

**Independent Review of  
Wagering in NSW**

**Submission by Betfair  
Australia**

**31 July 2008**

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## 1. Introduction

This submission responds to some of the questions raised in the Issues Paper. But specifically it addresses the fundamental issue of how the NSW racing industry can grow its wagering-related revenue stream.

This submission focuses on three key factors that we believe are necessary for the efficient functioning of wagering in NSW and the ongoing viability of the NSW racing industry. They are:

- (1) the need for competition within the wagering industry;
- (2) the opportunity to grow the local market for wagering on NSW racing; and
- (3) the opportunity to commercially exploit the appeal of NSW racing internationally.

Shortly after the Issues Paper was published, Betfair engaged The Allen Consulting Group (“ACG”) to analyse the likely impacts of betting exchanges continuing to operate within NSW and on NSW racing and, more broadly, the implications of a liberalisation of the NSW regulatory regime to better fit with National Competition Principles. To some extent, events such as the Government’s promulgation of “race fields” regulations and our challenge (together with Sportingbet Australia) to the validity of NSW advertising restrictions have overtaken the brief we gave ACG. Nonetheless, in light of the independent and apparently far-reaching nature of the Review being undertaken, we thought it worthwhile attaching the ACG report to our submission. A copy of the ACG report may be found in Appendix 1. ACG are available to discuss their report with you if you have any questions.

Finally, the Background Paper published in June this year contained a number of material errors insofar as Betfair and its operations are concerned. It is important that those errors are corrected for the record. We have endeavoured to provide a succinct summary of the relevant errors and corrections in Appendix 2. We reiterate our offer to provide you with details of our operations so that you can avoid having to make assumptions.

## 2. About Betfair

Betfair is the world's largest betting exchange. It is licensed in various countries around the world, including Australia through its licence in Tasmania. Betfair can lawfully accept bets from customers throughout Australia. Betfair has approximately 2 million customers worldwide, approximately 50,000 of whom are in Australia.

All customers transacting on Australian markets with Betfair are required to satisfy identity verification requirements prescribed by the Federal Government's anti-money laundering and counter terrorism financing legislation.

The Australasian business of Betfair is a 50:50 joint venture between Crown Limited (ASX listed) and Betfair Limited (UK private company). The business is regulated by the Tasmanian Gaming Commission pursuant to a licence that runs until 6 February 2011. Betfair's Australasian operations are based on Hobart, Tasmania, where it has a state of the art data centre. The business currently employs over 100 staff.

The betting exchange operated by Betfair offers fixed odds betting products to customers in all countries where it is legal to do so. Some countries impose bans on their residents betting with offshore betting agencies. No country in the world has specifically banned the use of betting exchanges.

Since commencing operations under its Australian licence, Betfair has generated approximately \$40 million in revenue. Over 60,000 customers have bet through Betfair Australia. Table 1 below shows the revenue per licence year:

**Table 1**

<b>YEAR</b>	<b>REVENUE</b>
FY2006 (7 Feb 2006 to 30 April 2006)	\$3.8 million
FY2007	\$16.9 million
FY2008	\$18.9 million

Betfair's Australasian business has offered markets on NSW thoroughbred and harness races since 7 February 2006 (i.e. the day Betfair's Australian licence was granted). We started covering NSW greyhounds around September 2006. By far the majority of customers betting on all codes of NSW racing have been from interstate and overseas. Table 2 below shows revenue, volume and unique active customers on NSW racing (all codes) for the 12 months to 8 July 2008 split by customer residence (NSW, interstate and overseas):

**Table 2**

<b>Total</b>	<b>Revenue</b>	<b>Volume</b>	<b>Actives</b>	<b>% Rev</b>	<b>% Vol</b>	<b>% Actives</b>
NSW	\$1,914,273	\$133,411,675	3,547	44%	39%	18%
Interstate	\$1,899,792	\$140,183,485	6,548	43%	41%	34%
Overseas	\$584,001	\$67,926,011	9,204	13%	20%	48%
<b>Total:</b>	<b>\$4,398,066</b>	<b>\$341,521,170</b>	<b>19,299</b>			

Prior to Betfair gaining its Australian licence, Betfair UK had covered NSW thoroughbred and harness races. In doing so, it committed to paying a product fee equivalent to 20% of gross revenue from worldwide customers betting on those events. The accrued product fees total approximately A\$1.4 million and remain available to the NSW racing industry if and when they choose to accept the payment.

Betfair is a leader in the wagering industry in its harm minimisation initiatives. Its technological capabilities enable Betfair to implement best practice strategies to help ensure wagering remains an enjoyable pastime for customers. These initiatives include the ability for customers to impose loss limits, deposit limits, the ability to self exclude (for six months) and the ability for third parties to apply for a customer to be excluded. Betfair has been recognised internationally for its harm minimisation initiatives.<sup>1</sup>

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<sup>1</sup> Betfair was named “Socially responsible operator of the year” at the annual E-Gaming Awards in 2005 and 2006.

### 3. The benefits of a competitive wagering environment

We believe NSW (and Australia) needs a truly competitive wagering environment if the racing industry is to have any chance to prosper.

Further, it is contrary to the interests of the racing industry to protect the NSW TAB from competition. An important caveat to both of those propositions is that all wagering operators wishing to offer markets on NSW racing should pay a product fee that is calculated on an equitable basis. This applies to all interstate and international totalisators, bookmakers and betting exchanges. It also means that the NSW TAB must pay equitable product fees to interstate racing bodies (whose product it covers) and that the NSW racing industry must accept the consequences of this in terms of its impact on its distributions from the NSW TAB.

The question is on what basis should wagering operators (including the TABs) be charged. We think the industry should continue with the revenue-based model it already has in place with the TABs and extend it to all bookmakers and betting exchanges.

The problem with an approach that protects monopolies in any industry, including wagering, is that it stifles product innovation, leads to consistently higher prices and lower service quality. The side effects of an anti-competitive wagering environment throughout Australia, and in NSW in particular, have caused racing to lose a significant share of the gambling market. Racing now occupies just 10% of the total gambling market compared to around 35% in 1992.<sup>2</sup>

Tabcorp, the owners of the NSW TAB say that racing should learn to live with declining market share because other gambling products offer attractions with which racing can't hope to compete.<sup>3</sup> We don't agree. We think there are ways to reinvigorate racing as a gambling product in the increasingly competitive broader gambling market but this can't be achieved without competition in the wagering sector of the market.

Aside from arguments about the basis on which product fees are charged to wagering operators, there are several remaining barriers to competition – such as advertising restrictions and prohibitions on bookmakers and on course patrons using licensed betting exchanges – that need to be lifted to stimulate activity and interest in racing. In relation to the advertising restrictions, no one has a stronger incentive to promote racing as a sport and betting product than a wagering operator. It is false logic to suggest that industry revenue is protected if interstate operators are prevented from advertising. Racing continues to miss out on sponsorship money and much needed promotion of the sport for so long as the advertising bans remain in place. In relation to bookmaker reforms, again the logic is false. By refusing bookmakers the permission to back and lay with Betfair on course, they are being hamstrung in their ability to offer a decent service to on course punters and to better manage their business risk.

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<sup>2</sup> Source: 24<sup>th</sup> Edition of Australian Gambling Statistics, Office of Economic and Statistical Research, Queensland Treasury.

<sup>3</sup> Tabcorp submission to Sport 927 industry debate, 14 July 2008 (see [www.sport927.com.au](http://www.sport927.com.au)).

#### 4. Opportunities for local market growth

We mentioned above the decline in market share experienced by racing (as a gambling product) relative to other forms of gambling. One reason for this decline is that the TABs were unwilling to price their racing products within a range that enabled racing to meet customer demand for low margin gambling products. Virtually all the market share lost by racing went to low margin products such as casinos, sports betting and poker machines. Of concern is that the loss of market share does not even take account of the percentage of true market share lost to offshore online gaming products such as online poker and online casinos, which operate on very low margins.

The NSW TAB is a high margin operator. They aren't required to set their takeout rates at the upper limit of their statutory cap – they just choose to do so. High margin products come at a cost - 20 years of statistics show that consumers are increasingly spending less on racing (because it's too expensive) and more on other forms of gambling (because it's better value). Betfair's lower margin product stimulates new wagering by way of:

- (1) more bets because of the higher return;
- (2) more bets because of value – a punter may bet at odds of 3.0 but not at 2.5 as this is his value equation
- (3) more bets from new punters who recognise the higher returns from Betfair's products.

Apart from the ability to compete with other low margin products, there are other reasons racing should look to offer some low margin alternatives to the old-fashioned, high margin TAB products. Chief among those reasons is that low margin products allow punters to develop a longer and potentially broader relationship with the sport than they can with the TABs. For instance, if a punter has \$100 to spend on wagering for the month, he gets to bet on far more races with a low margin operator (like Betfair) than he does with a high margin operator (like the TAB). So instead of blowing his bank in the first weekend, he makes it last the whole month. He's more engaged with the sport during that period – reading more racing stories in the paper, watching more on TV, listening more on the radio. He feels better about the association with the sport. This may not be the case with every punter, or even the typical punter, but it's a segment of the punting market that's growing – as the figures show – and one which racing needs to try and fill one way or the other.

Punters should have access to a range of channels for delivery of products; it's what they want.

## 5. Opportunities for international expansion

Access to vision and form are the things that drive revenue in wagering. Without those tools, punters may still bet, but they won't bet as often or as big.

To give some idea of the potential we see for stimulation of overseas customers to wager on NSW racing overseas, about 48% of Betfair customers who bet on NSW thoroughbred racing last year were from overseas (18% from Victoria and 34% from interstate). Critically, however, overseas punters accounted for only 11% of revenue. Their activity on local racing would increase markedly if we could provide them with access to vision and better quality form.

Betfair is working towards 24 hour streaming of racing and sport from around the world. We already have streaming agreements in place for UK and Irish racing, international tennis, soccer and a range of other sports. Locally, we're interested in acquiring (for a fee) non-exclusive rights to stream Australian racing content over the internet to our overseas customers. To the extent the racing industry has granted exclusive rights to media companies without any obligation for those companies to meet performance obligations (e.g. to actually show the races overseas) racing is losing opportunities to generate interest in NSW racing, and revenue from, overseas punters.

Last year, Betfair purchased Timeform in the UK with a view to improving the ability of customers to access racing form. Whenever we promote Timeform products to our local customer base, it has a material impact on their activity on UK racing. We're investing in similar initiatives for our overseas customers with respect to Australian racing product. We have expressed an interest in purchasing enhanced data from the racing industry to assist in generating interest in Australian racing.

We now have over 2 million registered online customers worldwide (about 1.2 million of whom are "active"). It's difficult to think of a more efficient way for the racing industry to export its product to a global network of dedicated racing punters than through established channels like (but not limited to) ours.

End



# **Appendix 1**

## **Report by The Allen Consulting Group**

The Allen Consulting Group

## **Submission to the Independent Review of Wagering in New South Wales**

Prepared on behalf of Betfair Australia

**31 July 2008**

Written by the Allen Consulting Group

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## Executive summary

### Introduction

The Allen Consulting Group has been commissioned by Betfair Pty Ltd ("Betfair") to develop a submission on Betfair's behalf to the *Independent review of wagering in New South Wales*. The *Independent Review* has been commissioned by the New South Wales Government to "provide a framework for the future growth and sustainability of the NSW racing industry" (NSW Wagering Review 2008, p. 2).

Betfair is an on-line betting exchange company, allowing customers to wager on racing, sporting events, and other activities. Launched in 2000 in the United Kingdom, Betfair first accepted bets on Australian horseracing in October 2002.

When using Betfair customers effectively bet against each other — a wager can only be made if another customer (or multiple customers) is prepared to accept the bet. Accordingly, Betfair customers can bet on a selection either winning or losing.

### Regulatory arrangements for betting exchanges in New South Wales

At present, Betfair is licensed to operate from Tasmania, and permitted to accept wagers nationally. However, Betfair (like other interstate operators, other than licensed totalisators) is currently prohibited by law from advertising its products and services in NSW.

There are no arrangements in place for Betfair to make direct financial contributions to the NSW racing industry via product fees unless and until approvals are provided by the racing controlling bodies subject to the new legislation, and equitable product fees are agreed. Neither is Betfair able to sponsor races through providing prize money. The NSW racing industry (harness and thoroughbred codes) has so far refused to accept the product fees (20 per cent of gross revenue - totalling approximately A\$1.4 million) offered by Betfair UK on account of its coverage of NSW racing up until the date Betfair began operating under its Australian licence.

A more liberal regulatory regime in NSW would see all wagering operators treated equitably. This would comprise product fee arrangements, in combination with access to race field data, the ability to advertise, and on-course wagering.

Economic modelling reported in this submission indicates that provided there is equality in product fee arrangements. Any movement of customers to betting exchanges from other wagering operators will be neutral for the racing industry.

Drawing upon the overseas experience, wagering operator innovation is likely to draw additional customers to race wagering, leading to increased contributions to the racing industry, and elevating public interest in racing more generally.

Betfair is of the view that all wagering operators should pay a product fee based on gross revenues. It has been suggested that this rate should lie between 10 and 20 per cent. For the purposes of this submission, a product fee rate of 20 per cent has been assumed. Estimates reported in this submission suggest that assuming a 20 per cent product fee on gross profits, by 2012 Betfair could contribute \$2.6 million per annum to the NSW racing industry, and the TAB an additional \$13 million per annum. This estimate does not consider the potential contribution that may be made by interstate TABs and bookmakers.

### **Wagering environment in New South Wales**

The *Independent review* issues paper highlights how the NSW racing industry has stagnated in recent years. This stagnation is reflected on measures including race meetings, prize money and wagering turnover, and ultimately taxation revenues and the product fees received by the NSW racing industry. Without significant reform the future of the NSW racing industry is bleak.

Competition from other wagering operators has been used to explain declining TAB revenues. However, this view ignores substitution with other forms of gambling, including sports wagering, casinos and poker machines and online gaming with illegal offshore operators.

The potential for more liberal regulation to improve the prospects of the NSW wagering industry is great. This could be achieved through increasing competition by allowing new entrants, and introducing an internationally competitive licensing regime for interstate and international wagering operators.

In recent Australian history, those industries subjected to microeconomic reform, such as more liberal regulation and new entrants, have experienced significant productivity improvements. The examples of the financial services, air travel and telecommunications industries demonstrate the potential gains from reform.

### **How betting exchanges operate**

Betting exchanges differ from existing wagering products in several ways - most notably the additional flexibility they provide customers including the capacity to accommodate direct 'lay' bets, whereby customers bet on an outcome not to occur.

