Internal Affairs Briefing

Hon Chris Tremain
Minister of Internal Affairs

Title: Policy Briefing: Paper 2 - Response to your request for advice on various issues relating to Class 4 gambling

Date: 12 October 2012

Key issues

- A number of benefits exist with the current distribution model of gaming machine proceeds.
- There are several options available to improve and tighten the regulation of the grant distribution system.
- The current venue payment scheme is costly to administer and has some inherent problems.
- Questions have been raised regarding the consequences of societies using management companies to provide support services.

Action sought

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<th>Timeframe</th>
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<tr>
<td>18 October 2012</td>
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<td>When convenient</td>
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Contact for telephone discussion (if required)

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<tr>
<th>Name</th>
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<th>Telephone direct line</th>
<th>Telephone after hours</th>
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Return to: Level 10 WT
DMS file reference: POL-3221-10-01
Ministerial database reference: IA2012000997
Purpose of briefing
1. This briefing responds to your request on 20 September 2012 for information on a range of issues relating to Class 4 gambling.

Executive Summary
2. A number of benefits exist with the current distribution model of gaming machine proceeds. Smaller, more agile gaming machine societies (societies) tend to conduct more funding rounds and make a larger number of smaller grants.

3. Reforming the grant distribution system would incur potentially significant costs to existing grant distribution bodies, which are not equipped to handle an increase in the volume of applications. Some major gaming machine societies indicated that they would have little incentive to continue to operate machines if they could not distribute net proceeds.

4. There are several options to improve and tighten the regulation of the grant distribution system. For example, locally raised proceeds could be specifically required to be distributed locally. Transparency could be increased to balance the autonomy of societies making their own distribution decisions. Community representation on distribution committees could be reviewed and potentially strengthened. The Gambling Amendment Bill (No 2), which is partially through its Parliamentary process, contains some improvements.

5. The current venue payment scheme is costly to administer and has some inherent problems. There are two potential options for reform. One is a commission-based payment scheme where venues receive a prescribed amount based on a percentage of gaming machine proceeds and number of gaming machines. The second option involves deregulating operating costs, allowing societies to negotiate venue payments with venues.

6. Questions have been raised regarding the consequences of societies using management companies to provide support services. Some societies argue that the costs incurred by using management companies are high and that it would be more useful if the money directed to these costs was distributed to authorised purposes. The Department has compared the two management models and finds little difference in the rate of return as a percentage of proceeds.

Background information
7. On 19 September 2012 you met with Te Ururoa Flavell about the Gambling (Gambling Harm Reduction) Amendment Bill (the Bill). As a result of that meeting you sought advice on a number of issues relating to Class 4 gambling, specifically:
   - the benefits or advantages of the current distribution model compared with other options;
   - options for tightening up the regulation of the existing distribution model;
   - alternative options for venue payments (in particular, fixed payments per machine or commission-based payments); and
   - the issues around management companies being used by societies, and possible options for dealing with these entities.
8. You also requested advice on the options for increasing the overall return to the community. This advice is provided in Policy Briefing: Paper 3 - Options for raising the rate of return to authorised purposes dated 12 October 2012.

The benefits or advantages of the current distribution model

Proposal in the Bill to change distribution model

9. The Bill proposes that responsibility for the distribution of gaming machine proceeds (GMP) be transferred from the societies to special committees of local authorities. This was not widely supported.

10. In their submissions on the Bill, a number of societies indicated that they would have little incentive to continue operating gaming machines if they could not distribute the net proceeds.

11. Eighty-seven submitters on the Bill proposed a different grant distribution model. Possible options included the Lottery Grants Board (LGB) and the Community Trusts.¹ A large number of submitters supported the status quo. The Department considers that there are some benefits to the status quo.

Societies conduct more funding rounds and make a larger number of smaller grants

12. Many community organisations rely on societies for their fast turnover of grant applications and approval of smaller grants to support the delivery of their programmes. The high turnover of applications achieved by societies is a major advantage over other grant makers.

13. The majority of larger societies (those that raise more than $20 million per annum) tend to make grants on a monthly basis. In comparison the LGB regional distribution committees and the Community Trusts generally only make grants between two and five times per annum.

14. Societies also make a much larger number of smaller grants when compared to other grant-makers. Average society grants are around $10,000 each, compared to roughly $30,000 for the LGB and more than $50,000 for the ASB Community Trust.

