 10% x 6.1 / 9.6).

The second step calculates Betting earnings without the fixtures. With the same assumptions Betting would lose £105.8m of gross win if the leasehold fixtures were withdrawn (assuming no substitution into other racing fixtures). Assuming Betting could save the media costs for these fixtures and a portion of labour costs, its loss of profits on the lost leasehold fixtures would be £53.1m. This would be partly offset by a saving in Betting's Levy costs on the remaining fixtures of £29.2m. Combining these figures, this would leave Betting a net £23.9m worse off than it was before the Levy was reduced. As a result, Betting would not want to push the levy so low that the leasehold fixtures were withdrawn. The lowest Betting would seek would be just above the breakeven point of 6.4%.

Table A2: Racing lower bound - Minimum Levy for leasehold fixtures (as a "block")	
£m	**Leasehold fixtures**
Number of leasehold fixtures (with data)	207
Racecourses:	
Levy/BHA distribution Racecourses	9.6
Implied gross win leasehold [a]	105.8
Raceday profit (loss) before Levy	-6.1
Levy for leasehold breakeven %	**6.4%**
Betting:	
Lost gross win (no substitution)	105.8
Lost profit (ex TV, part labour) post-Levy [b]	-53.1
Levy saving on remaining fixtures (new rate)	29.2
Net gain (loss) (ex TV, part labour)	**-23.9**

(Source: 50th Horserace Betting Levy Scheme – Submission of British Horseracing, Section 3.2.5; LECG analysis)

[a] Gross win calculated from Levy distribution assuming 10% rate and an average 90.3% share of total Levy payments made to Racecourses (2008/09), for Levy contribution for prize money, integrity and other raceday costs (*i.e.*, approx. 9.6 x 10 / 90.3%).

[b] Cost reduction: save TV media rights and half labour costs *pro rata* on racing gross win

The "block" analysis is mainly for illustration, and our full "incremental" lower bound analysis considers the leasehold fixtures as a distribution, in which the fixtures have different earnings and gross wins, rather than as a block in which all fixtures are assumed to be the same. When allowance is made for these differences between fixtures, the "incremental" analysis shows that Betting would not reduce the Levy below about 8.7% (higher than the 6.4% in the "block" analysis) before it starts to lose more profit from the lost fixtures than it gains in reduced Levy on the remaining fixtures. Under other assumptions, including the possibility that some proportion of lost gross win on withdrawn fixtures might be substituted back to other racing, it is concluded that the lowest possible bound for the Levy at which Racing would supply a quantity and quality of racing that Betting would accept is at or above 7.5%.

A similar analysis of other Levy sources (exchanges, telephone and internet) shows that the equivalent lower bound is likely to be similar or higher than for the retail business, so that the results for LBOs are applied across the whole Levy.

The analysis also considers whether Racing might be able to find other sources of funding to maintain the same level of fixtures, such as Racecourse media earnings or increased funding from Owners or Trainers. It appears, as explained in greater detail in the full report, that the scope for supplementing income from other sources is too small to affect the result (See LECG report, section 5.3).

Based on these analyses, we define two figures for the lower bound: a minimum lower bound of 7.5% and a preferred lower bound of 10%, equivalent to £69m and £92m respectively based on the 2008 Levy total.

1.4. Share of surplus

The final stage of the negotiation model is the share of the surplus that goes to each party. It is usual in such models to assume that the relative bargaining power of the parties determines where between the two extremes a rate might be agreed.

- In the model we assume that the surplus (difference between upper and lower bounds) would be split in a 25/75 ratio (25% to Racing).
- The split is based typically on the share of risk or required investment borne by the parties, as well as other less definable aspects of bargaining power. A 25% split reflects "rules of thumb" sometimes used in other licensing contexts.
- This split is considered conservative and generous to Betting. The actual investment risk taken by the parties may be more balanced between Racing and Betting. In equivalent commercial negotiations Racing might achieve a higher share.[23]

Sensitivity analysis of the results show that there is only limited sensitivity of the Levy price to changes in the lower bound but greater sensitivity to changes in the split.

The results of the analysis are summarised in Table A3.

Table A3: Levy bargaining range – Racing betting only

	Max lower bound		Min lower bound	
Levy	**%**	**£m***	**%**	**£m**
Maximum Upper bound:				
Upper bound (maximum Betting might pay)	35.9%	328.9	35.9%	328.9
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	**16.5%**	**150.9**	14.6%	133.7
Minimum Upper bound:				
Upper bound (maximum Betting might pay)	30.3%	277.5	30.3%	277.5
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	15.1%	138.1	**13.2%**	**120.9**
Current Levy (2008)	10.0%	91.6	10.0%	91.6

* Equivalent Levy amount applying Levy % to total Levy for all betting (£91.6m in 2008)

The main case is for a Betting upper bound of 35.9% and Racing lower bound of 10%, which leads to a Levy rate of 16.5%, equivalent to £150.9m based on the 2008 actual Levy amount. The lowest most conservative case is for a Betting upper bound of 30.3% and Racing lower bound is 7.5%, which leads to a Levy rate of 13.2%, equivalent to £120.9m. The total levy range would then be £121-151m.

1.5. "Convoyed" sales of other betting products

A further aspect of the economic model is the contribution of horseracing to sales of other products in the LBOs, called "convoyed" sales. The full contribution of horseracing to betting should also reflect the value derived from sales of other products in the LBOs that

[23] The theoretical "Nash Equilibrium" in bargaining games for similarly placed parties is a 50/50 ratio. The traditional "needs and capacity" Levy framework might imply a share between Racing and Betting in a ratio of 50/50, or possibly if between Racing, Betting and Society of 33/67.

depend partly on racing as the anchor product that brings punters in. FOBTs in particular work as highly profitable filler products for punters whose primary object in visiting the LBOs may be horseracing betting. Racing remains the dominant LBO product and appears to be the main reason for most punters to visit an LBO. This means that withdrawing racing from LBOs is likely to have greater impact on LBO earnings than just the direct effect, and the upper bound should reflect that.

It is not a simple matter to estimate the "convoyed" sales of other products that would be lost if horseracing were withdrawn from LBOs. The analysis makes an estimate from the "diverted" horseracing betting gross win that is likely to have been displaced by new products, primarily FOBTs, and would be lost if horseracing were not available.

- It compares actual horseracing gross win against what this is likely to have been had horseracing betting grown in line with overall GDP growth, over the period since about 2003 when FOBTs and other new betting products became important.
- It assumes that these earnings would not occur if horseracing were not available in the LBOs, that the "primarily horseracing" business would be lost and with it the diverted sales of other products.[24]
- This would increase the maximum Betting would pay to retain horseracing. The incremental effect on the Levy is then calculated using this higher upper bound.

The effect is to add about a further 14% to the upper bound, or 3.6% to the Levy, equivalent to about £33m. The levy range would then be £154-184m, measured between the minimum upper and lower bound assumptions (44.7%, 7.5%) and the maximum upper and lower bound assumptions (50.3%, 10%). The effect is shown in Table A4.

Table A4: Levy bargaining range – Including FOBT/Other betting sales

	Max lower bound		Min lower bound	
Levy	**%**	**£m**	**%**	**£m**
Maximum Upper bound:				
Upper bound (maximum Betting might pay)	50.3%	460.9	50.3%	460.9
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	**20.1%**	**183.9**	18.2%	166.8
Minimum Upper bound:				
Upper bound (maximum Betting might pay)	44.7%	409.6	44.7%	409.6
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	18.7%	171.1	**16.8%**	**153.9**
Current Levy (2008)	10.0%	91.6	10.0%	91.6

1.6. Other betting platforms

Retail accounts for about 68% of the total Levy in 2008, with telephone at around 14%, internet at 7%, betting exchanges at 7% and other betting about 4%.

A similar analysis of telephone betting indicates that the upper bound for telephone might be around 45% for the main case in 2008. An analysis of betting exchanges indicates an upper bound of around 56%. It has not been possible to make estimates for internet betting. These upper bounds are similar to, or above, those used for the retail business

[24] This assumes that on balance the gross win for Other sports betting (and any convoyed sales associated with this) is unchanged by the withdrawal of horseracing.

(30% - 36%). A similar analysis of the lower bounds for the other platforms indicates that these are also likely to be similar to or higher than those for the retail business. Thus, the Levy rate for the retail business is applied across the whole Levy. The LBO implied rate may underestimate the Levy rate that might be agreed in a market context for these other platforms. This assumes that the Levy amount applies to the items currently levied and that these levies can be collected (*e.g.*, including betting operations transferred offshore).

The current analysis is based on 2008 data, before the move offshore by some telephone and internet betting operations. The Levy amount is thus the total that would be expected to be collected for all these platforms. The question of how to Levy offshore operations is not addressed in these figures.

1.7. Other critiques

The full LECG report also contains a review of the critiques of the market approach made by OCP and London Economics at the time of the 47th Levy Submission. The critiques are rejected.

2 Introduction

This report describes an economic bargaining model used to determine an equivalent market price for the Levy payment. The analysis considers how the Horserace Betting Levy might be determined in a market context applying commercial principles. It develops an economic framework for the Levy and uses this to derive a range of possible Levy prices.

The analysis builds on the previous LECG economic report made at the time of the 47th Levy Submission in 2007.[25] The analysis focuses primarily on the impact of GB horseracing on LBO retail business and the results are applied across the whole Levy.

The analysis includes two aspects which are addressed in more detail than previously.

- First, the analysis reviews the minimum compensation that Racing could accept from Betting and still be able to supply an acceptable level and quality of fixtures. The previous analysis argued that any reduction of Racing Levy funding below current levels would lead to a reduction in fixtures, that this was undesirable to Betting and this defined a Racing lower bound. The current analysis considers the lower bound in more detail. It assesses the impact on the supply of racing, and the effect on Betting, if the Levy were reduced. This is done through an analysis of the "marginal" leasehold fixtures that comprise the bulk of the fixture expansion since 2003 and may rely on the Levy to make good their actual losses. This also reviews the potential for substituting greater funding from owners or Racecourse media earnings. This reviews the possibility of a "spiral of decline" with lower levels of racing and betting in the longer term if the Levy were reduced excessively.
- Second, the analysis reviews how media payments are included in the model and the extent to which this treatment might be revised following the introduction of Turf TV in 2008. Turf TV has increased Betting's costs in LBOs and this is automatically part of the analysis. It may also have impacted total Racecourse funding. The model also includes the possible effect of Racecourse earnings from Turf TV on the minimum funding needed for Racing to supply an acceptable quantity and quality of racing product.

The analysis includes the contribution of racing to sales of other products ("convoyed sales") and how this might affect Levy rate. This aspect may become increasingly relevant given the increase in LBO earnings from FOBTs and the continuing role of GB horseracing as the lead product in LBOs.

The report notes other areas of the Levy which may need to be included quantitatively and/or qualitatively in the economic approach. It also summarises responses to some comments on the previous LECG analysis for the 47th Levy by Organisation Consulting Partnership (OCP) and London Economics.

[25] The current model is based on the LECG analysis included in the BHA's 47th Levy submission in 2007. "Setting the Horserace Betting Levy – Analysis and Commentary", LECG, 26 November 2007.

3 Basic economic model

The basis for the analysis is to consider a price that might be agreed in hypothetical market negotiations for a “right to access racing for betting purposes”. In all other respects the Levy mechanism is assumed to be unchanged. The Levy is seen as an administrative arrangement for ensuring that such an access right exists and is effective.