In many other respects - such as the ability to obtain fixed odds superior to pari-mutuel odds, along with the need to establish an account and wager over the internet - betting exchanges offer a similar product to fixed-odds operators (especially corporate bookmakers). This opens to question the degree to which betting exchanges may divert customers from the TAB pari-mutuel product. Customers for whom the features of betting exchanges are attractive are already offered many of them by competitors to the TAB and may have already substituted.

Establishing a definition of betting activity for betting exchanges that is comparable to the definition of activity applied to pari-mutuel and fixed-odds betting is problematic. Commission is also calculated on a different basis. These characteristics make it difficult to draw comparisons about the level of activity on betting exchanges relative to other forms of wagering. Accordingly, the nature of betting exchange operations need to be taken into account when comparing product fee arrangements.

### **Betfair in operation**

Since commencing operations in Great Britain in 2000, Betfair has experienced significant growth in both customer numbers and gross revenues. Comparable growth has also been experienced in Australia since Betfair obtained a licence to operate in Tasmania in February 2006.

In the various jurisdictions where Betfair operates around the world, the local racing industry has grown following Betfair's entry. This growth is in direct contrast to the stagnation currently experienced in the NSW racing industry. Furthermore, Betfair has been able to contribute to local racing industries through paying product fees and providing sponsorship and prize money.

Although Betfair has achieved significant growth over the past two years, Betfair is still a very small player in the New South Wales wagering market. As at May 2008, Betfair had just over 16 000 registered NSW customers.

## Chapter 1

# Introduction

### 1.1 Background

The Allen Consulting Group has been commissioned by Betfair Pty Ltd to develop a submission on Betfair's behalf to the *Independent review of wagering in New South Wales*. The *Independent review* has been commissioned by the New South Wales Government to "provide a framework for the future growth and sustainability of the NSW racing industry" (NSW Wagering Review 2008, p. 2).

Betfair Pty Ltd is an on-line betting exchange company, allowing on-line customers to wager on racing, sporting events, and other activities. A particular feature of Betfair is that customers effectively bet against each other — a wager can only be made if another customer (or multiple customers) is prepared to accept the bet. Accordingly, Betfair customers can bet on a selection either winning or losing.

As part of the *Independent review*, a detailed issues paper and background paper has been released. The issues paper raises a number of issues of direct interest to Betfair, with this submission addressing these issues throughout the submission.

At present, Betfair is licensed to operate in Tasmania, and permitted to operate nationally. However, Betfair is not permitted to advertise in NSW, with recent legislative changes introducing a fee for the use of race field data by wagering providers not accompanied by reforms that allow advertising. This is of particular concern, given that a discussion question posed by the *Independent review* was whether the payment of a product fee by wagering providers should be accompanied by concessions such as access to race field data and the ability to advertise (NSW Wagering Review 2009, Q5.7, p. 40).

### 1.2 A short history of Betfair

Betfair was launched in 2000 in the United Kingdom. Betfair also operates under licence in Australia, Austria, Italy and Malta.

Betfair first accepted bets on Australian horseracing during the Caulfield Cup in October 2002.

Prior to Betfair being issued a licence to operate in Australia, the Australasian Racing Ministers' Conference established the Betting Exchange Task Force (BETF) in 2003 to examine:

- the legal position in Australia regarding betting exchanges
- the effects of betting exchanges
- measures available to governments and the racing industry in response.
-



The majority of members of the BETF (with the exception of the Northern Territory) recommended against the granting of a betting exchange licence in Australia. A key argument made by the BETF in support of this recommendation was that betting exchanges were likely to become a popular alternative to TABs and licensed bookmakers, thus reducing contributions made from wagering to the racing industry (Betting Exchange Task Force 2003).

In spite of the recommendations of the BETF, Betfair was granted a licence to operate a betting exchange in Australia on 10 January 2006. This licence was issued by the Tasmanian Government under the *Gaming Control Act 1993*. Betfair commenced operations in Australia through a telephone call centre in Hobart on 16 June 2006, and on-line operations on 28 August 2006.

Betfair was also given formal approval to cover Victorian racing in July 2006. Furthermore, Racing Victoria has approved licensed bookmakers to use Betfair while operating on course. This approval assists licensed bookmakers to manage their books, and reduce exposure to particular runners.

Since Betfair commenced operations in Tasmania, residents in all Australian state and territory governments, with the exception of Western Australia, have been permitted to wager with Betfair. In the case of Western Australia, the *Betting Control Act (Western Australia)* prohibited Western Australian residents from placing bets through a betting exchange, imposing a penalty of \$10 000 or 24 months imprisonment. Other provisions of the Act restricted publication of Western Australian race field information, thus limiting the ability of Betfair to offer markets on Western Australian races. Responding to a Betfair challenge, the relevant provisions of the legislation were overturned by the High Court of Australia by a unanimous decision on 27 March 2008 (*Betfair Pty Limited v Western Australia* 2008).

### **1.3 Submission structure**

The remainder of this submission responds to key facets of the Issues Paper. The submission is structured as follows.

Chapter 2 provides an overview of the NSW wagering environment, responding to the somewhat bleak picture presented in the issues paper, and considers factors that may explain the current situation.

Chapter 3 provides an overview of betting exchanges, detailing how they operate and make contributions to the racing industry.

Chapter 4 outlines the experience of Betfair operating in both Australia and the United Kingdom. Included are details of the performance of the racing and wagering industry following Betfair commencing operations, and an overview of the reasons behind the growth of Betfair.

Finally, Chapter 5 identifies regulatory arrangements for betting exchanges in NSW, including potential product fee regimes, and reports the results of modelling of product fee scenarios.

## Chapter 2

# Wagering environment in New South Wales

### Key points

- In recent years, the New South Wales racing industry has stagnated. This stagnation is reflected on a wide range of quantitative measures, including race meetings, prize money and wagering revenue. The exception to this trend has been the breeding industry.
- The stagnation of the racing industry is ultimately reflected in taxation revenues, and the distribution of funds from wagering to the NSW racing industry.
- The current stagnation of the NSW racing industry suggests that in the absence of significant changes, the future of the industry is bleak.
- Competition from other wagering operators has often been used to explain stagnation of TAB distributions. However, this view ignores the role of substitution with other forms of gambling (e.g. casinos or sports betting).
- In recent Australian history, those industries subjected to microeconomic reform, such as more liberal regulation and new entrants, have experienced significant productivity improvements. The examples of the financial services, air travel and telecommunications demonstrate the potential gains from reform.
- The potential for more liberal regulation of the NSW wagering industry to improve the prospects of the NSW racing industry is great.

### 2.1 Historical performance of the New South Wales wagering industry

The *Independent review* issues paper provides a detailed review of the historical performance of the NSW wagering and racing industries. In summary, the issues paper presents a picture of a stagnating industry.

The stagnation of the NSW wagering and racing industries is depicted via a wide range of quantitative measures. These measures include the number of racecourses and meetings, prize money, wagering turnover, and taxation revenue, to name a few. For each of these measures there has either been a decline, or at best no change, in recent years.

For example, wagering turnover on racing fell, in real terms, from \$5.97 billion to \$5.13 billion between 1995-96 and 2005-06 (see Figure 24 of issues paper). The issues paper also reports that the number of NSW racecourses declined by 4.3 per cent between 2003 and 2007 (see Figure 4 of issues paper), with the number of race meetings falling over the same period by 5.7 per cent (see Figure 5 of issues paper). Similarly, prize money declined, in real terms, by 1.9 per cent between 2003-04 and 2006-07 (see Figure 7 of issues paper).

This decline in the performance of the racing and wagering industry has resulted in a fall in the financial contributions made by TAB Ltd to the NSW racing industry, along with a fall in the taxation revenues received by the NSW Government from racing wagering. The issues paper reports that NSW Government taxation revenue from TAB racing wagering fell, in real terms, from \$152 million to \$146 million between 2001-02 and 2005-06, with the distribution made by TAB Ltd to the NSW racing industry declining in real terms to \$221 million in 2006-07. Such ongoing decline puts the viability of the NSW racing industry at risk.

## 2.2 Future prospects of the New South Wales wagering industry

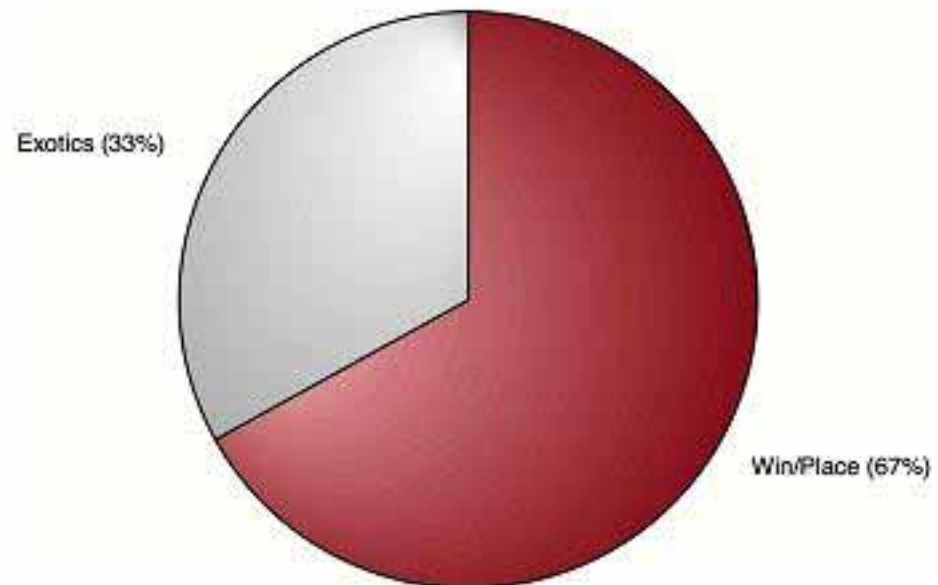
The issues paper asks the question of what the NSW racing industry is likely to look like in the future in a 'do nothing' scenario. If recent history is any guide, the future of the NSW racing can only be described as bleak. Under a 'do nothing' scenario, it is likely that there will be further decline in the size of NSW racing industry, as measured by employees, races, and wagering turnover and the like. Furthermore, this decline is likely to be reflected by a further reduction in taxation revenues and industry distributions attributable to wagering.

The issues paper suggests that some of the recent decline in wagering industry performance is due to competition from other wagering operators. With corporate bookmakers and betting exchanges increasing their NSW customer base, this competition can only be expected to increase.

However, it is important not to overstate the role of competition from other wagering operators as a way of explaining stagnant TAB wagering growth. Both corporate bookmakers and betting exchanges provide very different wagering products to those making up the bulk of TAB revenues. The bulk of TAB revenues are from shopfront pari-mutuel wagering, of which approximately 67 per cent of turnover is from win/place bets, with the balance from exotics (see Figure 2.1).

Figure 2.1

### NSW TAB PARI-MUTUEL BET TYPES

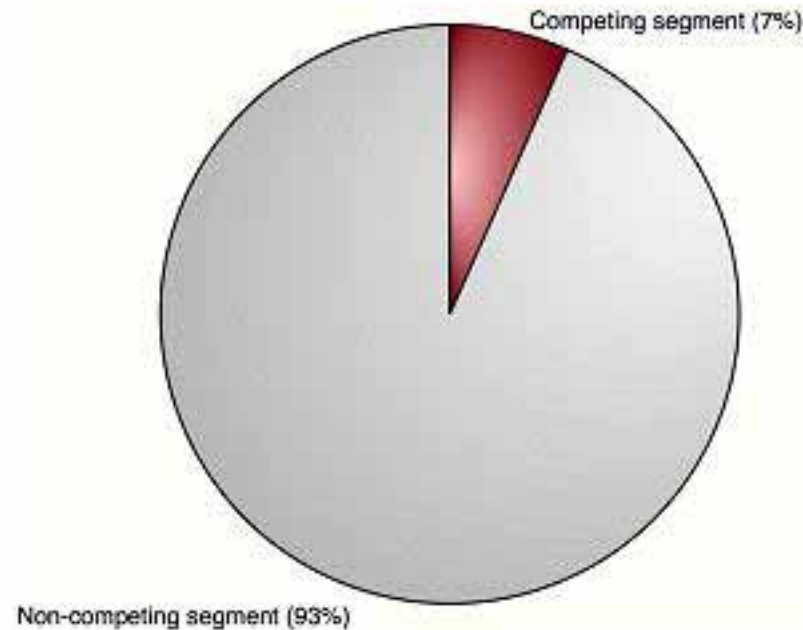


Source: The Allen Consulting Group analysis of Australian Racing Fact Book 2006-07

In contrast, betting exchanges and corporate bookmakers offer either on-line or telephone fixed odds wagering. Betting exchanges only offer win/place products, with corporate bookmakers offering win/place and only limited exotics.

Estimates developed by the Allen Consulting Group suggest that Betfair currently competes in only 7 per cent of the TAB Ltd market. This market is the win-place products offered by TAB Ltd through on-line operations (see Figure 2.2). In reality, though, the area of direct competition is even less given the differences in the product offering and the relative sophistication of customers (e.g. TAB customers can place their bets at any time prior to the race whereas Betfair customers can only do so by offering a price or accepting a price that is on offer at the time).

Figure 2.2

**SEGMENT OF TAB REVENUES WHERE BETFAIR COMPETES**

Source: [The Allen Consulting Group analysis of Australian Racing Fact Book 2006-07](#)

Accordingly, it is important not to directly assume that growth in corporate bookmakers and betting exchanges is at the expense of the TAB. Furthermore, provided there is an appropriate regulatory and industry contribution regime in place, there is no reason why the growing size of race wagering alternatives to the TAB should adversely affect the NSW racing industry. This is an issue that will be explored further in Chapter 5.

Perhaps more important than alternative race wagering operators are the substitutes offered in other forms of gambling, such as sports wagering, casinos and electronic gaming. These forms of gambling have seen significant growth in recent years, with the issues paper reporting that Tabcorp Holdings Ltd, the parent company of TAB Ltd, is projecting that earnings from wagering will stabilise in the future, whereas growth is expected in earnings from gaming and casinos. The substitution of race wagering for other types of wagering clearly has consequences for race wagering turnover, and thus contributions made by TAB Ltd to the NSW racing industry.

A key vulnerability of the NSW racing industry is that NSW is a net importer of racing product. In other words, NSW residents wager more on interstate racing than interstate residents wager on NSW racing. This situation has important implications for the "Gentlemen's Agreement", whereby all wagering revenue received by NSW TAB on both NSW and interstate racing is included in the industry contributions paid to the NSW racing industry. If the "Gentlemen's Agreement" was to collapse, it is estimated that the NSW racing industry would lose \$20 million per annum as a result of reduced contributions from the NSW TAB. It is also understood that NSW TAB has agreed to indemnify the racing industry against any shortfall that may emerge in industry contributions should the "Gentlemen's Agreement" collapse (When 2008).

