

Options for change in the Class 4 Gambling Sector

Executive Summary

- The Class 4 Gambling sector fails to deliver the expectations of Parliament of a non-corrupt sector focused on delivering the maximum value for the community and minimising the harm from problem gambling
- Endemic non-compliance (and some corruption) cannot be promptly solved by incremental change or by existing approaches to enforcement action
- To address the current failings of the Class 4 sector this proposal envisages:
 - Changing the nature of current licensing arrangements so that licensees are focused on community service
 - Removing incentives for competition for venues and machines
 - Structurally and legally separating responsibility for fundraising from grant distribution

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Introduction

The Class 4 gambling sector continues to deliver significant value to the community and the Crown.

Total turnover for the Class 4 (non-casino gaming machines or "pokies") sector in the year to June 2010 was \$9.16 billion. After allowing for prizes of \$8.31b, proceeds of \$849m were distributed to the three stakeholders; the community, the Crown and licensed gambling providers.

In fiscal 2010 about \$280m was distributed in grants to a wide range of organizations in the community and a similar amount was paid to the Crown in taxes, levies and payments.

However, the social, economic and political costs associated with the achievement of these outcomes is also significant and poses real questions about whether a new structure for Class 4 gambling would be more effective in achieving the strategic outcomes set out in the Gambling Act 2003.

In recent months the sector has been constantly under intensive scrutiny and criticism as more than half the operating society licence holders have been subject to sanctions action by the DIA for breaches of their legal and operating obligations. Many of the sanctions decisions relate to a long history of non-compliance.

Background

Parliament has determined it will permit gambling on electronic gaming machines only when stringent conditions are met.

These conditions are primarily intended to ensure:

- Class 4 gambling providers (including venues) are focused on provision of gambling as a community service rather than as a profit making venture
- the harm from gambling is minimized,
- the profits of Class 4 gambling (net proceeds after prizes) are distributed to the community, the government and licence holders (to meet actual, reasonable and necessary operating costs),
- the community share is the largest and the money should flow to worthy organisations rather than to individuals,
- the fundraising and grant making processes are operated honestly and transparently and are free from corruption

A very high level of detail consistent with the above principles has been set out in the Gambling Act 2003, in associated regulations and in tertiary legislation such as the Gazette Notice on Venue Costs.

In order to monitor and regulate the performance of the Class 4 sector the DIA has employed a significant number of staff and made significant investments in new technologies such as EMS.

The levies and charges imposed on the Class 4 sector are designed to completely offset the cost of regulation and monitoring as well as returning a dividend to the Crown.

While some positive progress has been made in respect of minimizing harm from gambling it is also clear that the other objectives set out above are not being met on a consistent basis across the sector. In fact, recent experience suggests compliance is the exception rather than the rule among licensed operators in the Class 4 sector.

For more than six years the DIA and even some people inside the sector, attempted to develop a voluntary compliance culture in Class 4 gambling operations – but without success. Every attempt by the industry organisation (the CGA) to encourage a compliance –focused industry culture has foundered on the inability of the sector to agree on, and implement, the fundamental principles of compliant operation.

Constant reminders to the industry of the imperative need to change to survive were crowned in 2010 when the Minister of Internal Affairs delivered a strong message to a special conference organized by the CGA.

Early acknowledgement of the validity of the message received from the Minister was completely eroded within a short period of time by continued behaviours inconsistent with a culture of compliance.

So, despite all the recent intense scrutiny of the Class 4 sector by the DIA and the Gambling Commission the sector continues to demonstrate that large numbers of licence holders (societies and venues) and other participants in Class 4 gambling continue to deliberately operate in a manner which is in direct contravention of the decisions of the Gambling Commission, the legislation and regulations, and of the intentions of Parliament.

Motivations

The critical issue here is that, for some (but not all) participants, the motivation to continue to operate unlawfully is more powerful than the motivation to comply.

This motivation is driven by competition. Because of the particular circumstances, and in particular the drivers of Class 4 gambling, competition has driven costs up rather than resulting in increased efficiency.

There is no competition to deliver a better product to the community.

There is little competition to deliver a better or safer product to the gambler.

There is only competition to deliver:

- better value to licensed venues
- bigger licensed operating societies

Risk v reward and sanctions

For decision makers in Class 4 gambling the risk v reward calculation often shows the cost of non-compliance (which may occur at a date sometime in the future) is more than compensated for by the value derived during the period of non-compliance.

Sanctions for non-compliance can be applied both to organisations and individuals.

So far sanctions imposed for non-compliance on organisations have often been an irritant rather than a disincentive and have been calculated as an affordable cost of business. They appear only infrequently to have imposed a substantial penalty on the organization or the individuals who run the organisation.