In preparing for the negotiations the model identifies the upper and lower bounds the parties might accept, as the maximum value that the bookmaking industry (“Betting”) might be prepared to pay for access and the minimum that British horseracing (“Racing”) might be prepared to accept to supply the requested level of access. These two “walk away” positions define the bounds of the negotiations. The analysis then identifies a price between the two extremes where the parties might agree to share the “surplus”, depending on their relative bargaining strength and other considerations.

This analysis mirrors the behaviour in real-life negotiations frequently seen for specialised goods for which there are unique users and suppliers (or both parties choose to negotiate as groups) and there is no readily identified price in a regularly functioning market. Such negotiations are widely used to set prices for unique assets, such as a one-of-a-kind building or a right to use specialised intellectual property. Similar economics techniques of hypothetical negotiations and the factors determining the share of the surplus are frequently used in patent litigations to calculate damages, where they may indeed be considered the leading approach.

The aim here is to identify a market price that might be achieved for the Levy in a market framework, essentially as an independent benchmark for the Levy. The market model overlaps with some of the concepts built into the actual Levy process. The idea of a Levy based on a balance between the needs of Racing and the capacity of Betting to pay for access to racing, possibly also allowing for other social aims, is consistent with the market model that compares Betting’s demand for racing (and how much it is prepared to pay) with Racing’s funding needed to provide racing for betting purposes (and how much it will accept). In the market model the two bounds are defined specifically according to profits and costs. The balance between the two positions is assumed to be determined by market negotiations, allowing for the strengths of the parties’ positions and other considerations, rather than an external evaluator. Even so, the market and Levy principles are not so far apart as might be imagined.

The analysis is based primarily on data for the British retail business, which accounts for the bulk of the Levy. A similar analysis of Levy sources from other betting channels (exchanges, telephone and internet) shows that figures for the upper and lower bounds are likely to be similar to or higher than those for the retail business. Thus, the results for the LBOs are applied across the whole Levy. This assumes that the Levy amount applies to the items currently levied and that these levies can be collected (*e.g.*, including betting operations transferred offshore). The Levy amount does not address issues of applying the Levy to currently unlevied items, such as overseas racing.

The current analysis is based on 2008 data. This is before the move offshore by some telephone and internet betting operations. The Levy amount is thus the total that would be expected to be collected for all these services. The question of how to Levy offshore operations is not addressed in these figures.

4 Upper bound – maximum value of racing to Betting

The first part of the analysis considers the theoretical maximum value that Betting might place on access to horseracing and be prepared to pay, in preference to having horseracing withdraw from LBOs altogether. In the analysis the marginal contribution of racing to betting earnings is estimated by considering what profits LBOs would make if racing were withdrawn compared to (actual) profits with racing. In the short term withdrawing racing would reduce racing gross win and those direct variable costs attributable to racing betting, but not fixed costs. In the long term LBOs are assumed to be able to reorganize so that the share of fixed costs and overheads attributable to racing betting may also be reduced. The short term, or marginal, impact of withdrawing racing on betting profits is likely to be higher than the long term effect. Both are considered in determining the maximum value in different time frames.

The maximum value that LBOs would place on access to racing is estimated from the impact on bookmaker's operating profit if racing were withdrawn from them. Data on the bookmakers' operating performance has been collected for the 'top 3' Bookmakers (Ladbrokes, William Hill and Coral). These represent about three quarters of GB racing retail business, indicated by Levy receipts.[26] Data for other smaller bookmakers are generally not available in the required level of detail for the analysis and the top 3 are believed to be representative of the industry. Even for the top 3 firms, racing gross win figures are not available broken out from total retail, and it has been necessary to estimate these figures from the HBLB default percentage of the share of OTC receipts that are due to GB horseracing betting.[27]

The main analysis considers only the direct effect on betting earnings of withdrawing racing, due to the loss of revenues (*i.e.*, gross win) specifically for racing betting. This is likely to understate the impact on earnings, due to "convoyed" sales of other betting products in LBOs that depend on horseracing to bring punters into the LBOs. The analysis includes an estimation of the convoyed sales effect, recorded separately below.

A similar analysis of other Levy sources (exchanges, telephone and internet) shows that the equivalent upper bound is likely to be similar or higher than for the retail business, so that the results for LBOs are applied across the whole Levy.

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

[27] The HBLB default percentage may underestimate the share of horseracing in OTC. The current figure used is 44%, some independent indications are that this may be lower, possibly 42%. Which is used has little effect on the final results.

The calculations and data used for the Betting upper bound are shown in Table 1.

Table 1: Betting upper bound – Marginal contribution of Racing to GB Retail (top 3)		
(£m)	**2008**	**2007**
OTC gross win	1,367.2	1,342.2
FOBT gross win	820.1	716.2
Total GB Retail gross win	2,187.3	2,058.4
Retail operating profit %	25.9%	27.2%
Share racing in OTC (default %)	44%	45%
Racing gross win [a]	601.6	604.0
– GPT + Levy	-150.4	-151.0
– TV costs (est) [b]	-50.7	-26.7
– Staff costs (est) [c]	-244.7	-231.4
Total racing marginal cost	-445.8	-409.2
Racing marginal contribution	155.8	194.8
Contribution as % racing gross win	25.9%	32.3%
Equivalent Levy % [d]	**35.9%**	42.3%
Equiv. Levy % (full cost allocation) [e]	35.9%	37.2%
Equiv. Levy % (dir + full admin) [f]	**30.3%**	31.6%

(Source: Bookmaker Annual Reports, HBLB default percentage, LECG analysis)

[a] Racing gross win = OTC gross win x default percentage (HBLB).

[b] TV direct costs saved due to rights costs and other operating costs (est. £8,500 per shop).

[c] Staff costs saved conservatively estimated based *pro rata* on proportion of racing gross win in total OTC gross win (assumes no staff costs due to FOBTs).

[d] “Equivalent Levy” is the pre-Levy profit contribution, as the upper bound for bargaining.

[e] Contribution assuming all costs allocated to products (racing, FOBT, other) in proportion to gross win.

[f] Contribution allocating direct GPT and Levy costs to racing, remaining administration/other costs allocated to products (racing, FOBT, other) in proportion to gross win.

The analysis indicates that the upper bound for the Levy for Betting is likely to be around 30% - 36% in percentage terms, equivalent to £278m - £329m in absolute terms when applied to the 2008 Levy total of £91.6m for all betting.

5 Lower bound – minimum Racing would accept

5.1 Lower bound methodology

The second part of the analysis considers the minimum Racing would accept to supply racing at a quantity and quality acceptable to Betting.

In the LECG analysis in 2007 it was argued that the lower bound, the minimum that Racing would be prepared to accept, was equal to the current amount of the Levy, a rate of 10%. This was considered the minimum that Racing would be able to accept to provide the current quality and quantity of racing fixtures.

This was based on the view that while Racing has increased the number of fixtures, in line with Betting requests, this had increased its costs. The increased costs appeared to be only just covered by the incremental increase in Levy earnings from the added fixtures and may in some case have incurred greater losses to Racing. It was concluded that any reduction in Levy funding would likely have made the increased fixture list increasingly unprofitable and in the long term would have resulted in a retrenchment and fewer fixtures.

The analysis did not question in detail Betting's decision to request more fixtures. The fact that Betting continued to ask for more fixtures at the current Levy level implied that the fixtures were profitable for Betting. The benchmark for determining the lower bound was therefore taken as the least Racing would accept to supply the current (requested) number of fixtures at an acceptable quality level.

It was also apparent that an attempt to make a full analysis the effects of reducing the level of racing fixtures would be outside the scope of the Levy analysis. It might involve a possible "spiral of decline" of the Racing and Betting industries in which fewer fixtures imply lower Levy earnings and then further fixture reductions. It is not clear where this process would end, a risk being that the number and quality of fixtures could be significantly reduced and the industries significantly changed.

In the current analysis, the preferred lower bound benchmark remains the minimum Racing would accept to maintain the current level of racing – meaning a full fixture list of races of a quality acceptable to both Racing and Betting. Since Racing is having difficulty funding this level of fixtures the preferred lower bound is the current Levy rate of 10%.

However, there is now more data available of the impact of the increase on the fixture list since 2006 on Betting and Racing and some further analysis is possible. The current analysis is able to look at the lower bound in some more depth. First, it reviews the question of whether Racing and Betting might jointly consider reducing fixtures, or equivalently reducing the quality or number of races, as an extreme position, and the lower bound Levy that implies. Second, it also considers the extent to which Racing might be able supply the current, or acceptable, level of racing at lower Levy funding, by diverting funds from other sources.

5.2 Calculation of lower bound – leasehold fixtures

a) Profitability of new fixtures

This section considers more closely whether, if the Levy rate were reduced below its current level of 10%, (a) would Racing need to reduce the number of fixtures, and (b) would Betting want this reduction to take place?

In general, it seems clear that Racing is nearing or has surpassed the point where it can profitably supply all the product requested by Betting. The constituent parts of Racing, such as the Owners, are providing an increasing subsidy to the running of the sport, while the share of the costs that are funded via the Levy is declining.[28]

This is most apparent for the fixture list expansion, which may have been only marginally worthwhile for Racing (including the Levy payments that racing receives from these fixtures). The expansion of the fixture list has resulted in increased costs to Racing which may not be covered by the Levy, which in total has remained flat. This includes concerns that the new fixtures might stretch supply, with a possible reduction in quality and increased

[28] Racehorse owners' funding of the sport for training and breeding has increased by £162m since 2002. Even taking into account the prize money funded by the Levy, Owners' net expenditure on training rose from £125m in 2002 to £275m in 2008, a total growth of 120% or 14% per annum compounded. (See Table 10 below).

integrity costs. [29] For example, the numbers of runners per race appears to have fallen for the past two years.

Conversely, the increase seems to have been profitable for Betting, which seems satisfied that extended opening has been financially successful.[30] This has allowed the LBOs longer, more uniform opening hours, notably winter evening opening, and greater opportunity for sales of other betting and FOBTs. It therefore seems that fixture expansion has been successful for Betting but less so for Racing. Much of the value derived by Betting does not return to Racing.

To get a better view of the lower bound we consider the impact of the increase in the fixture list and in particular the profitability of "BHA leasehold" fixtures – introduced in 2003 to enable fixture expansion. The analysis first considers the profitability of these fixtures as a block, for both racecourses and betting. The main question is how far the Levy might be reduced before Racing would find it unprofitable to provide the leasehold fixtures (as a block), and if the Levy were reduced below this whether Betting would lose income and therefore not seek to reduce the Levy further. This provides an estimate of the lowest Levy Racing would consider before reducing the number of fixtures below a level acceptable to Betting.

The analysis relies on data in the following tables. The uses of Levy funding and the profitability of the leasehold fixtures, are shown in Tables 2 and 3.

Table 2: HBLB Levy Expenditure 2008/09

	(£k)	%
Prize money	59,418	58.3%
Integrity services	24,978	24.5%
Other racecourse expenditure	7,729	7.6%
Administration	3,614	3.5%
Veterinary	2,633	2.6%
Improvement of breeds	1,917	1.9%
Training	973	1.0%
Other improvements (net)	449	0.4%
Bookmakers' Committee	264	0.3%
Total	101,975	100.0%
Total prize, integrity, other racecourse	92,125	90.3%

(Source: HBLB Annual Report 2008/09)

[29] "Since 2002 racing's … expansion of the fixture list [has included] a high number of fixtures at the lower end of quality spectrum". (50th Horserace Betting Levy Scheme: Submission of British Horseracing, 10 March 2010, Section 3.3.3).

