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Determination of the 47th levy scheme: Betfair response to BHA submission

This paper is a response to the BHA's submission to Government in relation to the determination of the 47th levy scheme. In part 3.2.3 of that submission the BHA suggests that betting exchanges should be subjected to levy on a different (and much more punitive) basis that the rest of the betting industry. Given the draconian nature of the BHA's proposal, Betfair feels compelled to address the points raised in some detail.

This response is divided into 3 sections as follows:

- Section A counters 4 general themes from the BHA submission.
- Section B addresses specific points made in the BHA submission, which Betfair believes to be particularly misleading or inaccurate.
- Section C describes why Betfair believes the charging mechanism proposed by the BHA (a levy based on the 'net winnings' of exchange customers) is deeply flawed.

Section A

1. *It is a fallacy that exchange gamblers making lay bets are conducting the same activity as bookmakers*

A common theme in the BHA submission is the characterisation of betting exchange customers making lay bets as "unlicensed layers", who are engaging in activity which should be distinguished from gamblers making back bets (whether through an exchange or elsewhere).[1] Since 2001, traditional bookmakers have (without success) attempted to persuade, among others, HM Treasury, DCMS and the Gambling Commission that betting exchange layers are bookmaking and should be licensed and taxed accordingly.

Backing and laying are interchangeable. The DCMS recognised this fact in its response to the Parliamentary Committee on the Gambling Bill, by stating that any attempt to distinguish between backing and laying: *"would introduce unnecessary and unwise regulatory loopholes"*.[2]

A lay bet struck through an exchange is simply a bet that an outcome will not happen. It is equivalent to backing the other outcomes ('the field') to win. There is no additional cost associated with backing the field through an exchange, instead of laying a specific selection, because the exchange over-round hovers at around 100% on both the back and the lay sides. Consequently it is no surprise Betfair data confirms that layers enjoy no advantage over backers – either group is as likely (or unlikely) to be profitable. This was demonstrated, through the provision of extensive data by Betfair, to HM Treasury officials during their 18-month review of the tax treatment of exchanges and their customers.

[1] For examples, see BHA submission at paras 3.2.3 (b)(ii); 3.2.3 (b)(iii); 3.2.3 (b)(vi); and 3.2.3 (d (iv).
[2] Para 107, Government response to report of Joint Committee on the Draft Gambling Bill, June 2004.

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Notwithstanding the above, any attempt to pigeonhole exchange customers as either 'backers' or 'layers' is simplistic. Most Betfair customers make both back bets and lay bets. Again, this was demonstrated to HM Treasury officials. A Betfair customer will back or lay an outcome depending on whether he or she believes that the market has underestimated or overestimated that outcome's prospects.

The BHA bemoans the fact that the profits of exchange layers are not subject to levy. This ignores the fact that the profits of gamblers across all betting platforms, whether they are supporting or opposing outcomes on British racing, are not subject to levy.

2. *The exchange business model is merely an extension of the traditional bookmaking model*

In its attempt to single out exchanges for a more punitive levy charge, the BHA claims that the business model of an exchange is *"fundamentally different"*[3] from that of a traditional bookmaker. Betfair does not accept this proposition.

Before September this year Betfair was licensed as a bookmaker in the UK. Betfair is now licensed by the Gambling Commission as both a betting intermediary and a general betting operator. This latter licence is the same as that held by traditional bookmakers. Betfair can choose to operate its exchange under either licence.[4] Indeed, the Gambling Commission has recognized that these two classes of licensee pose identical regulatory risks, and as a result it has imposed a general set of licence conditions and codes of practice which apply equally to all remote betting.

Betfair is a no-risk bookmaker. It has a perfectly-balanced book at all times, because it will not accept a bet unless it can off-set the risk with other balancing bet(s). 'Balancing the book' in this manner was – and still is – the essence of bookmaking. A traditional bookmaker who has successfully balanced his book has effectively pitted his customers against each other, charging the margin built into his prices for providing this bet matching service.[5]

Betfair uses exchange technology to manage its risk perfectly. Traditional bookmakers, although their own risk management tools have improved significantly in recent years,[6] choose not to invest the huge resources necessary to operate a no-risk betting platform. Instead they are prepared to take some level of risk, so that (unlike Betfair) they do not have to refuse a bet until they wait for an equal and opposite balancing bet(s). The degree of risk a traditional bookmaker is prepared to take will depend on a variety of factors including its confidence in its odds compilers,

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[3] BHA submission para 3.2.3 (d)(i).

