House of Commons

Culture, Media and Sport Committee

Reform of the National Lottery

Fifth Report of Session 2003–04

Volume I

HC 196

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Report, together with formal minutes

Ordered by The House of Commons to be printed 9 March 2004

HC 196
Published on 25 March 2004
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Culture, Media and Sport Committee

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Committee staff

The current staff of the Committee are Fergus Reid (Clerk), Olivia Davidson (Second Clerk), Grahame Danby (Inquiry Manager), Anita Fuki (Committee Assistant) and Louise Thomas (Secretary).

Contacts

All correspondence should be addressed to the Clerk of the Culture, Media and Sport Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 6188; fax 020 7219 2031; the Committee's email address is cmscom@parliament.uk

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Summary

The Committee has examined the Government's proposals for reform of the National Lottery.

The Government wishes to break-up the single licence for operating the Lottery into more manageable discrete parts in order to stimulate competition from the private sector in the run-up to competition for the third licence, or as contemplated, licences. However, we are not convinced that the advantages of breaking-up the single licence will (a) materialise in the manner and to the degree expected, nor (b) outweigh the risks that are posed to returns for good causes by destabilising the existing system. The key risk is that in seeking to promote competition *for* the right to operate the Lottery, or parts thereof, the Government will introduce competition *into* the operation of the Lottery, between successful bidders. Far more work needs to be done to demonstrate that this proposal is workable and can deliver the Government's stated objectives. If the Government persists with this policy it must accept that the National Lottery Commission - the regulator - will have a new, and far more sophisticated, role; the NLC will have to be resourced accordingly.

The Government's proposals on the funding and distribution side of the system - with the exception of the introduction of a new good cause to fund the Olympics – seem less significant. We heard concerns that the new über-distributor, being created from the merged Community and New Opportunities funds, might have too expansive a remit and encroach upon the operations of the specialist agencies for heritage, sport or the arts. We believe that it would be inefficient and ineffective to waste the experience and lessons learned within the existing specialist distributors. To gain advantage from a single entry-point for applicants, once 'in' the system there must be efficient and accurate referral to the appropriate fund or particular distributor.

A new good cause is being established by the Government through primary legislation. This is estimated to generate £750 million between 2004/05 and 2011/12 for staging the 2012 Olympic Games should, of course, London's bid be successful. Up to 59% seems likely to arise from a switch of play from existing Lottery Games to a new family of Olympic Lottery products. When taken in conjunction with other calls upon Lottery funds resulting from a range of prospective measures, including a Government fiat directed at the sports distributors, the Olympics becomes a huge potential drain on all the existing good causes which must be carefully monitored and remedial action taken if necessary. Provision has been made for Ministers to transfer resources directly from the mainstream National Lottery fund to the Olympics fund "in exceptional circumstances". We believe that, conversely, the National Lottery should be in the position of a 'preferred creditor' if, as confidently predicted by the Government, the eventual call on the public's money is significantly less than provided for under current arrangements.

The principle of "additionality" – whereby Lottery resources are not supposed to be used by Ministers to replace Government spending – is being eroded, especially in the light of contingent plans for staging the Olympics. We deplore this. We regard the £1.5 billion earmarked by the Government as the Lottery's overall contribution to the Olympics as a straightforward raid. We will consider returning to examine additionality in more detail

before the end of this Parliament. In the interim, we recommend that the Secretary of State make report to Parliament each year setting out how the additionality principle has been applied.

Given this view, it will come as no surprise that we believe that the taxation of Lottery returns for good causes represents an inappropriate double hit for the Treasury. Returns for good causes should be treated more like charitable giving than other spending on gambling products. Within the gambling sector we note that the Government recognises the unique status of the Lottery for the purposes of regulation but not for the purposes of taxation. This is inconsistent and wrong and, whatever regime replaces the regressive 12% Lottery Duty, returns for good causes should be exempt from tax. A concrete commitment by the Government of this kind is likely to do more for the promotion of the Lottery as a 'good thing' amongst the public than any amount of plaques and open days.

1 Introduction

Inquiry

1. The Committee announced its inquiry into the Government's proposals for reform of the National Lottery on 9 December 2003. The Government's proposals are set out in two decision documents on the reform of National Lottery Funding and National Lottery Licensing and Regulation published on 3 July 2003. We took oral evidence on four occasions in January and February from: the Lotteries Council, the National Council for Voluntary Organisations and the Coalfields Community Campaign; the National Lottery Commission, Camelot Group plc and The People's Lottery; the New Opportunities Fund, the Community Fund, Awards for All, Sport England and the Arts Council England; and the Heritage Lottery fund, UK Sport, HM Treasury and the Department for Culture, Media and Sport. Written evidence was received from a number of individuals and organisations. We thank everyone for their contribution to the inquiry. The relevant evidence is set out in Volume II of this Report.[1]

2. The Committee has taken into consideration the timetables of the Horserace Betting and Olympic Lottery Bill, proceeding through Parliament at present, and the pre-legislative scrutiny of the draft Gambling Bill by the Joint Committee due to report to the House before 8 April 2004. The former provides for, *inter alia,* a new Lottery game in the event that London is awarded the 2012 Games and the latter is intended to contain clauses implementing those proposals for the Lottery that require primary legislation. However, at this stage no such clauses have been published.

3. We appointed two Specialist Advisers for this inquiry: Professor Ian Walker, Department of Economics, Warwick University and Dr Rob Simmons, Lecturer, Department of Economics, Lancaster University. We would like to thank them both for their advice throughout the gathering of evidence. The Committee would also like to thank Professor David Miers, our adviser during a previous inquiry into gambling policy, for informal advice provided during this inquiry.

1 HC 196-II

2 Background

Establishment of the National Lottery

4. The National Lottery was established under the National Lottery etc. Act 1993 and was launched in November 1994. The Act was later amended by the National Lottery etc. Act 1998. These Acts set out the role of Secretary of State, the National Lottery Commission (NLC) and provided for the award of a single licence to run the Lottery to a commercial operator. The first licence period ended on 30 September 2001, the second licence runs from 27 January 2002 until 31 January 2009. The key terms of the current licence are that: the NLC will regulate and licence the National Lottery, ensuring the propriety of the game whilst protecting players and maximising returns to good causes; that the income from sales will be split (shown in table 1 below); and funds in and out of the National Lottery Distribution Fund (NLDF) and distributed to five good causes: sport; arts; heritage; charities; and health, education and the environment.

5. The proceeds from National Lottery games are divided according to fixed proportions applying over the seven years of the current licence (*i.e.* the figures may vary in any one year – figures in brackets below show 1999-2000 outturn). The operator therefore is under an incentive to maximise ticket sales and minimise costs in order to maximise profits.

Table 1:Division of Proceeds of ticket sales (average over second licence period so far)

Prizes	Good Causes	Lottery Duty	Retailer Commission	Camelot Retention (Running costs and profits)
50% (47%)	28% (31%)	12% (12.1%)	5% (5.1%)	5.0% (4.9%)

Source: National Lottery Commission information note 9.

6. From the outset, Lottery Duty was set at 12% which was intended to ensure that the Lottery would be "revenue neutral" so that the Government was compensated for lost revenue arising from expenditure diverted to Lottery ticket purchase from other goods and services (that were taxable).

7. Good causes receive, in total, 28% of the total revenues of National Lottery sales. These funds are paid into the National Lottery Distribution Fund (NLDF) (the Lottery's bank account managed by the Office for Debt Management, part of the Treasury). From the NLDF funds for good causes are distributed to the five good causes in fixed proportions. In 2003-03 the total paid into the NLDF was £1,591,781,000.[2] Funds from the NLDF, including interest earned, are distributed by 16 National Lottery distributors covering all of the five good causes (see table 10 later in the Report for further details). These funds are drawn down by the distributors when needed for expenditure by successful applicants. This gives rise to the NLDF 'balance' issue (the amount in the Fund at any one time) which is discussed later in this Report.

