CommSec

Company Report | August 2003 | Consumer Discretionary

Betting exchanges
here today, gone tomorrow

Key points

- **Competition from betting exchanges can lower the TABs' valuations by up to 30%**
- **The Government and the racing industry will lose up to $240 million per annum in taxes if betting exchanges are permitted to freely operate in Australia**
- **We expect the Government to ban betting exchanges within 12 months**

Executive summary

Betting exchanges (BEs) provide an alternative to TABs for gamblers to bet on racing events. The exchanges operate along similar principles to a stock exchange, allowing backers of a runner to trade with layers (those who believe the runner will lose).

The significant growth of betting exchange gambling has been facilitated by the internet. The internet allows gamblers in remote locations across the globe, that are unknown to each other, to come together and trade bets on the exchange's internet site.

Betting exchanges have become serious competition to the TABs for the wagering dollar since the largest exchange, Betfair, began targeting Australian racing in a serious manner in February 2003.

Government estimates suggest the TABs will lose up to 20% of their wagering revenues to betting exchanges within five years if the Government allows betting exchanges to freely operate in Australia. TABs' valuations would decrease by up to 30% if they lost this proportion of their wagering revenues to betting exchanges, according to our calculations.

Overseas betting exchanges currently pay no Australian tax or contribution to the racing industry. We calculate the Government and the racing industry will lose up to $240 million pa in contribution from the TABs if betting exchanges are allowed to freely operate in Australia.

Even if betting exchanges were to pay Australian taxes according to the rates proposed by Betfair, their net tax contribution would be between $20 million and $120 million. The Government and the racing industry would be net worse off by at least $130 million pa.

We expect the Federal Government to legislatively ban betting exchanges within the next 12 months to protect tax revenues and TAB contributions to the racing industry. A number of countries with similar totalisator betting systems have already banned betting exchanges.

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The Government will ban betting exchanges by making amendments to the *Interactive Gambling Act 2001*, and potentially requiring the blocking of credit card payments to BEs.

Similar measures have been effective in stopping interactive gaming in Australia and have proved effective overseas in preventing betting exchanges supply services.

Even if the Federal Government does not ban BEs, State Government bans on BEs will be effective.

Betting exchanges can expand wagering revenues by:

- providing an alternative betting product for punters including the ability to lay contestants, obtain fixed price odds on a contestant, and make fixed price offers on contestants, and
- bringing together a larger pool of bettors to trade different expectations on the likelihood of a binary event.

Betting exchanges decrease gambling revenues by:

- reducing the commission on gambling turnover; and
- threatening racing integrity through providing an easier mechanism for gamblers to bet on and profit from contestants losing races.

There are potential gains to the Government from allowing a betting exchange, provided the trade-off between the demand-increasing and demand-reducing features of BEs are carefully managed.

The solution is to license the current TABs to be the monopoly providers of betting exchange services in each state and territory. The TABs would be appropriately motivated to efficiently manage integrity issues and minimise price competition between the new and traditional forms of wagering.

If the Government does allow BEs in the future, we expect them to license the TABs to be the sole providers of betting exchange services. This solution maximises the potential net wagering take from gamblers, and therefore maximises the possible contribution from wagering to be distributed to the Government and racing industry.

Betting exchanges are not a valuation risk for the TABs.

UNiTAB is the least exposed to the competitive risk posed by betting exchanges because the Queensland Government could only legalise betting exchanges by obtaining UNiTAB's express consent.

Section 1: What are betting exchanges?

Betting exchanges allow people with opposing views on an event to 'match' their bets. Punters either 'back' or 'lay' a contestant. A backer is prepared to bet a contestant will win at certain odds. A layer is prepared to bet the contestant will lose at particular odds – which is equivalent to backing the rest of the field. Each bet is about a binary event – that something will or will not happen.

Betting exchanges operate in a similar way to a stock market. Backers and layers post their best offer on a noticeboard. The 'to back' odds are ranked from highest to lowest, and the 'to lay' odds are ranked from lowest to highest. A maximum stake is attached to all odds that are offered, indicating the limit that a bettor or layer is prepared to offer. Other customers can then accept all or part of the offer. If a customer accepts part of an offer, the residual stake remains on offer. Orders are filled according to a 'price-time' priority ranking, as they are on the Australian Stock Exchange. Orders are also filled on a limit basis. Customers can withdraw their offer as long as another customer has not accepted it.

Similar to a stock market, the depth and breadth of offers on a betting exchange is important. The more offers posted on a betting exchange, the greater the probability of matched bets. Also, the more offers that are posted, the closer will be the odds for a contestant to its theoretical probability of winning (with some adjustment for the commission rate).

The popular person-to-person (P2P) model is the simplest form of a betting exchange. In this model, bets take place at the odds offered by the initiator. The betting exchange operator does not adjust the odds. These operators earn revenue by charging the winning customer a commission (usually based on their net winnings). Operators earn a risk-free return because their earnings do not depend on the outcome of the event.

Betting exchanges have existed on the internet since the mid-1990s. However, most of the bets were for sporting events, rather than races.

In 1999, Betfair was founded in England. It is now one of the largest wagering organisations in the world, and dominates the global betting exchange market. It has experienced exceptional growth, with matched bets growing from 5 million pounds per week in December 2001 to 50 million pounds per week in December 2002.[1] It is growing at 25% per month.

What are the issues?

Betting exchanges became important in Australia in February 2003 – when Betfair began targeting Australian racing and sports in a serious manner. Betfair targets Australians, offering customers a customised Australian site and allowing them to settle transactions in Australian dollars.

A moratorium applying to all betting exchanges existed from 21 February 2003 to 30 June 2003. This prevented the Australian States and Territories from licensing or authorising betting exchange activities, until the Betting Exchange Taskforce (BET) report was tabled.

[1] Report of the Betting Exchange Task Force to the Australasian Racing Ministers' Conference, 10 July 2003

All State and Territory Governments, except for the Northern Territory Government, want to ban betting exchanges. Their view is also supported by the majority of the racing industry bodies – all but two of the controlling industry bodies that made submissions to the BET wanted betting exchanges banned.

