

**ANNEX C to Letter to The Secretary of State from the Government Appointed Members of the
Horserace Betting Levy Board dated 30th November 2010**

THE 50TH LEVY SCHEME

EXECUTIVE SUMMARY FROM DELOITTE'S REPORT TO THE GOVERNMENT APPOINTED MEMBERS

1. REPORT

- 1.1 This Summary should be read in conjunction with the description of the work performed and its limitations, as set out in section 1, and our detailed findings as set out in appendices A to H.
- 1.2 We have set out the major features of the last nine Levy Schemes (being all those since the basis of the Levy changed from Turnover to Gross Win) in Appendix G.
- 1.3 The basis of the Levy has remained stable over the last eight Levy Schemes: there have been no changes in Levy rate, thresholds have moved in recent Schemes in line with inflation¹ and the basis of the Scheme has been settled by negotiation in seven of the eight years. The major change in landscape in 2009 and 2010 has been the movement of some 'big 3' Bookmakers' operations offshore². We have taken account of the estimated likely effect of this change in our levy scenarios in Appendix E.
- 1.4 Both Racing and the Bookmakers' Committee argue that there should be significant changes for the 50th Levy.

Overview – Appendix A

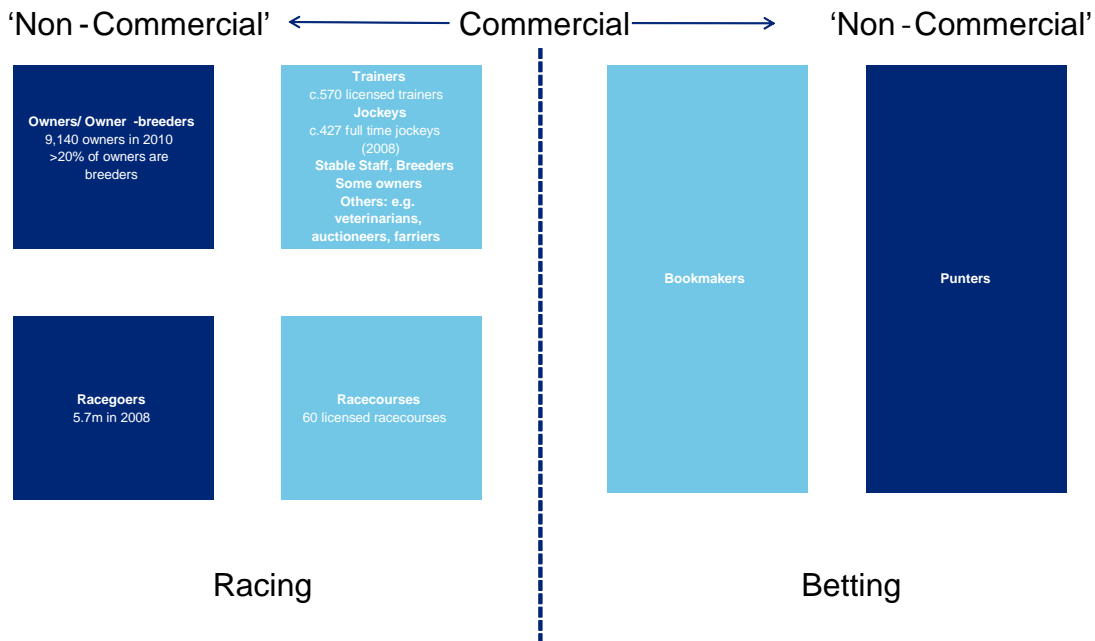
- 1.5 The constituent elements³ of Racing and Bookmaking can broadly be categorised as:

¹ Between the 41st and 42nd Schemes thresholds halved and foreign racing was removed from the base of the Levy. The Bookmakers' Committee states that this was part of the agreement to the terms of the Levy Scheme whereas Racing states that it was not.

² The internet businesses of William Hill and Ladbrokes were levied for part of the 48th Scheme moving offshore in September 2009 and November 2009 respectively. The telephone business of William Hill was levied for all of the 48th Scheme and will be levied for part of the 49th Scheme. It is anticipated it will move offshore in Autumn 2010.