2 DCMS 2004.

Performance of the Lottery

Revenue

8. Since the first National Lottery draw on 19 November 1994 until April 2003 total Lottery sales have been a huge £41.36 billion.[3] A breakdown of the total revenues since launch is shown below:

Table 2: National Lottery total revenue

Year £m	2003-2009	2002-2003	2001-2002	2000-2001	1999-2000	1998-1999	1997-1998	1996-1997	1995-1996	1994-1995	Since launch
On-line		-	-	4,124	4,532	4,536	4,713	3,847	3,694	1,157	26,327
Instants		-	-	546	562	669	801	877	1,523	34	5,010
Total	**4.5****	**4,574.5**	**4,834**	**4,983**	**5,094**	**5,228**	**5,514**	**4,723**	**5,217**	**1,191**	**41,36***

**Up to 2002-03. **Planning assumption – advice from DCMS*

Source: National Lottery Commission information note 9 and Annual Report & Accounts 2002-03 (total figures may not add due to rounding)

9. Table 3, below, illustrates the trends in National Lottery tickets sales from its creation in 1994 until February 2004. In this time, the Lottery sales have declined; however there was a period of increasing sales between March 1995 and August 1999.

Table 3:Trends in Lottery product sales

Sample period	No. of draws	Mean sales (£m)	Trend
1994-2004	482	55.0	Declining at increasing rate; rate of decrease per draw at Feb 2004 was £102,000
1997-2004	366	26.7	Steady decline at £22,000 per draw
June 1999-July 2003	213	4.6	Steady decline at £950 per draw
October 2002-July 2003	38	2.2	Rising at decreasing rate, levelling out in July 2003
November 2000-Feb 2004	169	1.2	Declining at decreasing rate; rate of decrease per draw was £3,200 at Feb 2004
November 2000-Feb 2004	165	0.8	Steady decline at £2,800 per draw
March 1995-August 1999	230	17.9	Declining at decreasing rate then *increasing*; rate of increase was £78,000 at August 1999

Source: Dr Robert Simmons, 2004

10. Table four shows the source and distribution of revenues since the beginning of the National Lottery.

3 National Lottery Commission Annual Report & Accounts 2003-03 HC 871.

Table 4: Distribution of Lottery Revenues 1994-2003

Category	Total for the period (£m)
Total revenues	41,361
Revenue of National Lottery Game	33,564
Prizes won by players	17,475
Payments to NLDF from ticket sales	10,009
Total payments to NLDF	11,088
Lottery Duty (12% of sales)	4,364
Retailer commission (5% of sales)	1,850
Retentions by licensee	7,083

Source: National Lottery Commission Annual Report & Accounts 2002-03

11. The National Lottery is presented as one of the most successful in the world; ranking as the second largest in terms of both total sales and returns to government (good causes and taxation).[4] Camelot informed us that, at present, 70% of the adult population play on a regular basis and approximately 30 million people have a ticket for the main draw on a typical Saturday.[5]

12. The UK ranks only 40th in the world in terms of equivalent per capita Lottery spending. The National Lottery Commission says this is evidence that the UK's lottery success is not therefore based on a small proportion of the population playing excessively.[6] The weekly average Lottery expenditure by household is shown in table five below for both Saturday and Wednesday draws and Saturday only. The average over all socio-economic groups was £5.37 (for Saturday and Wednesday) and £2.49 (for Saturday only) in 1999.

Table 5: Weekly average lottery expenditure - by household (May 1999)Table 5: Weekly average lottery expenditure - by household (May 1999)

Socio-Economic Group	A	B	C1	C2	D	E	All
Saturday & Wednesday draws	£5.98	£5.50	£5.35	£6.31	£5.09	£4.13	£5.37
Saturday only	£2.75	£2.65	£2.43	£2.97	£2.25	£1.91	£2.49

Source: National Lottery Commission

13. More recent research suggests that average spending per player is still modest - on Saturdays, an average of £2.60, on Wednesdays, an average of £2.20. Only 7% of players spent £5 or more on Saturdays and 3% did so on Wednesdays. Those with incomes of over £9,500 per annum spent similar sums playing the main Lottery game (up to £2.90 per week). There seemed to be little variation in how much was spent by players with annual incomes above £9,500. Spending on the Lottery dropped sharply for those with incomes below £9,500 pa, down to £1.90 per week for those in the lowest income group of below £4,500 pa.[7]

14. National Lottery revenue is generated through the sale of tickets for a number of different games. Table six, below, provides information about the introduction dates and total sales figures (up to April 2003) for all of the National Lottery games. The table clearly

4 www.natlotcomm.gov.uk/Information

5 Q 112

6 National Lottery Commission, information note 9.

7 National Lottery Commission Report on Participation, Expenditure and Attitudes by Kerry Sproston, 2003.

shows that the most popular game is the main National Lottery Game which was introduced on 19 November 1994 as a Saturday draw and to which was added a Wednesday draw from 5 February 1997.

Table 6: Summary of UK National Lottery games

Game	Introduction	Sales in 2002-03 (£m)	Total sales up to April 2003 (£m)
National Lottery Game (Lotto)	Saturday: 19 November 1994 Wednesday: 5 February 1997	£3387	£33564
Thunderball	Saturday: 7 June 1999 Wednesday: 23 October 2002	£280	£956
Lottery Extra (Lotto Extra)	15 November 2000	£89	£263
Christmas Millionaire Maker	November 2001	£25	£169
Scratchcards (incl. Instants)	21 March 1995	£578	£6167
HotPicks	13 July 2002	£216	£218
EasyPlay	September 2003	n/a	n/a
Euromillions	February 2004	n/a	n/a

Source: National Lottery Commission Annual Report 2002-03

15. Out of a total of 850 draws from inception until 14 February 2004 (Saturday and Wednesday), there have been 137 rollovers with an average top-up of £6.05m and an average jackpot pool of £42m. There have also been 59 superdraws with an average top-up of £6.8m and an average jackpot prize pool of £12.8m.[8] These periodic larger jackpots are a key driver for increasing the popularity of playing.

16. The National Lottery is made up of eight different games, these are: Lotto (The National Lottery Game); Lotto Extra; Thunderball; Scratchcard games (including instants); Christmas Millionaire Maker; Lotto Hotpicks; Lotto EasyPlay (via the internet); and Euromillions. The portfolio of National Lottery games includes two types of game available through retailers: draw-based games and scratchcards. Draw-based games require the player to either fill in a playslip or choose to have their numbers randomly generated by purchasing a Lucky Dip ticket. Scratchcards are an alternative way of playing the lottery through which players can achieve an instant win.[9]

17. The National Lottery is largely "pari-mutuel" in that the games have a prize structure based on predetermined proportions of the prize fund generated for each game by the relevant ticket sales for that game. [10] The exceptions are: the £10 award in the main Lotto game for matching three numbers; and the Thunderball game which has fixed prizes. Sales for each game in 2002-03 and total sales since 1994 are shown in table 6 above.

8 Dr Rob Simmons, 2004.

9 Information from Camelot Group plc website. www.camelotgroupco.uk.

10 Pari-mutuel describes a betting mechanism which automatically pools stakes and distributes winnings (usually less costs and a profit for the operator)

18. Going into the future, the NLC have recently agreed to the launch of Euromillions and the introduction of playing Lotto on the internet. It has yet to be seen how successful these initiatives will be. There is also the possibility that Camelot will extend the range of scratchcards available and, depending on the success of the London 2012 Olympic bid, there is the potential introduction of new Olympic Lottery games in 2005.[11]

Good causes

19. All the money that is distributed to good causes is paid into the NLDF by Camelot. This is from a number of sources (shown below) but the bulk comes direct from sales of Lottery tickets.

Table 7: Payments to the NLDF

Year £m	2002-2003	2001-2002	2000-2001	1999-2000	1998-1999	1997-1998	1996-1997	1995-1996	1994-1995	Since launch
Ticket sales	1,259	1,331	1,376	1,413	1,483	1,554	1,259	1,402	311	10,009
Unclaimed prizes	85	81	76	71	78	74	48	34	0	471
Prize shortfall	9	104	91	88	100	122	130	18	0	568
Ancillary income	1	1	1	1	0	0	0	0	0	4
Interest (trust a/c)	3	5	7	6	10	3	2	3	0	30
Miscellaneous	1	1	0	2						6
Amount	**1,358**	**1,523**	**1551**	**1,581**	**1,671**	**1,753**	**1,444**	**1,457**	**312**	**11,088**

Source: National Lottery Commission (total figures may not add due to rounding)

20. The percentage split of NLDF funding to each of the good causes at present is shown later in the report (figure 1). These proportions have changed over time and the table below shows the history of the destination of good cause revenues (from the NLDF).