15. Large societies review thousands of grant applications annually. In 2011, the Lion Foundation made more than 4000 grants. By comparison, all eleven LGB community distribution committees combined made 1750 grants in the 2010/11 year.

Costs of reforming distribution system

16. The LGB or Community Trusts would require significant reform of their grant-making operations in order to fulfill the role currently played by societies. For example, new committees would need to be established and there would also need to be consideration of grant strategies and evaluation criteria. Such a significant overhaul would likely be expensive, leading to a reduction in returns to the community, at least in the short term.

¹ There are twelve Community Trusts established by statue operating in New Zealand, which were established following the trustee bank restructuring in 1988. Each covers a different geographic area. In order to fund their grant distribution programmes the Community Trusts maintain their own investment portfolios. Members of the Trusts are appointed by the Minister of Finance.
Consequences of separating gaming machine operations and grant distribution

17. If societies no longer operated gaming machines and this role was transferred to another grant distribution organisation, there could be significant short term inefficiencies as the organisation took over this function.

Department’s view on the distribution model

18. There is a lack of objective evidence to show that the LGB or Community Trusts would be more effective at minimising costs and maximising the benefits to the community. Given the unique role of corporate societies, their ability to currently deliver approximately $300 million per annum to communities, and the likely costs of reform the Department does not recommend a complete overhaul of the system at this stage. Further consideration of ways to improve the existing model, as discussed below, would be preferred.

The options for improving the regulation of the grant distribution system

Weaknesses in the current distribution system

19. Some of the problems in the current distribution system are discussed in Policy Briefing: Paper 1 - Analysis of the Gambling (Gambling Harm Reduction) Amendment Bill dated 12 October 2012. These include the wide autonomy societies have in choosing their authorised purposes and distributing their proceeds. Other issues are the apparent lack of responsive societies can have to changing community needs, and the difficulty in determining how effectively the money is being used. Improper grant-capture activities are also a problem.

Local distribution of proceeds

20. Policy Briefing: Paper 1 - Analysis of the Gambling (Gambling Harm Reduction) Amendment Bill proposes a new regulation-making power so that new regulations relating to local distribution would be specifically permitted.

21. If this power was established, there could also be a new requirement for societies to publicly consult about their distribution policies on a periodic basis, which would be linked to the local distribution principle. Local distribution would mean that societies would need to formally identify the areas where their GMP was raised, allowing them to align their consultation about grant decision-making with those communities.

Increased transparency

22. Transparency in decision-making provides a balance to the wide autonomy of societies in distributing their grants. The Gambling (Class 4 Net Proceeds) Regulations 2004 currently require societies to publish certain information online, including the names of declined and approved grant applicants; the society’s grant distribution policies; and the results of the society’s annual review of grant distribution criteria.

23. However, a recent desktop survey of society websites found that not all content on society websites appeared up to date, complete or was easily found. For example, only 17 out of 47 provided clear links to their distribution policies. ²

² Department of Internal Affairs, Desktop review of information available on non-club gaming society websites (2012) (not yet published).
24. It is not possible to gain a clear picture of how effectively a society is maximising community benefit on the basis of the current requirements. This could be improved by increasing the transparency of the grant-making process. Imposing further reporting requirements on societies would mean that there is more detailed grant information available. New reporting requirements could include an outline of process societies use to assess community needs, a description of the focus of their grants (e.g. sport, health, education, etc), and the purpose for which grants have been given.

25. The standardisation of reporting, in an accessible format that supports analysis, would allow for comparisons across societies and better aggregation of grant data at regional and national levels.

**Appointments to distribution committees**

26. The current regulations also require societies to establish distribution committees to make decisions on the application or distribution of net GMP. The rules for appointments to these committees could be reviewed, to consider whether changes are needed to better encourage diversity, independence, and the regular turnover of members.

**Legislative options**

27. Another approach would be to make changes to the Gambling Act 2003. The Gambling Amendment Bill (No 2), currently awaiting the Committee of the whole House stage in Parliament, includes some amendments relevant to this area. For example, it would extend the conflict of interest safeguards to apply to all persons who make decisions on gaming machine grants (currently they only apply to those with key roles in the management of the society).