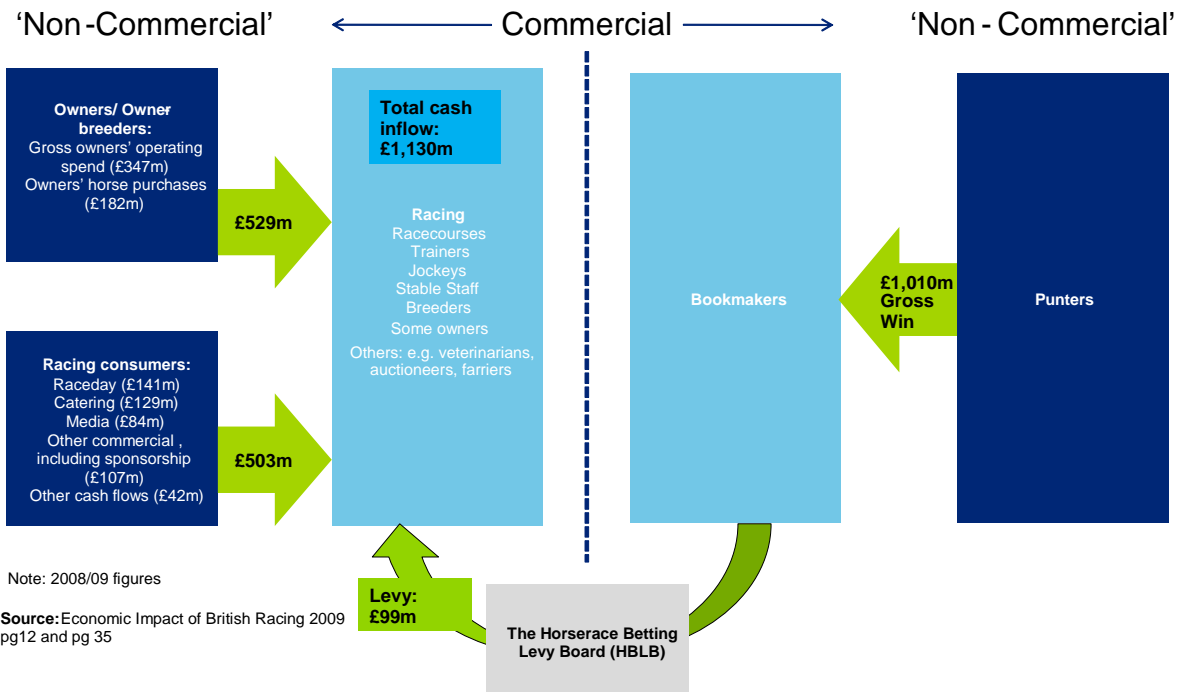
³ All numbers are as of 2008 except for owners/owner-breeders for which we have 2010 data (as indicated).

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1.6 Those elements whose motivation we have described as commercial are those who make all or the majority of their income from their involvement in Racing or Bookmaking.

1.7 The following chart overlays the principal cash flows between these categories:



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- 1.8 This demonstrates that the majority of the cash funding both the Racing and Bookmaking industries receive is provided by individuals whose primary motivations are not commercial⁴.
- 1.9 It is evident that Racing and Bookmaking have very different understandings of the purpose of the Levy and, indeed, both have provided more than one definition of its purpose.
- 1.10 Racing has argued that it is:
- A grant and not a payment for content or a service;
 - It is not a subsidy or payment for a product; and
 - It is a yield.
- 1.11 Bookmaking has argued that it is:
- Compensation for loss of attendance at racecourses;
 - Not meant to be a subsidy but a transfer to help Racing help itself;
 - Not a price for a product; and
 - A mechanism not a yield.
- 1.12 The legislation⁵ states the Levy is to be applied for:
- the improvement of breeds of horses;
 - the advancement or encouragement of veterinary science or veterinary education; and
 - the improvement of horse racing.
- 1.13 During the passage of the Horserace Betting Levy Act 1969 a summary⁶ of the then current arrangements was given as to what would be considered should the Levy Scheme have had to be determined by the GAMs⁷. These have developed into the present analysis which directs that account should be taken of⁸:
- All prevailing economic, fiscal and social circumstances as may relate to Betting and Racing;
 - Betting's reasonable capacity to pay; and
 - Racing's reasonable needs.