Table 8: Division of Lottery funding for good causes

	Arts	Charity	Heritage	Sport	Millennium	Health, education and environment
To October 1997	20%	20%	20%	20%	20%	-
From Oct 1997	16.66%	16.66%	16.66%	16.66%	20%	13.33%
August 2001	16.66%	16.66%	16.66%	16.66%	-	33.33%

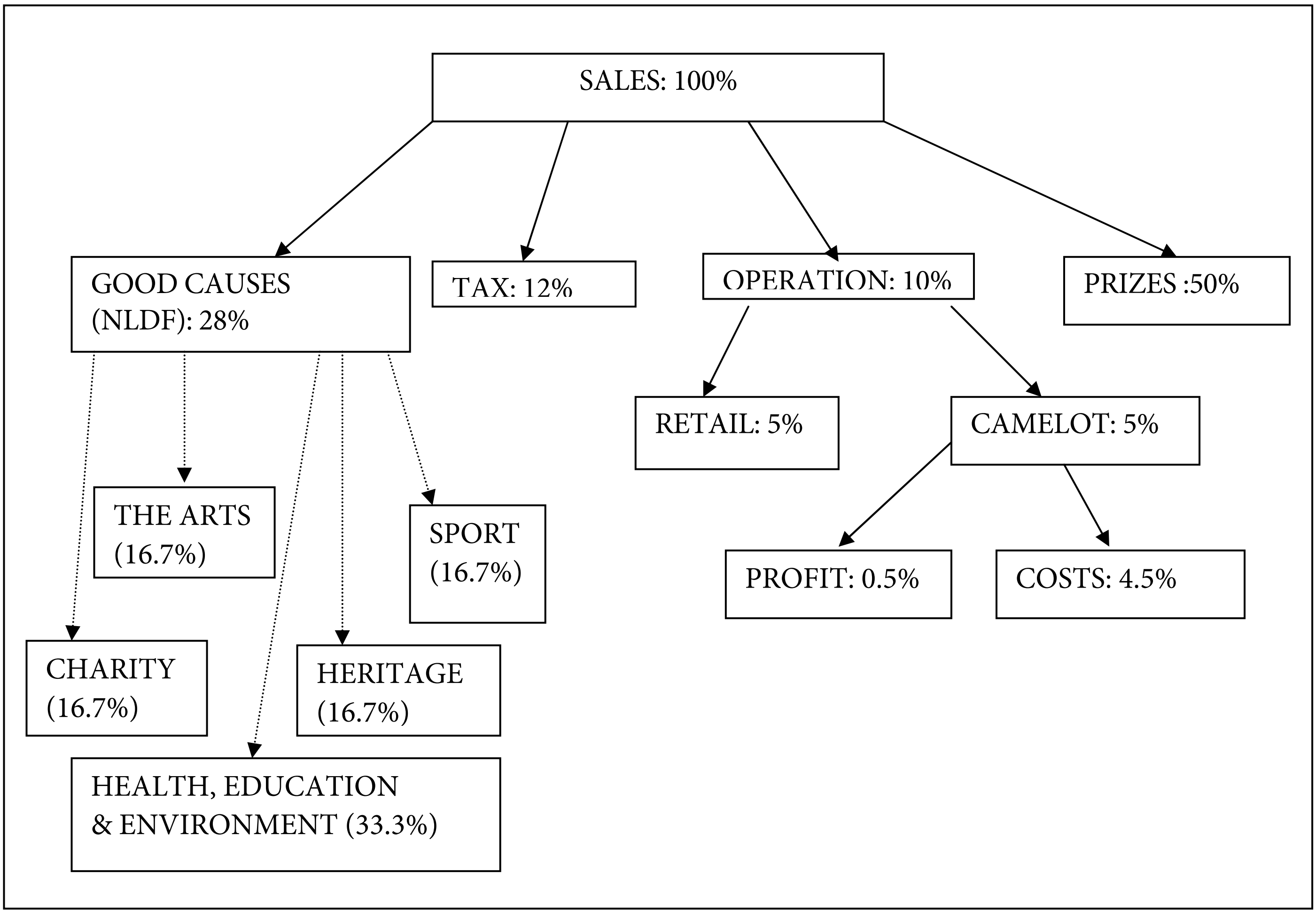
11 National Lottery Commission Annual Report 2002-03 p 22-23.

21. Recent figures given by the DCMS set out the amounts distributed to each good cause since 1997. The total was given as £13.473 billion. These shares are set for review at the end of the current licence period.

	Arts	Charity	Heritage	Sport	Millennium	Health, education and environment
£billion	2.225	2.639	2.331	2.243	2.131	1.904

Source: National Lottery Commission Annual Report 2002-03

Flow of funds raised by National Lottery ticket sales



History of the Lottery

Competition for the first licence

22. After the National Lottery etc. Act 1993 was passed, the Director General of the Office of the National Lottery, assisted by a panel of selectors, was charged with selecting the first operator of the National Lottery. Seven companies tendered bids for the original United Kingdom Lottery licence. The seven-year licence for the operation of the National Lottery was awarded to Camelot by the Director General of Oflot on 25 May 1994.[12] The National Audit Office concluded that the process was "comprehensive, consistent, logical and properly controlled".[13]

The creation of the National Lottery Commission

23. In April 1999, the Office of the National Lottery (Oflot) was replaced by the National Lottery Commission (NLC), under provisions of the National Lottery Act 1998, after the conduct of the Director General of Oflot has been called into question following the award of the first licence.[14] The establishment of a commission reduced the actual, or perceived, risk of a conflict of interests between a single regulatory office-holder and the licence holder. The Government also argued that increased expertise and knowledge would be available to regulate the National Lottery through the appointment of five commissioners.[15]

Competition for the second licence

24. By 29 February 2000, the deadline for submission of bids for the second licence period, the Commission had received two bids: from Camelot and The People's Lottery. After some delay, on 23 August 2000, the Commission announced that it would start new negotiations with only one bidder, The People's Lottery. High Court action in the form of a judicial review resulted in Camelot being readmitted to the process and, on 19 December 2000, the Commission announced its decision that Camelot would be awarded the next licence to operate the National Lottery. The licence period began on 27 January 2002. Although, on paper, the People's Lottery proposals would have contributed more to good causes than Camelot at the same level of sales, the Commission believed that, overall, Camelot would generate more sales and so contribute more in total to good causes. The Commission decided, on a four to one vote, that the accumulated risks in The People's Lottery bid were significantly higher than in Camelot's bid.[16]

12 First Report from the Culture, Media and Sport Committee, Session 2000-01, *The Operation of The National Lottery,* HC 56.

13 National Audit Office, Evaluating the Applications to Run the National Lottery, HC (1994-95) 569.

14 First Report from the Culture, Media and Sport Committee, Session 2000-01, *The Operation of The National Lottery,* HC 56.

15 For further information see First Report from the Culture, Media and Sport Committee, Session 2000-01, *The Operation of The National Lottery,* HC 56.

16 First Report from the Culture, Media and Sport Committee, Session 2000-01, *The Operation of The National Lottery,* HC 56.

3 National Lottery Reform

The problems

Licensing and regulation

25. After the competition for the second licence, and the difficulties surrounding it, a number of concerns were raised about the process used and the implications for any future licence competitions. The previous Committee, the National Audit Office (NAO), and the Committee of Public Accounts (PAC) all reported on the second licence competition and recommended a number of changes to the structure of future competitions. [17]

26. In summary these reports highlighted that: the cost of bidding was significant and the 'all or nothing' result prevented many companies from participating; Camelot held a significant incumbency advantage and there was a need for this to be tackled in the future; and, although competition comparable to that for similar overseas lotteries had been achieved, there was a significant risk of there being no serious competition for a third licence if a similar process was repeated. The PAC in particular recommended: that the NLC should develop contingency plans to deal with circumstances where there was no challenge to an incumbent operator of the National Lottery at any point in the future; and that in future licences the risks involved should be equally spread between the operator and the good causes - rather than allowing good causes alone to suffer if sales forecasts were not met. Our predecessor Committee specifically recommended that the Government carry out a review of the process for the selection of the operator of the National Lottery and of the role of the Commission in that process.[18]

27. The regulation of the National Lottery has historically been separate from the regulation of the rest of the gambling sector. Recently, with the proposed establishment of the Gambling Commission, there have been calls for the National Lottery to come under that body.[19]

28. With these recommendations in mind, the Department for Culture, Media and Sport issued a consultation document reviewing licensing and regulation of the National Lottery in June 2002.[20] This led to the White Paper *National Lottery Licensing and Regulation Decision Document* published in July 2003 within which proposals were announced aimed at resolving the issues highlighted by the second licence competition.