28. The Gambling Amendment Bill (No 2) also clarifies and enhances an existing power allowing the Secretary for Internal Affairs to collect gambling-related information from gambling operators, together with an obligation to make the information that is collected available to the public. This is another way of improving the transparency of societies’ grant-making processes.

29. It has proven problematic for the Department to gather the necessary evidence to successfully prosecute those who make informal arrangements that seek to capture grant funds. The conflict of interest provisions could be examined to see if any amendments could be made to better combat these arrangements.

**Reforming the venue payment scheme**

**Costly to administer current venue payment scheme**

30. Societies are required to maximise the net proceeds from their Class 4 gambling operations and minimise operating costs. They are limited to reimbursing Class 4 gambling venues for those costs that are actual, reasonable and necessary, subject to the Gazette Notice – Limits and Exclusions on Class 4 Venue Costs.

31. There are four limits on venue costs in the Gazette notice. These relate to hourly operating costs, weekly operating costs, and venue operating costs. They also place an overall limit on the amount that societies can pay to all their venues (a maximum of 16 per cent of GMP).

32. It is expensive and time consuming to administer this scheme. Societies submit venue cost schedules to the Department, which are checked to ensure that
costs are actual, reasonable and necessary, and that they comply with the specified limits.

33. Despite the regulatory controls, the Department has not been able to eliminate specific problems. There is an inherent tension between the legal obligation for societies to minimise operating costs and the incentive for commercial venue owners to maximise their earnings.

34. One problem is competition between societies for high revenue venues. Audit reports from the Department illustrate how the owners of profitable venues, or multiple-venue owners, leverage their position to obtain venue payments and concessions from societies that potentially exceed the actual, reasonable and necessary limits. Audits show: unjustifiable venue enhancements (such as renovations); overstatement of hours in order to increase venue payments; unnecessary equipment purchases; and inducements.3

**Options for reforming the venue payment scheme**

35. There are two broad options for reforming the venue payment system. Both options would require legislative change to the Gambling Act 2003.

**Table 1: Advantages and disadvantages of two options for venue payments**

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<tr>
<th>Options</th>
<th>Advantages of option</th>
<th>Disadvantages of option</th>
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| i. A commission-based payment scheme | • Societies and venues would support a commission-based scheme.  
• This scheme would be simple to administer and enforce for both the Department and the societies.  
• It could help eliminate competition for high-GMP venues by prescribing costs.  
• It would compensate high-yield venues for their costs, and could lead to the phasing out of inefficient, low-turnover machines and venues. | • The prevention and minimisation of gambling harm at venues could be affected as venues seek to maximise gaming machine usage to maximise their commission.  
• However this would be mitigated by harm minimisation measures. |
| ii. De-regulation of operating costs | • The cost of the Department developing and maintaining a new venue payment scheme (as per option i) would not be required.  
• There could be greater regulatory and compliance focus on harm minimisation and auditing returns to authorised purposes.  
• Societies would be in a position to make decisions about their cost structures and there would be greater financial incentives to minimise costs. | • Societies could pay high turnover venues more than is actual, reasonable and necessary to cover costs.  
• The introduction of a profit-motive could have implications for minimising gambling harm as venues would be financially incentivised to maximise turnover. However this would be mitigated by harm minimisation measures. |

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3 Audits conducted during 2009-2010. Examples include $56,000 on an individual venue enhancement and $400,000 in over-expenditure on venue costs.
36. A significant difference between the current system and the commission-based system is that the current system has *maximum* limits, which enables venues to claim and be paid less than the limits for their costs. Similarly, societies can pay a maximum of 16 per cent overall to venues, but can pay less than this. A commission-based system would remove the ability to vary payments.

37. The Department believes there may be some advantages to a commission-based system or de-regulation of costs, in conjunction with an increase in the minimum rate of return to authorised purposes. For a commission-based system the percentage rate for venue payments would need to be modelled. If it was too high, funds that should be available for community purposes would be paid as private profit. If too low, venue operators may not be fairly compensated for their costs.

**Society usage of management companies**

*Management companies provide services to gaming machine societies*

38. Management companies are commercial entities that provide a range of support services to gaming machine societies. These services include, for example, administration and financial management; grant application processing; gaming machine servicing; and ensuring gaming venue compliance with the Gambling Act 2003. Currently, there are 11 management companies servicing 18 gaming machine societies (this compares to 17 companies servicing 23 societies in 2009).

