## WINNERS AND LOSERS

### Finance & Economic Aspects of Gambling in Tasmania

There's no denying that the election of Andrew Wilkie to a position on the cross benches in a Parliament with a minority Government has propelled the issue of gambling into the public policy spotlight.

And rightly so.

It is a many faceted issue.

The obvious social implications of gambling are foremost in most discussions.

But there is also a fiscal aspect to gambling as it raises about 11% of total State taxes, about $100 million out of total State taxes of $880 million for 2010.

Lotteries, wagering and Betfair produced $40 million of State revenue, leaving $60 million raised by table gaming, keno and electronic gaming machines (EGMs).

The terms of exclusive arrangement covering keno and EGMs until 2018, between 3 companies in the Federal Group and the State of Tasmania is set out in a Deed which is now contained in a schedule to the Gaming Control Act 1993.

The companies which signed the Deed are 3 of the 18 wholly owned subsidiaries of the parent company Mulawa Holdings Pty Limited which will be hereinafter referred to as Federal Hotels (FH).

A third facet is the equity and economic efficiency aspects of an exclusive license and how the economic flows filter through the economy, some ending up with Government but the rest being shared between the FH and some pubs and clubs, largely justified as support for the Tasmanian tourism industry.

There are some amongst those actively involved in the debate who feel little need to understand the numbers, how it all works. This is not surprising and is not intended to be a criticism.

But there are others myself included who need a better understanding of the numbers to be able to assess all the claims and counter claims.

**Broad overview**

Federal Hotels operate 2 casinos with table gaming, kenos and EGMs. EGMs are also conducted in 100 licensed pubs and clubs, and keno in approximately 160 licensed premises.

Some of the pubs are owned by FH.

Player losses are euphemistically described by the Tasmanian Gaming Commission(TGC) as 'player expenditures'. The losses are needless to say, Federal Hotel's winnings, or to be a little less hubristic, FH's gross profit.

There are 1,280 EGMs in the casinos and 2,379 in the pubs and clubs. The total of 3,659 is just below the statutory limit of 3,680.

Of the machines in pubs and clubs, 330 are in 11 premises owned by FH. For the 2010 year the figure was 270. FH is limited to 25% of EGMs in pubs and clubs, or about 600. From hereon unless otherwise stated figures will relate to the 2010 year.

FH's share of EGMs in pubs and clubs is 11%. Overall 42% of all EGMs are located in premises owned by FH.

But as we shall see below FH's share of the cake in $ terms is much larger.

Owners of pubs and clubs (other than FH's) are paid a commission by FH. The pubs and clubs in turn pay to FH an equipment hire fee for the EGMs and keno equipment installed in their premises, and in the case of EGMs, a promotion fee per machine

The commission is calculated at 30% of player losses for EGMs and about 8.5% of player outlays for keno.

FH has to share player losses with the State Government, 21% of the first $35 million each year goes to the Government, and 26% of the remainder. From 2013 the rate will be a flat 26%. The share of losses to the Government is termed a 'tax'. Certain parts of the Calabrian economy operate in a similar fashion.

In addition the Government's receives an extra 4% from player losses in pubs and clubs. This is termed a 'community service levy' (CSL) and has to be spent in stipulated ways by the Government, 25% for sport and recreation, 25% as payments to charities and the remaining 50% on gambling education, problem gambling etc.