[30] "OTC gross win benefited from extended winter evening opening in the first three months". Ladbrokes, Annual Report 2008, p. 8.

Table 3: Leasehold fixtures revenues/costs (2008) (£k)				
	Leasehold	**Other***	**Leasehold**	**Other***
Number of fixtures	207	668	*Per fixture*	*Per fixture*
Admission	2,667	29,392	13	44
SIS/LBO monies	5,975	20,040	29	30
Race sponsorship	645	6,012	3	9
Other rev.	485	5,344	2	8
Total revenue	9,772	61,456	47	92
Total prize money	-7,153	-32,064	-35	-48
Integrity costs	-3,693	-12,024	-18	-18
Other raceday operating costs	-5,040	-20,040	-24	-30
Total costs	-15,886	-64,128	-77	-96
Raceday profit (loss) before Levy	-6,114	-3,340	-30	-5
Levy/BHA distribution	9,556	35,404	46	53
Raceday profit (loss) after Levy	3,442	32,732	16.6	49

(Source: 50th Horserace Betting Levy Scheme – Submission of British Horseracing, Section 3.2.5.)
* Totals may not appear exact due to rounding

b) Basic model

The basic analysis addresses the tradeoffs between a reduced Levy and lower number of fixtures and the impact this has on the earnings of Betting and Racing. This considers how much the Levy rate might be reduced before the average leasehold fixture becomes unprofitable for the Racecourses, assuming other sources of funding remain unchanged. It then considers how far Betting would seek to reduce the Levy knowing that this may lead to reduced fixtures.

This analysis is shown in Table 4.This shows the costs and revenues for the leasehold fixtures, which comprise the main expansion of the fixture list since 2003 and the most likely to be withdrawn if Levy income were reduced. There are 207 relevant leasehold fixtures for which there are data.

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Table 4: Betting & Racecourse earnings - Minimum Levy for leasehold fixtures (as a block)		
£m	**Leasehold fixtures**	**Impact at break even**
Total Levy (all Betting)	91.6	
Number of leasehold fixtures (with data)	207	
Racecourses:		
Levy/BHA distribution Racecourses	9.6	
Implied gross win leasehold [a]	105.8	
Raceday profit (loss) before Levy	-6.1	
Levy for leasehold breakeven %	**6.4%**	
Betting:		
Lost gross win (0% substitution)	105.8	
Lost profit (ex TV, part labour) post-Levy [b]	-53.1	-56.9
Lost profit (ex TV, labour) post Levy [c]	-74.6	-78.4
Lost profit (all sales) post-Levy [d]	-91.5	-113.4
Levy remaining fixtures	81.0	91.6
Levy remaining fixtures (new rate)	51.8	58.6
Levy reduction remaining fix (new rate)	29.2	33.0
Net gain (loss) (ex TV, part labour)	**-23.9**	-56.9
Net gain (loss) (ex TV, all labour)	**-45.4**	-78.4
Net gain (loss) (all sales)	**-62.3**	-113.4

(Source: 50th Horserace Betting Levy Scheme – Submission of British Horseracing, Section 3.2.5; LECG analysis)

a Gross win calculated from Levy distribution assuming 10% rate and an average 90.3% share of total Levy payments made to Racecourses (2008/09), for Levy contribution for prize money, integrity and other raceday costs (*i.e.*, approx. 9.6 x 10 / 90.3%).

b Cost reduction: save TV media rights and half labour costs *pro rata* on racing gross win.

c Cost reduction: save TV media rights costs *pro rata* on racing gross win and no labour costs.

d Assumes: All sales lost (racing + other + FOBT).

In the basic analysis these fixtures are considered as a 'block' or as an average leasehold fixture. This shows that the minimum Levy income for the Racecourses to break-even is £6.1 million, equivalent to a 6.4% Levy.

The analysis then identifies the minimum Levy Betting would seek before it loses more profits from lost gross win than it gains from reduced Levy payments. The results show that if the Levy were reduced below the break-even point, Betting would lose more direct profits from the lost fixtures than would be offset by gains from the lower Levy on the remaining fixtures. [31]

The net impact on Betting is calculated using the LBO cost and revenue figures and applying these to Betting as a whole. If the leasehold fixtures are lost Betting costs are

[31] This assumes that the gross win to Betting is proportional to the Levy distribution to the fixtures. This depends on the criteria used in distributing Levy funding to the fixtures. In the long term it seems reasonable to assume that the Levy distribution, and notably the prize money and other racecourse expenditure portions, should reflect the gross win, and hence Levy, earned by the fixtures.

assumed to be reduced by the media rights for the lost fixtures and part or all of its direct labour costs, allocated to Racing *pro rata* according to the loss in racing gross win. [32] Assuming in Option 1 that for the lost fixtures Betting saves the TV costs for those fixtures and 50% of labour costs, Betting would lose £53.1m from the lost fixtures offset by Levy savings of £29.2m on the remaining fixtures, making it a net £23.9m worse off by losing the fixtures. In Option 2, if Betting is able to save the TV costs but no labour costs it would be £45.4m worse off than currently. This is the preferred case, as it seems that if the LBOs remained open during the limited periods allocated to the leasehold fixtures it would not be able to save much labour. In Option 3, if we were to factor in the loss of sales of other products ("all sales") as a result of the reduction of leasehold fixtures resulting in lower footfall in betting offices or closure, Betting might be £62.3m worse off.[33]

In each of these cases, Betting would not push the Levy below the breakeven point of 6.4% (treating the leasehold fixtures as a block).[34]

Note that the 6.4% figure for the Racecourse breakeven point is based only on the leasehold fixtures' marginal contribution to Raceday operating profits, and does not include any contribution to general overheads. This breakeven therefore understates the true breakeven Levy before the Racecourses would be forced to withdraw the fixtures. Also for the full number of leasehold fixtures (260) the loss would be greater.

This shows that:

- For a Levy below the breakeven Levy rate the racecourses would find it unprofitable to provide leasehold races and would withdraw them. The breakeven is the minimum Racing would accept to continue offering leasehold fixtures, considering just the direct Raceday costs and revenues.
- If the leasehold races were withdrawn, then the net effect on Betting profits is to reduce them below the current level. Betting would not seek a Levy rate below the breakeven rate.

c) "Incremental" model

A weakness of the basic approach is that, although it illustrates the principle, It treats all leasehold fixtures as equally profitable. The basic analysis is a simplification in that it treats all leasehold fixtures as the same and estimates a Levy rate at which the average leasehold fixture would be unprofitable. In fact fixture Racecourse costs and Betting profits are likely to vary. Betting might prefer a higher Levy, closer to the current 10%, to ensure

[32] There may be limited potential to reduce staff while still keeping the LBOs open during "leasehold" periods.

[33] The lost direct earnings from horseracing betting are likely to underestimate Betting's total loss due to withdrawn fixtures, which may also include lost earning from FOBTs and other sports betting. This would allow for the fact that punters might not visit the LBOs during non-fixture periods, that the LBOs do not find it profitable to stay open without the additional fixtures, or that LBOs might not be permitted to stay open without racing fixtures under the terms of their licenses.

[34] At a Levy rate just above breakeven, before fixtures are withdrawn, Betting would benefit from a reduction in Levy costs on all fixtures of £33.0 million. At a Levy rate just below breakeven, the leasehold fixtures would be withdrawn and Betting would suffer an incremental loss of £56.9 million, for a net loss of £23.9 million compared to current. Thus, for the Racing lower bound, Betting would seek to reduce the Levy rate to just above breakeven but no further. This implies a lower bound of 6.4%. However, this does not include allowance for other Racecourse overheads so understates the likely breakeven Levy.

that some fixtures were not withdrawn. This corresponds to the view that since Betting is still asking for more fixtures at the current Levy amount it would be unlikely to seek a reduction if this were to mean fewer fixtures. We turn next to an analysis allowing for differences between fixtures.

A more complete analysis would assume that the profitability of the fixtures varies. This ‘incremental’ analysis allows for a distribution of profitability for the leasehold fixtures. As the lower bound Levy is reduced a greater proportion of the leasehold fixtures are withdrawn, the least profitable for Racing and for Betting being withdrawn first. There is a minimum Levy value below which Betting loses more from lost betting earnings than it gains from lower Levy on the remaining fixtures.

This is modelled as follows. For each reduction in the Levy below the current 10% level, some of the least profitable leasehold fixtures are likely to become unprofitable to Racing and so be withdrawn. The impact on Betting profits is that while it loses profits from the lost fixtures this is offset by the Levy savings on the remaining (leasehold and racecourse) fixtures. The incremental analysis investigates how many fixtures would be withdrawn by Racing at each level of the Levy, and how low the Levy could be reduced before Betting’s lost profits from the withdrawn fixtures exceed its Levy savings on the remaining fixtures.

It is assumed that some of the Racecourse costs and revenues for the leasehold fixtures are linearly distributed between minimum and maximum ranges (± 55% above/below the average, estimated from actual distribution) among the different fixtures. These include Admission, Race sponsorship, Other revenues, Total prize money. Some items are assumed to be the same for all fixtures. These include SIS/LBO monies, Integrity costs, Other raceday operating costs. [35] It is also assumed the gross win for Betting, and Levy payments on these gross wins, are distributed between minimum and maximum ranges and vary together for each fixture. This simplified distribution mirrors the actual distribution of leasehold fixture costs and revenues reasonably closely. This is shown in Table 5.

[35] A minor unpopular fixture would have below average admission, sponsorship and other revenues, and similarly reduced prize money costs, but would bear the same average integrity, media and raceday costs as more popular fixtures.