⁴ By this we mean not that these individuals are not interested in the financial returns, but rather that if their investment in Racing or Bookmaking were evaluated rationally it would show that for the vast majority of them they receive back less than they spend.

⁵ Betting, Gaming and Lotteries Act 1963.

⁶ Should a determination be required then the GAMs will *".....balance the needs of horseracing against the capacity of the bookmakers to pay"* (Hansard 28 January 1969 – Mr Morgan, Under-Secretary of State for the Home Department). This was then clarified such that *"we are aiming to determine not what the bookmakers are capable of paying but what it is reasonable for them to pay."* (Hansard 5 March 1969 – Mr Morgan).

⁷ Mr Morgan went on to state *"It is only right that the Home Secretary should be given a much wider discretion. It is perfectly proper for him to take into account the ability of bookmakers to pay, to take into account the needs of the horseracing industry, and to take into account all manner of other considerations as well – the financial policies of the Government and wider social considerations."* (Hansard 28 January 1969).

⁸ Letter from HBLB to Minister for Sport, DCMS, dated 30 April 2009.

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- 1.14 None of these terms is further defined either in the legislation⁹ or otherwise.
- 1.15 There is a substantial gap between the Bookmakers' Committee's proposal for the 50th Levy Scheme (estimated yield £56 million to £64 million) and Racing's assessment of its reasonable needs (being £130 million to £150 million).
- 1.16 The challenge facing the GAMs is a complex one. They have to determine whether or not the proposed mechanism for transferring funds from Bookmaking to Racing is appropriate in circumstances where the other major financial providers to both industries are acting in a non-commercial way and where there is no clear practical definition of the criteria for making their decision. This problem is exacerbated for the 50th Levy by the substantial difference between the likely financial outcome of the Bookmakers' Committee proposals and Racing's quantification of its reasonable needs.

Racing's reasonable needs – Appendix B

- 1.17 Racing perceives its key risk in relation to the Levy to be the potential fall in prize money which, it argues, would result in owners / breeders taking their business to countries with higher prize money or ceasing or reducing their involvement with horseracing altogether. Although the Levy provides a relatively small proportion of the total funding received by Racing¹⁰, it is a very significant provider in two areas - it provides over 50% of total prize money and funds all integrity and regulation costs.
- 1.18 In the period 2002 to 2008 racecourses experienced strong attendance averaging 5.9m per year, and over the last four years benefited from a rise in media rights payments. Collective racecourse profits were £16.8 million¹¹ on revenues of £456 million¹² in 2008. Several racecourses are however expecting a dip in revenues from corporate and private hospitality activities and a slight reduction in attendances this year.
- 1.19 The monthly average number of horses in training increased by around 9% between 2005 and 2010, the number of fixtures increased by 18% between 2002 and 2009 and prize money fell slightly from £116 million in 2004 to £111 million in 2009¹³ in real terms.

⁹ Mr Morgan stated *".....the expression which has been in statute since the Betting Levy Act, 1961, and now appears in Section 27(5) of the 1963 Act, is one which may well be incapable of definition. It has never been tested. What does the term "capacity to pay" mean? It may mean next to nothing at all. On the one hand, can one imagine a term more capable of an infinite variety of interpretations than "the needs of the horseracing industry"?"* (Hansard 28 January 1969).

¹⁰ 9% in 2008 and probably less currently.

¹¹ Racecourse Financial Performance, the Racecourse Association Limited (Schedule 1), 2008 data.

¹² Economic Impact of British Racing, 2009, page 21. Figure 11 - total revenue was £456m.