Analysis of Betfair data confirms this point, with Table 2.1 indicating that, of total wagering on Australian thoroughbred and harness racing, NSW residents account for 38.1 per cent of total Australian Betfair wagering, but only 33.5 per cent of total Australian wagering is on NSW racing. This contrasts with Victoria, where 34.8 per cent of total Australian wagering is on Victorian racing, but Victorian residents account for 29.5 per cent of total Australian wagering.

Table 2.1

**BETFAIR WAGERING ACTIVITY BY AUSTRALIAN STATE (MAY 2007 - APRIL 2008)**

Australian jurisdiction	Percent of total Australian wagering volume <sup>a</sup>	
	Wagering by residents	Wagering on jurisdiction racing <sup>b</sup>
New South Wales	38.1	33.5
Northern Territory	0.7	0.1
Queensland	23.4	17.6
South Australia	4.2	11.0
Tasmania	4.0	2.2
Victoria	29.5	34.8
Western Australia <sup>c</sup>	0.2	0.8

Note: a = Wagering volume is 2 ! backers stakes

b = Includes New Zealand-based Betfair customers

c = WA customers were prohibited from using Betfair up until 27 March 2008, such that only one month of data is reported. Betfair ceased covering WA racing from 10 October 2007

Source: Betfair Australia

### 2.3 Scope for improvement: competition and innovation

#### 'Five Forces' model

The issues paper applies the 'Five Forces' model developed by Michael Porter to explain the recent performance of the NSW wagering industry. Overall, the findings of this 'Five Forces' analysis appear reasonable, with key findings including that:

- there is strong rivalry between wagering firms, with growing competition between TAB Ltd and other wagering operators. However, as noted above, it is important not to overstate the degree of effective competition;

- the purchasers of wagering products (i.e. the punters) have increased bargaining power, with increasing options available for betting on NSW races;
- there is a strong threat of substitutes to race wagering, such as other forms of gambling.

One issue that could be further explored is why NSW licensed wagering operators such as TAB Ltd have not responded to the threats presented by competing wagering operators, or substitute forms of gambling. The three following related reasons provide a possible explanation:

- other wagering operators (e.g. corporate bookmakers and betting exchanges) are currently competing on a small segment of the TAB Ltd market, and are thus not imposing significant competitive pressures upon TAB Ltd to innovate. Furthermore, these alternative operators are currently prohibited from advertising in NSW, thus limiting their ability to compete with TAB Ltd;
- competition from substitute forms of gambling, particularly the Star City Casino, is not of great concern to TAB Ltd, since Tabcorp Holdings is the Star City licensee;
- the NSW regulatory regime provides limited incentive for TAB Ltd to develop innovative products and strategies in NSW;
- restrictions on NSW oncourse bookmakers prevent them from effectively competing with interstate or intrastate operators.

The recent application by Tabcorp for a racing and sports wagering licence in the Northern Territory further suggests that the NSW regulatory regime is not supporting the growth of the NSW wagering industry. A key reason for TAB Ltd proposing to move approximately 19 per cent of its NSW race wagering business to the Northern Territory is the attraction of a more favourable regulatory regime, including the ability to offer tote odds betting. If successful, Tabcorp will have a Northern Territory licence to offer fixed odds racing, tote odds betting, as well as fixed odds sports betting and other products (Tabcorp 2008).

### ***The benefits of competition and innovation***

To maintain operators such as TAB Ltd in NSW, as well as to encourage innovation and growth in the wagering market, it is necessary for NSW to have a 'best-practice' regulatory regime. Under such a regime multiple wagering operators would be encouraged to operate in NSW through the establishment of a regulatory regime that encourages and promotes competition, to the benefit of the racing industry and consumers of wagering products more generally. Furthermore, product fees paid by wagering operators under a new regulatory regime should be internationally competitive. Only if product fees are competitive will interstate and international wagering operators have an incentive to promote NSW racing interstate and abroad.

Such an approach to regulation has underpinned much of the microeconomic reforms in Australia over the previous 30 years. These reforms saw the regulation of numerous industries liberalised. This has included the privatisation of Government owned businesses (e.g. Telstra, Qantas, Commonwealth Bank) accompanied by the removal of barriers to entry for new operators.

Three sectors where significant gains have been made following regulatory liberalisation comprise financial services, telecommunications and air travel.

The various reforms to the regulation of these sectors, particularly financial services and telecommunications, occurred at a time of significant development in information communications and technology (ICT). This overlap between regulatory reform and ICT developments allowed Australia to make significant gains that would not have been possible in the absence of regulatory reform. This concurrence of regulatory reform and ICT developments provides insight into the development of betting exchanges in recent years.

#### *Financial services*

The financial services industry, including banking, insurance, stock broking, funds management and superannuation, was one of the first sectors of the Australian economy to be subjected to microeconomic reform.

This reform program commenced in the early 1980s with the implementation of recommendations made by the Campbell Inquiry into the Australian Financial System resulting in widespread deregulation of the Australian financial services industry. Key reforms emanating from the Campbell Inquiry included:

- removing controls on interest rates charged and paid by banks, as well as lending terms
- removing controls on foreign exchange rates
- removal of an embargo on the entry of foreign banks into Australia, with the regulation of new entrants no more onerous than that for incumbents (Financial System Inquiry 1997).

These and other reforms emanating from both the Campbell Inquiry, and related policy decisions, led to significant change in the Australian financial services industry during the 1980s. These included the entrance of overseas banks into the Australian market, as well as increased competition between banks on lending and other products. Indeed, the 1997 Financial System Inquiry, chaired by Stan Wallis, found that:

... consumer choice has increased, the quality of services has improved and the aggregate cost of providing financial services has fallen since deregulation. Deregulation has also improved the productivity and competitiveness of the financial system...

Financial System Inquiry 1997, p. 595.

The improvements in efficiency resulting from these reforms are reflected in productivity estimates. Over the period 1988-89 to 1997-98, it is estimated that multi-factor productivity (MFP) in the finance and insurance industry grew at an average rate of 2.5 per cent per annum. This compares favourably to MFP growth in the whole Australian market sector over the same period of 1.7 per cent per annum (Forsyth 2000).

<sup>1</sup> Multifactor productivity (MFP) is a productivity measure that accounts for the main factors of production (which would normally include capital and labour).

### *Telecommunications*

Significant reform of the Australian telecommunications industry commenced with the establishment of a general carrier duopoly in 1990. Following this reform, the *Telecommunications Act 1997* brought about the removal of all restrictions on the issue of carrier licences. Consequently there was no limit on the number of telecommunications carrier licences which may be issued, with the number of carriers increasing from 3 to over 100 since 1997 (PC 2005).

Around the same time as the removal of restrictions on carrier licences, the Commonwealth Government commenced the privatisation of Telstra in 1997.

The benefits to consumers from the liberalisation of the telecommunications industry have been significant, with telecommunications prices falling by 29 per cent for businesses, and 17 per cent for households between 1996-97 and 2002-03 (PC 2005).

Over the same period, the quality of telecommunications services have improved, with Telstra's fault repair performance improving over the period 1998-99 to 2002-03. Despite declining prices, improved service quality and increased competition, Telstra was able to maintain a return on assets in excess of 15 per cent over most of the period 1994-95 to 2002-03.

During this period the telecommunications industry has seen significant innovation in the range of products and services available. These services range from wireless broadband internet services that operate via mobile phone, to Voice Over Internet Protocol (VOIP) services.

### *Air travel*

Reforms to air travel in Australia have encompassed both regulation of airlines, and the management of air travel infrastructure - namely airports.

Reforms have seen the previous Commonwealth Government airlines (Qantas and the then Australian Airlines) corporatised and subsequently privatised. At the same time, new entrants were allowed into the Australian domestic airline market, with Compass Airlines, followed by Virgin Blue, Jetstar and Tiger Airways entering the Australian market. The entry of new players was made possible through reforms allowing access to airport infrastructure, and to Australian domestic airline routes.

Reforms to airport infrastructure have also seen the transfer of airport ownership or management to the private sector and deregulate prices, with all 22 airports in Australia sold and in 2002 price caps were replaced with price monitoring.

The performance attributable to these various reforms is reflected in estimates of the growth in productivity over the period 1988-89 to 1998-99, with total factor productivity estimated to have grown at an average rate of 7.1 per cent per year (Forsyth 2000).<sup>2</sup>

Over this time there has been competition between airlines, on the basis of both price and quality. This competition has been to advantage of all airline consumers.

In addition to reforms to domestic air travel, there have been a range of reforms to international air travel, including:

<sup>2</sup> Total factor productivity (TFP) is a productivity measure that accounts for all factors of production (including, for example, intermediate inputs).



- negotiating reciprocal 'open skies' arrangements when considered to be in the national interest
- offering international airlines unconstrained access to international airports other than Sydney, Melbourne, Brisbane and Perth for freight and passenger services
- offering unrestricted access to all international airports for dedicated freighters (PC 2005).

#### 2.4 Scope for improvement: growing overseas wagering market

One area where Betfair feels that there is significant scope to grow the NSW wagering market is through increasing wagering among overseas customers. Financial information provided by Betfair provides a guide to the scope for improvement. Table 2.2 indicates that overseas-based customers account for 43 per cent of all active customers using Betfair to wager on NSW racing, but only 20 per cent of wagering volume<sup>3</sup>, and 13 per cent of commission received by Betfair. This discrepancy, particularly when compared to NSW resident Betfair customers, indicates that overseas customers frequently wager on NSW racing, but at relatively low stakes.

Table 2.2

#### WAGERING VIA BETFAIR ON NSW RACES (12 MONTHS TO MAY 2008)

Racing code	Customer location	Percent of code		
		Active customers	Commission	Wagering volume <sup>a</sup>
<b>Thoroughbred</b>	Australia - interstate	38	45	42
	Overseas	41	11	18
	New South Wales	21	43	40
<b>Harness</b>	Australia - interstate	31	36	35
	Overseas	52	23	29
	New South Wales	17	41	36
<b>Greyhound</b>	Australia - interstate	42	40	36
	Overseas	35	17	27
	New South Wales	24	44	37
<b>Total racing</b>	Australia - interstate	37	43	41
	Overseas	43	13	20
	New South Wales	20	43	39

Note: a = Wagering volume is 2 ↓ backers stakes.

Source: Betfair Australia

<sup>3</sup> Wagering volume = 2 ↓ backers stakes

The relatively low level of overseas wagering on NSW racing, compared to the number of overseas customers, suggests that global wagering providers, such as Betfair, may be able to use their global presence to increase the number of consumers wagering on NSW racing.

One factor limiting the growth in international wagering on NSW racing is the inability of Betfair, and other wagering providers, to provide racing audio-visual over the internet to international wagerers. In the absence of race vision, many overseas customers are reluctant to wager large amounts on Australian racing. Although this issue is beyond the scope of the *Independent review*, it is nevertheless related. For instance, the company holding the international internet rights to certain NSW races, Sky Channel, is owned by Tabcorp. The provision of internet audio visual to overseas wagerers is therefore indirectly controlled by Tabcorp. The other relevant party is ThoroughVision Pty Ltd (TVN).

## Chapter 3

# How betting exchanges operate

### Key Points

- Betting exchanges differ from existing wagering products in several ways - most notably the additional flexibility they provide customers including the capacity to accommodate direct 'lay' bets, in which customers bet on an outcome not to occur.
- In many other respects - such as the ability to obtain fixed odds superior to pari-mutuel odds, along with the need to establish an account and wager over the internet - betting exchanges offer a similar product to fixed-odds operators (especially corporate bookmakers). This opens to question the degree to which betting exchanges would divert customers from the TAB pari-mutuel product (which provides the vast majority of taxation revenue from wagering). Customers for whom the features of betting exchanges are attractive are already offered many of them by competitors to the TABs and may have already substituted.
- Establishing a definition of betting activity for betting exchanges that is comparable to the definition of activity applied to pari-mutuel and fixed-odds betting is problematic. Commission is also calculated on a different basis. These characteristics make it difficult to draw comparisons about the level of activity (i.e. volume or "turnover") on betting exchanges relative to other forms of wagering.
- Furthermore, the nature of betting exchange operations need to be taken into account when comparing product fee or industry contribution arrangements. The fairest way of determining product fee arrangements is on the basis of what punters spend with each operator (i.e. on a gross revenue basis).

### 3.1 Introduction

Betting exchanges are a platform for wagering that first emerged in 2000. Betting exchanges allow different customers to effectively bet directly against each other rather than against a betting operator. The betting exchange operator obtains revenues by charging commission on customers' net winnings. Wagering on betting exchanges has been largely enabled by the internet, although betting exchanges also accept bets via the telephone.

Betfair is the world's largest betting exchange. It has accepted bets on a comprehensive range of Australian racing and sporting events since early 2003 and now operates on several Australian race meetings daily.

### 3.2 How betting exchanges work

Betting exchanges operate under a different business model to that of TABs and bookmakers who operate pari-mutuel and fixed-odds betting systems.

In broad terms, betting exchanges facilitate transactions between punters with diametrically opposed positions. They essentially act as broker, matching fixed offers of odds and quantum of bets by parties willing to wager that an outcome will occur (backers) or will not occur (layers). In this regard, the key activity undertaken by betting exchanges is bookmaking, albeit conducted somewhat differently to a 'traditional' bookmaker.

In a sense, betting exchanges operate in a similar manner to a stock market, with individuals 'asking' and 'bidding' for a 'price' on a particular outcome. Due to the interactivity of real-time 'bidding' and 'asking', betting exchange participants require internet access, although Betfair also accepts bets via the telephone. Betting exchanges also require volume, which increases the range of odds available to be matched and the likelihood of those offers being matched.

Betting exchanges are different to the existing pari-mutuel and fixed-odds betting services, as operated by the TAB and corporate bookmakers. The key operational differences relate to the:

- level of risk incurred by the operator
- basis from which operators retain revenue from customers
- 'fixed' nature of odds to the customers
- ability for customers to oppose outcomes directly, and<sup>4</sup> set odds.

These are summarised in Table 3.1.

Table 3.1

**DIFFERENCES BETWEEN BETTING EXCHANGES AND OTHER WAGERING MODES**

	Betting exchange	Parimutuel	Fixed-odds betting
Risk to operator	None	None	Yes
Revenues to operator	Fixed percentage of customers' net winnings on a particular market	Fixed percentage of betting turnover on an event and bet type	Variable depending on bookmaker's exposure to risk. Risk is often offset through use of selected totalisators.
Odds for customers	Fixed	Not fixed	Fixed
Ability for customer to oppose an outcome directly	Yes	No <sup>a</sup>	No <sup>a</sup>
Ability for customer to set odds	Yes	No	No

Note: a = A punter can indirectly oppose an outcome in parimutuel or fixed-odds betting by backing the entire field minus one.