Key issues posed by BEs offering race wagering services in Australia are:

- the valuation risk to the TABs from the transfer of gambling turnover to the BEs;
- the threat to tax funding for Governments and the racing industry, TABs pay high taxes to these bodies whilst overseas BEs currently make no contribution; and
- the threat to race integrity.

Valuation risk for TABs from BEs

The BET government inquiry on betting exchanges estimated 20% of TAB turnover was at risk of being transferred from the TABs to BEs within 5 years if BEs are allowed to freely operate in Australia[2].

We have calculated the valuation impact to the TABs using the inquiry's estimates. The downside risk to the TABs is shown in Table 1 under two scenarios:

Scenario 1: the Government makes it illegal to gamble on Australian races on betting exchanges; less than 1% of TAB revenue is transferred to the BEs from illegal gambling.

Scenario 2: betting exchanges are allowed to freely operate in Australia; 20% of TAB turnover transfers to BEs.[3]

Table 1: Valuation impact on TABs from legalising BEs

	Tabcorp valuation	TAB NSW valuation	UNiTAB valuation
1: Betting exchanges are banned	$12.02	$4.30	$7.60
2: Betting exchanges are legalised	$11.17	$3.09	$5.26
Reduction in value from legalised BEs	7%	28%	31%

Source:CommSec

The pure-play TAB operators - UNiTAB and TAB NSW - are the most exposed to the competitive risk posed by BEs. Their valuations decreases by about 30% if BEs capture 20% of their wagering revenues.

Why BEs threaten TAB revenue

Betting exchanges can reduce the TABs' revenue in two ways:

- By substitution – punters place bets with the betting exchanges instead of the TABs
- By cannibalising existing revenue – punters place less bets overall because of racing integrity concerns.

[2] See "Report of the Betting Exchange Task Force" 10 July 2003 at pg 108.
[3] The TAB gambling most at risk to BEs is the turnover put through the electronic channels (phone and internet). These channels account for a growing proportion of total TAB turnover – currently 20%. In our modelling, we have assumed that half of the TABs' loss of revenues to BEs comes from these higher margin electronic channels, with the other half coming from the traditional distribution channels.

Substitution of revenue

The BET estimated that the TABs could lose up to 20% of their turnover to betting exchanges. The TABs are likely to lose turnover from their:

- simpler wagering services - Win, place and doubles bets are easily replicated in a betting exchange, (which only accept bets with binary outcomes). Therefore, these bets will be more vulnerable to price competition. Such bets are highly vulnerable because BEs offer better odds than the TABs. TABs take-out 16% of turnover from win and place bets, whereas BEs take-out about 3%: the effective price of BEs is therefore 1/5th of the TABs for these bets. The exotics (such as quinellas, quadrellas and superfectas) are harder to replicate, so punters will continue to place these bets with the TABs.
- self-service distributions – The internet distribution channel used by the betting exchanges is a good substitute for the TABs' internet, natural voice recognition systems, and touch-tone phone channels. These channels will be more vulnerable to price competition from betting exchanges.
- serious punters – Serious punters will prefer betting exchanges because they offer fixed odds and better prices. The odds in a totalisator pool vary according to the proportion of money backing each runner in the pool. Thus, if punters place a large bet in a totalisator pool it reduces their odds. Large bets also have worse odds because new punters tend to back the favourite when entering a pool.

Cannibalisation of revenue

People will be less inclined to place bets with the TABs if they perceive there is a reduction in racing integrity because of betting exchange activity. BEs threaten racing integrity because they allow people to profit from a runner deliberately losing.

The relationship between the perceived loss of integrity and wagering turnover was seen during the mid-1970s. At that time, punters believed that races were being rigged. The perceived integrity issue was so severe that the NSW Trotting Club tried to ban a particular punter from attending its races. Wagering turnover fell dramatically because of the racing integrity concerns.[4]

BEs threat to tax funding

Tax revenue and industry funding

Overseas BEs such as Betfair do not pay any product fees to the Australian racing industry, nor do they pay wagering taxes to State and Territory Governments, or taxes on profits to the Federal Government. BEs are able to offer wagering services to Australians at a more attractive price because of these non-payments.

The wagering tax revenue received from the TABs by the State and Territory Governments and racing industry will be reduced if BEs are allowed to target Australian punters (and are not subject to similar taxes). We discuss this issue in detail in Section 2. We show why the Government will ban BEs to protect the tax base in Section 2.

[4] Report of the Betting Exchange Task Force to the Australasian Racing Ministers' Conference, 10 July 2003

BEs threat to racing integrity

Racing integrity is an important determinant of wagering demand. If punters do not believe in the integrity of races, they will bet less. Thus, if betting exchanges reduce punters' perceptions of racing integrity wagering turnover will fall for both TABs and BEs.

Betting exchanges allow anonymous punters to lay a runner at fixed odds. This makes it easier for punters to profit from inside information or by changing the outcome of an event. Betting exchange characteristics that threaten racing integrity are:

- punters can lay a runner - The racing industry is based on the philosophy of winning. For instance, prize money is offered to the winner of a race. This philosophy is reasonable because it is harder to win than to lose. The relative ease in deliberately losing, and profiteering from laying the runner on the BE, is the crux of the racing integrity issue.
- punters are anonymous - Betting exchanges show the offers of backers and layers, but do not disclose their identity. People with inside knowledge or the ability to influence racing outcomes can use their knowledge of a runner's 'true' probability of winning without other punters realising.
- the availability of fixed odds– Punters like fixed odds because this enables them to identify and lock in valuable bets – where the odds offered do not reflect the punter's view of the outcome's probability. The TABs' variable odds do not allow views to be locked in; and are exacerbated by people following the favourites.

Betting exchanges' current legal position

The legal position of betting exchanges falls under several jurisdictions. States and Territories have jurisdiction over gambling. However, the Commonwealth has jurisdiction over communications including the internet under the Constitution[5]. Appendix 1 outlines the legality of BEs in each state and territory.