[4] Betdaq operates its UK exchange by standing as counterparty to all bets, just like a traditional bookmaker. Currently Betfair operates as an intermediary in the UK, but a simple contractual change (i.e. standing as counterparty to all bets), would result in Betfair operating as a general betting operator, like William Hill and Ladbrokes.

[5] "*The bookies act as agents for the market and take a percentage of the losers' money before redistributing it among the winners. [...] The crux is that winning punters do not take their profits from the bookies, but from the losing punters.*" From 'Against the Crowd' (1995), by Alan Potts

[6] Most notably through use of EPOS technology.

the identity of the punter and what level of price sensitive information it has on the event.[7]

The crucial issue is not the appetite for risk, but how betting platforms make money. After all, the Tote is not singled out for a charge on a different basis, but it does not take risk as a bookmaker does. All betting operators make money in the same way: they pay out less to their customers in winnings than they take in from other customers in losses. Each business is set up to maximise its take from the customers it is targeting. Suggestions that Betfair – a commercial entity – somehow seeks to pay back more to its customers than it needs to to retain their business suggests that it is run by business-illiterates, which seven years of success would imply is a bizarre proposition.

The only difference between Betfair's business model and that of William Hill, is that Betfair adopts a more conservative attitude to market risk. The use of 21st century technology to eliminate risk means that Betfair can charge its customers a lower price for gambling and can provide more choice.[8] This should not mean that the BHA can demand that Betfair be subjected to a 300% increase in levy contributions.

3. *Turnover is no longer a relevant metric on which to base a charge on betting operators*

For over 5 years the UK betting industry has been subjected to betting duty and levy based on gross profits of operators. Operator turnover is no longer a relevant metric for either charge. Yet, throughout the BHA's submission in relation to exchanges, the BHA continues to refer to turnover as if it is relevant. Indeed the introduction to that submission argues that: "*The levy mechanism must be amended........ensuring a fair levy return relating to every pound staked.*" In a gross profits era, the number of pounds staked (i.e. operator turnover) is not relevant.

Again, the BHA's analysis in para 3.2.3 (c) is based on the 'return to the punter'. This is a turnover-based metric which is meaningless. Gross profit is the product of turnover and margin. Implying that exchanges pay a low level of return to racing relative to its turnover is as absurd as implying that it pays a high return relative to its margin.

A levy based on the net winnings of gamblers is a charge based on quantity rather than price. It would represent a return to a turnover-based levy. The BHA is asking Government to impose a turnover levy on some betting operators (exchanges), but in relation to other operators (traditional bookmakers) seems prepared to stick with a levy based on their gross profits. This discriminatory distinction flies in the face of the comprehensive analyses conducted previously by HM Treasury, DCMS and the Gambling Commission.

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[7] "*The Group relies on information from various sources [including] betting patterns of customers known to have access to information or whose opinion on individual horses or events is respected by management ("warm sources").*" William Hill plc prospectus, May 2002.
[8] For example, offering 'in-running' betting on horseracing is just about impossible for an operator taking market risk.

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4. ***The claim that punters are migrating from traditional bookmakers to exchanges is an unproven assumption, which even if true, only tells half the story***

Intuitively Betfair agrees that some gamblers will have switched at least some of their betting activity from traditional operators to exchanges. However, the BHA provides no evidence for this sweeping claim.[9]

The BHA's hypothesis also assumes that a gambler who has switched to exchanges is placing the same bets as previously with traditional bookmakers. This is not credible. Because the cost (i.e. the margin or commission) of each bet struck through an exchange is lower than the same bet with a traditional bookmaker, it is likely that (at least) some gamblers who have switched their betting to exchanges have increased their betting volumes.[10]

Indeed, the overwhelming balance of academic opinion concludes that the price elasticity of demand for gambling is high and rising. As the price falls, betting activity will increase such that the total take will at the very least remain the same.[11]

Given one of the key attractions of betting exchanges is their superior pay-out rate, it is logical that exchange customers are likely to be more price sensitive than gamblers who conduct their activity exclusively with traditional operators. Does the BHA believe that if all Betfair customers stopped betting through Betfair tomorrow, they would be either willing or able to replicate their betting with UK-based traditional betting operators?

Separately, Betfair has brought new revenue to British racing by providing additional levy yielding betting opportunities for gamblers:

- disenfranchised by traditional bookmakers for having the temerity to win;

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[9] "*The increased popularity and prevalence of betting exchanges has led to a situation whereby a significant number of people who previously placed bets via traditional bookmakers, whose profits are subject to the Levy, instead place them, via exchanges...*" Para 3.2.3 (b)(ii), BHA submission.