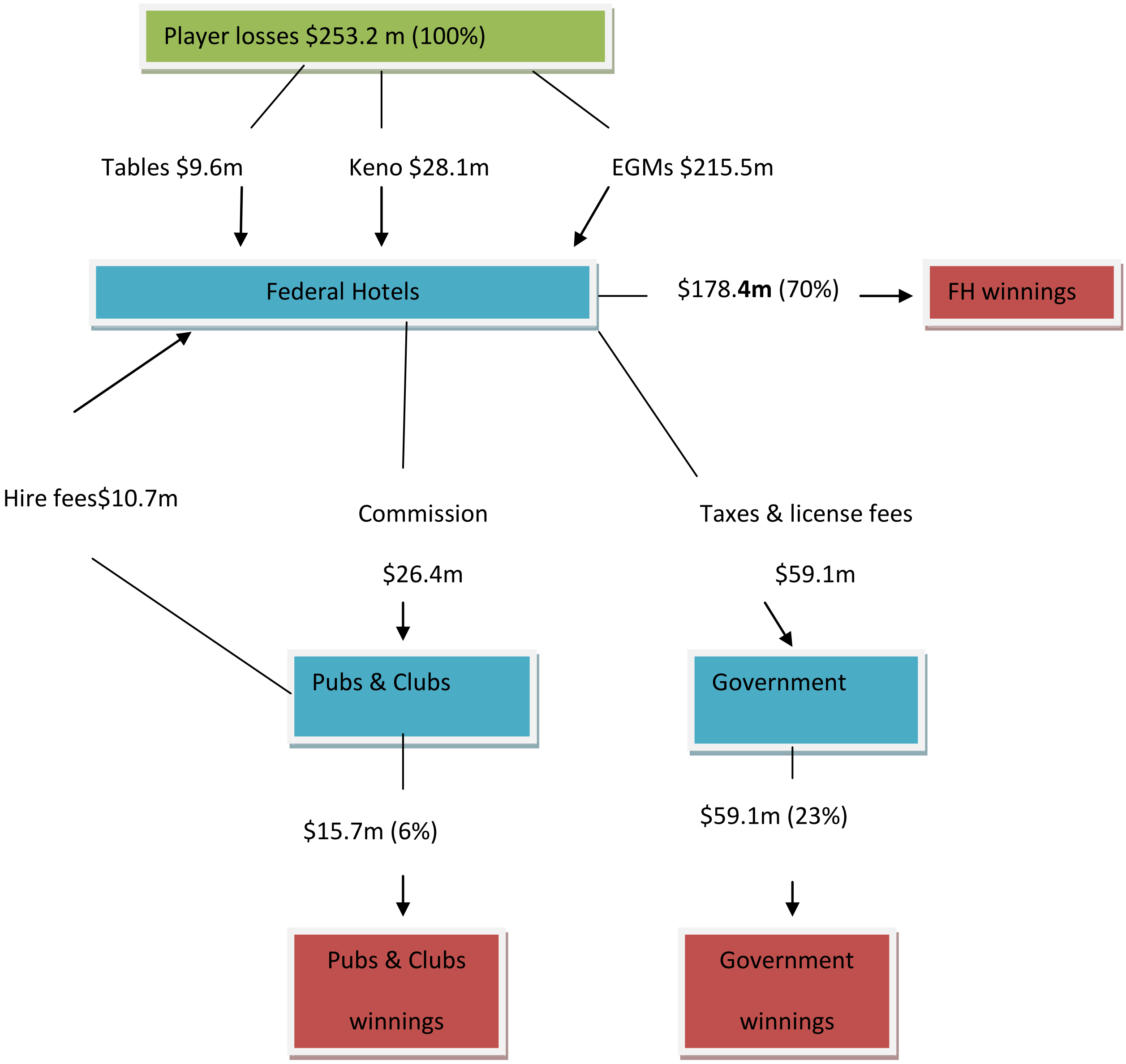
FH convinced the Government that the extra tax should only apply to losses in pubs and clubs not those in casinos. FH's casino patrons are either nobly responsible gamblers or are beyond redemption.

The CSL assists in assuaging any guilt felt by participants in the EGM industry. The TGC gets to report on the lucky recipients of CSL grant money, in addition to regulating the industry, making sure gaming places are sufficiently well lit, and that clocks are available to let punters know when it's time to go home and get the dinner out of the oven before their wallets are completely bereft, all that caring-for-problem-gamblers stuff

The Government only takes about 6% of keno winnings and approximately 1% of table winnings. But in the latter case casino license fees are about $3 million.

**The money flow for FH games**

The following diagram explains the money flow for all FH games.



The Government ends up with 23%, pubs and clubs, 6%, and the rest remains with Federal Hotels

In the case of EGMs only, the spoils are shared as follows.

| | | |
|---|---|---|
| Fed Hotels | $147.2m | 68% |
| Government | $53.9m | 25% |
| Pubs & Clubs | $14.4m | 7% |
| | $215.5m | 100% |

The amount of $14.4 million is the pubs' and clubs' gross profit from EGMs. Wages of approximately 20% and other costs, electricity and cleaning of say 10% will reduce the figure to $10.1 million or about $4,800 per machine on average per year. This could be termed the EBIT (earnings before interest and tax) per machine.