**Sector views of management companies**

39. Some Class 4 societies (including The Lion Foundation and the Southern Trust) have expressed their concerns about other Class 4 societies engaging the services of management companies. The concerns are that management companies provide services that are more appropriately carried out by licensed societies themselves, and that they are costly and absorb funding that would otherwise be available for distribution to authorised purposes.

40. The contrary view is that it can be more efficient for small and medium sized societies to engage management companies instead of directly employing the necessary expertise (e.g. field staff, administrators).

**Department’s view of management companies**

41. Societies must minimise the costs of Class 4 gambling and maximise the benefits to the community in order to be relicensed. The key issue with management companies is whether they assist societies in fulfilling this obligation. The Department, through its auditing programme, has seen examples where the use of management companies assists a society in minimising costs, as well as examples of where their use is poor practice because costs have been high.

42. The Department believes that there have been instances where management companies have been used to hide prohibited costs from the Department. Some societies have hired management companies that have close connections to the trustees. In several such cases the management company has been owned by one of the society trustees or a close family member.

43. To date, the Department has no compelling evidence to suggest that generally the use of management companies is any more or less efficient than the use of
in-house services. Table 3 shows the total proceeds and the return to authorised purposes for societies that use management companies and those that do not. In terms of rate of return to authorised purposes, it indicates that there was very little difference between the two for the March 2012 quarter.

Table 3: Comparative rate of return to authorised purposes (AP) March 2012

<table>
<thead>
<tr>
<th>Society Type</th>
<th>Total Proceeds</th>
<th>Return to AP</th>
<th>Rate of Return as a percentage of proceeds</th>
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<tr>
<td>Societies that use a Management Company</td>
<td>$132,429,495</td>
<td>$53,288,093</td>
<td>40.24%</td>
</tr>
<tr>
<td>Societies that do not use a Management Company</td>
<td>$452,807,028</td>
<td>$180,319,773</td>
<td>39.82%</td>
</tr>
<tr>
<td>Total</td>
<td>$585,236,523</td>
<td>$233,607,866</td>
<td>39.92%</td>
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As reported in March 2012 Gambits

44. However, as the Department does not currently have the power to audit management companies there is no certainty that costs are being minimised, and that returns by societies using management companies should not be much higher.

**Options for the future of management companies**

45. In addition to the status quo there are two broad options for regulating the use of management companies by societies and these are canvassed in the Table 2.

**Table 2: Advantages and disadvantages of two options for societies’ use of management companies**

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<tr>
<th>Options</th>
<th>Advantages of option</th>
<th>Disadvantages of option</th>
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| i Provide specific powers for the Department over management companies (e.g. auditing powers) and amend the definition of ‘key person’ to make it clear that it includes management companies | ● The Department could ensure that society costs are fully actual, reasonable and necessary.  
● The Department would have some control over the suitability of the people involved in these companies, who are often closely involved in societies’ decisions.  
● Conflict of interest provisions would apply. | ● Potentially increased administration and compliance costs. |
| ii Prohibit management companies              | ● Societies would be fully accountable for the costs of their Class 4 operations.     | ● Small societies that engage management companies for efficiencies would face increased operating costs.  
● A range of service providers in the sector that could be captured by such a prohibition (e.g. gaming machine technicians, accountants etc.) |

46. The Department does not believe there is a basis to pursue a prohibition on management companies. Under the status quo the financial management within management companies is opaque, as the Gambling Act 2003 does not provide
a specific authority for the Department to audit management companies. Accordingly providing a specific power for the Department to audit management companies could be a useful addition to the Department’s regulatory tool kit.

**Next Steps**

47. You may like to use this information to support your next meeting with Mr Flavell that we understand is on 18 October 2012.

48. The Department would welcome a discussion with you about these issues and the conclusions we have reached.

**Recommendations**

49. The recommendations are that you:

   a) **use** this information during your next meeting with Mr Flavell on 18 October 2012.  
      | Yes/No |
   
   b) **advise** the Department of your preferences in relation to the issues and options discussed in this paper.  
      | Yes/No |

Director Policy Group

**Hon Chris Tremain**

**Minister of Internal Affairs**

/ /2012