The key points in relation to the current legality of betting exchanges in Australia are:

- it is illegal for persons in Queensland and NSW to gamble on BEs; it is legal to gamble on BEs in other states and territories
- BEs could only be legalised for Queensland residents with the consent of UNiTAB.

The Commonwealth Government is currently undertaking a review of the *Interactive Gambling Act 2001,* which prohibits interactive gambling. Wagering activities, including betting exchanges, are excluded from the current prohibition on interactive gambling.

Ministers in all states and territories, other than the Northern Territory, agreed to ask the Federal Government to ban betting exchanges.[6] The Federal Government is considering this request in its review of the *Act*.

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[5] The internet is important to betting exchanges because of they allow the exchanges to operate in real-time and reach a large number of people.

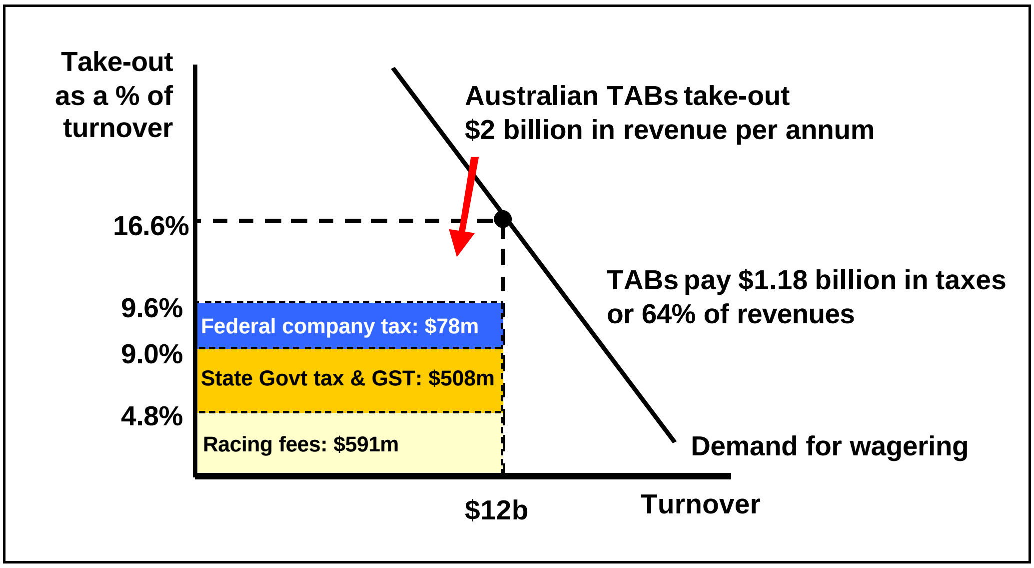
[6] Report of the "Betting Exchange Task Force" 10 July 2003

Section 2: Why the Government will ban BEs

Importance of tax revenue

The Commonwealth Government will ban betting exchanges to protect Federal and State tax revenues and the contribution TABs make to the racing industry. The TABs will contribute $1.18 billion to these bodies in FY 03.

Figure 1: Contribution of TABs to the Government and racing industry in FY 03



Source: CommSec

Figure 1 shows the current tax contribution made by the TABs to the Government and the racing industry. In FY 2003, $12 billion in turnover was bet with the TABs. The TABs made $2 billion in net wagering revenue from this turnover – they take-out on average 16.6% of turnover in wagering revenues. Of the $2 billion in wagering revenue, the TABs paid:

- $591 million to the racing industry (4.8% of TAB turnover);
- $508 million (inclusive of GST) to State and Territory Governments (4.2% of turnover); and
- $78 million to the Federal Government in company tax (0.6% of turnover).

In total, the TABs pay $1.18 billion or 64% of their net wagering revenues in taxes and racing industry fees.

Table 2 shows the importance of TAB revenue to the State and Territory Governments. The TABs paid 93% of all wagering taxes in FY 2003.

Table 2: State and Territory wagering tax revenue for FY 2003

State/territory	Total wagering tax revenue ($m)	Proportion of wagering tax revenue from the TABs
NSW	215	90%
Victoria	158	93%
Queensland	43	100%
SA	28	89%
NT	7	79%
WA	43	100%
Tasmania	9	100%
ACT	5	97%
Total	508	93%

Source: Tabcorp, UNiTAB and TAB NSW annual reports, The Tasmanian Gaming Commission, CommSec estimates

Monopolies maximise tax revenue

The TABs have a legal monopoly to supply totalisator race wagering services. The TABs maximise profits by maximising their net take-out from gambling turnover.[7] A monopoly gambling provider will maximise the revenue earned from punters by setting the price of gambling to maximise take-out from gambling turnover.

BEs potentially reduce total wagering revenues by introducing price competition into the system — resulting in lower average prices to punters. The gambling providers retain a lower proportion of gambling turnover due to price competition. Total take-out (wagering revenues) will fall in comparison to a situation where the gambling provider(s) set prices at monopoly levels.

The Government and racing industry receive a fixed proportion of the TABs' wagering revenues in taxes and fees. These bodies should ensure the TABs maintain their wagering monopolies to maximise the potential funding contribution the TABs pay to them.