17 First First Report from the Culture, Media and Sport Committee, Session 2000-01, *The Operation of The National Lottery,* HC 56. National Audit Office, *Evaluating the Applications to Run the National Lottery*, HC (1994-95) 569. Committee of Public Accounts, Sixty-fifth Report of the Session 2001-02, *Awarding the New Licence to Run the National Lottery*, HC 881.

18 First First Report from the Culture, Media and Sport Committee, Session 2000-01, *The Operation of The National Lottery,* HC 56, para 126.

19 Ev 190, 193

20 Review of Lottery Licensing and Regulation: A consultation paper, June 2002. Found at www.culture.gov.uk.

Distribution and funding

29. As part of a general review of the National Lottery, and accompanying the consultation on licensing and regulation, the Department also consulted on Lottery distribution and funding in July 2002[21]. DCMS published its conclusions in July 2003.[22]

30. A number of concerns over the National Lottery distribution process were highlighted. These issues came to the attention of DCMS through a number of sources, which included over 400 responses to the consultation document (from distributors and many in the voluntary sector, charities and others), further attitudinal research, and consultation with other Government departments.[23] Problems included:

- the over-complicated application process;
- the inequity of the distribution of Lottery funds throughout the UK;
- the lack of support given to applicants and re-applicants;
- the over–sized National Lottery Distribution Fund and the need to reduce balances;
- the negative image of the Lottery sometimes projected by the press and others;
- the need for increased promotion to the public of the good causes that receive funds;
- the lack of public involvement in decision-making regarding distribution; and
- the effect of the Olympics (both the impact of the Olympic Lottery on overall income for good causes; and the direct call on the sports distributors for resources).

The proposals

31. Since the publication of the DCMS' conclusions[24] some of the Government's proposals have been incorporated into primary or secondary legislation currently proceeding or already passed through Parliament (the Horserace Betting and Olympic Lottery Bill and New Opportunities Fund (Specification of Initiative) Order 2004 setting up a "Youth Fund[25]). The remainder are expected as part of the draft Gambling Bill currently under consideration by a Joint Committee of both Houses. On 3 February the Secretary of State told us that draft clauses relating to the Lottery had not already been published because "of the volume of legislation that as a government we are seeking to get through and, secondly, the resources of Parliamentary Counsel to draft the clauses."[26] We hope that in future, where possible, the scrutiny of draft bills within the remit of the Department will be aided by all the clauses being published in time for the appropriate committees to be able to take

21 Review of Lottery Funding: A consultation paper on Lottery distribution policy, June 2002. Found at www.culture.gov.uk.

22 "National Lottery Licensing and Regulation Decision Document" July 2003. Found at www.culture.gov.uk.

23 "National Lottery Funding Decision Document" July 2003. p 42.

24 "National Lottery Licensing and Regulation Decision Document" July 2003, and "National Lottery Funding Decision Document" July 2003.

25 *Votes and Proceedings*, 21 January 2004, p 143.

26 Q 340

evidence from relevant parties on the implications of specific legislative provisions. This, after all, is the point of the pre-legislative process.

32. The Department, through the proposed reforms which are described in greater detail later in the Report, aims to: increase returns to good causes (whilst still protecting players and ensuring due propriety); ensure effective competition for the operation of the National Lottery going into a third licence period; maintain public confidence and support for the National Lottery; and ensure that the National Lottery thrives in light of the deregulation of the wider gambling sector.[27] **The primary aim of DCMS is to increase the total resources available to the good causes. We support this objective.**

Licensing

33. The fundamental rationale for a tender process for the licence to run the National Lottery is to maintain and, where possible, increase the return for good causes offered by the operator. Increasing total sales through innovation in the games portfolio, reducing costs, and changing the split between prizes, profits and returns are all relevant factors on which the bid process should exert pressure. However, without credible, or any, competing bids, this strategy must needs fail. The only alternative is the more intrusive 'second-guessing' type of regulation practised of necessity in the utilities sector; particularly the water industry.

34. The Government, therefore, in the licensing and regulation consultation paper of July 2002, asked for views on the following four proposals aimed at inviting bidders to a more attractive 'party':

i. the separation of infrastructure and Lottery products to create competition within the single licence by increasing competition to provide services;

ii. NLC to run the Lottery through the private sector;

iii. maximum flexibility;

iv. the establishment of a state-owned National Lottery operating company.[28]

35. Ten responses to the consultation document were received by the Department.[29] In the decision document, published a year later, DCMS analysed the responses and concluded that there was little or no support for the first, second or fourth options, but there was broad agreement that there needed to be an element of flexibility built into the licensing system in time for the third competition. **Although consultation appeared to rule out three of the proposed changes suggested by the Department, we conclude that this does not amount to overwhelming support for the third option which has now been put forward for implementation, namely, the break-up of the single operating licence.**

36. Regardless of how the conclusions were reached, the Government has decided on a number of changes to the licensing of the Lottery and these form the bulk of reform in this

27 "National Lottery Licensing and Regulation Decision Document" July 2003.

28 "National Lottery Licensing and Regulation Decision Document" July 2003 p 8.

29 "National Lottery Licensing and Regulation Decision Document" July 2003 p 28.

area. The Department proposes to shift away from a single licence to run the National Lottery and wants to empower the NLC to offer a number of Section 5 licences to operate different parts of the National Lottery .[30] At the same time, the proposals will remove the requirement for each game to hold an individual Section 6 licence (although it is likely that some sort of individual approval will be needed to launch each new game). This will mean that, if the Lottery is split into parts, the operators would have greater freedom over the running of their game or games.[31]

37. Under the Government's proposals the NLC will be able to offer a number of different licences, which could be divided either by type of game or, possibly, by purchase method. The licences might also be varied in the period for which they were valid. The NLC emphasised that the details of the licences that might be offered must be a matter for decisions taken nearer the end of the present licence period when more research had been carried out.[32] At this time, it is assumed that the possibility of one operator obtaining more than one, or all, of the licences would still be feasible within any new process. The proposals, however, do fulfil the Government's desire to create the *option* of having a number of operators, perhaps of different sizes, running separate parts of the National Lottery for varying periods of time.[33]

38. Whatever form the new licences take, the Department is hoping that this multiple licence regime will stimulate greater competition in the next licence period by creating a more attractive and, crucially, more cost-effective bidding process.[34] The Department also believes that introducing this flexibility at an early stage will create a sufficient lead–in time up to the next competition in 2009 and allows the NLC to research and consult about how to minimise any harmful effects to which the innovations may give rise.[35]

39. There is also likely to be an impact on the role of the NLC (as the body that awards the licence) due to increased demands of managing the process. The Department envisages that it will have to take on a more strategic role, continuously reviewing the National Lottery, and developments across a potentially greater number of operators, to ensure its effective operation.[36]

Regulation

40. The NLC has regulated the National Lottery since it replaced Oflot in 1999. The remainder of the gambling sector is regulated, at present, by the Gaming Board. However, the draft Gambling Bill proposes the creation a Gambling Commission to take over this role. There have been calls for the National Lottery also to be regulated by the Commission. The Department does not agree and the decision document states that this function will remain the responsibility of the NLC. The Department argues that the regulation of the National Lottery must be separate from the rest of the gambling sector because the NLC

30 "National Lottery Licensing and Regulation Decision Document" July 2003, p 10.

31 Ev 238

32 Q 87 [Mr Harris]."National Lottery Licensing and Regulation Decision Document" July 2003, p 10.

33 Ev 153

34 Ev 153

35 Ev 238-9

36 "National Lottery Licensing and Regulation Decision Document" July 2003.

has a unique regulatory responsibility to ensure that returns to good causes are maximised. The regulation of the gambling sector gives rise to no such responsibility and this is argued to create the risk that regulation under the Gambling Commission could cause a potential conflict of interests.[37]

41. The decision document does, however, concede that a number of improvements could be made to the machinery of regulation. The Secretary of State will have more flexibility regarding the number of Commissioners that are appointed. For example, she will be able to appoint the Chair of the NLC for a fixed period which can be for longer than a year, and there will be provision for the Chief Executive and one other executive to be appointed as a Commissioner.[38] By these changes the Department hopes to strengthen the position of the NLC, maintain public confidence in the regulation of the National Lottery, and help improve returns to good causes.[39]

42. In relation to contingency planning, the Department proposes to keep the provision for the Secretary of State to be able to set up a Government company to run the Lottery. It stated that this facility would only be used in extreme circumstances.[40]

Distribution and funding

43. In the National Lottery Funding decision document, the Department sets out a number of changes to funding and distribution mechanisms. Unlike with licensing and regulation, the consultation on distribution was not in response to specific problems. However, a number of concerns had arisen through earlier consultations and reviewers. Many of these receive attention in this decision document.