Table 5: Range of leasehold fixtures earnings (2008) (£k)					
	Total	*Per fixture*	*Per fixture*	*Per fixture*	*Per fixture*
	Leasehold	**Avg.**	**Min***	**Max**	**Avg.**
Number of fixtures	207	-	-	-	-
Admission	2,667	13	5.8	20.0	12.9
SIS/LBO monies	5,975	29	28.9	28.9	28.9
Race sponsorship	645	3	1.4	4.8	3.1
Other rev.	485	2	1.1	3.6	2.3
Total revenue	9,772	47	37.1	57.3	47.2
Total prize money	-7,153	-35	-15.6	-53.6	-34.6
Integrity costs	-3,693	-18	-17.8	-17.8	-17.8
Other raceday op costs	-5,040	-24	-24.3	-24.3	-24.3
Total costs	-15,886	-77	-57.7	-95.7	-76.7
Raceday profit (loss) before Levy	-6,114	-30	-20.6	-38.5	-29.5
Levy/BHA distribution	9,556	46	20.8	71.6	46.2
Raceday profit (loss) after Levy	3,442	16.6	0.2	33.1	16.6
Lowest Levy breakeven %	6.4%	6.4%	**9.9%**	**5.4%**	**6.4%**
Levy/BHA distribution Racecourses	9,556	46	20.8	71.6	46.2
Total gross win leasehold	105,777	511	230	792	511
Lost profit (ex TV) Betting	53,104	257	115	398	257
Lost profit (ex TV, labour) Betting	74,616	360	162	559	360
Lost profit (all sales) Betting	91,462	442	199	685	442
* Min /Max range multiplier			55%		

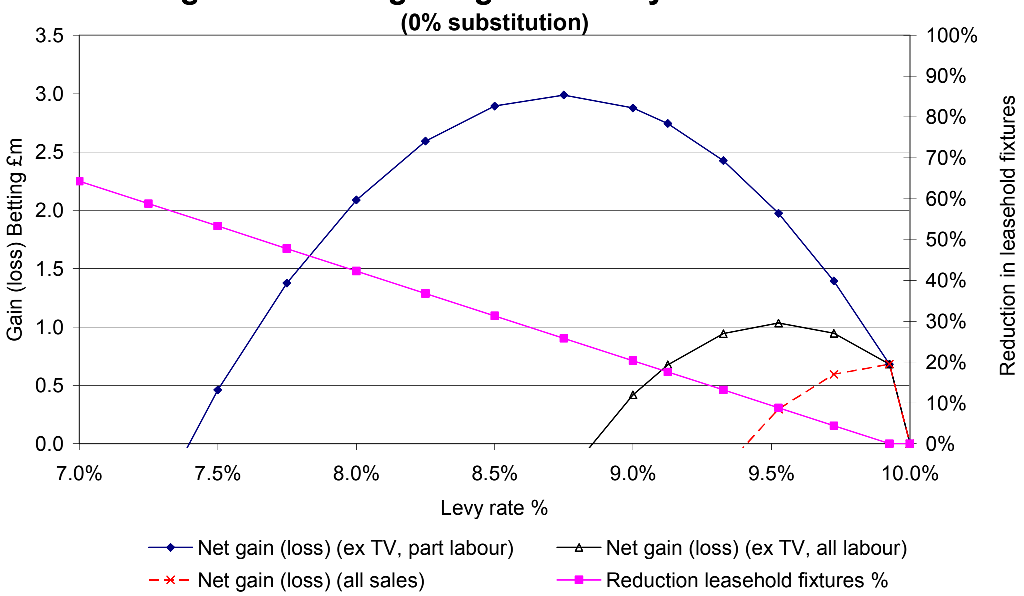
With these assumptions the profitability of the fixtures (including the implied 10% Levy distribution), increases linearly from £200 for the least profitable to about £33,100 for the most profitable (average profitability £16,600 per fixture as before). The breakeven Levy rate varies from a maximum of 9.9% (for the least profitable fixture to breakeven) to 5.4% (for the most profitable fixture). The average breakeven Levy is 6.4% as before.

A schedule is created for the reduction in the number of leasehold fixtures for different Levy rates, and the corresponding net effect on Betting profits compared to current. The lost profit to Betting from lost leasehold fixtures is calculated as in the basic model. This includes both the lost earnings from horseracing betting for lost fixtures plus the saving from the lower Levy rate on all the remaining fixtures. This is shown in Table 6.

Table 6: Betting & Racecourse earnings - reduced leasehold fixtures (no substitution)									
Levy new rate	**5.4%**	**6.0%**	**6.5%**	**7.0%**	**7.5%**	**8.0%**	**9.5%**	**9.9%**	**10.0%**
Redn. leasehold fixtures	100.0%	86.2%	75.3%	64.3%	53.3%	42.3%	9.4%	0.0%	0.0%
Lost profit (ex TV, pt lab)	-53.1	-42.3	-34.5	-27.4	-21.0	-15.3	-2.5	0.0	0.0
Lost profit (ex TV, lab)	-74.6	-59.5	-48.5	-38.5	-29.5	-21.5	-3.5	0.0	0.0
Lost profit (all sales)	-91.5	-72.9	-59.5	-47.2	-36.2	-26.4	-4.3	0.0	0.0
Levy redn (lost l'hold)	-10.6	-9.1	-8.0	-6.8	-5.6	-4.5	-1.0	0.0	0.0
Levy rem fixtures	81.0	82.5	83.6	84.8	86.0	87.1	90.6	91.6	91.6
Levy cost (new rate)	43.5	49.5	54.4	59.4	64.5	69.7	86.1	90.9	91.6
Levy redn (new rate)	37.5	33.0	29.3	25.4	21.5	17.4	4.5	0.7	0.0
Net gain (ex TV, pt lab)	-15.6	-9.3	-5.3	-2.0	0.5	2.1	2.0	0.7	0.0
Net gain (ex TV, lab)	-37.1	-26.5	-19.2	-13.1	-8.1	-4.1	1.0	0.7	0.0
Net gain (all sales)	-54.0	-39.9	-30.2	-21.8	-14.7	-9.0	0.2	0.7	0.0

The net gain (loss) to Betting vs. the lower bound Levy rate, for the three cases, is shown in Figure 1.

Figure 1: Betting net gain vs. levy lower bound



(Source: LECG analysis)

Figure 1 shows that Leasehold fixtures begin to be reduced once the Levy falls below 9.9%. As the Levy is reduced, Betting first gains by the Levy cost reduction then begins to lose profits as the loss of fixtures starts to predominate. For the case where Betting costs are reduced by media rights costs and part (50%) of the allocated labour costs, the net gain to Betting first increases as the Levy rate is reduced, and reaches a maximum of £3.0 million at about 8.75% Levy. After that further Levy reductions decrease Betting profits and after about 7.4% Levy Betting is worse off than currently. This indicates that Betting would not seek a Levy below 8.75% since below that it would lose more earnings from further reductions in the leasehold fixtures than it would gain from the lower Levy rate, applied to gross win from the remaining fixtures. At a 8.75% Levy racing would withdraw about 26% of the leasehold fixtures, about 54 of the 207 fixtures considered.

For the preferred case, where Betting costs are reduced by media rights costs and no labour costs, the net gain to Betting first increases as the Levy rate is reduced. The net gain to Betting reaches a maximum of £1.9 million at about 9.5% Levy. After that further Levy reductions decrease Betting profits and after about 9.4% Levy Betting is worse off than currently. This indicates that Betting would not seek a Levy below 9.5% since below that level it would lose more than it gains. At an 9.5% Levy Racing would withdraw about 9% of the leasehold fixtures, about 19 of the 207 fixtures considered.

For the “all sales” case where Betting loses all sales that would have been made during the leasehold fixture periods, Betting profits fall even more quickly and Betting would not seek a Levy below 9.93%, *i.e.*, before any fixtures are withdrawn.

This indicates that in the preferred case Betting would not seek a Levy below about 9% since below that level it would lose more earnings from further reductions in the leasehold fixtures than it would gain from the lower Levy rate applied to betting revenues from the remaining fixtures. The results are summarised in Table 7.

**Table 7: Racing lower bound –
Minimum Levy for leasehold fixtures (as a distribution)**

£m	Option 1 (ex. TV costs, part labour)	Option 2 (ex. TV costs, no labour)	Option 3 (all sales)
Betting minimum Levy %	**8.75%**	**9.50%**	**9.93%**
Betting net gain	3.0	1.0	0.7
Reduction in leasehold fixtures %	26%	9%	0%
Reduction in leasehold fixtures	54	19	0

The incremental model indicates that the Levy lower bound in the hypothetical negotiations would be around 8.75% - 10%. This is the lowest rate the Racing would be prepared to supply racing fixtures at a quantity and quality that Betting would seek.

Note that these are illustrative figures only and depend on the assumptions made in the analysis. However, they imply that Betting would be unwilling to seek a Levy much lower than currently as this is likely to lead to too great a reduction on the number of fixtures and a subsequent loss of earnings to Betting.

A similar analysis of other Levy sources (exchanges, telephone and internet) shows that the equivalent lower bound is likely to be similar or higher than for the retail business, so that the results for LBOs are applied across the whole Levy.

Combining the basic and the incremental analyses, and bearing in mind that this considers only the direct Raceday costs before and contribution to other overheads, two figures are defined for the lower bound. These are a minimum lower bound of 7.5% and a preferred bound of 10%, equivalent to £69m - £92m based on the 2008 Levy total.

d) Possible substitution of betting on other fixtures

i. Assumptions in analysis

This analysis of the leasehold fixtures is illustrative, designed to show that Betting would not want to reduce the Levy far below its current level if this meant it would lose the ability to offer bets on leasehold fixtures. The fact that Betting has sought these additional fixtures supports this and suggests that the incremental value of these fixtures to Betting's profitability is positive. Whether that incremental value arises solely from gross profits derived from betting on just these additional fixtures, or whether it arises at least partly as a result of sales of other betting products on the back of these fixtures is harder to answer, as is the question as to what precisely that incremental value is.

There are many complexities to such an analysis. There is a range of possibilities as to what might happen were these fixtures to be withdrawn. We have assumed that the Levy paid to these fixtures reflects the incremental value (gross win) that such fixtures generate, that would be lost without the fixtures. These are "incremental" since the contributions of these fixtures are being assessed in terms of what they add on top of the value that would have been generated by other fixtures anyway. There are also savings in terms of television costs and some labour costs.

Alternative assumptions are possible. At an extreme one might assume that if all or many leasehold fixtures were withdrawn, then the rationale for extended opening hours for licensed betting offices might be threatened. This could be seen as a loss of all gross win, on all products, generated by extended opening hours. Similarly, there are assumptions on savings on labour and media rights costs that could also be varied.

There is also a question as to whether the gross win generated by such fixtures is fully incremental, or whether it reflects some diversion from other racing betting. Betting might recoup some of the lost gross win from the withdrawn fixtures through increased betting on other races or other products. We include some analysis of this "substitution" possibility of other betting as a sensitivity to our main analysis. However, it should be noted that this is just one of many possible scenarios for estimating the impact of leasehold fixtures on betting's profitability – one might just as well give more weight to the lost betting receipts on betting on other products if, for example, shops' ability to operate in evening hours was jeopardised.

ii. Sensitivity to substitution

This addresses the sensitivity of the results if there is some substitution of betting between the withdrawn fixtures and other fixtures, so that Betting does not lose the entire gross win on the withdrawn fixtures.

The main analysis does not include substitution, primarily on the grounds that the lost gross win is estimated as an increment based on the associated Levy payments.

- In calculating the lower bound, Betting's gross win from leasehold fixtures is estimated from the Levy payments to those fixtures at the current rate. This assumes that on average the Levy payments reflect the gross win reasonably accurately. It is further assumed that if the fixtures were withdrawn then Betting would lose all that gross win. In other words, the Levy payments are assumed to reflect the incremental gross win after allowing for any substitution from other fixtures.
- This is a reasonable assumption given the purpose of the Levy expansion and the bidding procedure used to allocate leasehold fixtures. This implies that the Levy payment should reflect incremental value of the fixtures in terms of gross win.
- It is also reasonable given the intention of the analysis is to illustrate the general principle that Betting would not seek a major reduction in the Levy, if this implies a reduction in fixtures. This does not try to address the many auxiliary effects that might impact the total effect on Betting gross win or on the mechanism for allocating the Levy to fixtures in detail.