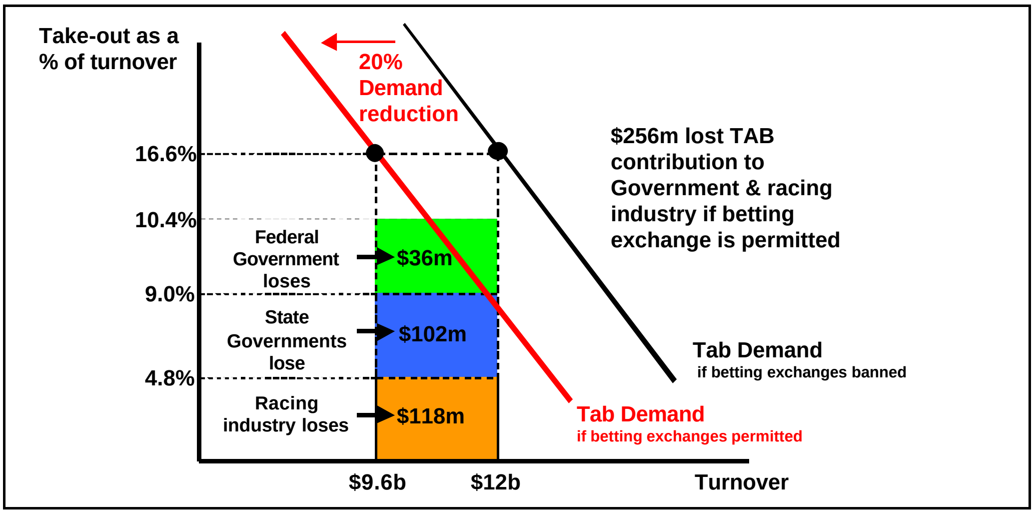
We show the loss of net wagering revenues and tax revenues from the legalisation of BEs below.

[7] The TABs maximise take-out subject to the constraints imposed by retail price controls. These constraints require the TABs to on average payout 84% of win and place turnover in winnings.

Lost contribution from legalisation of betting exchanges

The loss of TAB contribution to the Government and the racing industry from the legalisation of BEs is shown in Figure 2.

Figure 2: Loss of tax contribution from legalisation of BEs



Source: CommSec

If 20% of TAB bets are transferred to BEs:

- the racing industry would lose $118 million pa;
- State and Territory Governments would lose $102 million pa;
- the Federal Government would lose $36 million pa in company tax payments.[8]

In total, the Government and the racing industry would lose $256 million pa of contributions from the TABs.

Tax contribution from legalisation of betting exchanges

Betfair is prepared to pay similar taxes for its Australian product as it does in the UK. In the UK, Betfair pays 15% of its commission to the Government in tax, and a further 15% of its commissions to the racing industry.

We consider the effect of legalising betting exchanges under these assumptions. We look at two possible scenarios, with different levels of wagering demand generated from the BEs:

- **Low contribution case** – betting exchanges do not stimulate further demand either from the lower prices they charge gamblers or from the different gambling product they provide to the market (the ability to lay runners).
- **High contribution case** - betting exchanges stimulate further turnover. Gamblers lose the same amount on betting exchanges that they would have lost on the TABs. The lower take-out rate means the BEs generate proportionally more turnover than the TABs for every dollar that gamblers lose.[9]

[8] Under our analysis, the Federal Government will lose more than 20% of TAB company tax because the wagering lost to BEs has a high margin. We assumed that half of the TABs' lost revenues come from traditional electronic channels, with a marginal cost of distribution of 1% of turnover. The other half comes from traditional distribution channels, with a marginal cost of 3.5% of turnover. Under these assumptions the TABs make a 4.8% profit on turnover. The Federal Government would collect 30% of this profit, or 1.4% of turnover in company tax.

Low case scenario

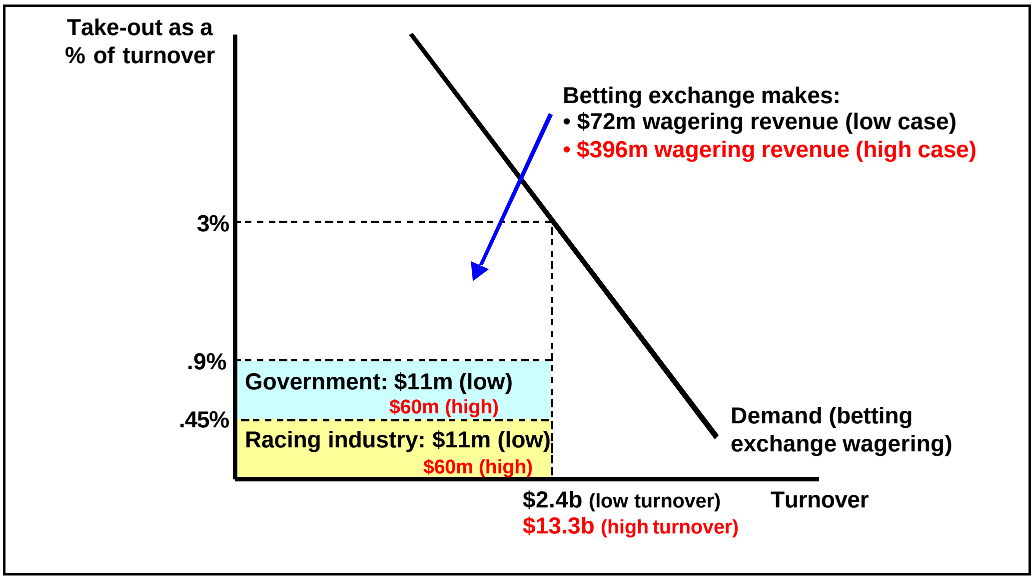
The lost TAB turnover of $2.4 billion per annum will be bet BEs, transferred one-to-one, under this analysis in Figure 3. The betting exchanges collect $72 million per annum in wagering revenue under a 3% commission structure, with 15% of this revenue paid to the Government and a further 15% paid to the racing industry.

The betting exchanges would make a net contribution to Australian stakeholders of $22 million pa, leaving the Government and the racing industry worse off by a net amount of $234 million pa. The split of Betfair commissions is shown in Figure 3.

The lower contribution arises from two factors:

- betting exchanges take-out a lower percentage of turnover (3% versus 16% for TABs); and
- betting exchanges offer a lower share of take-out to the Government and the racing industry (30% versus 64% for the TABs).

Figure 3: the Government and racing industry gains if betting exchanges pay Australian tax



Source: CommSec

High case scenario

Under our high case assumptions, the TABs lose $2.4 billion of turnover pa, but the BEs stimulate $13.3 billion pa of wagering turnover on their exchanges.