[10] "*I was profitable before Betfair and have been profitable since, but exchange betting has changed the way I play. The main change is that I now make a lower percentage profit but the volume of money I am turning over has increased enormously.*" Professional punter, Dave Nevison, speaking to the Racing Post, 25 August 2005.

[11] See for example the following analyses:

- "The Impact of Taxation on the Demand for Gambling" by Paton, Siegel and Vaughan Williams (November 2002) concluded that "... the overall demand for gambling is extremely price elastic. The short run elasticity estimates are – 1.058 and -1.139, while the long run estimates are -1.718 and 2.017,...." And "A key result is that the demand for betting appears to be highly sensitive to changes in tax rates. Not surprisingly, the reduction in the rate of betting tax in October 2001 induced a large increase in the demand for betting.
- "A Time Series Analysis of the Demand for Gambling in the United Kingdom" by Paton, Siegel and Vaughan Williams (2001) ran two tests resulting in estimates for gambling elasticity of demand of -1.19 and -2.50;
- "Elasticity of Demand for Gambling" by Suits (1979) concluded that the elasticity of demand for gambling was between -1.36 and -1.82;
- "An Inquiry into the Economics of Race-Track Gambling" by Green (1976) estimated the elasticity of demand for gambling at -1.57.

- not prepared to bet to bloated margins traditionally charged on racing, especially when other lower margin betting products are now so readily available;
- who want to bet on exchange markets that didn't exist previously, such as 'in-running' betting and 'place only' betting at fixed odds;
- who want the ability to request their own odds instead of the 'take it or leave it' offering available from traditional bookmakers; and
- who want to 'trade' sports betting on a platform in a manner that is comparable to what is available in financial markets.

The fastest growing segment of Betfair's customer base comprises gamblers based outside the UK. Betfair is helping to grow the British racing product by introducing it to many gamblers who had never previously bet on the sport.

The BHA therefore paints an absurdly one-sided picture. Without evidence but on the basis of perception, it suggests that a segment of customers are producing lower returns by virtue of moving business from the traditional operators; and where there *is* empirical evidence of growth being stimulated by exchanges and new money being provided, it ignores it completely.

Section B

The BHA submission at para 3.2.3 (b)(i) states: *".....a small recreational layer winning £100 has a £5 commission deducted by the exchange, on which the exchange currently pays betting tax at 15% (75p) and the Levy at 10% (50p).........In contrast, a licensed bookmaker winning £100 is charged 15% betting tax (£15) and 10% levy (£10) on the lost bet placed by the punter."*

Although the BHA's submission does recognise that an exchange charges a commission (from a backer) when a layer loses a bet, the claim highlighted above is hugely misleading. A traditional bookmaker does not pay levy on 100% of the £100 it wins, because that win is offset by what it loses on the event. The bookmaker pays GPT and levy which is determined by its actual margin achieved – just as Betfair pays based on its actual margin (its commission).

Indeed, a traditional bookmaker may have many winning £100 bets (i.e. bets where punters lose) but lose overall on the event. In that case, not only does the bookmaker pay no levy, but its losses on the event can be set-off against future profits to reduce levy payments.[12] Betfair's no-risk bookmaking model means it always makes a profit and therefore always pays levy.

[12] Perhaps the most stark example of this was caused by the exceptional run of winning favourites at the Cheltenham Festival in 2003. Losses sustained by bookmakers as a consequence, meant that they effectively paid no levy for the last the last 2 months of the relevant levy period. In contrast, Betfair accrued for levy on every single race in the period.

The BHA submission at para 3.2.3 (b)(iv) states: *"Racing is not against the principle of low margin exchange operators taking market share from traditional bookmakers."*

It is difficult to take this claim seriously. The net winnings charge on exchange customers as proposed by the BHA would impose a pricing floor on exchange operators. The lower the margin charged by the exchange, the more punitive a charge based on 'net winnings' would be. The charge would mean that, unlike all other betting operators, exchanges could not set their prices at the point they believe would maximise profits.

The BHA's proposal would put "*low margin exchange operators*" in a pricing straightjacket. In fact it would either drive them out of business, or out of the UK.