Source: The Allen Consulting Group

<sup>4</sup> Customers who oppose outcomes directly, i.e. bet that an outcome will not occur, are known as 'layers' of bets. Those on the opposite side of the transaction i.e. who bet that an outcome will occur, are known as 'backers' of bets.

### 3.3 Key concepts

#### *Price of betting*

Normally, the price of a good or service can be calculated by dividing total expenditure by the volume of units consumed. However, gambling is different and the price of gambling is often not obvious.

Punters either win or lose when betting, but lose on average — if punters did not lose on average wagering operators would not make a profit. In aggregate, the price of betting can be viewed as the sum of customer losses (or customer expenditure) relative to the volume of betting activity required to generate these losses.

For pari-mutuel and fixed-odds betting, the volume of *betting activity* is measured as wagering *turnover*. Turnover is the total amount staked by backing customers and which they therefore risk losing in a wager. Customer expenditure is equivalent to the *commission* retained (or 'taken out') by the betting operator after winnings are paid out to customers. In aggregate, commission is equivalent to the amount lost by customers.

For pari-mutuel and fixed-odds betting, the price of betting is expressed as the *commission rate* — the proportion of turnover deducted as commission. A lower commission rate (or lower prices) implies that customers lose (spend) less for the same amount of betting activity (turnover).

The pari-mutuel model provides the simplest illustration of these concepts. Operators extract a commission by retaining a portion of the pool of monies gambled, thus returning to winning punters a fraction of the entire pool. Although the level of commission differs across bet types (eg. win/place bets versus exotic bets), it is always calculated as a constant percentage of turnover. The commission rate for pari-mutuel betting at NSW TABs has recently been changed from being an average of 16 per cent of all TAB pari-mutuel wagering, to varying on the basis of the relevant product, ranging from a cap of 14.25 per cent for a place, to 22.5 per cent for the first four (West 2008).<sup>5</sup>

For fixed-odds betting, betting activity is again defined as the total amount wagered by customers but commission (measured as a percentage of turnover) is variable rather than constant. This arises due to the nature of fixed-odds betting. Operators must guarantee the returns on a winning bet 'on-the-spot' and are exposed to risk where winnings paid exceed the level of turnover. Operators manage this risk by factoring a commission into odds offered and endeavouring to construct a series of offsetting bets. These practices lead to some consistency in commission. For example, the commission rate achieved by on-course bookmakers has averaged at around 5.5 percent of turnover for the past 25 years.

<sup>5</sup> The NSW Government recently amended the *Totalizator Act 1997*, such that there is a commission rate cap for each of the different TAB products, instead of an average commission rate. These caps will be set at the current rates being charged for each product, comprising: win, 14.5 per cent; place, 14.25 per cent; quinella, 14.75 per cent; exacta, 16.5 per cent; trifecta, 21 per cent; duet, 14.5 per cent; doubles, 17 per cent; first 4, 22.5 per cent; quadrella, 20 per cent; and FootyTAB, 25 per cent.

As definitions of expenditure and betting activity are the same for pari-mutuel and fixed-odds betting, 'like' price comparisons can be made between TAB and bookmaker betting. That is, until the recent pari-mutuel commission cap changes, the price of betting with TAB Ltd has been approximately three times more than the price of betting with bookmakers (that is commission is 16 percent versus 5.5 percent of turnover).

However, as discussed below, there is no commonly accepted or directly comparable definition of betting activity for betting exchanges. As a consequence, the ability to draw price comparisons between betting exchanges, TAB Ltd and corporate bookmakers is not straightforward.

### **Betting activity**

In a betting exchange, a bet needs to be 'matched' between a backer and a layer before the bet is activated. Each wager 'matched' in a betting exchange effectively represents two separate bets. For example, a \$100 bet on a particular horse in a race, matched at a price of \$3 is equivalent to:

- \$100 staked by the backer, at a price of \$3
- \$200 staked by the layer, at a price of \$1.50.

In this instance, the backer will win  $\$200 = (3 \times \$100 - \$100)$  if the horse wins the race, and will lose \$100 if the horse does not win the race. Converse results hold for the layer. The layer will lose \$200 if the horse wins the race, and will win \$100  $(\$1.50 \times \$200 - \$200)$  if the horse does not win the race.

Defining betting activity as simply the aggregate wagers of backers, as occurs under parimutuel and fixed-odds betting, would therefore omit the wagers of layers. Such a definition may considerably understate the amounts wagered by customers.

Using the 'backers' and layers' stakes' definition of betting activity, which captures the stakes of backers and layers (equating to \$300 in the example above), would be more reflective of amounts wagered or money at risk. However, this is not consistent with the definition of betting activity under pari-mutuel and fixed-odds systems, where activity does not count the 'lay' bet implicit in each wager:

- for fixed-odds betting, the 'layer' of each outcome is the operator. Every wager made by customers (backing an outcome) corresponds to a 'lay' bet made by the operator.
- for pari-mutuel betting, the 'layers' of each outcome are those who back conflicting outcomes. Every wager made by customers (to back an outcome) simultaneously represents a 'lay' bet against conflicting outcomes — dividends to winning customers are funded from the stakes of losing customers.

Accordingly, the 'backers' and layers' stakes' definition of betting activity may overstate (double-count) betting activity compared to the alternative betting systems.

Betfair itself measures betting activity using the concept of 'matched bets'. This is the amount a 'backer' risks added to the amount a 'layer' stands to win (which equates to twice the amount wagered by the backer). Using the previous example, matched bets would be \$200. This method of defining betting activity calculates a figure in between the 'backer stakes only' (understated) and 'backers' and layers' stakes' (overstated) approaches discussed above.

A summary of these three definitions is presented in Box 3.1.

Box 3.1

### THREE DEFINITIONS OF BETTING ACTIVITY ON BETTING EXCHANGES

Betting activity on betting exchange can be defined three ways. Consider a \$100 bet by a backer at \$3, and matched by a layer. The backer stands to win \$200 or lose \$100. The layer stands to win \$100 or lose \$200.

- **Backers' stakes** - Backers' stakes is the sum of money staked (or risked) by backers (\$100 in this example). This definition is used to calculate pari-mutuel and fixed-odds betting activity.
- **Matched bets** - This is the amount staked by backers, added to the amount layers stand to win (which equates to twice the amount of backers' stakes or \$200 in this example). Betfair uses this definition.
- **Backers' and layers' stakes** - This is the total amount that backers and layers could lose, between them, which is \$300 in this example. This is the definition used by the Betting Exchange Taskforce.

Thus, on an entire market on a betting exchange, *backers' stakes* would be less than *matched bets*, which in turn would be less than *backers' and layers' stakes*.<sup>6</sup>

Source: The Allen Consulting Group

### **Betfair commission on net customer winnings**

Betfair does not deduct commission using any of the above definitions of betting activity, unlike pari-mutuel and fixed-odds operators who deduct their commission from turnover. Rather, Betfair's commission is calculated as a percentage of the net winnings of individual customers on an event. Net winnings take into account all monies wagered on the event, including those on conflicting outcomes. Accordingly, net winnings (and commission) may vary depending on:

- the odds of the winning outcome. This may increase or decrease the net winnings of an individual without changing the actual amount wagered
- the number of offsetting bets a customer makes on a single event (for example, where a customer backs or lays more than one runner in a race). Customers backing several outcomes may receive lower net winnings in the event that one of their bets is successful.

In effect, Betfair deducts commission only from money that changes hands in the system.

Importantly, these differences in gambling behaviour affecting net winnings and hence commission mean that it is difficult to draw a relationship between commission and betting activity.

<sup>6</sup> Note that matched bets and backers' and layers' stakes are the same for a two outcome event, such as a sporting contest between two teams where one team or the other will always win (i.e. no draws). Generally, in an event N contenders, layers' stakes = (N - 1) backers' stakes).

An example of differences in expected winnings under different odds can be observed by comparing the two scenarios presented in Table 3.2 and Table 3.3.

In the scenario presented in Table 3.2, total betting activity (backers' and layers' stakes), is equivalent to \$20 for an even money bet (that is, at a price of \$2). Assuming that the price is reflective of the true probabilities of winning (that is, 50 percent), Customer A (the backer) has a 50 percent chance of winning \$10 from Customer B, if the backed outcome eventuates, while Customer B (the layer) has a 50 percent chance of winning \$10 from Customer A, if Customer A's backed outcome does not eventuate.

The 'expected winnings' for each customer can be calculated by the multiplication of potential winnings by the probability of winning. Total expected winnings are the sum of expected customer winnings. Intuitively, this means that if this same event were conducted numerous times, then on average, a customer (irrespective of being a layer or backer) would be expected to win this amount.

Expected commission to Betfair is simply the commission rate (4.5 percent of customer winnings<sup>7</sup>) multiplied by expected customer winnings. Under scenario 1, expected commission is \$0.45, equating to 2.25 percent of betting activity (backers' and layers' stakes).

Table 3.2

**SCENARIO 1: ODDS OF \$2 FOR BACKER WIN**

	Customer A (Backer)	Customer B (Layer)	Total
Betting activity (backers' and layers' stakes) (\$)	10	10	20
Potential winnings (\$)	10	10	20
Probability of winning (%)	50	50	100
Expected customer winnings (\$)	5	5	10
Expected commission (\$) (@4.5 of winnings)	0.225	0.225	0.45
Expected commission rate as a percent of betting activity			2.25

Note: Expected winnings are calculated by the multiplication of potential winnings by the probability of winning.

Source: The Allen Consulting Group

The same scenario is presented in Table 3.3, except the odds and probabilities of winning are changed. Here, the probability of Customer A winning is lower (25 percent chance of winning), but the price is higher, reflecting the lower probability of winning. Keeping total betting activity the same as before, expected winnings under this scenario are lower as a proportion of total betting activity. Correspondingly, expected commission is also lower in this scenario (1.69 percent of activity versus 2.25 percent of activity).

<sup>7</sup> Betfair's commission rates range from 2 to 5 percent. The average rate of commission deducted by Betfair for its entire business is around 4.5 percent.



It can be shown that total expected winnings (and expected commission to Betfair) as a proportion of activity are maximised when the probabilities of winning are spread evenly across punters (backers and layers). Expected winnings as a proportion of activity are lower when there is a clear favourite in the market (and therefore divergent odds between backers and layers).

Table 3.3

**SCENARIO II: ODDS OF \$4 FOR BACKER WIN**

	Customer A (Backer)	Customer B (Layer)	Total
Betting activity (backers' and layers' stakes) (\$)	5	15	20
Potential winnings (\$)	15	5	20
Probability of winning ( )	25	75	100
Expected customer winnings (\$)	3.75	3.75	10
Expected commission (\$) (@4.5 of winnings)	0.17	0.17	0.34
Expected commission rate as a percent of betting activity			1.69

Note: Expected winnings are calculated by the multiplication of potential winnings by the probability of winning.

Source: The Allen Consulting Group

The scenario presented in Table 3.4 illustrates a situation where a customer makes multiple and offsetting bets to reduce his exposure to risk. This has an impact on commission retained by Betfair, as commission is only charged on net winnings.

For the first bet, Customer A places a \$6 wager on a particular outcome at a price of \$2, for a 50 percent chance of winning \$6. Customer B matches this bet by laying \$6 for a 50 percent chance of winning \$6 if the outcome does not eventuate.

After the first bet, the probability of the outcome backed by Customer A is reduced from 50 percent to 25 percent, and this is reflected by a change in the odds from \$2 to \$4. Because the odds on the initial bet are 'fixed' at \$2, Customer A would not be compensated for the additional risk incurred when odds lengthen. To reduce his risk, Customer A would make an offsetting bet, laying \$6 at the price of \$4 to win \$2 on the chance that the outcome will not eventuate. (The bet would be matched by Customer B who would back the outcome by placing a bet of \$2 at a price of \$4.)

If the outcome eventuates, then Customer A would win \$6 from his initial bet, but lose \$6 from his second bet, for net winnings of zero. Customer B would lose \$6 from his initial bet but win \$6 from his second bet, for net winnings of zero. As total net winnings are zero, Betfair retains no commission.

If the outcome did not eventuate, then Customer A would lose \$6 from his initial bet, but win \$2 from his second bet, a net loss of \$4. Despite winning on his second bet, net winnings are negative and Customer A would not pay commission to Betfair. Similarly, Customer B would win \$6 on his initial bet, but lose \$2 on his second bet. Customer B's net winnings would be \$4, from which commission is levied.

Thus, as presented in Table 3.4, commission to Betfair would range from zero to \$0.18 with backers' and layers' stakes of \$20. This level of commission is lower than scenario 1 and 2, despite the same level of betting activity. In this instance, total betting activity (backers' and layers' stakes) gives a misleadingly inflated picture of the amount of risk that is being incurred in this betting market, because Bet 2 is being placed to offset risk from Bet 1, rather than add to it.<sup>8</sup>

Table 3.4

**SCENARIO III: MULTIPLE BETS**

	Customer A	Customer B	Total
Bet 1 (Customer A backs at odds of \$2 on outcome to eventuate) - \$6 wager	6	6	12
Bet 2 (Customer A then lays \$2 wager at odds on outcome not to eventuate) - \$2 wager	6	2	8
<b>Total betting activity</b>	<b>12</b>	<b>8</b>	<b>20</b>
<i>Outcome eventuates</i>			
Customer winnings	6	6	12
Customer losses	6	6	12
Net winnings	0	0	0
Commission @ 4.5 of net winnings	0	0	0
<i>Outcome does not eventuate</i>			
Customer winnings	2	6	8
Customer losses	6	2	8
Net winnings	(4)	4	0
Expected commission @ 4.5 of net winnings	0	0.18	0.18

Source: The Allen Consulting Group

<sup>8</sup> In this respect, the betting market depicted in Table 3.4 - which reflects an important feature of actual Betfair betting markets, that they are 'grossed up' over time as a result of risks being hedged - can be compared to financial markets for derivative contracts (swaps, options etc). In April 2007, the average daily turnover in the Australian over-the-counter financial derivatives markets exceeded US\$29.5 billion (Cassidy et al 2008). This apparently huge amount vastly overstates the amount of risk actually incurred in those markets, because most of this turnover was due to the hedging (offsetting) of risks previously incurred.