The consequence of this is that the community eventually pays for the non-compliance through reduced grants to the community.

Attempts to apply sanctions to individuals who have initiated or implemented the breaches have often failed at prosecution or not resulted in non-deterrent penalties.

When sanctions have been imposed on individuals they appear to have generally been non-monetary and have mostly resulted in exclusion from the sector.

In addition there appear to have been few cases where licences have successfully been cancelled and as a result licence holders do not fear the possibility of loss of licence as a consequence of their behaviour.

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The need for change

The Gambling Act 2003 was an attempt by Parliament to reform the gambling sector to meet community concerns about probity and problem gambling.

Submissions to the Select Committee show a widespread level of concern about practices within the non-casino gaming machine sector.

Parliament adopted the 2003 Act to address community concerns and, at the same time, retain a valuable source of fundraising for the community.

Eight years later community concern continues to be expressed during territorial Authority hearings into local gambling venue policies. The response from local government has been to impose sinking lids on machine and venue numbers in the absence of an ability to do anything more constructive.

Local communities identify failure to get "a fair share" of local gambling revenues as the most consistent complaint about current arrangements.

There is little prospect of the continuing slow erosion of political and public confidence in the Class 4 gambling sector being arrested without decisive action by the DIA or by the Crown. Further erosion of confidence in the regulation and management of Class 4 gambling activities (to deliver public benefit) will undermine confidence in the regulation of all gambling.

Being seen to do nothing about the corruption which exists in the Class 4 sector is not a tenable position for the Government to allow to continue.

Incremental change will do little to remove the current incentives and competition which are driving the non-compliant behaviour.

Current Drivers

The key driver is:

- the desire of organisations and key people to capture significant proportions of the total revenue stream for:
 - purposes other than those authorised by licence or the legislation, or
 - purposes which are designed to favour one sector of the community over others

This driver manifests itself as follows:

- the desire of certain groups in the community (the racing industry particularly but also some of the major sporting codes and others) to secure access to large, regular and ongoing streams of funding from Class 4 gambling
- the desire of the majority of holders of Class 4 operating licences (some licensing trust based societies excluded) to maximise the number of high turnover venues in their portfolio – high turnover venues provide a revenue cushion which makes compliance with the requirement to return a minimum of 37.12% to the community easier to achieve
- the desire of the significant majority of owners/operators of hospitality venues where gaming machines are located to maximize the return to their business from the operation of gaming machines (which they see as a business revenue stream rather than as a community service)
- the desire of the majority of operating licence holders to do whatever they can to help venues to maximize their business returns from gaming machines
- the desire of grant makers to continue to support causes and groups they have personal empathy for and have supported in the past
- the desire of some individual managers of Class 4 operating societies to generate large personal salary and benefits packages
- the desire to be seen as successful businesses focused on growth
- the desire of gaming machine manufacturers to sell new products
- the desire by some to be seen to be delivering value to the community from which they come

These drivers have been consistent since the first legislative control of electronic gaming machines was imposed in the late 1980's.

Competition

Current drivers have led to a very competitive environment: intensive competition between holders of operating licences (societies).

Despite existing legislation, and Government policy, clearly stipulating that Class 4 gambling is only permitted to raise funds for distribution to the community (i.e. the essential purpose is philanthropic fund-raising in which a competitive business model has no place) many societies appointed Business Development staff to recruit new venues to their portfolio.

This suggests many societies appear to have interpreted the environment as one in which they would only succeed by becoming the biggest and the most generous - and, by implication, to favour the causes/organisations which decision makers personally support.

The power to fund the causes you want (with other people's money) can be a powerful motivator for decision making.

This widespread interpretation resulted in the establishment of many societies focused on a narrow outcome for grant distribution e.g. art, air rescue services, the racing sector etc.

The net result was that competition for high performing venues escalated as the numbers of venues and machines declined since 2003. While total numbers have continued to decline the impact has been more marked in some communities than in others.

By December 2010:

- total numbers of machines had declined 26% since 2003 (to 18601)
- Donchall venue numbers had declined 23% since 2004 (to 1118)
- society numbers had declined by 54% since 2004 (to 50)
- total revenue declined by 18% (\$186m)

Because the number of venues is declining, and very few licences are being issued for new venues, the drive for size inevitably involves recruiting or poaching venues which are contracted to other societies.

Societies have found numerous and ingenious ways to entice venues to leave existing relationships. Inducements have included (but not been limited to):

- recalculating venue payments,
- ensuring the venue operator's favourite cause or community group received grant funding
- free tickets to sports events,
- venue fitouts, and
- cash payments.

Societies either meet fire with fire or find themselves at risk of financial failure and running foul of other compliance requirements such as the minimum return to AP and the financial viability requirements for license renewal.