For completeness the analysis considers the impact if substitution were assumed to take place and Betting only loses a portion of the gross win attributed to the lost fixtures. This assumes some of the estimated lost gross win from the lost leasehold fixtures is recovered by substitution of betting back to other racing fixtures. For illustration we assume a substitution factor of 25% (Betting loses 75% of the gross win associated with the lost fixtures and 25% is substituted into other racing betting). We also consider a 50% substitution factor.

iii. "Block" analysis

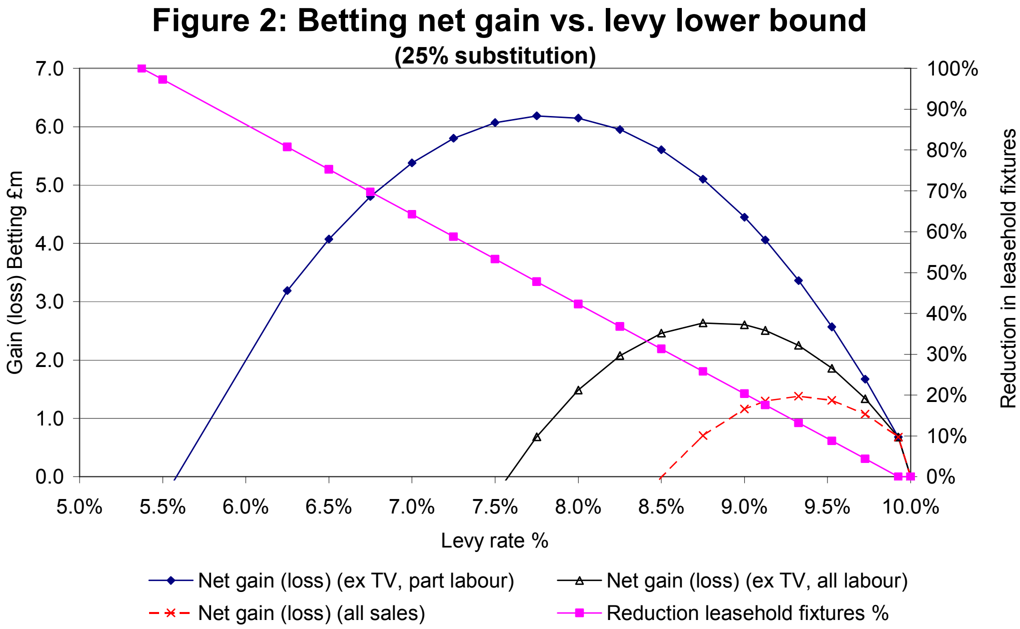
The results are that this makes no effective difference to the 'block' analysis -- Racing would still withdraw fixtures for a Levy below the break even 6.2% point and Betting would not want a lower rate. This is shown for 0%, 25% and 50% substitution factors in Table 8. In each case, Betting would not reduce the Levy rate below the breakeven point, as it loses compared to its current earnings.

Note that even in the 50% substitution case with part labour cost savings, where Betting is £4.5m better off than currently, Betting would still prefer a rate just above the breakeven Levy rate. At that point, no fixtures are withdrawn and Betting would be £33.0m better off than currently from the Levy reduction on all fixtures. This is Betting's equilibrium point.

Table 8: Racing lower bound – Substitution effect on minimum Levy ("block" analysis)			
£m	No substitution	Substitution (25% factor)	Substitution (50% factor)
Total Levy (all Betting) (2008)	91.6	91.6	91.6
Number of fixtures	207	207	207
Racecourses:			
Levy/BHA distribution Racecourses	9.6	9.6	9.6
Implied gross win leasehold	105.8	105.8	105.8
Raceday profit (loss) before Levy	-6.1	-6.1	-6.1
Levy for leasehold breakeven %	**6.4%**	**6.4%**	**6.4%**
Betting:			
Lost gross win	105.8	79.3	52.9
Lost profit (ex TV, part labour) post-Levy	-53.1	-39.8	-26.6
Lost profit (ex TV, labour) post Levy	-74.6	-56.0	-37.3
Lost profit (all sales) post-Levy	-91.5	-68.6	-45.7
Levy remaining fixtures	81.0	83.7	86.3
Levy remaining fixtures (new rate)	51.8	53.5	55.2
Levy reduction remaining fixtures	29.2	30.1	31.1
Net gain (loss) (ex TV, part labour)	**-23.9**	**-9.7**	**4.5**
Net gain (loss) (ex TV, all labour)	**-45.4**	**-25.8**	**-6.2**
Net gain (loss) (all sales)	**-62.3**	**-38.5**	**-14.6**

iv. "Incremental" analysis

In the 'incremental' analysis, the allowance for substitution of betting out of the lost fixtures into other racing slightly reduces the lower bound Levy that Betting would seek before reducing profits by a small amount, but does not change the general result. The effect of a 25% substitution factor into other racing betting is shown in Figure 2, which may be compared with Figure 1.



The results comparing the analysis without and with substitution are shown in Table 9.

Table 9: Racing lower bound – Substitution effect on minimum Levy ("incremental" analysis)

£m	Option 1 (ex. TV costs, part labour)	Option 2 (ex. TV costs, no labour)	Option 3 (all sales)
No substitution:			
Betting minimum Levy %	**8.75%**	**9.50%**	**9.93%**
Betting net gain	3.0	1.0	0.7
Reduction in leasehold fixtures %	26%	9%	0%
Reduction in leasehold fixtures	54	19	0
Substitution (25% factor):			
Betting minimum Levy	**7.75%**	**8.75%**	**9.30%**
Betting net gain	6.2	2.6	1.4
Reduction in leasehold fixtures %	48%	26%	13%
Reduction in leasehold fixtures	99	54	27
Substitution (50% factor):			
Betting minimum Levy	**6.00%**	**7.50%**	**8.25%**
Betting net gain	13.6	7.4	4.7
Reduction in leasehold fixtures %	86%	53%	37%
Reduction in leasehold fixtures	178	110	77

A high substitution rate for betting gross win, of 50% or even 25%, implies that the Levy allocated to the leasehold fixtures includes a significant implicit transfer or subsidy from other fixtures, which lose Levy to the new fixtures. This moves beyond the realm of our more partial analysis, getting into the structure of the Levy and the broader aims of Racing and Betting in agreeing to expand fixtures. To be consistent with the model, the impact should be analysed at a more fundamental level and certainly include the loss of other betting and FOBT earnings as well, rather than just the racing portion. In other words, if Betting is prepared to lose racing gross win from existing fixtures in order to gain additional fixtures that in terms of racing betting are only marginally profitable, then Betting must be considering its broader profits. This implies Option 3 is the appropriate measure for calculating the impact of the Levy on Betting profits and for setting the lower bound and/or convoyed sales should be included in the analysis. In terms of the lower bound, the greater the substitution rate, the less likely Betting is to want a lower Levy rate if this means fewer fixtures.

5.3 Lower bound – other potential funding

We also consider the minimum funding for Racing from the point of view that if the Levy were reduced might other sources of funding, or cost savings, be available to make up the shortfall. This focuses of the use of the Levy funds and whether any items appear to be discretionary or replaceable. It is assumed that Racing is willing to provide runners for fixtures, or increase them, but still needs to at the very least cover its costs on the fixtures. The question is whether it would be able to do so with lower Levy funding.

The most appropriate benchmark for the current analysis remains the price Racing would accept to supply the current level of fixtures at an acceptable level of quality in the long term. Remembering that this is a bare minimum level for bargaining purposes, is there scope for reduction in the Levy level before fixtures must be reduced or quality suffers to an extent that the fixtures become unsustainable?

Racing might be able to maintain this by, for example, cutting costs or increasing the effective subsidy of Racing by Owners and others. However, given the costs of increasing fixtures, gradual reduction in average real value of the Levy funding contribution to prize money it seems that Racing is finding it increasingly difficult to provide this level of racing product profitably.

The increase in expenditure on GB Racing by the various groups is shown in Table 10.

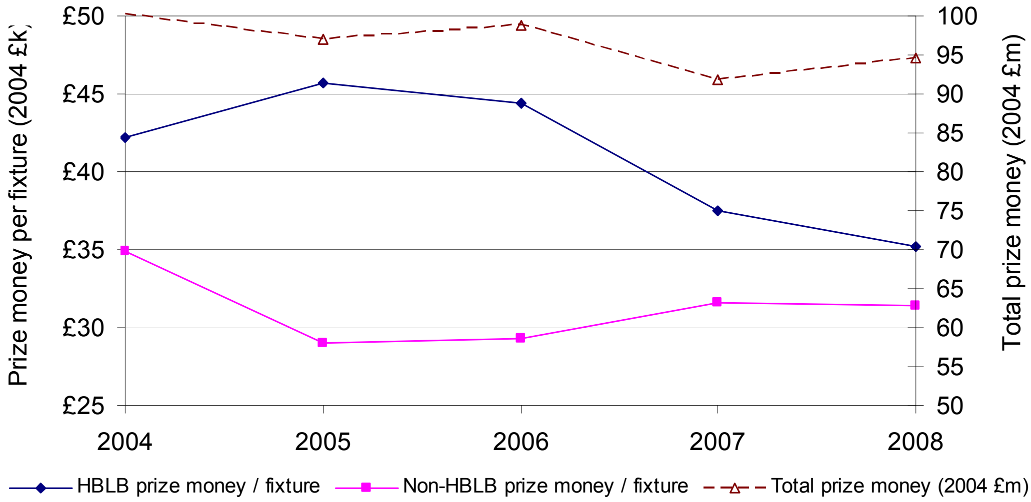
Table 10: Increase in direct expenditure on British Racing (2002-08)

£m	2002	%	2008	%	Growth	%
Betting	115	19%	160	15%	45	39%
Racing consumers	187	30%	404	39%	217	116%
Owners - net training costs	125	20%	275	26%	150	120%
Owners - breeding operation costs	191	31%	207	20%	16	8%
Total	618	100%	1,046	100%	428	69%

(Source: Economic Impact of British Racing (Deloitte) 2009; BHA estimates)

This is against a background of a decrease in the real value of Levy prize money funding per fixture, as shown in Figure 3. The reduction per fixture is partly a result of the increase in the fixture list and the addition of especially leasehold fixtures that by their nature are intended to have lower prize money, and are bid for by racecourses on this basis. However this shows that non Levy sources of funding per fixture have remained roughly constant in real terms. They appear partly to have offset the decline in Levy funding but have not fully offset this. This implies that additional sources of funding are not able to take up any reduction in Levy funding.

Figure 3: Real prize money per fixture



(Source: BHA, HBLB data, LECG)

One way to consider this is to focus on the uses of the Levy and whether these finds might be reduced or supplemented from other sources without impacting the supply of racing. The items of Levy funding are shown in Table 2, above.

Many of the Levy funded items do not seem to reducible without impacting the quality of horseracing. For example, the spend on integrity services has shown a marked increase, associated partly with the fixture expansion. Any reduction in integrity services would likely reduce the perceived value of racing. Most other racing costs do not seem to have much scope for further reduction.

As a working hypothesis, the items that might be adjusted in the use of Levy funds, and which might conceivably be offset by either increases in Owner or Racecourse contributions, seem to be Prize money (£59.4m) and Other racecourse expenditure (£7.7m). If these were reduced by 25% (£16.8m) this might conceivably be absorbed or made up from other sources (*e.g.*, Owners, Racecourse TV earnings). Relying on increased funding from Owners does not seems feasible or a risk free source of funding in the changing economic climate. As discussed below, the total impact of Turf TV earnings on Racecourse earnings might leave £3.5 - £7m per year, plus any increases in media rights earnings, which might be available to offset Raceday costs.[36]

This implies that replacing a reduction in Levy funding through increased Owner or Racecourse contributions would be difficult. It would also likely lead to a different distribution of funding than currently, depending on the interests of the Owners or Racecourses. This would be unlikely to offset reduction in Levy funding for leasehold fixtures sought by Betting.