### 3.4 Taxation of betting exchanges

In the United Kingdom, betting exchanges are currently taxed so that operators pay 15 per cent of commission (gross revenues). This regime was established in 2003 and brought the tax treatment of betting exchanges into line with all other bookmakers in the country (all bookmakers in the United Kingdom, including betting exchanges, pay tax at a rate of 15 per cent of their gross profits). In Tasmania, betting exchanges are currently taxed so that operators pay 15 per cent of their gross revenue.

TAB pari-mutuel and fixed-odds services are also taxed as a constant proportion of their commission.<sup>9</sup>

The linear relationships between turnover and commission, and commission and taxation, mean that taxes on TABs can be expressed as a constant percentage of turnover.

It is centrally important to recognise that commission and hence taxes of betting exchanges cannot be measured as a fixed proportion of turnover, however turnover is defined. As discussed in section 3.3, the degree of correlation between commission and turnover for betting exchange operators is far weaker than for parimutuel or fixed-odds operators. Levying taxes as a fixed proportion of turnover would expose a betting exchange to losses (when tax exceeds commission), particularly where turnover has been inflated by customers establishing offsetting wagers. More importantly, from a competition standpoint, this would represent a percentage of the betting exchange's gross revenue that is approximately 6 times higher than the TAB's. Such a relative tax rate would make it impossible for the exchange to compete in the market and can only lead to higher (worse) prices for consumers.

### 3.5 Racing industry contributions from betting exchanges

In the various Australian jurisdictions, it is commonplace for wagering operators to pay a product fee, or contribution, to the racing industry. This payment reflects the fact that the racing industry provides the product on which wagering operators generate turnover and profits.

The issues paper (section 3.1) provides a detailed overview of the product fee arrangements currently operating in NSW. In summary, TAB Ltd pays approximately 21.9965 per cent of its gross revenue to the racing industry, with these funds distributed between the various codes via the inter-code agreement. On-course bookmakers make a contribution to the racing industry by paying a levy directly to the race club where they are operating. This levy may be based on turnover, or be a stand fee. Finally, 'off course' corporate bookmakers pay on turnover, but at a lower rate than on-course bookmakers.

<sup>9</sup> Except in Western Australia

At present, there are no arrangements in place whereby betting exchanges make a contribution to the NSW racing industry. The general approach taken in jurisdictions where an agreement has been reached sees betting exchanges paying a percentage of gross revenue to the racing industry. For example, in Tasmania at present, Betfair contributes 31.4 per cent of its gross revenue to the Tasmanian racing industry (20 per cent of gross revenue is paid as direct product fee and 11.4 per cent of gross revenue which is part of the tax paid to the Tasmanian Government is passed to the racing industry). In the United Kingdom and Ireland, Betfair pays a horse racing levy, comprising 10 per cent of gross revenues. Arrangements for betting exchanges to make a contribution to the racing industry are discussed in more detail in Chapter 4 and 5.

### 3.6 Substitution and market growth

The introduction of betting exchanges may lead to gambling expenditure being diverted from existing wagering operators (the substitution effect) and/or expanded if new customers take up wagering or existing customers are motivated to spend more.

The Productivity Commission in its 1999 inquiry into Australia's gambling industries examined determinants of the demand for gambling products and substitution. The Productivity Commission identified the following factors as influencing this demand (PC 1999, chapter 3):

- the price of the gambling product and the size of the prize
- the probability of winning and the extent to which the probability can be changed by skill
- accessibility of the gambling product
- the experiences associated with the venue and the social acceptability of the activity.

These and other factors with implications for expenditure on betting exchanges are discussed below.

#### *The price of gambling products*

As mentioned previously, the price of a gambling product refers to the commission or take-out rate of the product (or the margins received by the gambling operator).

The Productivity Commission found that price sensitivities of gambling vary between different products. Demand for lotteries products is generally price insensitive because the infrequency of payouts makes prices hard to observe. In addition, the size of the prize pool is very large relative to the initial investment by any individual.

For wagering on races, the price of gambling is more observable because of the greater frequency of payouts. Consequently, wagering consumers may be more price sensitive than other customers when choosing products offered by different operators.

<sup>10</sup> Note that gross revenue is defined as the total commission received by the betting exchange. Gross betting exchange revenue is not the value of matched bets.

Take-out rates for various wagering products offered in NSW are presented in Table 3.5. Although it is difficult to draw comparisons between the price of betting exchanges and those of other operators (owing to the complexities identified in the previous section), betting exchanges are generally recognised as offering more favourable odds vis-à-vis existing totalisator and fixed-odds betting operators. This would tend to stimulate expenditure being diverted from bookmakers and the TABs to betting exchanges. In particular, other things being equal, the more favourable odds offered by betting exchanges may attract big punters ('high rollers').<sup>11</sup>

Table 3.5

**PRICE OF NSW WAGERING ACTIVITIES**

Gambling product or operator	'Price'
NSW TAB Ltd Pari-mutuel <sup>a</sup>	
• Win bets	14.5 per cent of turnover
• Place bets	14.25 per cent of turnover
• Quinellas	14.75 per cent of turnover
• Exactas	16.5 per cent of turnover
• Trifectas	21 per cent of turnover
• Duets	14.5 per cent of turnover
• Quadrellas	20 per cent of turnover
• Doubles	17 per cent of turnover
• First 4 bets	22.5 per cent of turnover
TAB fixed-odds <sup>b</sup>	19 per cent of turnover
Bookmaker fixed odds <sup>c</sup>	5.20 per cent of turnover
Betting exchanges <sup>d</sup>	2 to 5 per cent of net customer winnings

Note: a = NSW TAB Ltd pari-mutuel 'prices' reported above are maximum caps, replacing the previous annual average 'price' of 16 per cent across all TAB pari-mutuel products.

b = TAB fixed odds 'price' estimated from analysis of historical fixed odds closing prices.

c = Allen Consulting Group estimates

d = Betting exchange 'prices' are dependent upon individual customer wagering volume.

Source: The Allen Consulting Group and West 2008.

The recent imposition of product-based price caps by the NSW Government for NSW TAB Ltd pari-mutuel products reduces the price flexibility of the TAB, and thus its ability to compete with other wagering providers.

<sup>11</sup> The Productivity Commission reports that 'high rollers' are highly responsive to the 'price' of gambling, and for this reason are offered commission to gamble at some casinos (PC 1999, Appendix D).

A very important issue in modelling the impacts of product fees paid by betting exchanges is the price elasticity of demand for wagering products — in essence, how gamblers respond to decreases (or increases) in the price of wagering. A price elasticity of demand of one implies that a customer will offset any price changes with different staking behaviour so that the total amount they spend remains constant.<sup>12</sup> In this case, operator gross revenues will also remain unchanged because wagering expenditure equates to operator commission. Where the price elasticity of demand is greater than one, customers will increase expenditure by proportionally more than the decrease in price. Conversely, an elasticity less than one means a price increase will lead to a decrease in the amount spent by a customer. Changes in expenditure will be manifest in the customer increasing either the size of wagers or the number of wagers.

The price elasticity of demand for wagering is important because it indicates how commission (customer expenditure) varies with commission rates (price). As product fees are typically levied on commission, it therefore links the price of wagering to product fee revenues. Critically, this allows the impact on product fee revenues of introducing lower price betting exchanges to be estimated.

Empirical estimates of the value of price elasticity of demand for gambling range from 0.60 to 2.50. These are outlined in Table 3.6. There is clearly variability in these figures; in particular, there is no consensus on whether the elasticity of demand is greater or less than one. However, in a report in 2000 for HM Customs and Excise, Paton *et al* conclude that there is evidence that the price elasticity of demand increased significantly over the previous decade and will be likely to do so in the future, as the ability of consumers to choose amongst an increasing number of alternative operators makes them more price sensitive (Paton *et al* 2000). Furthermore, it could be argued that as Betfair's customers are likely to be relatively more informed and significant consumers of gambling products, they are going to be more price sensitive than the 'average' gambling consumer, and so their price elasticity is likely to be relatively high.

Nevertheless, in the modelling in Chapter 5, an elasticity of one is assumed in the estimation of the product fee impacts which will follow from a switch of wagering demand from TABs to Betfair. This is a convenient modelling assumption, because it means that consumers who switch to Betfair in response to Betfair's lower prices will spend (i.e. lose) exactly what they would have spent with the TABs, and. The question of interest is then how many times consumers will need to recycle their bets to generate the same losses, given that they will retain, on average, a greater proportion of their betting stake with Betfair than with the TABs.

However, this assumption, it must be stressed, is conservative. If the price elasticity of demand for Betfair's products is larger than one, then Betfair's customers are likely to spend more than they would with the TABs, in which case racing industry revenues are going to be higher.

<sup>12</sup> Elasticity is normally presented as a negative number. For this analysis, elasticities are presented as absolute values.

Table 3.6

**ESTIMATES OF THE PRICE ELASTICITY OF DEMAND FOR GAMBLING**

Source	Area	Elasticity
Paton et al (2001)	UK	1.19 to 2.50
Europe Economics (1998)	UK	0.60 to 0.70
BERL (1997)	New Zealand	0.72
Morgan and Vasche (1979)	US	1.48
Suits (1979)	US	1.36 to 1.82
Gruen (1976)	US	1.57

Source: [The Allen Consulting Group](#)

**Skill**

The probability of winning, and the ability to influence the probability of winning can affect a consumer's decision on whether to gamble, how much to gamble and which product to choose. Gambling involving a high element of skill would tend to attract 'serious' gamblers who believe their judgement of the probability of event outcomes is superior to that of other gamblers.

Serious gamblers were also found by the inquiry to have a reduced tendency to substitute into products requiring lower skill levels. The Productivity Commission recognised that some punters would never substitute wagering on horseracing with other forms of gambling because betting on horseracing is considered by these punters to involve an element of skill through following 'race form' (PC 1999, p. D.7). Conversely, 'recreational gamblers', who treat wagering in much the same way as gaming, would readily substitute any form of gambling (PC 1999, Appendix D).

Wagering on betting exchanges is a form of gambling that may require a higher element of skill and effort vis-à-vis traditional pari-mutuel betting since customers are required to have knowledge of:

- internet technology
  - racing and sports form
- probabilities and the 'fixed-odds market'.

Consequently, betting exchanges may be too demanding for the pure recreational customer.

**Accessibility**

Another factor influencing substitution between gambling products is the accessibility of products. Accessibility can be considered a measure of the overall cost of gambling, because it includes transaction costs such as the cost of travel to the venue, or the price of a telephone call or internet usage.

The importance of accessibility in demand for the products is evident in research findings that levels of pari-mutuel wagering were highly dependent on the costs of travel to a location where a wager could be placed (Ali and Thalheimer 1997). This research indicates that punters will readily shift wagering expenditure to a different operator in response to a reduction in the total cost of the wagering activity.

Accessibility to betting exchanges is facilitated by access to the internet, through a gambling account funded via a credit card or bank account. These factors restrict the accessibility of the product, because potential customers must have access to the internet, and they must also be willing to satisfy the requirements associated with gambling through an account (including the provision of relevant personal details and acceptance of settlement terms and conditions including an agreement to waive their rights to anonymity). TAB and on-course bookmaker retail customers do not face the same obligations.

Because gamblers are already able to access TAB and bookmaker services through the internet, the reliance of betting exchanges on this medium is unlikely to further increase accessibility. It is unlikely to drive the substitution of wagering turnover from TABs, or significantly grow the wagering market. Instead, this reliance limits the type of customers betting exchanges might attract from these operators.

### ***Product enjoyment and experience***

The extent of the substitution effects between products may be influenced by experiences at the venues of the gambling activity and the social acceptability of the gambling activity. For example, most casinos complement gaming activities with other forms of social entertainment. Likewise, the TABs introduced agencies in hotels and pubs in the late 1980s to enable wagering products to be offered in conjunction with other entertainment products.

Therefore, it is unlikely that betting exchanges would divert customers of TABs and on-course bookmakers who prefer the social atmosphere of TAB retail outlets and on-course racing.

The vast majority of TAB wagering turnover is derived from retail outlet customers. For the NSW TAB, retail outlet thoroughbred racing turnover (including on-course) comprised 80 percent of total turnover in 2006-07 (Australian Racing Board 2008). Likewise, the Betting Exchange Taskforce estimated that 80 percent of TAB turnover is provided by retail customers (Betting Exchange Taskforce, 2003, p. 102).

### ***New product***

Innovative new products in any industry may attract additional consumers to the market or cannibalise existing products. The major innovation of betting exchanges is increased flexibility for the customer, including their ability to accommodate 'lay' bets. Laying is technically possible under the traditional models but is generally less practical — in essence, every other runner in the field would need to be backed (a 'Dutch book'). Of course, more 'leverage' can be obtained (thus making it easier to 'lay') when backing all other outcomes in a more exotic bet such as a quinella or a trifecta.



The flexibility inherent in betting exchanges also attracts betting activity where a customer may hitherto have refused to bet altogether at the 'wrong' price. For instance, a value-sensitive customer who considers that backing a particular runner at \$5 is good value but currently has no option other than to walk away if only offered \$3, can use an exchange to take the opposite view (i.e. to lay the runner).

In addition, betting exchanges also offer a unique degree of interactivity compared with other wagering products through their 'active' approach to gambling. Betting exchanges allow customers to submit wagering offers rather than simply accept odds presented by others, and to monitor and manage their risk position over time. As such, this new element may entice a new form of 'arbitrage customer' who currently 'gambles' on the stock exchange or on financial markets.

Betting exchanges also provide enhanced access to certain information. Customers can directly observe real-time transactions incorporating runners backed, amounts wagered, and odds agreed. Pari-mutuel and bookmaker models do not offer this transparency.

Betting exchanges also require customers to locate an opposing offer before a wager is activated. This may require timely, continual monitoring of fluctuations in odds and betting — this element could attract new customers (who enjoy monitoring odds), or deter customers (who like the convenience of pari-mutuel betting).

More significantly, the betting exchange model is incompatible with a number of bet types popular with TAB customers. These are the 'exotic' bets, such as quinellas, trifectas and quadrellas. Betting exchanges can only accommodate win, place, and to a lesser extent doubles bets. Exotic bet types are estimated to comprise in the order of 33 percent of TAB thoroughbred racing turnover (Australian Racing Board 2008).

## Chapter 4

# Betfair in operation

### Key Points

- Since commencing operations in Great Britain in 2000, Betfair has experienced significant growth in both customer numbers and gross revenues. This growth has also been experienced in Australia since Betfair obtained a licence to operate in Tasmania in February 2006.
- In the various jurisdictions where Betfair operates around the world, the local racing industry has grown following Betfair's entry. This growth is in contrast to the stagnation experienced in the NSW racing industry.
- Betfair has contributed to the local racing industry through paying product fees and providing sponsorship and prize money.
- Although Betfair has grown over the past two years, Betfair is still a very small player in the New South Wales wagering market. It has just over 16 000 NSW customers.
- Five technological forces have contributed to the growth of Betfair. It is important that government regulation is used to encourage innovations such as Betfair, in a way that allows the entire NSW wagering industry to flourish.