44. The Department's proposals are aimed at building up public confidence in the Lottery through: a more transparent decision-making process; increased public involvement in that process; increasing awareness of what the Lottery does, and making the application process, and the customer care and complaints procedure easier to understand and use. The Government aims to increase accessibility not least by the creation of five new types of funding: open grants (similar to the grants at present offered by the Community Fund); national programme grants (similar to those at present offered by the New Opportunities Fund); transformational grants (big projects of national significance); a fund aimed specifically at young people; and very small grants (£500 or less) intended to be widely and more easily available.[41]

45. The most significant proposed change to the distribution of National Lottery funds is the merger of the New Opportunities Fund (NOF) and the Community Fund (CF) into a single distributor. The new distributor will also take on the responsibilities of the Millennium Commission and will have responsibility for the allocation of about 50% of total resources for good causes. The Department believes that the new single body will provide a more streamlined source of funding, improving distribution by "simplifying the

37 Ev 153, 154

38 "National Lottery Licensing and Regulation Decision Document" July 2003p 11-12.

39 "National Lottery Licensing and Regulation Decision Document" July 2003.

40 "National Lottery Licensing and Regulation Decision Document" July 2003.

41 "National Lottery Licensing and Regulation Decision Document" July 2003 p 5-6.

application process, cutting administration costs, and increasing responsiveness to public views."[42]

46. The National Lottery Distribution Fund (NLDF) holds Lottery good cause money until it is drawn down for payment to a project by one of the 16 main Lottery distributors. DCMS wants to reach good causes in a more timely and efficient manner which will reduce the amount held in the central fund at any one time (the balances). It intends to do this by removing any incentives for distributors to build up reserves and by legislating to give the Secretary of State the power to reduce and reallocate excessive balances where appropriate.[43]

47. As stated above, the DCMS aims to increase public awareness of what the Lottery actually funds in the hope that this will have a positive impact on ticket sales. The Department proposes to achieve this aim by creating a single Lottery identity; ensuring that all recipients of funding display a common Lottery logo; establishing the National Lottery Promotional Unit (NLPU) charged with raising awareness of projects; and by creating a National Lottery Day on which a variety of events would demonstrate and celebrate the Lottery's impact on people's lives.[44]

42 Ev 153.

43 "National Lottery Licensing and Regulation Decision Document" July 2003 p 7.

44 "National Lottery Licensing and Regulation Decision Document" July 2003 p 8.

4 Licensing and regulation

The National Lottery Commission (NLC)

48. In April 1999 Oflot was replaced by the National Lottery Commission (NLC). The Commission is made up of five Commissioners: Ms Moira Black CBE, Mr Brian Pomeroy, Ms Harriet Spicer, Mr Timothy Hornsby, Ms Jo Valentine. The Commissioners, at present, appoint their own Chair, currently Ms Moira Black CBE, for a period of 12 months at a time, they also appoint a Chief Executive, currently Mr Mark Harris. The Commissioners have all been selected by the Secretary of State for Culture, Media and Sport, who is also responsible for directing the Commission in the exercise of its functions under the powers of the 1993 Act.

49. The formal statutory duties of the Commission are to protect players of the National Lottery, to ensure the Lottery is run and promoted with due propriety, and, with that in mind, also to maximise returns to good causes. The Commission, at present, must also: award one Section 5 licence to the chosen private sector operator and any accompanying Section 6 licences required for individual games; enforce the conditions of licences that have been granted; and impose fines where serious breaches occur or revoke a licence if it sees fit. The Commission is accountable to Parliament through the publication of its annual report.[45]

50. The NLC also is responsible for ensuring that the National Lottery has the best possible private sector operator. In order to do this the NLC must ensure that there is sufficient competition for the licence so that favourable licence conditions can be negotiated and the chosen operator will maximise returns to good causes without taking excessive risks.

51. As the regulator of the Lottery, the NLC is responsible for ensuring that the operator adheres to all the licence conditions and the obligations it has signed up to. In order to police this, the NLC has a compliance division which carries out checks on Camelot's everyday work: the transfer of funds to winners and the NLDF; the Lottery draws; the performance, reliability, efficiency and security of Lottery equipment and technology; and compliance with marketing and advertising agreements. The Commission also monitors breaches of the code and performance against 'regulatory imperatives' that the NLC has developed.

52. The NLC has responsibility for making sure that the operator is doing everything in its power to maximise sales of National Lottery tickets and running the Lottery in a way that maximises returns to good causes (without jeopardising player protection or the propriety of the game). This is the critical feature and the reason National Lottery regulation is separate from the rest of the gambling sector. Sales of National Lottery products peaked in 1998-99, with total revenue of £5,228 million. But from that point until very recently sales have steadily fallen, with total revenue in 2002-03 of £4,574.5 million. However, Camelot announced on 13 February 2004 that headline sales for the third quarter of the financial year were £1.1 billion, equalling figures for the last two quarters, suggesting that the long term decline in sales had been halted.[46] Some research has been done across international

45 Information from the National Lottery Commission website: www, natlotcomm.gov.uk/Information.

46 http://www.camelotgroup.co.uk

lotteries and it indicates that the National Lottery is experiencing natural player fatigue.[47] However, the NLC told the Committee that it believed that not only could sales be stabilised but they could also be grown.[48] Mr Mark Harris, Chief Executive of the NLC, told us that growth could be achieved through a number of routes:

> "Part of the growth comes from the expansion in the portfolio; part of it comes from keeping the product alive in people's minds, selling the benefits of it, improving it where it is possible to improve it. That is very much what we are looking to the operator to do."[49]

53. This is the case both now and looking into the future of the National Lottery. There is a clear distinction between the role of the operator (responsible for the management of the games and with incentives to maximise sales) and the role of the NLC (tasked with making sure that it selects the best operator and that the operator properly carries out its responsibilities and meets its obligations).

Camelot

54. Camelot is the current private sector operator of the National Lottery and has been since it was awarded the first seven year Section 5 licence in 1994. This is accompanied by a number of Section 6 licences which are necessary to run each individual games of which include: the National Lottery Game (Lotto), Thunderball, Lottery Extra, Christmas Millionaire Maker, Scratchcards, Hotpicks, Easyplay, Euromillions. Other companies are able to hold Section 6 licences but only with the assent of the main licence holder. Camelot currently hold all 50 Section 6 licences.

55. Camelot has more specific roles and responsibilities as the main licence holder and these include: managing game design; stopping underage and illegal play; discouraging excessive play; providing player services and information; providing winner services; providing security; protecting the integrity of the games; and social reporting on a yearly basis.[50] As discussed above, the NLC is responsible for regulating the licence conditions and ensuring that standards are maintained in all these areas.

56. Under the current licence Camelot also has a number of more specific conditions to adhere to and Ms Diane Thompson, Chief Executive of Camelot, told us that Camelot shareholders have committed to invest £1 billion in the National Lottery over the present licence period, as well as a specific minimum marketing spend for each of the seven years from 2002 to 2009.[51]

Regulation

57. The NLC is currently responsible for carrying out the regulation of the National Lottery. As outlined above, the role of the NLC as the regulator of the National Lottery is to

47 Creigh-Tyte and Farrell, Is the UK National Lottery experiencing lottery fatigue?, in Vaughan Williams, *The Economics of Gambling* (2002) p 165-181.

48 Q 75

49 Q 75

50 Information form Camelot Group plc website: http://www.camelotgroup.co.uk/responsibilities/index.jsp

51 Q 111 [Ms Thompson]

check the performance of the operator and to enforce the conditions of the licence under its statutory duties (protecting players, ensuring propriety and maximising returns to good causes).