We regard this “high demand” scenario as unlikely because it implies more would be gambled on BEs than is currently wagered through all the TABs. BEs would have a 5.5-fold stimulatory effect on wagering demand under these assumptions and would more than double the total amount wagered in Australia.

[9] The argument rests on the circular flow theory of gambling; that gamblers have a set amount to lose and they will continue betting until the money is lost. Hence, a lower commission structure results in proportionally higher turnover. For example, if a gambler has $100 to bet, and take-out is 10% of turnover, the gambler will on average bet $1000; if the take-out rate is reduced to 5% the gambler will on average bet $2000. The Betting Exchange Taskforce found there would not be an increase in turnover in direct proportion to the lower commission structure — due to higher losses of money to professional punters.
A primary reason for gambling is the prospective thrill of winning a multiple amount of the stake wagered. Lower commission structures would not highly stimulate this type of betting.

Under this scenario, the BEs would contribute a net amount of $120 million per annum to the Government and racing industry as shown in Figure 4. The Government and the racing industry would be left $136 million pa worse off from legalising betting exchanges than under our high case scenario.

The shortfall comes from betting exchanges offering a lower proportion of their take-out to the Government and the racing industry (30% verses 64% for the TABs).

Summary

Our analysis indicates the Government has a strong policy rationale for banning betting exchanges to protect its own tax base and the funding to the racing industry. If the Government does not ban betting exchanges it risks a contribution shortfall of between $130 million and $240 million pa.

The optimal solution for the Government: Monopoly BEs owned by the TABs

Establishing tax equivalence may not solve the problem

It would be possible for the Government to impose a taxing regime on betting exchanges similar to the current regime applying to the TABs. For example, the Government could require BEs to pay 10.4% of their turnover in taxes to the Government and racing industry.

Such an arrangement would mean any turnover transferred from TABs to BEs would leave the Government and the racing industry no worse off. The Government and the racing industry would be better off to the extent BEs grow the market and provide a purely additive wagering revenue stream.

However, under a "turnover tax" arrangement it would be difficult for BEs to establish a viable market. For example, it would problematic constructing a tax system that takes-out 10% of turnover and permits viable trades between backers and layers for runners priced above 7 to 1. [10]

Nevertheless, BEs provide a different product to TABs and therefore have the potential to grow overall wagering demand. It would be possible for the Government to construct arrangements that allow the benefits of BEs, whilst also providing themselves and the racing industry with a greater tax contribution.

An optimal solution

BEs have three effects on wagering demand:

- they grow the market by providing alternative gambling consumption possibilities including: the ability to lay a runner, the ability to obtain fixed odds on a runner off-course, and the ability to make a fixed odds offer on a runner;
- they provide a substitute for TAB wagering; and
- they shrink the market by threatening race integrity and by providing price competition to the TABs' monopoly commission structure.

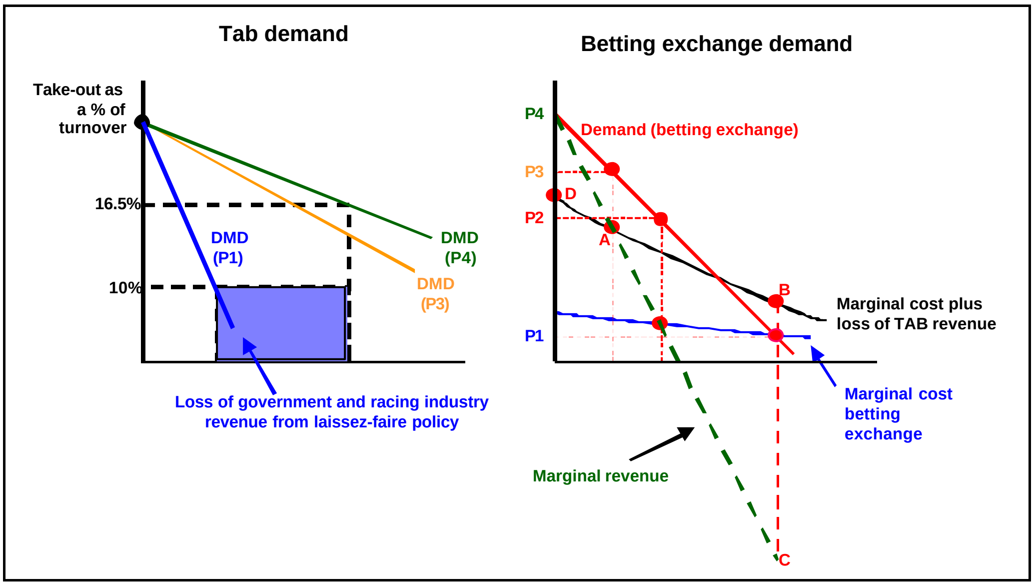
[10] It would be difficult to construct commissions that take-out 10% of turnover and provide viable trading opportunities for runners with odds above 7 to 1. For example, suppose a horse is 9 to 1: $10 is bet to win $90, and $90 is bet to win $10. If the BE takes out 10% of this turnover in taxes then the winning payout is $90 ($100 turnover – $10 tax): there is no incentive to lay the horse ($90 to win $90).

Provided the revenue-increasing effects of BEs exceed the revenue-reducing effects it would be possible for the Government to construct a set of taxes on BEs that leave the Government and racing industry no worse off.

There is an optimal solution for the Government that provides appropriate incentives to ensure the legalisation of BEs does *not* leave the Government and the racing industry worse off. The solution is for the Government to license the current TABs to be monopoly BE service providers – one in each state and territory. Such an arrangement would ensure the TABs would be correctly motivated to consider race integrity and pricing issues in the supply of BE services – and therefore not shrink the total take-out from wagering turnover.

Figure 4 shows our optimal solution to the issues posed by the legalisation of BEs.

Figure 4: Demand for TABs and betting exchanges under the optimal solution



Source: CommSec

The diagram shows four different prices for betting exchange services, and the corresponding wagering demand curves for the TABs' services. The betting exchange prices depend on the licensing regime the Government decides to follow.