¹³ Impact on Racing of 2011 Levy income forecast at £68.8m, 2010, British Horseracing Authority, Appendix B. The prize money data is adjusted for inflation per note 6: *'All amounts are restated up to 2009 using December RPI for each relevant year.'*

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- 1.20 In our opinion there are two main issues to consider when addressing Racing’s funding from the Levy:
- What are Racing’s reasonable needs? and
 - To what extent should Racing’s reasonable needs be funded by the Levy?
- 1.21 Consequently the consideration of the Levy requires an in-depth understanding of Racing’s costs and its sources of income.
- 1.22 In relation to ‘reasonable needs’ there is no statutory, widely accepted or documented definition of ‘reasonable needs,’ or any clear definition in Racing’s submission. Racing and Bookmaking’s views are different and cannot be reconciled. Neither party addresses the extent to which those reasonable needs should be funded by the Levy.
- 1.23 Sir Philip Otton’s view was that Racing should establish a business model based on the performance of the fixtures and create a business case for the needs of the Racing industry¹⁴. We agree with this suggestion and would add that the business case should be for all of Racing not just for some elements of the industry.
- 1.24 Racing has presented three methods to arrive at a ‘reasonable’ Levy yield:

Racing’s Needs	£133-152m
Reasonable Share of Benefits	£128-149m
Market	£121-151m (£154-184m including conveyed sales)
Racing’s Final Reasonable Levy Yield	£130-150m

Source: 50th Horserace Betting Levy Scheme, Submission of British Horseracing¹⁵

These all fall within a relatively narrow range of £130 million to £150 million which Racing argues strengthens its case.

- 1.25 We note that the approaches taken are not predicated on the basis of assessing Racing’s ‘reasonable needs’ as a whole but rather seek to estimate a required Levy yield in isolation. As a consequence Racing has not analysed in any detail around 87% of its costs and 90% of its income.

¹⁴ Otton III Consultant’s Advice to the Horserace Betting Levy Board (Final Version), by Rt. Hon. Sir Philip Otton, 19 December 2008, page 22, paragraph 77.

¹⁵ 50th Horserace Betting Levy Scheme, Submission of British Horseracing, March 2010, page 3.

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1.26 The table below summarises Racing’s three methodologies and our main observations for each one:

Summary description	Key issues / observations
Racing’s needs	
<p>Racing uses a base of £90-£105m (the 41st Levy determination expected yield), applies cumulative inflation and additional costs for integrity, costs / compensation for additional leasehold fixtures and partial compensation for owners’ transportation costs.</p>	<ul style="list-style-type: none"> • The arguments for using the 41st Levy as a base are not persuasive; • There is limited evidence to support the increase in integrity costs; • Racing needs to conduct a fixture review to substantiate its assumptions on fixture-profitability and Levy generation¹⁶; and • The compensation for owners’ transportation cost will not make a material difference to owners’ total costs.
Reasonable share of benefits	
<p>Using the 41st Levy determination expectation as a base, the following are then applied:</p> <ul style="list-style-type: none"> • accumulated RPI (27%); • an increase in costs of 23.5%, based on the increase in the fixture list; • a 50% substitution effect. 	<ul style="list-style-type: none"> • The arguments for using the 41st Levy as a base are not persuasive; • The ‘substitution’ rate of 50% is not substantiated by evidence; and • The average cost per fixture is assumed to be constant. We would expect that if the fixture expansion is efficiently managed, it should fall.
Market approach	
<p>This method simulates a market negotiation between Racing and Bookmakers for a ‘right to access racing for betting purposes.’</p>	<p>The key assumptions in this method are open to challenge because:</p> <ul style="list-style-type: none"> • The ‘product’ that Racing is trying to sell is not the product Bookmakers want to buy; • The Levy is not a market mechanism; and • The London Economics’ response shows that economic analysis of this sort is open to a wide range of interpretation.

¹⁶ HBLB has detailed information on Levy generation by fixture but not on fixture profitability.