Thus reducing the Levy items and seeking other funding does not seem to be a sustainable situation. As a lowest bound for the short or intermediate term the reductions above would

[36] Turf TV earnings would apply to the RMS racecourses, which are not the main racecourses offering leasehold fixtures.

mean a Levy reduced by about 2% to 8%. Even this would be quite problematic for Racing funding. A “safer” lower bound figure for Racing would remain 10%.

5.4 Lower bound summary

While these are illustrative figures only, they indicate the principle that Betting would be unwilling to seek a Levy much lower than currently as this is likely to lead to a reduction on the number of fixtures and a subsequent loss of earnings to Betting. The figures used there imply that lowest figure for the Levy at which Racing would offer fixtures, at a level Betting would also request, would between the current 10% and at the very least about 6.2%, with a figure about 7.5% - 8.5% most likely. The lowest level for the lower bound might then be 7.5%, with 10% as the preferred figure. This is equivalent to £69m - £92m in absolute terms based on the 2008 Levy.

6 Media payments – impact of Turf TV

1.1 Upper bound – impact on Betting’s media costs

If racing were withdrawn from the LBOs there would be some savings in pictures costs, which would reduce the maximum bound Betting would pay to avoid Racing withdrawing. In the previous analysis we included only the savings from media rights payments, on the grounds that if racing were withdrawn the LBOs would still pay for other SIS services.[37]

In the current analysis we assume that the LBOs costs would be reduced by the costs of one TV service (assumed to be Turf TV), and horseracing media rights portion of the costs paid by the remaining service (assumed to be SIS).[38] It is estimated that total Turf TV costs are about £6,500 per shop[39] and horseracing media rights portion of SIS costs are about £2,000 per shop. [40] The pictures cost saving (after 2008) would therefore be £8,500 per

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[37] Previously, TV direct rights costs saved if racing were withdrawn were estimated at £4,500 per shop out of total costs of TV (rights and operating costs) estimated to be about £12,500, so that other costs of providing TV coverage for other sports of about £8,000 per shop would remain. Current total rights costs from 2008 are estimated to be about £45m or about £5,000 per shop.

[38] This assumes that Turf TV only provides GB horseracing and not other sports which LBOs would continue to take, were horseracing withdrawn. Alternatively this might be thought of as the sum of all the media rights payments plus other Turf TV operating costs, as they would presumably no longer need to take any Turf TV services (they would still take SIS for other sports).This assumes that Turf TV only provides GB horseracing and not other sports which LBOs would continue to take, were horseracing withdrawn.

[39] This £6,500 is the standard undiscounted Turf TV price. The average price paid by larger bookmakers is likely to be lower. “However we know that the charges to the big 3 are significantly below this figure. Similarly the independent LBOs were offered an early adopter first year discount of 25%.” www.britishhorseracing.com/.../Submission_on_Turf_TV_and_SIS.pdf Ladbrokes and William Hill Annual Reports 2008 figures indicate additional pictures costs of about £4,500 - £5,100. After allowing for £1,900 reduction in SIS media rights payments would imply Turf TV costs of £6,400 - £7,000. However, these cost increases appear to include allowance for longer opening hours, so actual Turf TV costs may be lower than this.

[40] Assuming total media rights payments of £5,000 per shop with SIS providing around 43% of media content the rights component for SIS might be about £2,150, in turn total media right and Turf TV savings of about £8,500 per shop. This is consistent with the bookmakers reported additional

shop. These figures are considered conservative, in that they are likely to overstate the potential cost savings to Betting, especially as it assumed all the media cost savings would be passed on to the Bookmakers and that all the Turf TV costs would be saved.

1.2 Lower bound – possible Turf TV impact on Racing funding

We also consider the possible impact of Turf TV earnings on total Racing funding and whether this reduces the minimum Racing would accept to continue to offer racing access. In the previous analysis we did not include an allowance for lost TV rights earnings on Racing. This was on the basis that Betting was unlikely to seek a reduction in fixtures (it continues to request more fixtures at the current Levy rate) so the lower bound should be the minimum Racing would accept to keep the current level of fixtures. In that case media costs would be unchanged. [41]

In the current analysis it is not clear to what extent the earnings from Turf TV should be included in the funding for Racing. Considerations include the fact that any earnings from Turf TV other than the media rights portion (assumed unchanged at this point compared to the SIS-only situation, pre-2008) go to the group of 31 RMS Racecourses, which are 50% partners in Amrac, the supplier of Turf TV. It is not clear that these earnings would be "applicable" to broader Racing funding. The timing of any Turf TV earnings might be outside the current analysis. More fundamentally it is not clear that these earnings should be considered part of Racing funding, *i.e.*, as a possible offset to the Levy. Depending on how the funds are applied, they might be considered part of the Racecourses investment in improving their facilities or to relieve current overheads.

Conversely, Racecourses are a central part of Racing and receive support funding from the Levy. They also contribute to prize money alongside the Levy. Racecourse finances and the Levy are to an extent linked.

For the moment we estimate what the additional racecourse earnings from Turf TV may be. Alphameric (50% co-owner of Amrac with RMS) reports operating profit from Amrac in 2009 of £7.1m. [42] This implies earnings to the RMS racecourses of about the same amount.

For the current analysis one might assume that some of these funds are used for internal investment purposes of the Racecourses and administrative overhead (*e.g.*, racecourse facilities, repaying debt) which may not be applicable to providing fixtures for betting purposes. However, some of the funds might be used for functions currently provided for by the Levy, such as prize money, racecourse improvement, capital grants. If so, this could free up some Levy funding to be applied to benefit other aspects of Racing. Some portion of the RMS earning, perhaps 50% or £3.5m, might be available to reduce the minimum Racing would accept to continue to offer racing for betting purposes. In practice we assume that £3.5m - £7m might be available to reduce the lower bound for Racing. This is a

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costs. This assumes SIS would pass on the full media rights savings. When Turf TV was introduced, SIS reduced its prices by £1,900 per shop. Assuming media rights of £4,200 and content lost to Turf TV accounting for about 57% of British horseracing content (based on gross margin) a proportional reduction might have been £2,400 per shop.

[41] Any reduction in the Levy was assumed to cause Racing to scale back fixtures below current levels. This would reduce net Betting profits (evidenced that Betting was still requiring more fixtures) and so would not be sought by Betting. The criterion for the lower bound was therefore what is the minimum racing would accept to provide the current number and quality of fixtures.

[42] http://miranda.hemscott.com/servlet/HsPublic?context=ir.access.jsp&ir_client_id=927&ir_option=RNS_HEADLINES&transform=ir_home .

relatively small sum compared to the total Levy. It is considered as part of the possible adjustment to the lower bound, as above.

7 Determination of Levy amount

7.1 Share of surplus

The final stage of the negotiation model is the share of the surplus that goes to each party. It is usual in such models to assume that relative bargaining power of the parties determines where between the two extremes a rate might be agreed.

In the model the parties bargain over an available "surplus" from the activity between upper and lower bound "walk away" positions, as the difference between:

(a) the maximum Betting would pay to avoid withdrawal of racing from betting shops – based on the value contribution of Racing to the operating profits of Betting ("upper bound"), and

(b) the minimum that Racing would be prepared to accept from Betting ("lower bound") to continue to offer racing betting.

It is usual in such models to assume that relative bargaining power of the parties determines where between the two extremes a rate might be agreed.

- In the model we assume that the surplus (difference between upper and lower bounds) would be split in a 25/75 ratio (25% to Racing). The split is based typically on the share of risk or required investment borne by the parties, as well as other less definable aspects of bargaining power. The 25% split reflects "rules of thumb" sometimes used in other licensing contexts.[43]
- This split is considered conservative and generous to Betting. The actual investment risk taken by the parties may be more balanced between Racing and Betting, or indeed be greater for Racing. In equivalent commercial negotiations Racing might achieve a higher share.[44]

7.2 Parameters used

The analysis presents figures using Levy rate lower bounds of 7.5% and 10%. The 7.5% figure is considered a bare minimum which, given the considerations around the expansion of fixture list, may not be sustainable in the long run. The 10% figure is equal to the current rate, which in itself may not be profitable to Racing, even allowing for higher Racecourse media earnings or other potential funding.

In the main analysis the contribution to Betting GB retail operating profit is estimated allowing only for those direct revenues and costs that would be expected to be reduced if horseracing were withdrawn from LBOs.

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[43] The basic intuition behind the split, in the case of intellectual property, is the relative risk that licensor and licensee take in commercialising the IP (see Goldscheider, Robert, John Jarosz and Carla S. Mulhern, "Use of the 25 percent rule in valuing IP", *Les Nouvelles*: Journal of the International Licensing Executives Society, Volume XXXVII, No.4, December 2002.).

[44] For Racing and Betting, the balance of commercial risk relevant to "the use of racing for betting purposes" might be considered equal, or greater for Racing, implying a higher share of the surplus to Racing. The theoretical "Nash Equilibrium" in bargaining games for similarly placed parties is a 50/50 ratio. The traditional "needs and capacity" Levy framework may imply a share between Racing and Betting in a ratio of 50/50, or possibly if between Racing, Betting and Society of 33/67.

A lower limit to the direct value of horseracing to Betting is also calculated assuming that in the long term all LBO costs are variable. It is assumed that all costs associated with racing betting would eventually be reduced in proportion to the share of racing in total retail gross win (including racing, FOBT and other).

The analysis is based mainly on 2008 data as the most recent for which a complete year's data are currently available. 2008 figures are believed to be more representative given the adverse economic conditions in 2009.

Results

The results of the analysis are summarised in Table 11.

Table 11: Levy bargaining range – horseracing betting only

Levy	Max lower bound		Min lower bound	
	%	£m	%	£m
Maximum Upper bound:				
Upper bound (maximum Betting might pay)	35.9%	328.9	35.9%	328.9
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	**16.5%**	**150.9**	14.6%	133.7
Minimum Upper bound:				
Upper bound (maximum Betting might pay)	30.3%	277.5	30.3%	277.5
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	15.1%	138.1	**13.2%**	**120.9**
Current Levy (2008)	10.0%	91.6	10.0%	91.6

In the main case, Betting's upper bound is 35.9%, Racing's lower bound is 10%, and the 25% negotiation point is as 16.5%, equivalent to £150.9m. In the lowest case, Betting's upper bound is 30.3%, Racing's lower bound is 7.5%, and the 25% negotiation point is as 13.2%, equivalent to £120.9m.

8 Sensitivity analysis

The sensitivity of the results to assumptions about the Racing lower bound and the share of the surplus are shown in Table 12.

Table 12: Sensitivity analysis: Levy prices under different assumptions (2008)

	Short term effect [a] Minimum supply point				Long term effect [b] Minimum supply point			
Racing share of surplus	**5%**	**7.5%**	**10%**	**12.5%**	**5%**	**7.5%**	**10%**	**12.5%**
15%	10%	12%	14%	16%	9%	11%	13%	15%
20%	11%	13%	15%	17%	10%	12%	14%	16%
25%	13%	**14.6%**	**16.5%**	18%	11%	**13.2%**	**15.1%**	17%
30%	14%	16%	18%	20%	13%	14%	16%	18%
Total Levy (£m) [c]				**91.6**				
15%	88	108	127	147	81	100	119	139
20%	102	121	139	157	92	110	129	147
25%	117	**134**	**151**	168	104	**121**	**138**	155
30%	131	147	163	179	115	131	147	163

[a] Direct marginal impact of withdrawing racing (high value). Levy based on share of difference between minimum supply point (*e.g.*, 10%) and maximum demand point (45.4%)

[b] Fully allocated administration/other costs (lowest value) Levy based on share of difference between minimum supply point (*e.g.*, 10%) and lower bound demand point (30.1%)

[c] Based *pro rata* on 2008 actual Levy £91.6m.