Boards, and managers of societies, knowing that their activities are unlawful, weigh the risks and costs of being caught and determine the consequences are light compared with the potential loss of key venues and the revenue that goes with them.

In large measure their experience proves their analysis to be correct. The DIA has been unable to successfully monitor and regulate the sector to get rid of the competitive behaviour.

The corrupt behaviour has been all pervasive and pernicious.

The relative lack of constraint on the grant of new operating society licences and the ability to merge with other operating societies which continue to demonstrate the same behaviours means it will be some years before any significant change is able to be achieved.

The DIA has, for some years, been concerned about the prevalence of end-user societies because of their tendency to capture funding streams. Unfortunately the legislation does not allow the DIA to discriminate against an end-user society if its application for a licence meets all the relevant criteria.

There is no ability in the Act to limit the territorial reach or size of an end-user or single purpose society.

The risk for the DIA and the Government is that a regulatory agency of the Crown will be seen to be ineffective in its statutory role and that the Government has been unable to address the issue.

The solution is to embark on major structural change of the Class 4 gambling sector which removes the incentives and opportunities for inappropriate behaviour. It is desirable to do this with the minimum of change to the existing legislation.

Options for change

A number of alternative solutions are apparent.

Option 1

Centralise grant distribution by removal of that function from the activities undertaken by existing societies leaving them with the fundraising activity only.

This has been previously considered by Government and has been rejected on the grounds that centralized distribution would bring the decision-making too close to the political process.

Governments have favoured an approach which ensures decision making on the details of which grant applications should be approved and declined should be further from the political process and closer to the community – i.e. the reason why the licensed society model has been persisted with despite its shortcomings.

In addition transition to a new distribution model could be complicated and result in quite severe disruption. Any transition from one structure to another should be as smooth as possible to maintain public confidence that there is a readily available source of non-government funds available for worthwhile community projects.

Option 2

Transfer the entire Class 4 operation to another gambling provider such as the Lotteries Commission or Racing Board.

In either case this option poses problems because of an apparent monopoly being created and would potentially result in loss of public confidence in each of the two existing providers.

In addition, the racing sector has clearly been engaged in an intensive campaign to capture large amounts of money from another gambling sector – something which has already drawn extensive negative comment. Any move to regularise this arrangement would be seen to reward the racing sector for behaviour many see to be seriously inappropriate.

Any attempt to avoid this by segmenting Class 4 gambling activity as a separate operation would also be perceived with considerable skepticism about the implied undue influence of the parent body.

There is also the risk that current negative public perceptions about Class 4 gambling would taint the existing racing and lotteries brands.

Option 3

To re-structure the sector in such a way that the past negative activity is clearly put behind it and a well-defined new beginning is chartered.

This will mean creating an operating environment which eliminates opportunities and incentives for unlawful practice and behaviours, and will also remove, through a simple process consistent with the existing legislation, those organisations which are not prepared to operate in the new environment.

Desirably, this should be achieved without major legislative change and without any costs being imposed on the taxpayer.

In fact, the intended outcome of the change should be to simplify monitoring and regulation, reduce the cost of regulation and increase the benefit to the community through an increased proportion of the total net proceeds generated by Class 4 gambling being dedicated to community purposes.

Change Proposal

There are two fundamental elements to this proposal for successful change:

1. The first element is to adopt a licensing regime which is similar to the issue of use of resource licences (i.e. radio spectrum or mining licences).

Special Features:

The resulting licence would be for a defined geographical area for fund raising. Each licence should be for the exclusive right to use gaming machines to fundraise in the licensing area. Every gaming venue in the area would only be able to be licensed through the territory operating licence holder. The main outcome is to eliminate competition for sites in the licensed area and to standardize actual, reasonable and necessary costs of operating gaming machines in the area.

2. The second element is to functionally separate fundraising activities from grant distribution by the establishment of regional distribution committees which would be responsible for distributing the funds generated by the fundraising licences.

Fundraising licences

If the concept of exclusive territorial rights for fundraising is accepted there are a number of ways in which this could be formulated and issues to be considered.

Boundaries

1. Boundaries for fundraising licences could be determined by
 - a. North Island /South Island split
 - b. province
 - c. region
 - d. TLA district
 - e. liquor licensing district
 - f. some other appropriate allocation which recognizes community of interest
2. In making a decision about boundaries for licences care should be taken to ensure each territory included sufficient venues and machines to ensure financial viability of the fundraising organisation
3. Larger territories will tend to create economically viable units and to enable the licence holder to maximize opportunities for cost reductions through scalability.