The prices for BE services are:

- P1 – the price if betting exchanges are freely licensed
- P2 – the price if *independent* betting exchanges monopolies are licensed in each state and territory
- P3 – the price if the TABs are given monopoly betting exchange licenses for their franchise areas
- P4 – the price if betting exchanges are made illegal

TAB betting exchange monopolies (P3 price set by BE)

The Government can fully overcome the problems posed by BEs if it licenses the TABs to be the sole providers of BE services in each state and territory. Under this solution the TABs would fully consider the reduction in TAB wagering demand when setting the price of BE services.

The TABs would maximise total wagering take-out by setting prices for BE services at P3. At the profit maximising output level the marginal revenue from BE services is equal to the full marginal cost (the cost of supplying the BE services plus the indirect cost from the reduction in TAB wagering demand).

The net gain to the TABs, the Government and racing industry under this solution would be area (P4,A,D) on the right side of Figure 4. Hence it is possible for the three parties to construct a set of taxation arrangements that left them all better off.

In the specific case of UNiTAB, a BE can only be legalised in Queensland with its express consent. Therefore UNiTAB would only agree to the legalisation of a BE if it is better off from the arrangement. The current legal position means BEs are not a threat to UNiTAB's Queensland franchise. UNiTAB is also well placed in negotiations with the Government to gain a good proportion of the net surplus (P4,A,D) from the possible legalisation of a monopoly BE in Queensland.

Problems if Government free licenses betting exchanges (P1 price set by BEs)

If the Government allows complete liberalisation of BEs, competition amongst the BEs will push the price of their services towards P1 in Figure 4. BEs will provide competition for wagering services, lower commission structures, and reduce racing integrity. These three effects decrease demand for TAB wagering services from DMD (P4) to DMD (P1) on the left diagram in Figure 4.

The Government and racing industry lose the purple square in funding – the difference between their share of revenue under DMD(P4) and DMD(P1) - which we estimate to be $256 million pa.[11] The total loss to the Government, TABs and the racing industry from the over-supply of BE services is area (A,B,C) on the betting exchange demand diagram. We estimate this loss to be between $130 million and $240 million pa, depending on the tax rates applying to BEs and the amount of wagering demand they stimulate.

Problems if Government allows independent betting exchange monopolies (P2 price set by BEs)

An independent monopoly BE in each state and territory would set price at P2. There are three major problems in allowing *independent* monopoly BEs to operate alongside the TABs:

- the net take-out from gambling turnover is not maximised because of price competition between the BE and TAB: less net wagering revenue is available to be shared between the TABs, the Government and the racing industry;
- the BEs do not properly consider the decline in TAB demand when setting prices;
- the BEs do not fully consider racing integrity issues when supplying product.[12]

The BE over-supplies services and sets prices too low in comparison to the profit-maximising outcome.

It is not certain whether the Government and racing industry would be better off from a policy of licensing *independent* monopoly BEs in each state and territory.

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[11] These figures are the net loss to Government and the racing industry, including the positive funding contribution made by BEs, which we estimate would be between $22 million and $110 million.
[12] The BEs will only consider racing integrity issues to the extent they affect demand for their own product; that is, they do not consider the decline TAB demand. If the BE is owned by the TAB the racing integrity "externality" is internalised. That is, the BE then has appropriate incentives to fully consider racing integrity issues.

Summary

The Federal Government will initially ban BEs to protect State and Federal tax revenues and racing industry contribution. The Federal Government may provide the States and Territories with powers to license BEs.

Over the longer-term State and Territory Governments may then consider allowing the TABs to be the sole providers of BE services. Such a policy provides the potential for all parties to be better off (the TABs, the Government and the racing industry), whilst also providing appropriate incentives to deal with the racing integrity issues posed by BEs.

In section 3 we discuss the following:

- the findings of the State and Territory Governments' inquiry into BEs, and why this will provide the impetus for the Federal Government to ban BEs within the next 12 months;
- why State Governments will ban BEs even if the Federal Government does not;
- how BEs can be banned and the effectiveness of measures to ban them;
- the approach taken internationally to BEs - in particular, the current trend in other countries to ban them;
- why the bans on BEs will be effective even if one State decides to break ranks and license BEs.

Section 3: Findings of the Betting Exchange Taskforce

Government officers for the Australian States and Territories established the Betting Exchange Taskforce (BET). The BET focused on two likely effects from betting exchanges:

- Racing integrity – the unique characteristics of betting exchanges may worsen punters' perceptions of the integrity of races.
- Wagering revenue from the existing operators (such as the TABs), the racing industry, and the Government.

The majority of the States and Territories found that betting exchanges threaten racing integrity and, to a lesser degree, sporting integrity. The taskforce found there were no cost-effective and practical measures to deal with these racing integrity issues.

The BET found that betting exchange licenses would cause wagering tax revenue and racing industry funding to decline. It concluded the taxation and levy framework within which the betting exchanges operate is not compatible with Australia's wagering environment.

The recommendations by the Betting Exchange Taskforce include:

1. that betting exchange licences should not be granted in Australia
2. that if a licence is granted it should be restricted. The license should be restricted such that only those people physically located in the licensing state or territory could use the BE. The BE would also be restricted to provide betting services only on events run in the State or Territory that granted the licence.
3. that the ministers ask the Commonwealth Government to ban betting exchanges by amending the *Interactive Gambling Act 2001*.
4. that licensed Australian wagering operators should be prohibited from dealing with betting exchanges.

The Northern Territory's Minister did not support these recommendations.

The Federal Government is considering the request to ban BEs as part of its review of the *Interactive Gambling Act 2001.* We expect the Federal Government to agree to ban BEs within the next 6 to 12 months, and amend the *Act* accordingly.

In a worst case scenario, where the Federal Government does not ban BEs, we believe there is no possibility of the Queensland and NSW State Governments agreeing to the licensing of BEs in these states to supply race wagering services. Therefore the current illegality of BEs in supplying such services to these states will be maintained. BEs will then not pose a significant competitive risk to either UNiTAB or TAB NSW.