FH's returns from EGMs in its pubs are anything but average. Although having only 270 or 11% of EGMs in pubs and clubs, it is estimated FH ended up with 36% of overall player losses from pubs and clubs.

The numbers have been further boosted in 2011 with another 60 EGMs from FH's purchase of 2 establishments from the Goodstone Group on the NW Coast.

FH's current stock of 11 pubs operating EGMs are all conveniently located amongst those most favourably disposed to EGMs. Most fall within the top 20 ranking EGM pubs (out of 100).

The casinos attract more losing players. With 35% of machines overall, casinos end up with 45% of overall losses. It's more of a free market in casinos, longer hours, less regulation.

Hence FH was able to push up its share of the EGM spoils to $147.2 million or 68%.

There are considerable costs but $147.2 million makes a nice start.

In 2011 the share is likely to be at least 70%.

It's not just the icing.

Soon it'll be most of the cake.

**Revenue and expenses.**

FH's total revenue for 2010 was $478 million. Of that, as we have seen, $253 million was removed from the wallets of punters. And a further $10 million worth of fees from pubs and clubs.

This leaves $215 million from the normal ‘leisure’ offerings of accommodation, meals, bars, bottleshops and tours such as ABT Railway and Gordon River Cruises, plus a reputedly successful transport business Cope Transport (which will be lumped with other tourist operations).

In summary $263 million is from gambling, or to use the less pejorative term, gaming, and the remainder of $215 million from the other leisure activities.

FH’s earnings before interest and tax (EBIT) were $46 million.

FH doesn’t provide segment accounts (it is not required) so an estimate is needed to allocate the EBIT between gaming and other leisure activities.

If one splits EBIT on a revenue basis, and make adjustments for depreciation (depreciation expenses are likely to be less in the gambling area) then the EBIT for gambling is $30 million and for other activities $16 million.

Finance expenses of $11.1 million reduces the net profit before tax to $35.2 million.

After tax the profit was $27.1 million.

FH’s overall EBIT of $46 million is 10% of revenue.

**Federal Hotels’ strategy**

FH’s exclusive arrangement with the Government was examined by a Public Accounts Committee in 2003. The Deed had been negotiated in secret but was yet to be approved by both Houses of Parliament

FH told the committee that the agreement would assist in underwriting FH’s “significant investment strategy in Tasmania”.

A premium standard development of at least $25 million at Coles Bay was mandated in the Deed although FH had already decided to proceed. Initially to be completed early in 2005 it was finally finished 5 years later at a reported cost of $31 million.

Where has the rest of the gambling loot gone?

About $75 million has been paid to purchase existing businesses in the 5 years to 2010. The Henry Jones Art Hotel was acquired for $5 million, Cradle Mountain Chateau and Cradle Mountain Lodge for $25 million and the 9/11 Chain of bottleshops for $40 million. The delayed start to the Saffire project at Coles Bay meant that spare cash was available for acquisitions.

In the current year 2011 another 2 of the better performing EGM establishments have been cherry picked by FH at a reported cost close to $20 million.

‘Investment’ means different things to different people.

To accountants it means a capital amount and includes existing capital assets.

To an economist, from a national accounts perspective, the definition is much narrower. Buying an existing asset is not an investment.

The magnificent achievements of MONA, Barnbougle Dunes and Lost Farm golf courses are investments, existing bottleshops aren’t, and don’t appear to be quite in the spirit of the exclusive arrangement designed to allow certainty for FH to help develop the Tasmanian tourism industry.

Acquiring existing EGM premises from the Goodstone Group is even worse.

At a time when David Walsh and Richard Sattler were unveiling their masterpieces, FH were using the proceeds of its exclusive license and the leverage opportunities that ensue, to further corner the EGM market.

Over the past 5 years two thirds of after tax profits, or $79 million, has been paid to the 6 shareholders.

This is a surprisingly high % for such a capital hungry business.

Increased bank loans of $98 million were needed to supplement the cash tin.