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- 1.27 We set out our comments in detail in Appendix B. In summary these comments are to the effect that the key assumptions underlying the methods are open to challenge on a number of grounds including limited evidence and a lack of granularity of the data provided. We think it may be difficult, on the basis of the evidence and arguments put forward by Racing, for the GAMs to determine whether the amounts sought from the Levy are required to meet Racing's needs.
- 1.28 Racing's submission notes that British horseracing receives less income from Betting than horseracing does in other countries. It argues that this makes British horseracing less competitive for foreign owners and could result in owners / owner-breeders and trainers moving their operations overseas which would cause Racing to experience a serious decline.
- 1.29 We recognise that other countries do have different models for funding horseracing from the betting industry and agree that many of these raise substantially greater amounts in direct transfers than in the UK. Owners who run horses in the UK only receive a 23% return from prize money compared to 100% in Hong Kong or 55% in France¹⁷. However, given the very different models for the relationship between Betting and Racing in other countries, we do not consider a direct comparison between British horseracing and international racing can be made.
- 1.30 Falling Levy receipts may lead to owners, trainers and horses moving abroad and Racing has provided anecdotal evidence that some British horseracing activity may eventually be displaced. Racing has not, however, provided firm or quantifiable evidence to show the extent to which this displacement is happening or may occur in the future if the Levy does not achieve Racing's target. Further, the relative financial attraction of international racing has been a factor for many years and it is difficult to isolate the impact of a changing Levy from owners' other motivations in choosing where to race their horses.
- 1.31 A key theme underlying Racing's approach is its reliance on the determination of the 41st Levy as establishing a monetary value for the 'reasonable needs' of Racing and consequently uses it as a baseline for the 50th Levy Scheme.
- 1.32 The Secretary of State's statement regarding the 41st Levy indicates that if the scheme as set out was applied to the Bookmakers' forecasts then the scheme would yield a Levy in the range £90m to £105m. It is not clear that the Secretary of State was suggesting that the stated range was a target for the Levy. Further, the actual yield would depend on the Bookmakers' actual profits and in the event the 41st Levy generated £79.9m.

¹⁷ 50th Horserace Betting Levy Scheme, Submission of British Horseracing March 2010, page 48.

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- 1.33 We note that each Levy is set by reference to the circumstances relevant at that time and there is no doctrine of precedent which requires the practices of previous Levy schemes to be adopted.
- 1.34 Moreover, the circumstances surrounding the 41st Levy determination makes it a weak base for the 50th Levy. The 41st Levy negotiations were ‘clouded’ by negotiations over a commercial deal on data rights and it was expected to be abolished in 2002. Hence it may not be the most ‘representative’ Levy Scheme to use as a base¹⁸.
- 1.35 The 47th Scheme which also went to determination but did not include any statement about potential yield is not referred to by Racing. Even if Levy Schemes previously determined by the Minister should carry greater weight than those settled by agreement, it is certainly questionable as to whether there is any basis for giving greater weight to the 41st Levy determination than the 47th Levy. Indeed, given that the 47th Levy determination is the more recent, the reverse may be the case.
- 1.36 We note that Racing assumes the Levy should fund all its specifically identified needs, particularly prize money and integrity and regulation. Racing’s submission considers only the costs and provides no analysis of alternative revenue sources. We do not know, and Racing provides no analysis to show, whether owners could fund more (they provide around 47% of Racing’s funding - £529 million) or whether racecourses could afford to pay more and / or fund integrity and regulation costs.
- 1.37 It is not possible, on the data provided, to determine the impact of a drop in Racing’s income by 2% to 3% (£20 to £30 million) on the sport or the tipping point for, what Racing describes as the ‘spiral of decline’ for Racing.