Betting exchanges can be banned

An argument is sometimes made that people will still continue to bet on BEs illegally even if the Government bans them: legislation will not have a significant practical effect in deterring gambling on BEs.

We find betting exchanges can be practically banned, based on evidence from both Australia and overseas. Legislation and the blocking of gambling financial transactions are effective in reducing illegal betting activity.

Furthermore, these measures will be effective even if a single State or Territory decides to licence betting exchanges.

Effective bans in Australia

Legislative measures have been effective in reducing internet gambling in Australia. The Commonwealth Government banned interactive gambling under the *Interactive Gambling Act 2001.* The Act made it an offence to provide interactive gambling services (unless they were exempt) or to advertise those services to customers in Australia. In 1999, approximately 56, 000 Australians used internet gaming[13]. By 2003, we estimate only around 15,000 Australians use internet gaming. Thus, the *Interactive Gambling Act 2001* was effective in curbing a fast growing gambling service, and reducing consumption to 1/4th of previous levels.

Wagering services are currently exempt from the *Act*. The majority of the State and Territory Governments will ask the Commonwealth Government to prohibit betting exchanges by removing their exemption from the *Act*. There is no reason to believe an amended *Act* would not be successful in curtailing betting exchange activity in Australia, similar to the success achieved in stopping interactive gambling.

International experience

Foreign governments are also concerned about interactive gambling, and internet betting exchanges. Countries that have banned betting exchanges, or are moving towards such a ban, include:

- France – which has moved to block all online gambling transactions. The national French credit card organisation has ensured that all French banks will terminate their relationships with the online gaming industry.
- Hong Kong – which passed the *Gambling (Amendment) Ordinance.* This legislation made all forms of bookmaking (including betting exchange services) with Hong Kong residents illegal. It also made it an offence to advertise on-line bookmaking services. Importantly, the Executive Director of Racing at the Hong Kong Jockey Club has said that betting exchanges are the biggest threat to racing integrity.
- Japan – which banned the use of foreign wagering websites. Japan also does not allow wagering activities, unless they are authorised by the Government. The Japan Racing Association (JRA) has identified blocking credit card transactions as the most effective way to stop internet wagering. Because of lobbying by the JRA, some Japanese credit card companies will not deal with wagering operators.
- Netherlands – which ordered foreign wagering operators not to accept bets from Dutch punters. A Dutch court found the government-licensed provider had monopoly rights overs sports betting in the Netherlands.
- Denmark – which banned unlicensed internet gambling services and prevented offshore bookmakers from advertising in Denmark. Dansk Tipstjeneste has a local monopoly and pays 65% of its profits to the Government.
- Germany – where no new licences are expected in the foreseeable future. The country requires companies to have a German betting licence if they target the German market. There are only five licences and no more are expected to be issued.

[13] Productivity Commission – National Gambling Survey

Legislative measures

A combination of legislation and financial transaction regulations provide an effective method of banning betting exchanges.

Legislative measures that could be implemented in Australian include:

- prohibiting the publication of race betting odds – Six States and Territories already have such legislation in place (although the levels of restriction vary). Importantly, the High Court has concluded that contents on a website are 'published' in all jurisdictions where they can be accessed[14]. If this precedent is followed and extended, it would be possible to for each State to protect its TAB monopolies even if other states licensed BEs.
- restricting advertising for wagering services – Six States and Territories already have legislation to ban unlicensed operators from advertising their services. Media companies may be prosecuted for breach of this legislation.
- prohibiting the publication of racing data without the racing body's permission – New South Wales already has legislation to this effect. Again, the High Court's decision on website publications may provide an effective precedent to prevent interstate betting exchanges publishing other states' racing data.

Blocking financial transactions

Most internet gambling transactions are facilitated through the use of credit cards. Therefore, blocking these credit card transactions is one way of effectively stopping betting exchanges from supplying services.

Australian credit card issuers can block unlicensed betting exchange transactions. The issuers will need to verify the transaction by:

- scanning for the merchant category code '7995' (which indicates a gambling transaction)
- scanning for e-commerce transactions
- checking the transaction against a list of Australian licensed wagering operators.

Credit card transactions for illegal gambling have been blocked overseas.

In the United States, the State Governments generally regulate gambling. As a consequence, some states prohibit forms of internet gambling, while others do not. Recently, the Attorney General of New York asked banks to block credit card transactions that were coded as internet gambling. In June 2002, Citibank agreed to block these transactions.

Why blocking measures will be successful

Measures to reduce betting exchanges activity will be successful because:

- betting exchanges need scale
- a vicious cycle exists for betting exchanges

[14] See the defamation case of Dow Jones v Gutnick (10 December 2002)

Betting exchanges need scale so they can provide a liquid wagering market with depth and breadth. As the liquidity of the market increases, the probability of a matched bet increases, and therefore the attractiveness of the market increases. If legislative and credit card blocking measures reduce the number of offers, the liquidity of the market reduces. This will reduce the attractiveness of betting exchanges, compared with the TABs.

The effectiveness of the measures is enhanced by a vicious cycle. If the measures reduce the number of betting exchange customers, an exchange becomes less attractive to potential customers – because the chance of a matched bet falls. Potential customers will then be less likely to bet with the exchange. As existing customers leave, and without new customers to replace them, the attractiveness of the exchange decreases further. This makes betting exchanges even less attractive to potential customers (and to remaining customers) – and so the cycle continues until there is little or no demand to bet on the BE.

Why interstate betting will not be a problem

If one State or Territory licenses betting exchanges, interstate betting exchanges can be restricted based on:

- the BET recommendations
- the High Court's decision regarding website publications

The BET recommended that betting exchanges should be restricted to those people physically located in the state/territory where the license is granted. Only the Northern Territory's minister did not support the recommendation. Therefore, it is expected most States and Territories will legislate against interstate gambling on betting exchanges. They will also legislate against the use of their racing events by interstate betting exchanges – in order to protect their racing industries.