### 4.1 Introduction

This chapter provides an overview of the operations of Betfair in both Great Britain and Australia, particularly Tasmania. Included are details of the growth in Betfair customers and betting activity, as well as the contributions made by Betfair to the racing industry in Australia and Great Britain. The chapter also considers the impact of Betfair upon the wagering and racing industries in Great Britain and Australia. Finally, the chapter considers the factors that may explain the growth of Betfair since it commenced operations in 2000.

### 4.2 Betfair in Great Britain

Betfair commenced operations in Great Britain in 2000, with the first betting markets offered by Betfair being for horse racing.

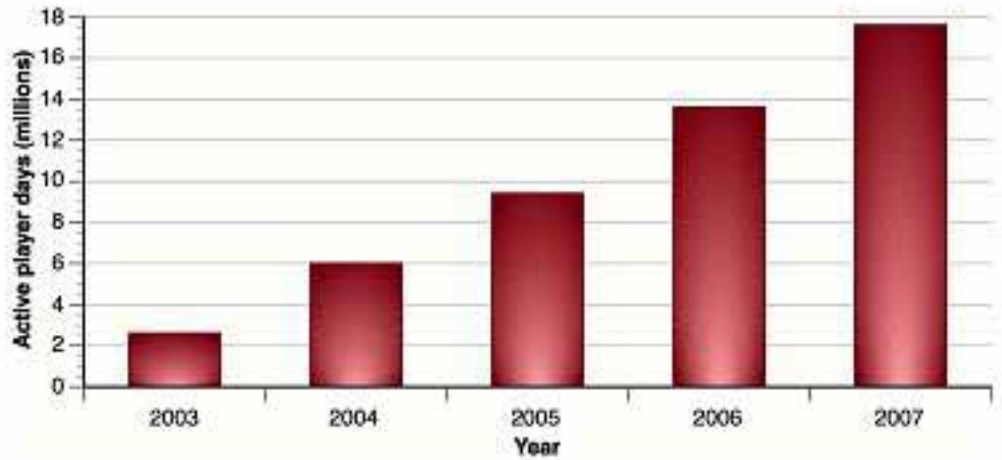
#### *Betfair performance following entry*

The rapid growth of Betfair is reflected in both financial and activity performance data. Figure 4.1 details Betfair active player days over the period 2003 to 2007, growing from approximately 2.3 million days in 2003 to 17.8 million days in 2007.<sup>13</sup> The financial and activity data reported below relates to all Betfair operations, including on-line poker and gaming.

<sup>13</sup> Active player days are the total number of days in a given period in which active players have wagered with Betfair.

Figure 4.1

**BETFAIR ACTIVE PLAYER DAYS (FOR YEAR ENDED 30 APRIL)**

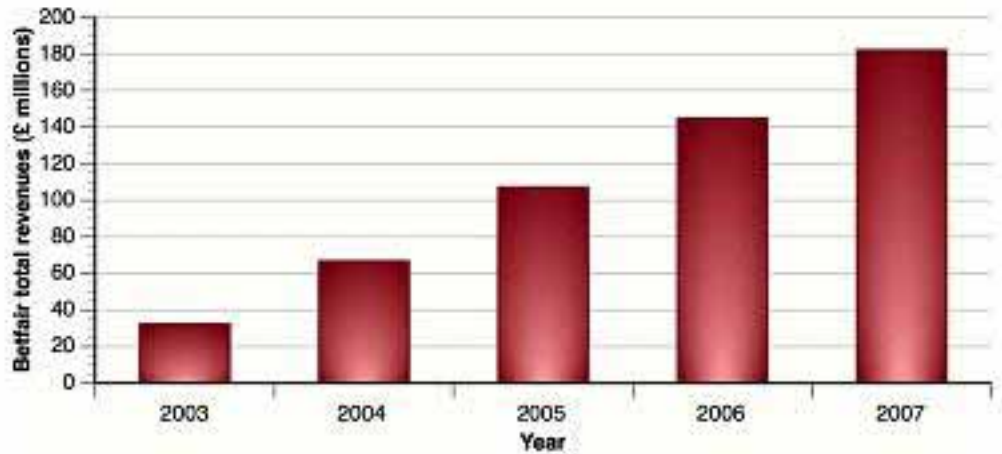


Source: Betfair Corporate

The growth in active player days is closely reflected in Betfair revenue data (see Figure 4.2). Gross revenues reached £181.9 million in 2007, with profits after taxation of £19.4 million. The vast majority of revenue is from commissions collected by Betfair — as noted above, Betfair revenue is not the value of matched bets made through Betfair.

Figure 4.2

**BETFAIR TOTAL REVENUES**



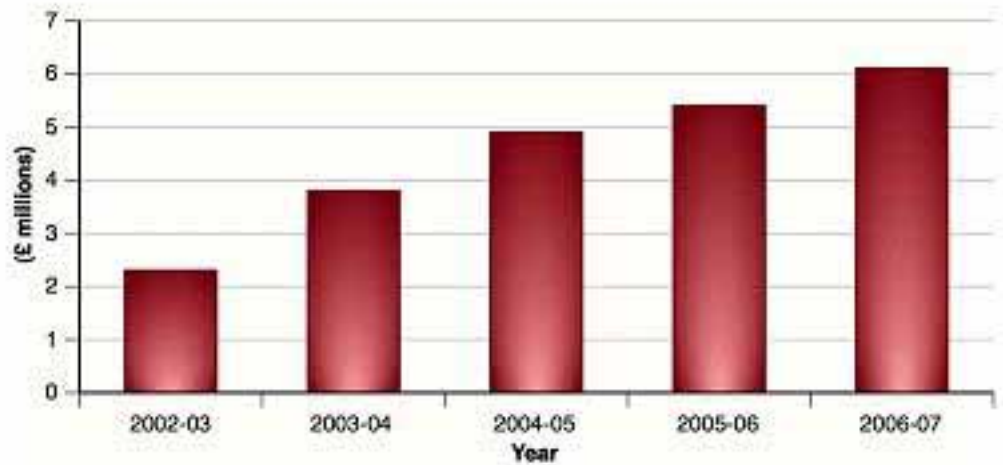
Source: Betfair Corporate

### ***Contribution of Betfair to the British racing industry***

Betting exchanges have made increasing direct contributions to UK horse racing industry through a levy, with payments increasing from £2.3 million in 2002-03, to £6.1 million in 2006-07 (see Figure 4.3). The share of the levy paid by betting exchanges has increased over this time from 2.9 per cent to 6.2 per cent. As noted in section 3.5, this levy is based upon 10 per cent of betting exchange gross revenues from horse racing (i.e. 10 per cent of commission). The same levy is paid by other British wagering platforms.

Figure 4.3

#### **GREAT BRITAIN HORSERACE BETTING LEVY — PAYMENTS BY BETTING EXCHANGES**



Source: Horserace Betting Levy Board

In addition to supporting the British horse racing industry through the payment of the horserace betting levy, Betfair also contributes to raising the profile of racing through advertising and increased public awareness. For example, Betfair is a sponsor of British races, such as the Betfair Million.

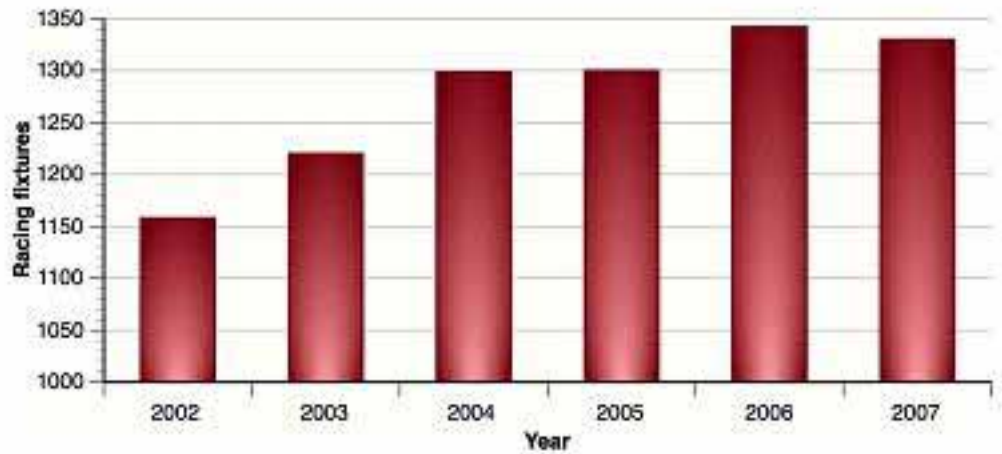
### ***Impact of Betfair on the British racing industry***

Since the entry of Betfair in 2000, the Great Britain racing industry has grown steadily, with this growth reflected in key measures such as racing fixtures (Figure 4.4) and prize money (Figure 4.5). It is understood that this growth occurred in response to betting operators (predominantly offcourse bookmakers) requesting additional racing fixtures.

Over the period 2002 to 2006, the number of horse racing fixtures has increased from 1158 to 1342. Similarly, the total horse racing prize money has increased in real terms over the same period from £91 million in 2002, to £103 million in 2006, representing real growth of 6.5 per cent.

Figure 4.4

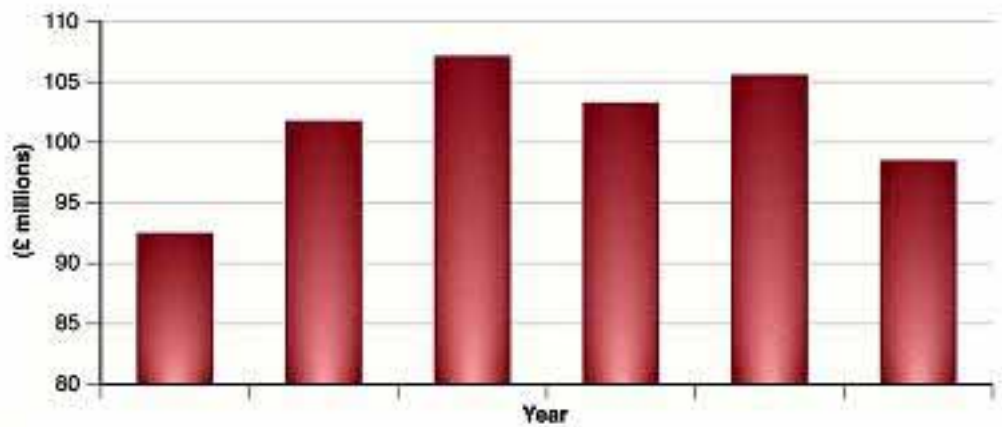
**GREAT BRITAIN HORSE RACING FIXTURES**



Source: British Horseracing Authority

Figure 4.5

**GREAT BRITAIN RACING INDUSTRY PRIZE MONEY**



Source: British Horseracing Authority

The growth reported above in British horse racing is also reflected in wagering operator gross revenues, increasing from £858 million in 2002-03 to £1119 million in 2004-05 (latest data available). This growth led Deloitte, in a report on the economic impact of British racing, to observe:

The significant growth in the betting industry's gross win from British horseracing is in contrast to the experience of most other major racing nations where profits are in decline.

Deloitte 2006

### 4.3 Betfair in Australia

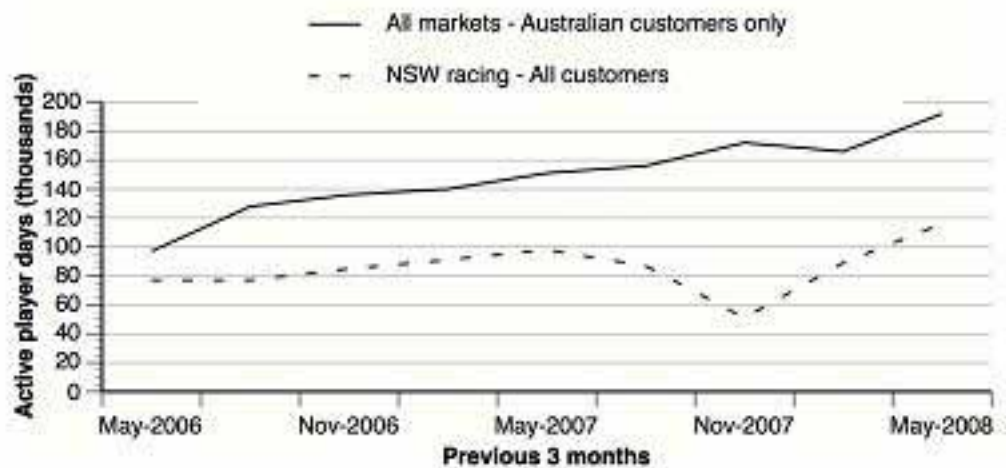
#### *Betfair performance following entry*

Since obtaining a licence to operate in Tasmania in February 2006, Betfair has experienced significant growth in both members and player activity in Australia.

Figure 4.6 displays the growth in active player days amongst all Australian customers across all wagering activities, and for all Betfair customers (including international customers) wagering on NSW racing. The dip in NSW race wagering in the three months to November 2007 is attributable to the equine influenza (EI) outbreak that severely disrupted NSW horse racing. Of particular note is that the EI outbreak did not affect total active player days for Australian customers, highlighting the substitutability of other wagering products for NSW race wagering.

Figure 4.6

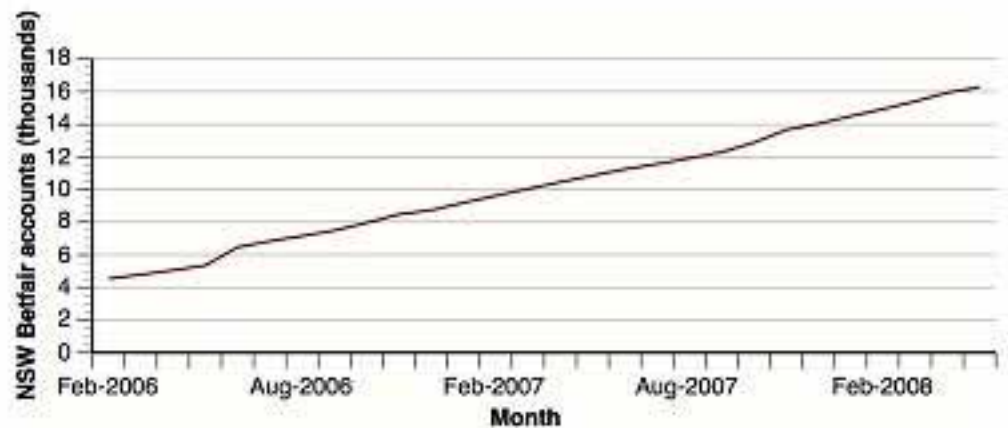
#### BETFAIR ACTIVE PLAYER DAYS



Source: Betfair

Betfair has also seen steady growth in the number of NSW-based account holders, growing from around 4 500 in February 2006 to currently reach around 16 000 in May 2008. This contrasts to TAB having 140 000 account holders across Australia at July 2007 (Tabcorp Holdings 2007).