Bookmakers’ capacity to pay and the mechanics of the Levy – Appendix C

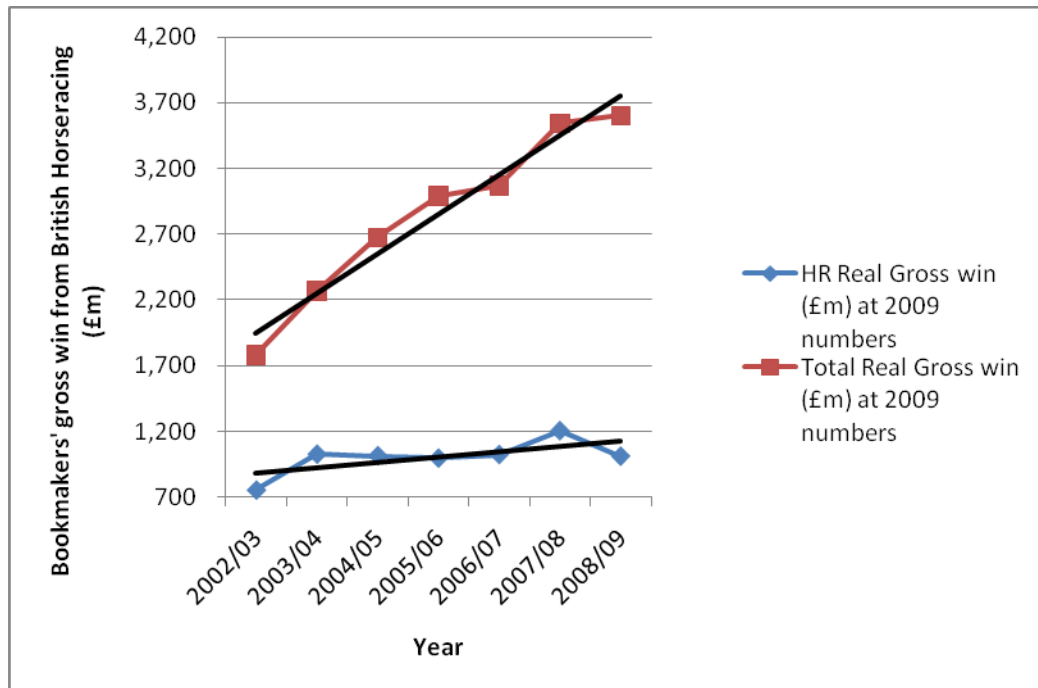
- 1.38 In our view there are two issues to consider when assessing the Bookmakers’ capacity to pay: (a) their overall capacity to pay and (b) the ‘base’ on which the Levy should be charged. We note however that both Racing and Bookmaking have, to some extent at least, treated these as a single issue.
- 1.39 Bookmakers have expressed the view that capacity to pay should be based on British horseracing gross win also taking account of media costs and the ‘base’ limited to British horserace betting. They have indicated that their capacity to pay has been reduced in the last

¹⁸ British Horseracing Board, 41st Levy Scheme 2002/03: Memorandum to the Department for Culture, Media and Sport, November 2001, page 8 paragraph 1.3. *‘The circumstances which led to the breakdown of the negotiations have been fully explained to DCMS... BHB does however take the opportunity to re-emphasise that the Bookmakers’ Committee was only prepared to negotiate a levy settlement which was conditional on an agreement relating to pictures and data’.*

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five years by increasing costs; particularly media costs, Gambling Commission fees and compliance costs, rent, rates and marketing costs.

1.40 Bookmakers argue when assessing their capacity to pay (and the needs of Racing) the total contribution from Bookmaking to Racing must be considered, including media payments and sponsorship. The Bookmakers' Committee submission shows that Bookmakers' overall gross win has increased year on year from 2002 to 2008 dipping slightly in 2009. British horseracing gross win has remained essentially constant over the period¹⁹.



1.41 Racing's view is that capacity to pay and the leviable base should be assessed on a wider range of Bookmakers' activities including foreign horseracing and FOBTs²⁰. The inclusion of all LBO activities would increase the capacity to pay at a gross win level substantially, although we question how wide it would be appropriate to extend the base, particularly when some Bookmakers' operate diverse businesses that extend beyond 'pure bookmaking'²¹.

1.42 Racing justifies this extension beyond British horseracing gross win by arguing that British horseracing is the anchor product which brings punters into LBOs and that it should thus receive an appropriate share of the profits made by Bookmakers from these activities. It calls this 'convoyed sales'. We do not consider the evidence to support this argument to be persuasive.