58. The Government's proposals to keep the regulation of the National Lottery under the NLC are likely to come under pressure from two angles. Firstly, the deregulation of the gambling sector has led to calls for the Lottery to be regulated with the rest of the sector by the Gambling Commission (proposed under the draft Gambling Bill). The Gaming Board argue:

> "the Gambling Commission could police and monitor all gambling operations, including the National Lottery. The Commission could also play a major part in the periodic competitions for licence(s) by investigating and vetting the competing bidders. But the NLC's current duty to maximise returns for good causes would need to be modified to bring it into line with Clause 14(b) of the draft Gambling Bill. And there is a case for a separate, time limited, body or committee to be established when necessary to invite bids, decide between them and appoint the operator(s) of the National Lottery."[52]

59. However, the NLC and others (including the National Council for Voluntary Organisations (NCVO), Camelot and The People's Lottery) recognise a potential conflict of interests due to the statutory duty of the regulator of the National Lottery to maximise the returns to good causes and they agree with the Government that the regulation of the National Lottery should be separate from the rest of the gambling industry.[53] The Lotteries Council agrees in principle but they argue that other society lotteries (such as those they represent) should also be regulated by the NLC in recognition of the fact that they also generate returns for good causes.[54]

60. The Government told the Committee that it appreciates the argument for amalgamation of all gambling activities under one regulator but has decided to keep separate the regulation of the National Lottery from the rest of the gambling sector. Responsibility for regulation will remain part of the role of the NLC rather than being transferred to the proposed Gambling Commission. This is because regulation of a "very different nature" is required for the National Lottery as the NLC is under statutory duty to maximise return to good causes.[55]

61. However, DCMS does envisage a role for NLC within the Gambling Commission, with a NLC holding a seat on the Commission so that it takes proper account of the effects on the National Lottery of any regulatory developments in the gambling sector.[56]

62. **We believe that due to the unique and proper responsibility of the National Lottery Commission (NLC) to maximise returns to good causes, the regulation of the National Lottery should remain the responsibility of the NLC.**

52 Ev 191

53 Q 70 and Ev 17, 49, 61

54 QQ 6, 8, 71

55 Q 333

56 "National Lottery Licensing and Regulation Decision Document" July 2003

63. **We agree that a representative from the NLC should have a seat on the proposed Gambling Commission proposed within the draft Gambling Bill.**

Licensing at present: single licence system

64. The present single licence system is made up of one Section 5 licence to run the Lottery with additional Section 6 licences for each game under that main licence. After experience had been gained from the first licence period and the difficulties of the second licence competition, many additions and changes were made to the second licence and to the conditions the operator had to adhere to. In light of this, the key characteristics of the present licence are:

- About 28% of sales are expected to go to the NLDF (National Lottery Distribution Fund). At sales of £5 billion per year over seven years, good causes would receive around £10bn (around 28% of revenue), plus interest. This is much the same as under the first licence (1994–2001), despite the challenges posed by player familiarity, increasing competition and the impact of new technology.

- A new incentive system links Camelot's return from the Lottery to the amount it raises for good causes. If the operator's profits exceed the level it forecast in its bid, half of the balance above this will go to good causes as a "secondary contribution".

- An extended minimum marketing commitment now applies to every year of the licence, instead of just the last $2^{1}/_{2}$ years, helping to keep the Lottery attractive and properly promoted. Marketing expenditure planned for the second licence period is significantly greater than the amount spent in the first.

- There are financial penalties if Lottery IT systems fail on start-up, and these are intended to act as a safety net to compensate good causes for any resulting loss.

- For 2002–2009, the share of prizes is expected to be closer to 50% than for 1994–2001 (48%). International experience suggests this helps to sustain sales. The Commission has required Camelot to consult players regularly and take account of their views in developing player information and other services.

- The Commission has powers to set performance targets on which Camelot must report monthly, as well as performance standards which it must meet. Camelot is required to develop and implement strategies – to be approved by the Commission – to prevent under-age and excessive play.

- Camelot must conduct not less than 10,000 under-16 tests a year (roughly two per retailer during the licence), with the Commission able to increase that number if it can show grounds. This doubles the previous number of tests.[57]

65. There are extended provisions for propriety, and tougher powers for the regulator, such as:

57 Under-16 tests are carried out to ensure under-age play of the National Lottery is reduced/eradicated.

i) requiring any of Camelot's contracts to contain provisions relating to internal controls and to include arrangements for reporting to the Commission as well as to Camelot;

ii) requiring independent testing of any software process at the *contractor's* expense;

iii) requiring Camelot to have code of conduct and whistle-blowing procedures approved by the Commission, with requirement to make employees and contractors aware of licence obligations;

iv) a new explicit requirement for Camelot to provide immediate reports on incidents that might reasonably be expected adversely to affect the proper running, regulation or image of the National Lottery;

v) reporting requirements widened to include any fraud affecting the licensee, whether or not the National Lottery is involved.

66. The Commission does not have a day-to-day role in respect of retailers, but the new licence includes provisions ensuring that:

i) Camelot publishes clear and fair criteria for selecting retailers for lottery terminals and for deselecting them;

ii) retailers' commission cannot be reduced without NLC permission;

iii) in order to deliver a reasonable geographic spread of Lottery terminals across the country, Camelot must install at least one online outlet in each postcode district with 2000 or more residents (instead of one in each local authority area as before);

iv) the minimum number of retailers with terminals during the term of the licence is similar to the numbers required previously, despite the expected introduction of new technology;

v) penalties will apply if numbers of terminals fall below the specified licence commitments.

67. The Commission has taken steps within the *current* legislative framework, to facilitate competition for the next licence and encourage independent games under the present one:

i) Camelot is required to develop and implement a strategy – to be approved by the Commission – to encourage potential applicants for an independent Section 6 licence;

ii) Camelot must for up to two years prior to the end of its licence co-operate with an incoming licensee;

iii) The Commission has acquired rights over Camelot's database of retailers and can in future make this available to bidders;

iv) The Commission can require the transfer of certain property or rights where this is necessary to the running of the National Lottery, e.g. terminals; and

v) Camelot must provide an incoming licensee with the information necessary for it to pay outstanding prizes.

Advantages and disadvantages

68. The advantages of a single operator holding a single licence were argued by Camelot to include: strategic overview of the overall National Lottery portfolio; consistency in game design and the ability to cross-subsidise between elements of the portfolio if needed; the increased ability to limit the effect of the cannibalisation between individual games; economies of scale; and increased receptiveness to a heavy regulatory focus.

69. One possible reason that organisations were deterred from bidding for the second licence was the incumbency advantage that Camelot was perceived to enjoy at the time of the licence competition. Camelot claims that this issue has been dealt with by "the changes that were made in the second licence by the NLC … in areas such as ownership of intellectual property rights (IPR), exclusive contracts and technology."[58]

70. However, the big disadvantage (and thought to be the main deterrent to bidders) of the single licence system is that only one of the bidding organisations is able to win the Section 5 licence and the others waste a large amount of money in a "winner takes all" process. We believe this deters organisations and may have reduced the number of bidding organisations between the first and second licence competitions from seven to two. It may also further decrease the number of bids for the next licence if the system remains. It is the fear of having no competition for the third licence that has stimulated many of the proposed changes to the licensing system.

71. Camelot believes that there would be a number of other bids for the third licence if the system were to remain. They claim that The People's Lottery (TPL) and Lord Mancroft have expressed interest in bidding for a single licence.[59] They also believe that the introduction of a multiple licence system would deter possible bidders.[60] However, the Government and the NLC assert, supported by reports by the previous Committee, the PAC and the NAO, that there is a danger of no other organisation bidding for another single licence. This is the primary justification that the Department cites for reforming the licensing system of the National Lottery. The introduction of a multiple licence system is proposed by the Government as a mechanism to increase the number of bidding organisations in competition for the operating period after 2009. It would therefore be a serious problem if these changes have the opposite effect and deter possible bidders.

New proposal: multiple licence system

72. The Government proposes to supersede the present system of licensing the National Lottery by giving the NLC the option of awarding multiple licences in the next licence period. The reforms aim to make sure that more than one company will have the ability to bid for the third licence.[61] In theory, the multiple licence system will empower the NLC to

58 Q 114

59 Q 141

60 Q 141

61 Q 347

obtain increased flexibility by splitting up the Section 5 licence into a number of packages that would then be awarded to a single or multiple operators. This is argued to make the licence(s) more accessible to a larger number of companies and encourage bidders by the number and variety of available licences and the increased likelihood of more companies getting a return on their investment in a bid.[62] Such a system would most probably be divided by game type.[63] The NLC will be the body to decide if, and how, the licence should be split up and would be responsible for deciding which operator or operators would run each part of the new arrangements.