Sensitivity analysis of the results show that there is only limited sensitivity of the Levy price to changes in the lower bound but greater sensitivity to changes in the split.

9 "Convoyed" sales of other betting products

9.1 Impact of other sales on Betting

The full contribution of horseracing to Betting should also reflect the value derived from sales of other products that depend partly on racing as the anchor product that brings punters in to LBOs. In particular FOBTs work as highly profitable filler products for punters whose primary object in visiting the LBOs may be horseracing betting. Survey evidence and the statements by Betting show that horseracing remains the main reason for most punters to visit LBOs, the anchor product. The willingness of Betting to pay increased media rights payments with the introduction of Turf TV in 2008, even though racing retail gross win has been mostly flat or declining since 2003, also indicates the critical importance Betting attaches to horseracing.

This means that withdrawing racing from LBOs is likely to have greater impact on LBO earnings than just the direct effect, and the upper bound should reflect that.

9.2 Diverted sales methodology

The analysis attempts to estimate the effect of these "convoyed" sales of other products in LBOs of FOBT and Other sports betting that would be lost if horseracing were withdrawn from LBOs. This is not a simple matter since survey or other analysis of how much the different forms of betting activity would fall without horseracing is not readily available.

The method used here is to estimate the "diverted" horseracing betting gross win that is likely to have been displaced by new products, primarily FOBTs, and would be lost if horseracing were not available.

- It compares actual horseracing gross win against what this is likely to have been had horseracing betting grown in line with overall GDP growth, over the period since about 2003 when FOBTs and other new betting products became important.
- It assumes that these earnings would not occur if horseracing were not available in the LBOs, that the "primarily horseracing" business would be lost and with it the diverted sales of other products.[45]
- This would increase the maximum Betting would pay to retain horseracing. The incremental effect on the Levy is then calculated using this higher upper bound.

The diverted sales approach essentially asks what the racing gross win might be if the product mix on offer in 2003, and the number and aims of horseracing punters, had remained relatively unchanged. In other words, what might product sales look like in 2008 for a typical mix of punters given the range of product choices that have been introduced since 2003, primarily FOBTs. It argues that for the "primarily horseracing" punter some portion of spend, which absent the new products would have gone to horseracing, has been diverted to newer products as a filler. If horseracing were withdrawn, the net "primarily horseracing" traffic would cease and the diverted filler sales would also be lost.

Other sports betting of various types was available in 2003 similar to today, and the share of OTC of the two areas has been relatively constant (other sports/virtual betting has increased its share slightly). Thus the "trade" between these two areas may be assumed to be relatively constant. The main change has been the introduction of FOBTs. These have attracted away a greater portion of horserace betting than previously by providing an attractive filler or alternative product.

An important question is whether the entire diverted sales should be included in the lost Betting earnings or whether only a portion, given that some "primarily horseracing" punters might switch to other betting. If horseracing were withdrawn there might be some offset for "primarily horseracing" punters who switch to other sports/dogs/virtual betting. It seems unlikely that racing punters would still come in for the FOBTs. However, they might switch to other sports betting and still use FOBTs as filler as for horseracing.[46] Against this, some other sports/dogs/virtual betting punters might stop coming in if horseracing were not available. These two effects would offset each other to a greater or lesser extent.

The assumption made in the main analysis is that if horseracing were withdrawn the losses to horseracing betting would not be made up by other betting. Since it is not clear where the balance might lie, it is assumed that any loss of other sports betting by horseracing punters who cease visiting LBOs is balanced by increases in other sports betting by horseracing punters who switch and by existing other sports betting punters. The net spend on other sports betting is assumed unchanged and any "convoyed" sales from these to FOBTs are assumed constant. Horseracing betting falls to zero and its diverted sales to FOBTs also fall to zero.

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[45] This assumes that on balance the gross win for Other sports betting (and any convoyed sales associated with this) is unchanged by the withdrawal of horseracing.

[46] There is also a small percentage of "primarily FOBT" punters who are outside this analysis.

It is therefore assumed in the convoyed sales analysis that the net effect is for all the horseracing sales and its associated “diverted” FOBT sales would be lost, with no net effect on other OTC sales.

9.3 Estimation

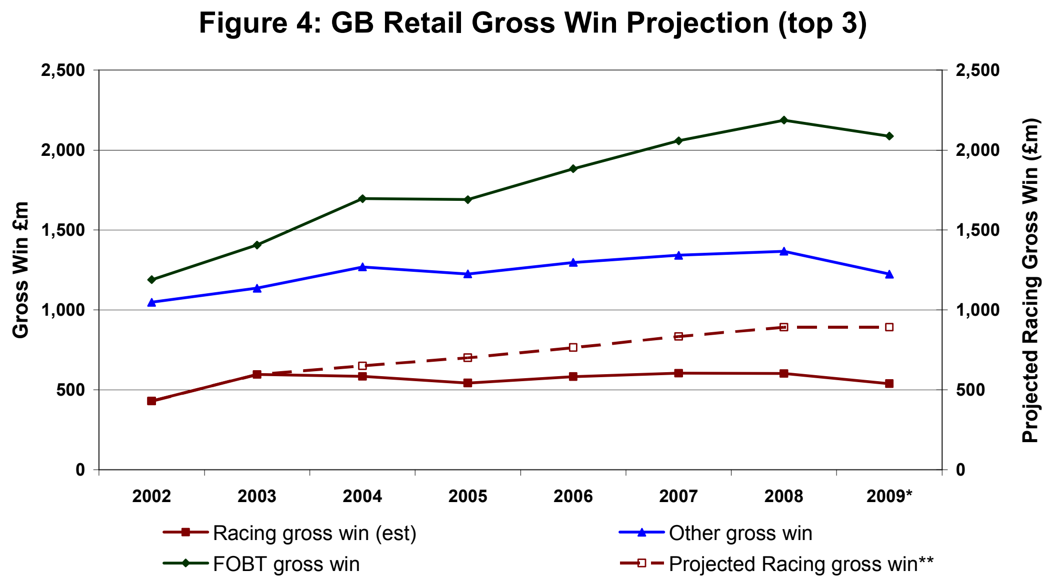
The “diversion” of horseracing betting income is estimated by considering what the revenues from racing betting might have been absent the new products. If these other products had not been introduced horseracing gross win may be expected to have grown since 2003 at some rate dependent at least on the growth in incomes and possibly on other factors. The profit on these diverted revenues are calculated at the overall average operating profit percentage for the LBOs. This is conservative in that the profit levels on FOBT sales are likely to be higher than for horseracing (involving lower costs). Also this conservatively assumes that the horseracing punters only divert their spending to FOBTs rather than increase their total effective spend.

It is estimated that total racing business might have grown annually at a rate equal to the year-on-year growth in nominal GDP between 2004-09 (4%-5% per year growth 2004-08 and a 3.6% decline in 2009) from the 2003 base. To this is added a further 3.5% to allow for the fact that the analysis is relying on data from the top 3 bookmakers; these have increased their number of shops by about 3.5% a year since 2003-08.[47] It is assumed that the increased numbers of shops earn the same gross win on average as the existing shops. Together these imply that an estimate for the growth rate of racing gross win (for the top 3), without other products, would have been an average growth rate (AGR) of 8.4% a year for 2003-08.

Projected racing gross win is then calculated assuming annual growth at a rate equal to the sum of the actual GDP rate plus the average shop rate (3.5%) in the underlying ‘true’ demand for racing betting from a 2003 base. The diverted sales increment is the difference between projected and actual racing gross win.

The impact of the diverted sales is indicate in Table 13 and Figure 4. The 2009 figures are included for information; calculations are based on 2008 figures.

[47] The actual annual growth rate in shops numbers is 4.1% for 2003-08 and 3.7% for 2003-09. The 3.5% figure is used to be conservative.



* 2009 estimate: Ladbrokes and William Hill 2009, Coral estimated from 2008

** Racing gross win projected from 2003 at GDP growth plus 3.5% average shops numbers increase per year

Table 13: Projected GB retail gross win from convoyed sales (top 3)

(£m) (years increase to right)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009[a]**	**AGR 2003-08[b]**
Racing gross win (est)	430.2	596.0	584.1	543.3	583.5	604.0	601.6	538.7	0.2%
Other gross win	618.3	540.4	685.0	681.7	713.1	738.2	765.6	685.6	7.2%
FOBT gross win	141.0	269.3	426.3	465.4	586.2	716.2	820.1	863.7	25.0%
Total	1,189.4	1,405.6	1,695.5	1,690.4	1,882.8	2,058.4	2,187.3	2,088.0	9.2%
Racing share of gross win %	36.2%	42.4%	34.5%	32.1%	31.0%	29.3%	27.5%	25.8%	
Other share of gross win %	52.0%	38.4%	40.4%	40.3%	37.9%	35.9%	35.0%	32.8%	
FOBT share of gross win %	11.9%	19.2%	25.1%	27.5%	31.1%	34.8%	37.5%	41.4%	
Shops GB top 3	4,583	4,885	5,197	5,564	5,837	5,944	5,961	6,064	4.1%
Fixtures (actual)	1,158	1,220	1,299	1,300	1,342	1,330	1,423	1,330	3.1%
Diverted Racing contribution:									
Racing gross win (est)	430.2	596.0	584.1	543.3	583.5	604.0	601.6	538.7	0.2%
GDP year on year (nominal)	5.3%	6.0%	5.5%	4.2%	5.7%	5.5%	3.5%	-3.6%	5.1%
Projected Racing gross win [c]	430.2	596.0	649.9	700.2	764.8	833.7	892.4	891.7	8.4%
Diverted Racing gross win	0.0	0.0	65.8	157.0	181.3	229.8	290.9	353.0	
Diverted Racing op profit	0.0	0.0	17.9	44.4	52.9	71.0	86.7	95.4	
Diverted op (% Racing GW) [d]	0.0%	0.0%	3.1%	8.2%	9.1%	11.8%	14.4%	17.7%	
Diverted Levy increment % [e]	**0.0%**	**0.0%**	**0.8%**	**2.0%**	**2.3%**	**2.9%**	**3.6%**	**4.4%**	
Actual Levy £m	79.9	110.7	105.6	99.3	99.2	115.3	91.6	90.0	
Incremental Levy			8.1	20.3	22.5	33.9	**33.0**	39.8	
Share total retail gross win (est)	54%	60%	65%	65%	70%	78%	78%	78%	

(Source: Bookmaker Annual Reports, BHB Annual Reports, HBLB Levy totals, LECG analysis)

[a] 2009 figures for information only: Estimated from Ladbrokes and William Hill 2009 full year, Coral estimated from 2008 results.

[b] Annual compound growth rates 2003-08.

[c] Projected Racing gross win estimated from: sum of growth at year-on-year nominal GDP form 2003 base plus AGR in number of shops of 3.5%, 2003-09. Other potential effects on underlying growth in demand for racing due to changes in margins, diversion to other products, declining base of racing punters, increased number of fixtures assumed to balance out).

[d] Diverted operating profit for punters whose reason to visit LBOs is "primarily racing" rather than "betting opportunities".

[e] Incremental Levy equivalent at 25% split.