¹⁹ Although there was a significant increase between 2002/03 and 2003/04, there has been very little overall change since then.

²⁰ Fixed odds betting terminals.

²¹ For example, bingo halls.

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- 1.43 Racing further argues for the inclusion of foreign racing on the basis that it was included until the 41st Levy and that there is nothing in the legislation to limit the Levy to British horseracing. There may be some pragmatic advantages of including foreign racing within the Levy in regard to the organisation of the fixture lists, although Bookmakers argue that they are limited.
- 1.44 Horses entered by Racing in foreign races²² do not presently generate any Levy and it may be that British punters bet more heavily on these than other foreign races as they recognise the horses. It is however also the case that foreign trained horses run in Britain and betting on such horses placed in Britain will be captured within the existing Levy scope albeit the relative value of these amounts is not known.
- 1.45 Whatever base is taken, we do consider that the cost of media rights is a factor that affects Bookmakers' capacity to pay²³.
- 1.46 We note that Racing proposes a return to Levy based on turnover rather than gross win which it argues is more predictable, less subject to fluctuation and more within the influence of Racing. We consider that gross win is a better measure of Bookmakers' capacity to pay than turnover, albeit net profit or cash flow would be better still. However we recognise the difficulty in estimating such figures given the problems in the allocation of costs of bookmaking between betting products.
- 1.47 In our view Bookmakers have not demonstrated in their submission '*an incapacity*' to pay or provided any evidence that they could not pay more than proposed in their recommendations. The measurement of Bookmakers' capacity to pay is very dependent on whether that capacity is measured in relation to British horseracing or includes a wider definition of Bookmakers' profits.

Impact of the economic, fiscal and social environment – Appendix D

- 1.48 Both Racing and Bookmaking have suffered and will continue to suffer through the economic downturn and are facing a similarly tough economic environment for the 50th Levy Scheme. The VAT increase on 4 January 2011 will impact both sides, leading either to higher gate prices

²² In other jurisdictions Levy is generated from betting on foreign racing.

²³ The Written Ministerial Statement for release on 20 February 2008 on the 47th Horserace Betting Levy Scheme states: "*Finally, turning to the issue of Turf TV, I accept that an argument can be put forward that bookmakers' subscriptions to the new service constitute a commercially-based flow of money to racing, albeit only from certain bookmakers to certain racecourses. I therefore accept that it may have a material effect both on bookmakers' ability to pay and on the needs of racing. However, it is apparent from the failure of the Bookmakers' Committee and the Levy Board to agree, and from the OCP report, that bookmakers and the racing industry hold widely divergent views on the status of Turf TV and the impact that it should have on the level of the Levy. In time its full economic impact on bookmakers, racecourses and on horse racing generally may become clearer. However, at this stage I consider that it would not be appropriate to take Turf TV into account in setting the level of the 47th Levy.*"

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at racecourses (which may impact attendances) or reduced margins (if racecourses choose to absorb the increase) and increased costs of additional irrecoverable VAT for Bookmakers.

1.49 We note that in recent years there have been no closures of racecourses (excepting Great Leighs – whose failure Bookmakers attribute to a flawed business model), although there have been job losses at racecourses and in other areas of Racing. Bookmakers have made regular shop closures, albeit there have been new shops opened too. Job losses within Racing tend to be less ‘visible’ in national media while Bookmakers, particularly quoted Bookmakers, make public announcements of LBO closures.

1.50 Commenting at an industry level, it is probably the case that the greatest effect in job losses will be felt at the ‘junior level’ (stable staff, jockeys, LBO staff etc.) and it may be that the HBLB could give consideration to the merits of re-directing Levy to support the weakest participants.

Levy scenarios – Appendix E

We have taken this out as it has been superseded by the HBLB model.

Other observations – Appendix F

1.51 Our findings point to five other issues that the GAMs may wish to consider further:

- Distribution of the Levy between prize money and integrity and regulation;
- Holistic fixture economic review;
- Future of media rights;
- Leakage; and
- Focus of prize money.

Deloitte LLP

19 October 2010

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