Figure 4.7

**BETFAIR - NSW BASED ACCOUNT HOLDERS**

Source: Betfair

***Contribution of Betfair to the Australian racing industry***

In Tasmania, Betfair contributes over 30 per cent of gross revenues to the Tasmanian racing industry in product fees and taxes which are passed on from the Tasmanian Government. In 2006-07, the first full financial year of Betfair's operations in Tasmania, Betfair provided a direct contribution to the Tasmanian racing industry of \$5.6 million in 2006-07 through product fees. This contribution occurred at the same time as TOTE Tasmania provided a record contribution to the Tasmanian industry of \$20.4 million, with TOTE Tasmania revenues increasing by over 20 per cent in the previous year. Betfair made a contribution to the Tasmanian racing industry of \$6.2 million in 2007-08.

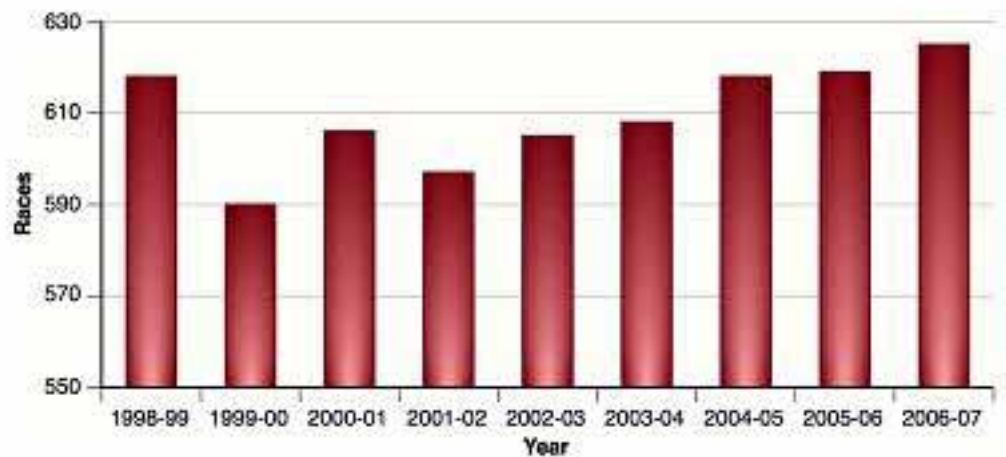
Since commencing operations in Tasmania, Betfair has also been a prolific sponsor of racing and sporting events across Tasmania.

***Impact of Betfair on the Tasmanian racing industry***

Analysis of the available data suggests that the Tasmanian racing and wagering industry has grown following the commencement of Betfair operations in February 2006. For example, the number of races has grown steadily in recent years (see Figure 4.8), with the introduction of Betfair in 2006 not appearing to dampen this growth.

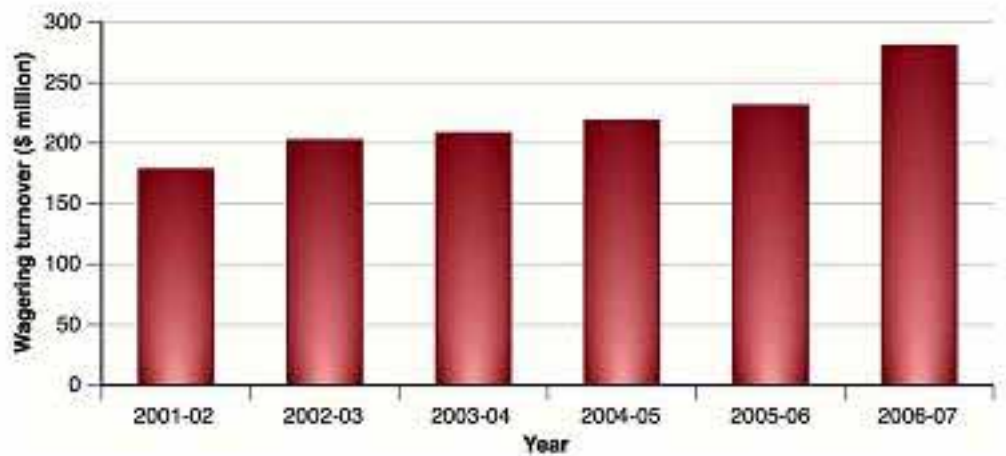
Furthermore, the entrance of Betfair corresponds with their being an upward spike in Tasmanian wagering turnover (see Figure 4.9), with turnover increasing by nearly \$50 million between 2005-06 and 2006-07.

Figure 4.8

**NUMBER OF HORSE RACES IN TASMANIA**

Source: Australian Racing Fact book, table 59.

Figure 4.9

**TASMANIAN HORSE RACE WAGERING TURNOVER**

Source: Australian Racing Fact book, table 83.

**4.4 Analysis of growth of Betfair**

In the various wagering markets where Betfair has commenced operations, it has experienced rapid growth in customer numbers and volumes of matched bets. There are a wide range of factors behind this success.

A recent academic article uses the 'five technology forces' to explain the growth of Betfair in the United Kingdom (Davies et al 2005). These forces also provide insight into how government regulation should potentially respond to innovations such as Betfair. These forces comprise:

- ongoing growth in computer speed, combined with falling computer prices, provide customers and firms access to enormous computer processing power



- ever increasing customer numbers increase liquidity in wagering markets, thus increasing market efficiency and stimulating further growth
- ongoing internet expansion (number of people with access, and internet speed), which provides the medium for betting exchanges at a low transaction cost
- innovations of the type developed by Betfair rarely originate from within an industry's traditional players, who are often wary of innovations
- existing government regulations and industry 'arrangements' often do not 'fit' innovations such as Betfair.

The last force identified above is highly relevant to the *Independent review*. Existing NSW regulations do not 'fit' innovative wagering operators, highlighting the need for the NSW Government to develop an innovative regulatory model which allows wagering operators to continue to be innovative, and which encourages the NSW wagering industry.

Section 2.3 of this submission provided examples of how a selection of Australian industries flourished following regulatory liberalisation. The telecommunications and financial services industries were able to harness the rapid developments in information communications and technology (ICT), in combination with regulatory liberalisation, to vastly increase productivity to be benefit of consumers. Without the liberalisation of regulations it is doubtful whether such improvements would have been made.

## Chapter 5

# Potential regulatory arrangements in New South Wales

### Key Points

- At the present time, Betfair is licensed to operate from Tasmania, and permitted to accept bets nationally. However, Betfair, along with other interstate and international wagering operators, is not permitted to advertise in NSW.
- Although NSW residents are allowed to be Betfair customers, the NSW racing industry appears to prevent NSW bookmakers and course patrons from using Betfair on-course. This is despite the Australian Racing Board's decision in 2006 to remove the Rule of Racing which prevented persons on a race course from using betting exchanges.
- There are no formal arrangements in place which will allow Betfair to make direct financial contributions to the NSW racing industry via product fees. Neither is Betfair able to provide sponsorship to races through providing prize money.
- A more liberal regulatory regime in NSW would see all wagering operators treated equitably. This would comprise equitable product fee arrangements - based on the same percentage of gross revenue (i.e. punter expenditure) in combination with publish to race field data, the ability to advertise, and on-course wagering.
- A more liberal regulatory environment will also enhance competition, encouraging innovation amongst wagering providers.
- Economic modelling indicates that provided there is equality in product fee arrangements, any movement of customers to betting exchanges from other wagering operators will be neutral for the racing industry.
- Drawing upon the overseas experience, wagering operator innovation is likely to draw additional customers to race wagering, leading to increased contributions to the racing industry, and elevating public interest in racing more generally.

### 5.1 Introduction

As noted earlier in this submission, Betfair is currently licensed to operate from Tasmania, and permitted to accept bets nationally. However, Betfair, along with other interstate and international wagering operators is not permitted to advertise in NSW.

In considering the status quo, the *Independent review* issues paper asks the question:

Is there a combination of concessions that could be offered to bookmakers and/or betting exchanges to create incentives to financially contribute to the NSW racing industry. What level of support should be expected? Such concessions could include, for example: allowing them to advertise in NSW; access to race field data for operators located and licensed in NSW; and so on.

NSW Wagering Review 2008, Q5.7, p. 40.

Betfair is seeking the two concessions outlined above, namely allowing betting exchanges to advertise, and access to race field data. The recent announcement by the NSW Government of new regulations allowing NSW racing bodies to levy a fee of up to 1.5 per cent of wagering turnover for wagering providers to access race field data, potentially undermines consideration of this issue by the *Independent review*.

In the absence of wider liberalisation of the NSW wagering market, the proposed race field fee of 1.5 per cent of wagering turnover will adversely affect the financial viability of wagering providers operating in NSW. For example, it has been estimated that NT-based bookmakers would see their margins reduced by approximately 30 per cent as a result of the race field fee (When 2008). Assuming TAB continues to fix its prices at the cap set by government, the 1.5 per cent product fee would erode approximately 75 per cent of its profit margin on NSW racing. This potential outcome makes it difficult to understand how the holding company could applaud the decision made by the racing industry to charge all local and interstate wagering operators an additional 1.5 per cent product fee when there is no right of set off for payments made in their home jurisdiction.

Related to the above issue, is a further question asked in the issues paper:

Should the NSW Government seek to protect or expand TAB Ltd's revenue on the grounds that a percentage of such revenue is used to support the NSW racing industry?

NSW Wagering Review 2008, Q5.10, p. 41.

This question is somewhat limiting in that it only considers the contributions received by the racing industry from TAB Ltd. It is also necessary to consider potential racing industry revenue from all wagering, and not just revenue provided by TAB Ltd. An overall increase in racing industry revenue from wagering is clearly a positive outcome for the racing industry compared to the current stagnation.

Accordingly, this chapter outlines a potential industry contribution regime, and considers its implications for racing industry revenues, as well as for TAB Ltd.

## 5.2 Options for new regulatory arrangements in New South Wales

As part of reforms to NSW wagering legislation, Betfair is seeking the following:

- the ability to advertise in NSW, including providing race prize money access to race field data
- the ability for customers to use Betfair while on-course.

In exchange for these reforms, Betfair proposes that interstate and international wagering operators pay a wagering product fee (i.e. industry contribution) based upon gross wagering revenues. Fees for access to race field data would be inclusive of this fee. Betfair currently pays a wagering product fee of 20 per cent of gross wagering revenues in Tasmania (the additional 11.4 per cent that the Tasmanian racing industry receives from Betfair is via the Tasmanian Government from tax paid by Betfair), and a rate of 10 per cent in Great Britain and Ireland.

As noted in Chapter 3, gross wagering revenues equate to the commission received by Betfair from net wagerer winnings in an individual market. The commission received by Betfair ranges between 2 and 5 per cent of net wagerer market winnings, with the amount of commission charged by Betfair dependant upon the level of individual betting activity.

<sup>14</sup> The relevant legislation, *Racing Administration Amendment (Publication of Race Fields) Regulation 2008* indicates that the race field fee may be up to 1.5 per cent of wagering turnover. Racing NSW has announced that it charge the maximum fee of 1.5 per cent.

This proposed product fee rate would also be applied to TAB Ltd.

### 5.3 Potential impacts of new regulatory arrangement options

#### *Modelling of fee arrangement options*

To examine how the payment of product fee for betting interstate and international wagering operators may work, a simple economic model has been developed. This model assumes a product fee rate of 20 per cent of gross wagering revenues.

This model compares the product fee payable by TAB on the 'losses' made by an individual punter placing 'to-win' bets, compared to those payable by Betfair from commission received from an individual punter. A number of scenarios are considered below.

The first scenario compares an individual punter wagering \$200 in 'to-win' wagers either through the TAB or Betfair until the funds are exhausted. This scenario also indicates the potential additional revenues able to be received by the racing industry from new wagerers attracted into the wagering market. Such growth could occur through Betfair advertising, if permitted, raising the awareness of racing.

The second scenario takes into account the fact that in effect, for every backer using Betfair, a layer is required to match the backer. This scenario therefore considers what level of movement between TAB backers and Betfair backers can occur, and maintain revenue neutrality in terms of product fees paid to the racing industry.

Finally, the third scenario considers the likely revenue implications for the racing industry of the liberalisation of NSW wagering regulations. In particular, this scenario considers the potential revenue implications for the NSW racing industry of regulatory liberalisation leading to growth in the overall wagering market.

#### *Scenario 1: Wagering \$200 until funds exhausted*

In the model the TAB punter starts with \$200, and bets until their funds are exhausted. As indicated in the issues paper, the TAB average 'take-out' for 'to-win' bets is 14.8 per cent (NSW Wagering Review 2008, p. 22). This 'take-out' reflects the nature of parimutuel wagering, whereby winnings are paid out from all 'to-win' wagers on a race, after the TAB first removes its 'take-out' of 14.8 per cent.

The model assumes that the TAB punter is average, meaning that they only 'win' 85.2 per cent of the money they wager on each event. For example, using a starting wager of \$200, the punter can only expect to 'win' \$170.40 of the \$200 wager (85.2 per cent) in the first betting round. Of the \$29.60 retained by the TAB, \$5.92 is paid to the racing industry as a product fee (the 20 per cent product fee).<sup>15</sup>

Assuming that the TAB punter wagers until their initial \$200 is reduced to an amount too small to wager with any more (i.e. \$1), the TAB punter exhausts their funds after 32 betting rounds. On the basis of 32 betting rounds, a total product fee of \$39.76 is paid to the racing industry.

The amount of product fee payable by Betfair is determined by a very different method to that applied by TAB Ltd.