The BHA submission at para 3.2.3 (b)(v) states: *"Betting exchanges, together with those who use their facilities, have benefited from these changes, as layers can set odds impervious to the requirement to pay 10% Levy and 15% Gross Profits Tax. This allows the layers to set more attractive odds to the punter and hence drive traffic away from the traditional platforms..."*

This is an entirely bogus argument. <u>The current gross profits charging mechanism for GPT and levy allows all UK-based operators to *"set odds impervious to the requirement to pay [tax and levy]."*</u> If GPT and levy were abolished in the morning would traditional bookmakers suddenly start betting to over-rounds of 101%? Indeed, would they cut their margins at all? Why do the prices of Victor Chandler and Stan James (whose remote businesses operate from Gibraltar with no GPT and zero levy contributions) not differ in any meaningful way from those of UK-based bookmakers? Have Ladbrokes ever said "we cannot compete on price with Chandler (a major bookmaker on any analysis) because he does not have to factor GPT and levy into his prices"?

The margins of traditional bookmakers are where they are because: (i) they are unlikely to be able to lay all selections in proportion (i.e. they cannot balance their books); and (ii) they need to build a buffer into their prices to protect against mistakes their odds compilers may make (so called 'ricks') in pricing up an event – even though they can pick and choose the customers with whom they are prepared to do business.

Exchange customers (backers and layers) are forced by the market to bet to around 100%. They cannot build in a buffer to their prices to protect themselves against ricks and because they do not know who is on the other side of their bet, they do not have the luxury of being able to decline betting against other successful punters. Making a book on an exchange by laying the field is as feasible as doing so by backing the field. Both are just about impossible with over-rounds of close to 100% for backers and layers.[13]

[13] On the first day of the 'Betfair SP' (12th December 2007 at Southwell), the Betfair SP was 'overbroke' (i.e. under 100%) on 4 of the 7 races in question. The biggest over-round on the 7 races was 102%. The prices from which the Betfair SP's were derived were effectively the prices of each selection at the 'off' of each race. Does the BHA believe that Betfair layers are acting as bookmakers in such an environment?

Exchange backers and layers are gamblers. Some of them gamble profitably,[14] but then the existence of professional punters for a hundred years and more, demonstrates that a small number of them have always been able to make their betting pay.

The BHA submission at para 3.2.3 (d)(ix) states: "*If the exchanges are bookmakers, then we question why they take deductions from punters, when the key proposition behind the gross profits tax and levy was to end such deductions.*"

This is an absurd argument. Betting operators make money because punters lose money. How you 'hide' that charge doesn't stop it being a charge. Bookmaking operations charge customers, like any other leisure-service operator does.

A traditional bookmaker builds its margin into the prices it offers to its customers. Betfair charges its margin in a more transparent manner – by charging a commission, stated up-front, from a customer's winnings on a market. If the commission charged by exchanges constitutes "*deductions from punters*" then the margin a traditional bookmaker builds into its prices similarly constitutes "*deductions from punters*", charged in a different form.

The BHA submission at para 3.2.3 (d)(v) states: "*Ultimately, it is unfair that levy payable should be dictated by commission charged by the agent matching punter and layer, rather than being directly linked to revenues deriving from the betting activity.*"

Much of the BHA's submission implies a belief that Betfair is somehow doing something other than operating a business. The fact is that like all other businesses, Betfair balances what it charges its customers with the likelihood of them otherwise leaving and taking their business elsewhere: in other words, it seeks to maximise profit, on the horseracing part of its business as on all others.

Betfair does this in a global market. It accepts business from more than 100 countries around the world, in the internet age. It does not do business in a small village in the 1960's, where it is the only shop in town and can charge what it likes and get away with it. This is why it operates on a low margin, to attract business from around the world, and keep it.

Betfair's business model manages risk perfectly, allowing it therefore to offer better value for every bet. That this does not change what people lose, is proven by the fact that betting margins have fallen across the world in the last ten years, on all products; but punter loss has gone up. This apparent discrepancy is the result a wider audience being attracted from other leisure activities as the cost of betting has come down.

The revenues that the betting exchange operator generates constitute its "*revenues deriving from the betting activity*" and this is subject to levy at the same rate as any other UK-based betting operator. As previously stated, the one and only key metric is

[14] As stated above, Betfair data confirms that, over time, customers making back bets are as likely (or unlikely) to produce a profit as customers making lay bets.

the profit of the operator (which equates to the overall loss of the operators customers), which the operator works to maximise because that is what makes him a business.

Nothing else is relevant. Discussing metrics like turnover or margin is as irrelevant as discussing number of employees, the cost of the electricity bill, or a company's carbon footprint. Also irrelevant are the risk of the operator, or the position for or against an outcome taken by its customers. The profits made by customers of all betting platforms are not subject to levy – whether they are betting with William Hill, Sporting Index or Betfair.