Competitive bidding for right to hold licence

4. This proposal envisages that Fundraising licences would be auctioned or subject to tender and allocated to the bidder which provided clearest evidence of delivering the best monthly outcome for the community as a percentage return to authorised purposes and cost of fundraising. Other factors, such as having comprehensive harm minimization programmes in place, would also be included
5. Annual surpluses would also be allocated to funds for distribution
6. Provision could be made for bidders to be able to bid for and acquire licences for multiple territories to achieve increased economies of scale
7. Licences could be subject to a single auction or tender process or, alternatively, they could be auctioned in tranches to ensure the higher value territories (Auckland, Christchurch, South Auckland) were issued last

Period of Licence

8. Fundraising licences would be issued for an extended period (say 5-10 years)

Issue and revocation of Licence

9. Licences would be issued by either the Secretary for Internal Affairs or the regional grant making body on behalf of the Crown (see below)
10. Each fundraising licence would incorporate a contract setting out specific performance targets and penalties for failure to achieve the targets
11. Fundraising licences would be revocable by the licence issuer in the event the outcomes contracted to in the bidding process are not achieved as a result of failure to perform the contract by the successful bidder
12. Licences would not be issued without the consent of the TLA in which the fundraising is to occur

Liability for failure to meet forecast targets

13. Key persons from the bidding organisation would be held personally liable for the achievement of the contracted outcomes on which the bid was made

Regional grant distribution

It is clear the existing close relationship between governance responsibility for fundraising and responsibility for distribution of net proceeds is a substantial reason for the corruption which currently exists.

Many of the worthy community people who give their time voluntarily to make the difficult judgments about which applications for funding are supported and which ones are rejected do so without any apparent bias or favouritism.

Grant funding capture

But it is also clear that "pet" causes do well and considerable emphasis at the operational level is placed on the achievement of revenue streams which enable "pet" causes to be sustained. While this is a generalization which many societies will deny there is clear anecdotal evidence from analysis of grant making decisions to support the assertion.

The lack of significant numbers of complaints (though there are some) tends to suggest that the community accepts the difficulty of the task and recognizes that some applicants will be disappointed when there are always more applications than there is money to go around.

The challenge is to develop a grant making decision system which assesses all grant applications on their individual merits and makes balanced decisions which are widely perceived to be appropriate.

It will always be difficult to achieve 100% acceptance that decisions are made in an unbiased fashion but some of the rules around grant making could be reconsidered to determine whether they are effective in achieving probity or are obstructive.

Management of community funds

The management of community funds on the same balance sheet in the same organisation has tended to result in a situation where societies have seen the pool of net proceeds as funds available for re-investment in the business provided the minimum distribution of 37.12% to the community was achieved on an annualized basis.

In this way the minimum requirement has also become the target. There has been no business incentive to exceed the minimum requirement – in fact the reverse becomes true.

In the event that the fundraising societies/entities are required to stipulate a guaranteed minimum monthly return as a condition of their licence and they have the prospect of retaining an acceptable level of funds for working capital then many of the complaints about financial viability raised from the sector will have been appropriately dealt with.

Forecasting and contracts

On the basis of past performance fundraising societies (for large enough territories) should be able to forecast relatively accurately what they expect monthly revenue performance to be. This should enable either a fixed percentage or a fixed sum to be guaranteed as being available for distribution.

The contracted amount would provide certainty of funding for the proposed regional grant distribution committees.

Regional Grant Distribution Committees

It is proposed there should be 6 regional grant distribution committees.

1. Auckland and Northland
2. Waikato and Bay of Plenty
3. Poverty Bay, Hawkes Bay
4. Taranaki, Manawatu, Wellington
5. Tasman, Nelson, Marlborough, West Coast, Canterbury
6. Otago, Southland

Committee representation

To ensure independence while being firmly grounded in the community it would be appropriate for each grant distribution committee to comprise a mixture of nominations from the TLAs in the area and government appointees. Appointments would be for a fixed period of up to 3 years and re-appointments could be permitted subject to approval by both the affected committee and the Minister.

Appointments would be staggered to ensure continuity.

Administration and support

The fundraising licensees could be levied to cover the cost of a centralized administration and support structure. Significant savings could be achieved through use of technology and on-line grant application systems.

The central organisation could also accept responsibility, in conjunction with Local Government New Zealand and the Department of Internal Affairs, for the development of community organisation support initiatives to overcome current deficits in grant application skills in some communities.

Local/Regional/National funding needs and priority setting

It is envisaged the regional grant distribution committees would establish regional and local needs and priorities for funding to be published annually and for the purposes of subsequent performance reporting.

It would not be necessary to impose a requirement for all funds to be distributed within 3 months of being received but each committee should be required to set targets.

Each committee would also be empowered to contribute to a national pool available for grant applications by national organizations.

There is still a considerable amount of detail to be worked through which I am available to assist with.

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