Advantages

73. The potential advantages of a multiple licence system have been explained to us in detail by DCMS and the NLC. The main advantage is the flexibility of the system which gives the NLC the option to break up the licence if it sees fit to ensure that there is sufficient competition for the next licence round.[64] DCMS said:

> "Under the proposals that we put forward in the discussion document, it may be the case that the licence is left in its entirety and it may be the case that the incumbent gets the licence for the third time. The proposals will not stop that happening but they will make sure that we do not have that as the only option in the way forward."[65]

74. This flexibility will, it is hoped, lead to the possibility that there will be more than one bidder for the next licence, increasing competition for it. In allowing for a number of different sized companies to bid to run different sections of the licence the reforms are expected to increase innovation within the National Lottery and stimulate a rethink about how best to run and promote Lottery products. The Government believes that the multiple licence approach solves "more of the problems that have come to the forefront that have stopped people bidding for the licence"[66] and that the reforms are what is needed to revive the UK Lottery in light of declining sales.[67]

Disadvantages

75. Mr Michael Grade, Chairman of Camelot, told the Committee that he believed the multiple licence system posed a serious threat to future returns to good causes.[68] Camelot commissioned an independent economic assessment of the DCMS proposals by consultants, Frontier Economics, which focuses on the likely impact on money raised for good causes and identifies a number of potential problems likely to arise with the use of a multiple licence system for the National Lottery.

62 Q 348

63 See appendix 1

64 Q 349

65 Q 349

66 Q 348

67 Q 350

68 Q 113

Frontier Economics report

76. The key conclusions of Camelot's commissioned report, which is appended to this Report, are set out below:

- Multiple licence holders competing "within the market" could reduce funds for good causes due to: the possibility of unmanaged cannibalisation between games; uncoordinated product launches being undermined by lack of coordination between licences; under-investment in the Lottery brand and infrastructure (free-riding); and the potential loss of economies of scale and scope.
- The total economic value of the Lottery would fall meaning that the multiple licence model would only increase funds for good causes if competition "for the licence" was increased significantly, and the share of the revenues given to the good causes was raised substantially.
- Moving from a single to a multiple licence model might not increase competition "for the market" due to increased uncertainty and a more complex strategic environment for bidders to contend with because of the flexibility given to the NLC.
- Competition "for the licence" can be increased within the single licence model by modifying the system and allowing: gambling and gaming firms to operate the Lottery through a subsidiary; the operator to select different suppliers during the licence period; the costs of bidding to be underwritten. The incumbent might also be required to submit a final bid before other bidders.
- Offering multiple licences would be a complex option with significant risks and no clear benefits to good causes.[69]

77. The report recommends a number of actions to be taken before the competition for the next licence:

- a risk assessment into the likelihood of weak bidding in the next round;
- an investigation into a number of options, other than multiple licences;
- an investigation into the possibility of increasing contributions to good causes under the single licence model, by modifying the shape of the retention schedule;
- the Government should ensure that all licences could be won by one operator, should design any division of the licence to minimise competition between operators and should ensure that the NLC is properly resourced to carry out its increased role and extra responsibilities.[70]

69 See appendix 1

70 See appendix 1

NERA report

78. The NLC responded to Camelot's report by commissioning its own study from NERA (its economic advisers) into the conclusions of Frontier Economics.[71] NERA highlighted three major concerns:

- The report is not clear enough about the form of multiple licence model that is being assessed. It does not distinguish between the awarding of only one licence for each different types of Lottery product and more than one licence being awarded for each type of product. The NLC envisages reducing cannibalisation, free riding and the problems of uncoordinated launches by splitting the licence by game type and awarding distinct non-competitive areas to different operators.

- The report ignores the benefits of dynamic competition, namely, innovation of game design and marketing and cost reduction, all of which could lead to increased returns to good causes.

79. Other criticisms of the report included:

- The fact that it assesses the risk of the proposals but does not do so against the costs of not changing the system in the context of declining sales.

- It undervalues the role that the NLC regulation can effectively play to avoid undesirable outcomes and does not take into account the Commission's ability to rely on expert advice when complex issues arise.

Role of the NLC

80. Camelot and Mr Simon Burridge, Chief Executive of The People's Lottery were also concerned that the increased role of NLC within the new system would lead to it effectively becoming the *de facto* operator of the National Lottery without the expertise or incentives of a private sector operator.[72] They argue that this radical change will create a conflict of interests between the licensing and regulatory roles of the NLC.[73] The NLC would have to manage the game portfolios (including the number of each type of game) and the marketing of the brand and the timing of game launches (in order to minimise cannibalisation). All this has previously been the responsibility of the licence holder. Mr Grade, Chairman of Camelot, summarised the position in oral evidence:

> "With the complexity of running multiple licences you cannot just launch a game. You need a software window, which is a very scarce commodity; there is a limit to how many new games retailers can learn and sell in one year; there is going to be tremendous competing pressure – all those decisions which have a very sensitive effect on returns to good causes will land on the desk of the regulator, and they will be in the position of having to make far-reaching commercial decisions between

71 Camelot have subsequently commissioned a further report, by Frontier Economics. This responds to the NERA report and is reproduced in appendix 3 of this Report.

72 Q 157

73 Q 157

> different operators. They will be the *de facto* operators of the National Lottery, and those are not the skills for which they have been recruited."[74]

81. Concerns have been expressed to us by Camelot and The People's Lottery that the NLC may not be the correct body to take on this role.[75] This is because they believe that the NLC would be responsible for making commercially sensitive decisions about game design, the make up of the game portfolio, timings of game launches and management of the overall brand, and, as the regulator, it is not well enough skilled or commercially aware to do.[76] Camelot have also identified the potential for conflict between operators, such as the current legal battle between two Italian operators, as something the NLC would have the responsibility to resolve without necessarily having the right skills.[77] The NLC and the Government, however, are both confident that the Commission, with a few small changes (detailed in the decision document and outlined above) will be able to take on this new role if it proves necessary to do so.[78]

82. It was of concern to us that the NLC did not seem sure of the exact implications of these reforms for the role they may have to take on and that it has not, so far, carried out much (if any) research into the detail of the proposals. Representatives from the NLC told us in oral evidence that they did not propose to do any detailed research until nearer the end of the current licence period so that any such work was up to date and relevant to the circumstances pertaining at the time of the third licence competition. The Commission argued that, by then, the resources will be available to carry out research, more details of the system to be used and the role of the NLC within that, will be known and it will be possible to examine the proposals properly.[79] **We agree that public resources should be used to gather relevant and timely information but we think that it is critical, at this time, for the Department and the NLC to have a clearer idea of how the proposals to establish a multiple licence system will affect the amount of competition for the licence and the role of the NLC. We therefore recommend that resources are made available for research to be carried out into the effects of the proposals so that the Department can judge adequately the likely effects of its decisions. The Department and the NLC must also consider examples of use of the multiple licence system by overseas lotteries and aim to learn from the experiences abroad.**

83. The proposed reforms have been developed because there is a need to ensure that there is adequate competition for the third licence. DCMS believes that the NLC must be given the flexibility in this way to get maximum returns for good causes in the third licence period. Ms Moira Black CBE, Chairman of the NLC, told us that they would

> "very much welcome the flexibility because we see, as indeed you yourself have said in a previous report, that we run a serious risk if we do not have the flexibility that we continue with a single monopoly operator."[80]

74 Q 138

75 QQ 138, 157

76 Appendix 1, para 14.

77 QQ 126 , 157, Ev 50

78 Appendix 2

79 Q 87

80 Q 77

84. The NLC believes, as do the Government, that the continuation of a single monopoly operator would seriously disadvantage good causes in the next licence period. It made clear that the introduction of flexibility would not stop the licence being awarded to one operator if it put forward the best bid. But, it does give the NLC the power to increase competition if only the incumbent operator seems likely to bid for the next licence.[81] It appears to us that the reforms are being put in place before research has been carried out properly into the implications, because the Government wishes to give itself a 'get out clause' if there appears to be a lack of competition for the third licence when it comes up for renewal. This is all well and good, but due to the lack of research done, the Department has not taken into account the potential risks of the multiple licence system (or just the prospects of having such a system) which could in fact reduce competition for the third licence. **We therefore urge the Department to consider fully all of the implications of introducing (or giving the NLC the flexibility to introduce) a multiple licence system, at the same time weighing up the multiple licence system against alternative solutions available .**