The BHA's claim here infers that any winnings achieved by a customer of William Hill or Sporting Index do not constitute "*revenues deriving from the betting activity*", yet winnings achieved by a Betfair customer do so. Where is the rational justification for such a distinction?

The BHA submission at para 3.2.3 (e) states: ".......*a levy system that takes no proper account of the level's [sic] of exchange activity and allows the exchange themselves to set commission rates and hence rates of levy payments.*"

Because the levy system charges on operator profits, it allows <u>all</u> betting operators to set their commission rates or margins as they choose. As discussed above, operators set their margins (or commissions) at levels which they believe will maximise their profits (which in turn will maximise their tax and levy contributions). Will the BHA make a submission to Government if William Hill starts betting to an over-round of 105% on every British horserace?

The BHA wants to stifle the ability of exchanges to control their pricing, but doesn't propose doing the same for traditional operators. This is because the limitations of the traditional bookmaking model oblige operators to charge margins with which the BHA is content. Ironically, at the same time, the BHA points out that it has lost market share in the world of betting – with no apparent realisation that in a competitive world, the way to compete is to reduce margin rather than maintain it at a high level. Far from being threat to racing's funding by charging a lower margin for its product, Betfair is a life-line for racing because it makes its product more competitive in an increasingly competitive betting world.

<u>Section C</u>

<u>A net winnings charge will be the end of the exchange model in the UK</u>

Under the current gross profits levy mechanism, the interests of racing and all UK-based betting operators are aligned. It is in racing's interests that operators in the UK are allowed to maximise their profits. The imposition of a 'net winnings' levy would mean that the interests of racing and exchanges are no longer aligned. Levy avoidance looms.

An exchange operator who realises that a 'net winnings' levy would restrict his ability to compete on price could instead opt to compete on betting 'quantity'. Instead of calculating a customer's 'net winnings' based (for example) on a single horserace, the operator could calculate and charge a commission on a customer's 'net winnings' over a racecard, or on all the races run in a given day. Spread-betting firms have for many years offered indices based on multiple events such as an entire racecard.

The exchange operator could take advantage of a levy based on customers' net winnings by providing more betting content on which 'net winnings' was calculated and commission charged, while simultaneously increasing commission rates. This would mean the exchange customer would pay more commission, but pay it less frequently. The BHA would receive a fixed portion of that customer's 'net winnings' on the infrequent occasions that the figure was calculated. It is probably not unreasonable to assume that the customer would be no worse off, and that the beneficiary of such a mechanism would be the exchange operator, at the expense of the levy.

More obviously, the imposition of a net winnings tax on exchanges would provide a gilt-edged opportunity for a jurisdiction outside the UK to become the home of betting exchanges. If that jurisdiction were in the EEA (or in a white-listed jurisdiction), operators there would be allowed to freely advertise their service into the UK. Betting exchange customers, many of whom are sophisticated and correspondingly price sensitive, will gravitate to where they can bet at best price. In the absence of the statutory obligation to contribute to the levy, racing would be reliant on the benevolence of such off-shore operators.

Conclusion

The BHA (in alliance with the traditional bookmakers) has already failed to convince HM Treasury that exchanges and/or their customers should be singled out for a more punitive basis of taxation. This latest effort to convince another Government department to revisit that issue, is opportunistic. The BHA is using a dispute between racing and the traditional bookmakers on a separate matter, to have another bite at the cherry in relation to exchanges.

The BHA bemoans the fact that the betting industry has benefited from a switch from a turnover charging metric to one based on operator profits.[15] However, levy receipts demonstrate that the racing itself has been a significant beneficiary of that change.[16] It would seem that the BHA is content for traditional bookmakers to continue paying levy based on gross profits, yet because exchanges provide their customers with more betting options and enable them to bet to reduced margins, those exchanges should be directly subjected to a turnover based levy. The BHA wants to have its cake and eat it.

There is absolutely no justification to single out exchanges or their customers for discriminatory treatment in relation to levy contributions. The arguments proposed by the BHA do not stand up to scrutiny. The BHA would appear to have no comprehension that the punitive nature of the net winnings charge would spell the end of the betting exchange model in the UK.

[15] See para 3.2.3 (b)(v) of the BHA submission.
[16] In the four years that preceded a levy based on operator profits, the average annual levy yield was £54m. For the four years following the introduction of a levy based on operator profits, the levy averaged over £90m annually. *Source, HBLB website.*