Total borrowings are now $181 million. There’s also $42 million owing in respect of equipment leases, principally EGMs.

FH have been borrowing like there’s no tomorrow without EGMs. But there are already signs that banks are starting to reassess the security value of gaming assets (see http://www.smh.com.au/business/pokie-limits-prompt-banks-to-review-lending-to-pubs-20110413-1de6d.html).

It’s not too dissimilar to Gunns and woodchips, circumstances do change.

And the similarities don’t end there.

As with the CFMEU foot soldiers in fluoro jackets at John Howard’s celebrated Albert Hall performance, the pubs and clubs will be doing their best Chicken Little imitations predicting doom should any changes be made to current arrangements.

The pubs and clubs have a little skin in the game, as was shown above, perhaps an EBIT of $10 million.

Maybe to get things into perspective the 10 clubs in on the deal only account for 173 of all machines in pubs and clubs, about 6%. And most are conspicuously at the bottom of the Top

100 table in danger of relegation so it is a little unfair to tar them with the same brush as some of their pub colleagues.

Hence when we talk about pubs and clubs, it's basically pubs we're discussing.

Overwhelmingly the pubs with EGMs are a separate bunch from the rest of the tourism industry providing accommodation meals and drinks.

At least 85% of EGM revenue is from locals not tourists.

Any changes will bring screams of pain. But do pubs have a basis for such a reaction?

**Rates of return and sustainability**

The question arises --- is the average EBIT of $4,800 per machine per year a reasonable rate of return?

How much did pubs invest to install the hired machines? Let's say $10,000 per machine, say $300,000 for a 30 machine venue (most venues spent less). That equates to a 48% return per machine per year. Many machines will earn 2 to 3 times the average. Those located on FH's premises for example.

Prudent economic policy suggests that if a license to operate is granted for a nil fee, then the Government 'rent' should be such as to allow the operator to achieve the normal rate of return for that particular industry.

In the case of pubs, the current buying price is roughly 10 times EBIT. In other words an operator expects a return of 10%.

Given uncertainties with FH's exclusive arrangement, it could be argued that a 20% return is needed. OK. This implies an EBIT per machine of $2,000 not $4,800.

Arguably therefore, pubs have organised a cosy rent seeker agreement in their favour.

The same argument applies to FH's return from EGMs although it's a little difficult to ascertain the EBIT from EGMs based on publicly available information.

From an economic policy perspective, normally there is no prima facie reason why the Government should structure its take so that FH is able earn abnormal industry profits from gaming.

At the time Messrs Bacon and Lennon had a different view of the world. An overriding Government fiat was deemed necessary to chart the way forward for the industry and the State.

Hence the Deed.

The Public Accounts Committee was sidetracked by FH and discussed the supposed need to align our tax rates with other States. Why? It's the EBIT rate of return that will determine whether or not an investment proceeds, not how much of the booty has to be split with others.

The EBIT from gambling was never discussed.

However FH's figures suggest that FH is not earning super profits overall. Its gross assets are $463 million and it has an EBIT of $46 million so that's only 10%.

But the nagging feeling however is that gambling's share of EBIT is higher than the revenues split suggests and that gambling is subsidising the tourism side of the business.

The intent of the exclusive arrangement was to give FH the opportunity to build a sustainable tourism industry.

When will the cross subsidy cease? Cross subsidies can distort the pattern of investments within the tourist industry and vis-a-vis other industries.

Just as Gunns dominated and bullied the forest industry into tacit acceptance that what was good for Gunns was also good for the forest industry, so too do we see FH's dominance of the tourism industry. Scarcely a peep to be heard from fellow operators that maybe what's good for FH isn't necessarily good for the industry.

When will the rest of the FH's business be sustainable without EGMs?

The answer is probably not for a while. With an EBIT of no more than $16 million for the non gambling side of the business, it would be quite uncomfortable trying to service a loan of $181 million as well as ensuring enough cash was available to meet the inevitable ongoing capital requirements of a tourism operation.