Table 13 shows that the diverted operating profit is equivalent to 14.4% of Racing gross win for the LBOs. The effect is to add 14.4% to Betting's upper bound, or 3.6% to the Levy with a 25% split. This is equivalent to £33.0m based on the 2008 actual total Levy. The results for different upper and lower bound rates are shown in Table 14.

Table 14: Levy bargaining range – Including FOBT/Other betting sales

	Max lower bound		Min lower bound	
Levy	**%**	**£m**	**%**	**£m**
Maximum Upper bound:				
Upper bound (maximum Betting might pay)	50.3%	460.9	50.3%	460.9
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	**20.1%**	**183.9**	18.2%	166.8
Minimum Upper bound:				
Upper bound (maximum Betting might pay)	44.7%	409.6	44.7%	409.6
Lower bound (minimum Racing might accept)	10.0%	91.6	7.50%	68.7
25% point	18.7%	171.1	**16.8%**	**153.9**
Current Levy (2008)	10.0%	91.6	10.0%	91.6

In the main case, Betting's upper bound is 50.3%, Racing's lower bound is 10%, and the 25% negotiation point is as 20.1%, equivalent to £183.9m. In the lowest case, Betting's upper bound is 44.7%, Racing's lower bound is 7.5%, and the 25% negotiation point is as 16.8%, equivalent to £153.9m. The total levy range would then be £154-184m.

The sensitivity of the results to different assumptions is shown in Table 15.

Table 15: Sensitivity analysis: Levy including "convoyed" sales (2008)

	Short term effect (inc CS) Minimum supply point				Long term effect (inc CS) Minimum supply point			
Racing share of surplus	**5%**	**7.5%**	**10%**	**12.5%**	**5%**	**7.5%**	**10%**	**12.5%**
15%	14%	14%	16%	18%	13%	13%	15%	17%
20%	14%	16%	18%	20%	13%	15%	17%	19%
25%	16%	**18.2%**	**20.1%**	22%	15%	**16.8%**	**18.7%**	21%
30%	19%	20%	22%	24%	17%	19%	20%	22%
Total Levy (£m)				**91.6**				
15%	128	128	147	166	120	120	139	159
20%	129	147	165	184	119	137	155	174
25%	150	**167**	**184**	201	137	**154**	**171**	188
30%	170	186	202	218	155	171	187	203

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10 Other areas of the Levy

The analysis focuses primarily on LBOs. A similar analysis of other Levy sources (exchanges, telephone and internet) shows that the equivalent upper bound is likely to be similar or larger than for the retail business, so that the results for LBOs are applied across the whole Levy.

Other areas of the Levy to be considered include telephone betting, internet betting and betting exchanges. GB retail accounts for about 68% of the total Levy in 2008, with telephone at around 14%, internet at 7%, betting exchanges at 7% and other betting about 4%.

Analysis of telephone betting indicates that the upper bound for telephone might be around 60% for the main case in 2008. An analysis of betting exchanges indicates an upper bound of about 56%. It has not been possible to make estimates for internet betting. These upper bounds are similar to or above those used for the retail business (30% - 36%), so that it is considered reasonable to apply the LBO Levy rate to other betting platforms. The LBO implied rate may if anything underestimate the Levy rate that might be agreed in a market context for these other platforms.

The analysis for telephone betting is shown in Table 16, based on telephone business for Ladbrokes and William Hill. Figures for 2009 are not included as they not are considered representative of long term performance – Ladbrokes and William Hill both reported operating losses on their telephone business in 2009.

Table 16: Contribution of racing to telephone (top 2)

£m	2007	2008
Gross Win (ex Highrollers)	83.2	67.1
– GPT, duties	-13.4	-10.6
– Levy	-5.1	-4.3
– Staff	-16.1	-16.3
– Direct op costs*	-19.5	-20.3
– Other costs (inc depn)	-8.4	-6.6
Cost of sales	-62.5	-58.1
Op Profit (ex Highrollers)	20.7	9.0
Op Profit % Gross Win	24.9%	13.4%
Gross Win racing	51.3	42.7
Racing % Gross Win (ex Highrollers)	61.6%	63.7%
Costs: GPT	-7.7	-6.4
Costs: Levy	-5.1	-4.3
Costs: Staff	-8.1	-8.7
Costs: Direct Op costs (Lad only)	-1.9	-1.6
Cost of sales	-22.7	-21.0
Racing marginal contrib op profit	28.5	21.8
Other op profit (non HR)	54.7	45.3
Marginal contrib. % Racing rev	55.6%	50.9%
Equivalent Levy %	**65.6%**	**60.9%**
Equivalent Levy (full cost alloc) %	**34.9%**	**23.4%**

(Source: Ladbrokes, William Hill Annual Reports 2007, 2008)

The analysis for betting exchanges is shown in Table 17.

Table 17: Contribution of Racing to Betting Exchanges: Betfair		
£m (FY April)	**2007**	**2008**
Total revenue (commissions)	181.9	233.6
– GPT [a]	*-18.7*	*-20.7*
– Levy	-5.0	-4.4
– Other data rights	-15.0	-15.0
Cost of sales	-38.7	-40.1
Gross profit	143.2	193.5
Admin + depreciation	-128.8	-169.9
Operating profit	14.4	23.6
Operating profit % revenue	7.9%	10.1%
Racing revenue (commissions)	49.6	43.9
Racing % total revenue	27.2%	18.8%
Costs: GPT	-7.4	-6.6
Costs: Levy	-5.0	-4.4
Costs: Other data rights (est) [b]	-5.0	-5.0
Racing Staff/Admin (est) [c]	-8.8	-8.0
Racing marginal contribution to operating profit	23.7	20.2
Other op profit (non HR)	-9.3	3.4
Marginal contrib. % Racing rev	47.9%	46.0%
Equivalent Levy %	**57.9%**	**56.0%**
Equivalent Levy (full cost alloc)	**17.9%**	**20.1%**

(Source: Betfair Annual Reports, LECG analysis)

[a] Reported GPT slightly under 15% of total commissions; assume Racing attracts 15% GPT

[b] Assume 33% data rights costs attributable to GB Racing

[c] Assume 25% admin. variable staff/admin costs, Racing share in proportion to revenue share

The current analysis is based on 2008 data, before the move offshore by some telephone and internet betting operations. The Levy amount is thus the total that would be expected to be collected for all these platforms. The question of how to Levy offshore operations is not addressed in these figures.

11 Response to critiques of previous LECG analysis

This responds briefly to two main reports that were critical of some aspects of the original LECG analysis, by Organisation Consulting Partnership (OCP) (report for the DCMS), and London Economics (report commissioned by the Bookmakers). Detailed responses to both reports are available from BHA as required.

11.1 Organisation Consulting Partnership (OCP)

The OCP report for the DCMS [48] based its recommended approach to the Levy on a "needs and capacity" framework very similar to that taken in its original 2001 review, updated in some straightforward ways. OCP rejected almost all issues raised by Racing as not relevant to the Levy determination. For the most part OCP did not seek to introduce additional considerations of its own. The main exception was its endorsement of netting out the cost of Turf TV against the bookmakers' "capacity to pay", with scant discussion of the various factors that would need to be considered before adopting such an approach. OCP effectively adopted the needs/capacity framework and accepted Betting's view of media payments as a full offset to the Levy.

OCP took a traditional approach to the Levy that did not allow for the significant developments in Betting and Racing since 2001. Its analysis made little allowance for the changes in the structure and conduct of the Betting industry over the past decade and in the relationship between Betting and Racing. OCP did not respond to the view that the Levy should reflect commercial principles to a greater extent. While the economic influences on Racing and Betting had changed dramatically, OCP's analysis had not moved.

OCP described the LECG approach as "interesting", but "not standard", and adopted what it termed a "standard approach". In fact, the OCP "standard approach" is standard only in regulatory economics. A bargaining model is absolutely standard in the extensive literature on negotiations around licensing royalty rates, copyrights, and other types of commercial "deals", and in litigation.

OCP did probe the question of a "spiral of decline" but appeared to suggest that the minimum bound used by LECG was too high. This concern has been addressed in the current report. In effect, OCP may be said to have taken the view that "Racing operates at a loss anyway", so viewed any positive Levy as a good thing for Racing.

11.2 London Economics

London Economics (LE) commented on the original LECG report in 2007 on behalf of the Bookmakers' Committee.[49] LE objected to the use of a commercial model in the context of the Levy and maintained that a traditional needs of Racing and Bookmakers' capacity to pay framework was more appropriate, with Betting as "purchaser of last resort". It claimed that the model overstated the value of racing to betting by focussing on data from only the Top 3 bookmakers. In maintained that the model should include an offset for the increased

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[48] Organisation Consulting Partnership (OCP) (2008), "47th Horserace Betting Levy Scheme – Report to the Department of Culture, Media and Sport", 21 January 2008.

[49] London Economics (2008), "Economic Assistance in the Determination of the 47th Horseracing Levy: Final Report for Bookmakers' Committee of the Horserace Betting Levy Board", January 2008, 32 pp.

total cost of TV pictures to Bookmakers and should allow for the opportunity cost of capital invested by Betting in racing. It claimed that the model did not correctly allow for the substitutability between racing and other betting, and that increases in other betting would reduce the impact of withdrawing racing rather than the reverse. Finally LE presented its preferred method of assessing the Levy, a traditional needs and capacity analysis, including a full offset for increased TV costs in the Levy, leading to even lower estimates for the Levy.

In response, LE did not appear to have understood the LECG market approach and reverted to a straightforward needs and capacity framework to compare the analysis. The LE report also contained some factual errors.

In the context of the market model:

- LECG focussed on the Top 3 bookmakers as the only ones for which sufficiently detailed data were available, accounting at that time for about 66% of the Levy. LE's attempt to broaden the sample failed because of lack of data.
- LE's proposed adjustments for TV costs were not thought through and overstated any possible effect.
- Its adjustments for the opportunity costs of capital invested by betting in horseracing were incorrect in theory for this model and applied incorrectly in practice. If capital costs were to be included in the commercial model they would imply other changes to the model which would lead to a higher Levy. LE did not identify avoidable capital costs correctly and vastly overestimated any possible effect.
- LE provided no evidence for its claim that other betting and FOBTs would benefit greatly from the withdrawal of racing by substitution, rather than being significantly harmed due to lack of LBO traffic as LECG argues. LE assumed that a staggering 60% of racing business would transfer to other betting business, largely offsetting racing losses. This contradicted Betting statements that GB horseracing is still the core product in LBOs.
- LE's other adjustments were arbitrary and in one case applied incorrectly.

In particular, LE did not appear to understand the basis for the 25/75 split. In response, the split allows only 25% of the surplus to Racing, favouring the user (Betting) rather than the intellectual property (IP) rights holder (Racing), because it is recognised that in many industries those who buy a license to use IP still need to take on significant investment and risk to commercialise the product. In fact, this is less true for a mature product such as Racing. Thus the 25% split is quite conservative.

LE also wanted to deduct risks and opportunity costs incurred by Betting (via the "cost of capital") from the upper bound and *then* split the difference 25/75 in Betting's favour. This argument contradicts the purpose of the split and was also rejected by LECG.

A review of the London Economics arguments indicates no reason to change the LECG market based analysis or its conclusions. If anything, London Economics' comments help confirm the value of a commercial framework in analysing a range of increasingly complex influences that are hard to reconcile in a needs and capacity approach.