Given the High Court's decision regarding website publishing, the State and Territory Governments could restrict interstate betting exchange activity on their own racing events by:

- prohibiting the publication of race betting odds
- prohibiting the publication of racing data without the racing body's permission
- restricting advertising for wagering services

Gambling has already been banned on a state-by-state basis in other countries. For instance, the United States has already banned internet gambling in some states, while not in others. Importantly, states with prohibitions have been allowed to block the credit card interchange system for internet gambling transactions.

Appendix 1: Legal position of betting exchanges (in their current form) in each state and territory

Jurisdiction	Can betting exchanges be established in?	Reasons	Can people in the jurisdiction use betting exchanges?	Reasons
NSW	No	P2P betting exchanges may breach the Unlawful Gambling Act 1998. The publication of betting information may breach the Racing Administration Act 1998 A TAB may be licensed under the Totalisator Act 1997.	No	Illegal to use unlicensed wagering operators under the Unlawful Gambling Act 1998.
VIC	No	Betting exchanges infringe provisions of the Lotteries Gaming and Betting Act 1966.	Yes	Unlikely that residents would be defined as engaging in an unlawful game.
QLD	No	Internet betting exchanges must be authorised under the Interactive Gambling (Player Protection) Act 1998. A licence would breach UNiTAB's exclusivity arrangements under the Wagering Act 1998. Licensed bookmakers cannot operate a betting exchange under the Racing and Betting Act 1980.	No	Prohibited under the Interactive Gambling (Player Protection) Act 1998.
SA	Yes	The Lottery and Gaming Act 1936 prohibits totalisators and bookmaker betting (unless permitted under the Authorised Betting Operations Act 2000). However, betting exchanges do not fall under the Act.	Yes	No laws against using a betting exchange. However, using a betting exchange to operate a book is illegal – under the Lottery and Gaming Act 1936 and Authorised Betting Operations Act 2000.
NT	Yes	The Racing and Betting Act does not preclude betting exchanges operated by a licensed bookmaker.	Unclear	Using betting exchanges may offend the Unlawful Betting Act.
WA	Yes	Betting exchanges would need a bookmaker licence and would have to pay a betting turnover levy.	Yes	Using an unlicensed-offshore betting exchange is not illegal. But, it is illegal to use an unlicensed WA exchange under the Betting Control Act 1954.
TAS	Yes	Betting exchanges can be licensed under the Gaming Control Act 1993. TABs could be authorised under the Racing Regulation Act 1952.	Yes	No laws against using a betting exchange. However the Racing Regulation Act 1952 may make it to hard to recover winnings.
ACT	No	The Race and Sports Bookmaking Act 2001 does not provide for licensing. Betting exchanges may breach the Games, Wagers and Betting Houses Act 1901 and the Gaming and Betting Act 1906.	Yes	No laws against using a betting exchange.

Appendix 2: Racing integrity issues

Betting exchange characteristics that threaten racing integrity are:

- punters can lay a runner
- punters are anonymous
- availability of fixed odds.

Combination of risks

Betting exchanges are a concern, not because of any one issue, but because of the combination of the three issues discussed above. Individual integrity issues already exist in Australian racing, but the combination of risks does not exist outside betting exchanges. Individual integrity issues in Australia include:

- fixed odds – which are offered by bookmakers. However the punters are not anonymous. The bookmakers generally know punters with inside knowledge or a good ability to pick winners. Bookmakers may offer these punters shorter odds or restrict the magnitude of their bets.
- Laying runners – which bookmakers can do. However, licensing and commercial incentives minimise the risks associated with laying runners. To be licensed, bookmakers must fulfil probity requirements, including a 'fit and proper person' test. Bookmakers are also prevented from laying bets with inside knowledge because of commercial reasons – they would lose their customers if this became known.

Racing integrity issues are important because they reduce the wagering industry's revenue. Punters will bet less if betting exchanges reduce perceptions of racing integrity. The fall in turnover will effect the incumbent TABs, as well as the betting exchanges.

UK racing integrity incidents

Racing integrity issues have been highlighted in Britain. Racing integrity incidents with betting exchanges include:

- extremely high odds on Betfair – odds of 49/1 to back Royal Insult were offered on Betfair, compared with the on-course starting odds of 10/1. Royal insult was pulled-up during the race and put down[15]. Similarly, odds of 21/1 to back Hillside Girl were offered on Betfair; while on-course bookmakers offered odds of 6/1. The horse was pulled-up during the race and found to be lame.[16]
- proposals of interference by trainers – A BBC program showed a trainer saying he could ensure a horse would lose so the owner could profit from laying the horse[17].

[15] Royal Insult was pulled-up during a Lingfield race, United Kingdom on 30 December 2002.
[16] Hillside Girl was pulled-up during a race at Carlisle, United Kingdom on 15 June 2003.
[17] Ferdy Murphy said this on the BBC television program, 'Keynon Confronts', in June 2002.

Why regulations will not work

Some supporters of betting exchanges have argued that integrity issues can be solved by:

- greater regulation of races and betting exchanges – which will make it harder to interfere with the races
- betting exchanges maintaining audit trails – which allows punters to be identified and therefore deters their incentives to use inside knowledge or interfere with runners.

However there are problems with both suggestions.

1. There will be significant costs in maintaining the public's perception of racing integrity. Measures which would need to be introduced include:
   - the pre-race examination of the runners
   - greater security for runners, stables/kennels and the people involved with the races
   - increased monitoring of races and betting
   - post-race examination of losers, as well as the winner
2. Audit trails are a retrospective measure – they are only used when a suspicious bet is identified. A person may still act dishonestly - even though they know they can be identified - because they think their betting transaction will not be scrutinised.

Furthermore, audit trails do not ensure that punters will be able to recover their losses from dishonest bets. For instance, Coloresque was the favourite for a Harold Park race, in Australia during November 1995. The trainer/driver pulled the horse out because of broken hopples – which were later found to be sabotaged. The trainer's brother collected $22,708 in a superfecta. However, the pair was convicted of false pretences after the event. Punters who backed Coloresque were unable to recover their money.[18]

[18] Report of the BET, 10 July 2003