What happens between now and 2018 will be of more than passing interest. Whether further acquisitions of bottleshops and gambling venues are pursued? Whether new 'investments' such as the one contemplated at Port Arthur are put on the backburner? To be transferred to the negotiating table when it's time to talk turkey about extensions to the Deed? Gosh it worked once, mandating expenditure of $25 million in return for an exclusive license valued by Citibank at $100 million. It might work again? What odds the double?

There's no panic as yet. Dividends to shareholders have continued their merry pace in 2011 with a further $15 million paid.

And there are still 61 Arabian horses valued at $926,000 on FH's books.

**Has the State optimised its returns with the exclusive arrangement?**

FH has not developed a sustainable tourism based structure. Because the shareholders have milked most of the profits from the Company, FH is still very much dependent on gambling to survive.

In return for an exclusive license for a nil fee, the quid pro quo undertaking accepted at the time of the Deed was to help develop a sustainable tourism industry.

The exclusive arrangement was a form of infant industry assistance to enable the growth of the tourism industry.

Arguably the infant industry has grown to become a handout dependant adult.

The result will be a continuation of demands upon Government. The beggars will continue to queue. Lest there be too many changes, the script has already been written “We’ll all be rooned, said Hanrahan” is ringing in my ear.

It is a little difficult to argue that the exclusive license which has allowed the monopoly operator to use resultant surpluses to acquire existing businesses such as bottleshops and gambling dens is an optimum resource allocation strategy. Turnover from EGMs is declining yet FH is acquiring more EGM venues. Has it chosen the right path? Has the State chosen the right path? What does this say about the Tasmanian tourism industry if the best returns can be found by buying more EGM venues? Are things out of balance? Have opportunities been lost by other operators being discouraged due to the cross subsidies that give FH an unfair advantage?

But maybe the saving grace for the exclusive license is that it allows for the collection of State revenue on an equitable efficient and simple basis.

Alas, it appears to fall well short again.

The burden of the tax falls on a small section of the population. Trying to achieve horizontal equity is all but a forlorn hope. Horizontal equity is achieved where taxpayers of similar means pay similar amounts.

Most people are burdened by little or no EGM tax.

As we have seen above the tax arrangements have little to do with the efficient allocation of resources. It is simply about providing a pot of money to a sole operator in the hope that the State’s best interests will be served.

But in a 2 horse race with the State’s Interest and Self Interest being the only runners it’s not difficult to pick a winner.

On the matter of simplicity, taxes on FH's products are relatively more costly to collect. It is estimated that about $5 million is required by Treasury and Finance to administer regulate and collect taxes of $59 million from FH. Collection costs are about 8%. This compares to about $10 million to collect the remaining $820 million in State taxes, a little over 1%.

**Winners and losers**

The shareholders comprise the majority in the winner's circle.

Evidence at the Public Accounts Committee in 2003 was that FH's employment numbers were about 2,000. Seven years later the annual ASIC report confirmed employment was 2,038.

One cannot rely on the ubiquitous multiplier to create more winners if one is merely purchasing existing businesses.

What is meant by the 'multiplier' is a measure of the ensuing activity that results from a particular investment decision.

Investment promoters often sell their projects by asserting that not only will their project produce X number of new jobs but the number of indirect jobs are likely to be Y in number. The Promised Land beckons. We've all heard the story before.

With the purchase of existing businesses the multiplier effect of the so called 'investment' is quite low.

Hence if an arrangement as agreed by the Deed between Federal Hotels and the State of Tasmania merely divides the spoils among the co conspirators, and no new investment are undertaken apart from a belated effort at Coles Bay, then we are basically talking about a zero sum game.

If the shareholders are the winners, then ipso facto the rest of us, collectively, must be the losers.

The exclusive arrangement is set to end on 30th June 2018, but can be extended. The Deed contemplates that FH will have at least 4 years notice of any changes, which suggests the issue should be a talking point at the 2014 State election, only 3 years away. Liquidators should have tidied up the remnants of the old forestry industry by then, and electors will be presented with another challenge.

It will be a measure of the State's maturity if it can navigate a way, hopefully on an apolitical basis, through the complex area of public policy where social, tax and economic issues are intermeshed.

**John Lawrence 1st May 2011**

**Disclosure**

The writer although having an interest in a business that derives revenue from gambling is unlikely to participate in an Albert Hall style rally in support of the industry.