<sup>15</sup> Product fee paid by TAB per betting round = Wager ! (1-85.2%) ! 31.1%

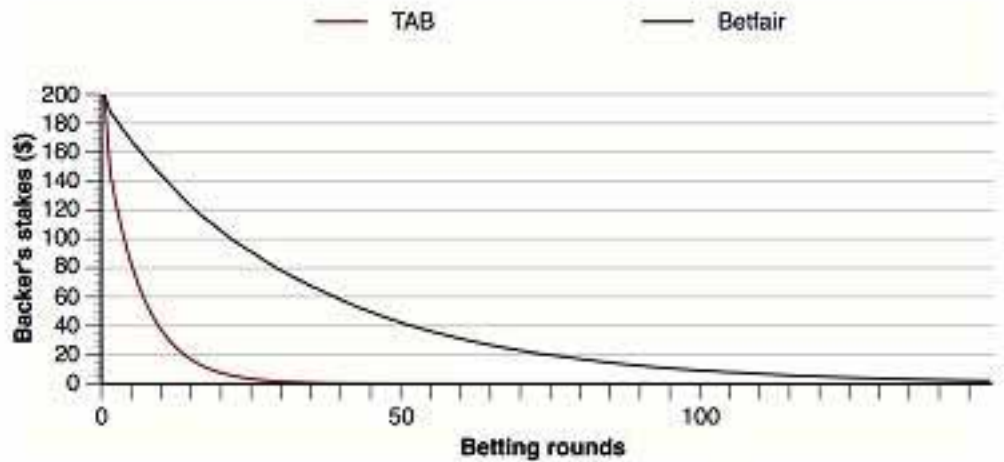
The amount of product fee paid by Betfair on an individual wager is based on the amount of commission earned. And the amount of commission received by Betfair is dependent upon the individual event odds and thus the net winnings received by a punter. A Betfair commission rate of 4.5 per cent is assumed in the modelling.

To illustrate this, a hypothetical book of a four-runner race has been developed. In this book, the odds of each horse winning are randomly generated such that the total probability of each horse winning adds to 1. This random process occurs for each round, with each backer matched by a layer. The results of this modelling discussed below change slightly following each simulation.

As the Betfair commission is much lower than the TAB take-out, the punter is able to stay in the market for much longer. This is clearly displayed in Figure 5.1, where it is assumed that an individual starting with \$200 backs runners either through TAB or Betfair. Compared to the TAB punter exhausting their funds after 32 rounds, the Betfair punter has \$75 remaining after this many rounds. It is not until 114 rounds that the punter has too few funds to wager through Betfair on an individual runner.<sup>16</sup>

Figure 5.1

**BACKER'S STAKES BY WAGERING PROVIDER (UNTIL FUNDS EXHAUSTED)**



Source: The Allen Consulting Group

Under this same scenario, Figure 5.2 displays the accumulation of product fees paid to the racing industry by both TAB and Betfair. The amount of product fees generated through TAB wagering after 32 rounds is \$39.76, however, by the time the Betfair customer has reduced their funds to \$6 after 114 rounds, they have contributed a total of \$77 in product fees. Indeed, after 21 rounds, the amount paid in products fees through Betfair wagering exceeds that contributed through TAB wagering.<sup>17</sup>

<sup>16</sup> The minimum Betfair wager is \$6.

<sup>17</sup> The hypothetical product fee payable by Betfair in each round is equal to:

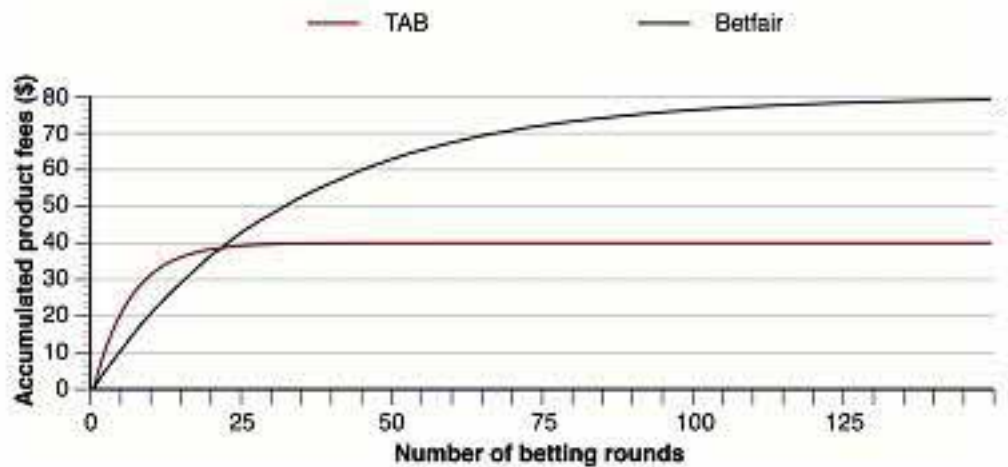
$$ProductFee = 2cT \frac{I}{n} \left( \frac{1}{n} + \frac{1}{n^2} var(P) \right)$$

c = Betfair commission, T = (Backer's stakes) + (Layer's stakes), I = Product fee as per cent gross revenue, n = number of runners, var(P) = variance of the probabilities that n runners will win the event.

Assuming that Betfair customers wager their funds as backers' stakes until they are fully exhausted, and TAB backers wager the same amount of funds until they too are fully exhausted, Betfair will always contribute twice as many funds to the racing industry as product fees. This finding stands irrespective of the nature of the racing book or odds. Taking a starting amount of \$200 which is subsequently wagered until fully exhausted, Betfair will contribute \$80 to the racing industry in product fees, and TAB will contribute \$40.

Figure 5.2

**PRODUCT FEES PAID BY TAB AND BETFAIR**



Source: The Allen Consulting Group

**Scenario 2: Revenue neutrality of substitution of Betfair for TAB**

An argument raised by various parties against liberalising the regulation of wagering in NSW by allowing Betfair to advertise, is that Betfair will lure away from TAB Ltd long-standing customers. Such a scenario should only be of concern to the racing industry insofar that product fees contributed to the racing industry decline.

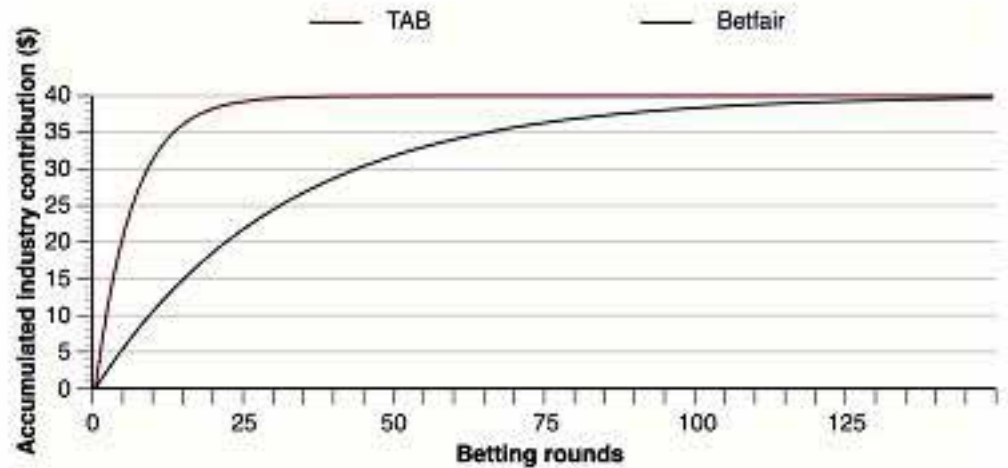
At present, as there are no arrangements in place for Betfair to pay product fees to the NSW racing industry, any movement of NSW TAB customers to Betfair will reduce racing industry revenues.

However, in the event that regulations are liberalised, with betting exchanges and other interstate wagering operators paying a product fee of 20 per cent of gross revenues, and TAB also paying a product fee of 20 per cent of its take-out, racing industry revenues will be unchanged so long as at least 50 per cent of wagers moving from TAB to Betfair become backers.

This scenario is displayed in Figure 5.3, which shows how the accumulation of products fees paid to the racing industry by both TAB and Betfair. In this scenario, the TAB punter is starting with \$200, and the Betfair customer with \$100 (or 50 per cent of \$200). The figure shows how the product fee payments from the TAB plateau after around 30 rounds (at \$40), whereas the payments by Betfair do not plateau at \$40 until after around 140 rounds.

As Betfair provides punters with the ability to very easily wager on numerous NSW races at the same time, it is quite feasible for an individual to place far more bets with Betfair than through retail TAB.

Figure 5.3

**PRODUCTS FEES PAID BY TAB AND BETFAIR UNDER REVENUE NEUTRALITY**

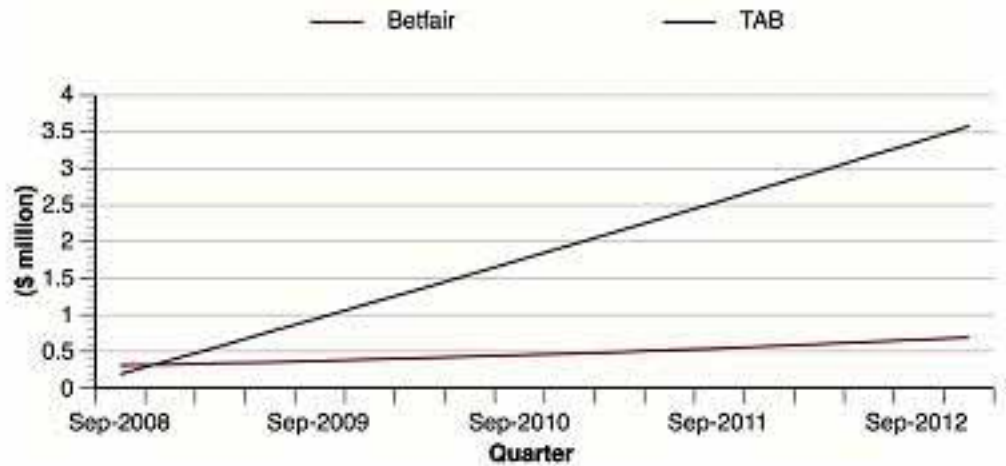
Source: The Allen Consulting Group

***Scenario 3: Regulatory liberalisation stimulating growth in wagering market***

As highlighted in section 2.3, regulatory reforms in various industries typically stimulate increased competition and innovation, as well as market size. Regulatory reform is often able to provide incentives that reduce industry costs and thus prices, resulting in increased demand for services and products.

This situation has been seen in Great Britain following the introduction of betting exchanges, with wagering commission revenue, and thus product fees (known as the betting levy in Great Britain) increasing, on average. Figure 5.4 applies the average growth experienced in the Great Britain betting levy, to see how product fees paid by Betfair and the TAB may change should regulatory liberalisation occur in NSW. Regulatory liberalisation would see Betfair starting to make contributions to NSW racing, whereas based upon the British experience, product fees paid by TAB grow. By 2012, it is estimated that Betfair could contribute \$2.6 million per annum to the NSW racing industry, and the TAB an additional \$13 million per annum. This estimate does not consider the potential contribution that may be made by interstate TABs and bookmakers.

Figure 5.4

**CHANGE IN REVENUES TO NSW RACING INDUSTRY (GROWTH SCENARIO)**

Source: [The Allen Consulting Group](#)

#### 5.4 Summary of findings

This chapter has reported modelling the effects of Betfair paying a product fee to the NSW racing industry. A rate of 20 per cent of gross revenue is assumed. Gross revenue is the *only* possible basis for a betting exchange to pay a product fee and is also the basis that TAB Ltd currently pays its product fees and taxes.

The modelling reported in this chapter shows that the racing industry in NSW is likely to be significantly better off under any plausible scenario where Betfair advertises in NSW and pays product fees to the industry.

First, experience from overseas shows that Betfair is likely to grow the racing industry, and thus will lead directly to greater revenues, as Betfair pays product fees, and as other providers of wagering services (especially TAB Ltd) pay fees on a growing base.

Second, even if Betfair wins market share from TAB Ltd, and abstracting from growth effects discussed above, under any plausible scenario, the racing industry is likely to be at least as well off as it is now. In simple terms, a cohort of punters will likely place bets until a given collective stake is exhausted. If they bet with the TAB, the stake will be exhausted relatively quickly, because the TAB's gross margin is high. In contrast, if they bet with Betfair, it will take them longer to exhaust their stake, because Betfair's gross margin is relatively low. However, given the multitude of betting options available on Betfair, 'longer' in this context primarily means it will take more events for a stake to be exhausted, not that it will take much longer in terms of elapsed time.

The important point is that if the racing industry gets a cut of the gross profit, the industry ends up with the same or more money, depending on how wagers are distributed as backers' or layers' stakes with Betfair.



## Appendix A

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# **Appendix 2**

**Correction of errors in  
Background Paper published  
June 2008**

## **Appendix 2: Correction of errors in Background Paper**

### **1. Betfair's growth rate**

On page 21 of the Background Paper you say that Betfair Australia's "profit" grew by \$3.32m to \$19.80m in the first year of operation. Those figures are in fact gross revenue; not profit. As such, they fail to take account of the significant operational costs and investment Betfair has made to set up an operation in Australia.

You also make the claim at this point that Betfair's Australian business grew by 500% in its second year. Whilst that may be technically correct of the incorporated joint venture entity, it is important to note that the figures you have used for FY2006 only account for 11 weeks of trading (i.e. the period between the start of Betfair's Australian licence and 30 April 2006, the end of the financial year. If the balance of the financial year is taken into account, the actual growth rate in year 2 was around 25%.

### **2. Local and Interstate betting tax regimes**

Table 2 is incorrect on a range of levels. First, it wrongly states that the NSW TAB pays tax at the rate of 19.11% of "turnover". The NSW legislation makes it very clear that the NSW pays tax at a rate of 19.11% of its gross revenue. It also pays its product fee on gross revenue; not on turnover. The same applies to Victoria and WA. QLD also pays on gross revenue – but it pays no taxes or product fees in relation to revenue earned from overseas customers. The reference to Tasmania paying "no betting tax" is also misleading in that it makes no mention of the significant financial contributions that Tote Tasmania is statutorily required to make to the racing industry. This is such a critical part of the Review you are conducting that we think you need to note these corrections in your final Report.

### **3. Comparison of Betfair's business against competitors**

The information you have obtained from Betfair UK's annual report in an attempt to highlight the size of Betfair's Australian operations does not enable a valid comparison to be made to the NSW TAB. This is because the figures you have chosen to use in relation to Betfair's business relate only to the revenue generated from Australian and New Zealand customers betting on all events managed by the global operation. A major portion of that revenue relates to betting on international racing and local and international sporting events, which we believe are largely irrelevant when drawing comparisons with the NSW TAB. A better comparison of our business compared to the NSW TAB may be the revenue generated by NSW punters betting on Australian racing. We would be happy to share those figures with you if you have any interest. However, in terms of identifying potential growth areas for NSW racing, we believe you should be looking at how much revenue we (and others) generate from customers worldwide who bet on NSW racing. We have included these figures in our submission. We suggest that other wagering operators, and particularly the NSW TAB and their interstate counterparts, should provide the same breakdown of betting on NSW racing product as we have done in our submission so that a truly accurate assessment can be made of so-called "leakage" and the opportunities for overseas growth.

End