85. We have heard from two prospective bidders that the introduction of a multiple licence system would in fact stop them from bidding for the third licence. Mr Simon Burridge told us that that TPL had so far found no-one with any interest in bidding for the next licence and that, under the current proposals, TPL would not do so themselves.[82] The Committee has also received a letter from Lord Mancroft, Chairman of Inter Lotto (UK), which states that he agrees with Mr Burridge and Sir Michael Grade that the "current proposal (for multiple licences) is unworkable" and goes on to say, "if I was interested in making a bid, I would not do so under these circumstances" and even, "I believe it unlikely that any competitive bids will emerge if this position is pursued."[83] **We recognise that there is a need to stimulate more competition for the third National Lottery licence. However we note that the proposed reforms, as they stand, do not have the support of obvious potential bidders and we believe the Department must look again at how it can attract more competition for the third licence.**

86. We are concerned that the Department is planning to pioneer this system without sufficient evidence that it will not be putting the National Lottery, and returns to good causes, at risk. In oral evidence Rt Hon Estelle Morris MP, Minister for the Arts, stressed to us:

> "We have to look at our record, our lottery, our country, our conditions, our people who are bidding for it. I do not think we should be fearful to go forward because nobody else in the world has done it up to this moment in time. Otherwise, we would never innovate."[84]

87. We agree that a solution should be found that is tailored to the needs of the UK's National Lottery but we do not think that the current proposals will create the competition for the licence that the Government aims to obtain nor, therefore, the increased returns to

81 Q 77

82 Q 157

83 Ev 224

84 Q 350

good causes that it seeks to achieve. We do not agree with the statement by DCMS that "this is the right way forward".[85]

88. **When considering the advantages and disadvantages involved with the retention of the present system or evolution to a multiple licence system, Mr Simon Burridge representing TPL made a clear and bold statement to the Committee that "faced between the choice of Camelot in perpetuity and the Government's new proposals, with the greatest reluctance I think I would volunteer for Camelot in perpetuity as the lesser of two evils."[86] Looking at the evidence presented to us in this inquiry, including on the limitations of the NLC, we have to agree.**

Alternative solutions to the proposed multiple licence system

Improve single licence system

89. One alternative solution to the proposed reform of National Lottery licensing would be to keep the single licence system but improve conditions for the third licence competition so that the Government can be sure that more companies would be able, and willing, to bid for the licence. This could be done by decreasing the cost of bidding for the licence, which has been identified as a significant barrier to applications. Mr Burridge told us that the cost of putting together The People's Lottery bid for the last licence round was over £15 million and took a huge amount of work.[87] It is easy to see why other organisations would be reluctant to spend that amount of money for, potentially, no return.

90. Two ways of decreasing the cost would be to subsidise or underwrite the process (although this would decrease funds going to good causes) or run a two-tier competition for the third licence, with a spending limit for the first round, reducing the burden on bidders. However, in oral evidence, Rt Hon Estelle Morris MP, told us that she believed it was not just the cost that deterred more companies from bidding for the second licence.[88]

91. As highlighted above, another problem with the second licence competition was the incumbency advantage that Camelot was perceived to have held at the end of the first licence. Camelot argued that, since the second licence, steps have been taken to ensure that they no longer have a significant (if any) incumbency advantage as problems with ownership of intellectual property rights, suppliers' contracts and changeover had been resolved:

> "The incumbency arrangements at the end of the second licence are quite different from the first, and all IPR [international property rights] is owned by the National Lottery Commission, so if Camelot were not successful to win the third licence then another operator would just take over in a seamless transition."[89]

92. Camelot argues that this means that a single licence competition would be much more likely to attract more bidders. The Government and the NLC dispute this.

85 Q 350

86 Q 147

87 Q 148

88 Q 348

89 Q 121

Competitive tendering

93. An alternative suggestion to the proposed reforms is the introduction of competition through the provision of services. This could be done by splitting the infrastructure and content of the licence in a similar way to the model used within the utilities sector. Camelot told us that competition could be created, not by splitting the licence, but by not requiring the licence holder to commit to all its suppliers for the entire length of the licence.[90] Instead, the operator could be awarded the Section 5 licence and then have an open-tendering process for the suppliers of advertising, software, scratch card provision, and other supplies in order to create competition whilst maintaining the advantages that are associated with having a single licence holder.[91] The People's Lottery think that competition should be introduced to the process not through multiple licences but through competitive tendering for areas of specialisation which would result in "better services, better marketing, better games, better infrastructure, better retail training and so on."[92] This would introduce the benefits of competition which the Government desires but without the risks associated with a multiple licence system. **We feel that competitive tendering would effectively introduce the attractive elements of competition to the National Lottery but would also encourage bids for the overall licence because a better package would be offered to potential operators containing significantly less uncertainty than is associated with the multiple licence system.** We recall that the accumulation of risks was a significant factor in the NLC's award of the second licence to Camelot in 2001 rather than TPL which proposed to give a greater proportion of revenues to good causes.[93]

Auction

94. Another possibility would be to sell the licence to the highest bidder (modelled on the auction for the 3G mobile phone licence). The NLC told us that the possibility of holding an auction for the next licence will be investigated as part of the preparation for 2009.[94] The advantage of such an auction would be that good causes would have a guaranteed known amount to spend over the licence period. However, the NLC also emphasised the pitfalls of such an auction: the companies involved would have to put forward a large amount of money at the outset of the licence (approximately £10 - £11 billion is raised over a 7 year licence); to borrow that money would increase the costs of bidding (due to the interest paid); and if a fixed sum from the takings was accepted (rather than a percentage) there is the risk that takings would be higher than expected and that the good causes would miss out or, if the company was in difficulty or ultimately failed, the fixed sum might have to be reduced or may be lost altogether.[95]

90 Q 127

91 Q 127

92 Q 165

93 NAO Report, 2001-02, HC 803

94 Q 72 [Mr Harris]

95 Q 72 [Mr Harris]

5 Funding and distribution

Good Causes

95. Since 1994 the National Lottery has raised £15 billion for good causes.[96] This money has been used to fund or part-fund a wide range of life-enhancing projects (although not all projects have proved sustainable). Some examples of large projects that received Lottery funding are: the Millennium Dome; Wembley National Stadium; Tate Modern; the Eden Project; the Falkirk Wheel; the Lowry; the renovation of the Royal Festival Hall; and the Millennium Stadium. On a smaller scale: projects providing disabled access; helping sports clubs build new facilities and equipment; and providing opportunities for people to engage in arts through funds given to many theatres, and music and drama clubs. The number of projects funded by each distributor and the amount spent up to February 2004 is shown below.

Distributing Body	No. of Projects	Amount
Arts Council England	19,979	£1,906,658,088
Arts Council of Northern Ireland	1,211	£45,548,105
Arts Council of Wales	3,979	£118,279,709
Awards For All (England) Joint Scheme	20,988	£79,553,470
Community Fund	53,863	£2,645,829,349
Heritage Lottery Fund	10,451	£2,381,070,632
Millennium Commission	2,947	£2,131,324,379
New Opportunities Fund	15,590	£2,068,742,576
Scottish Arts Council	5,087	£199,495,969
Scottish Screen	105	£6,754,099
Sport England	14,699	£1,860,554,889
Sport Scotland	4,529	£175,652,105
Sports Council for Northern Ireland	842	£42,625,047
Sports Council for Wales	1,047	£103,833,609
UK Film Council	1,059	£111,443,587
UK Sport	2,656	£118,748,032
TOTALS	159,032	£13,996,113,645

96 www.national-lottery.co.uk/player/p/goodcauses/fundraising.jsp

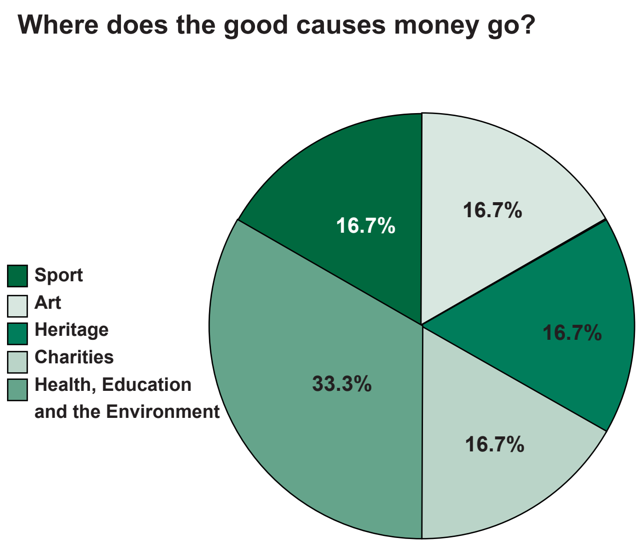
NESTA (The National Endowment for Science, Technology and the Arts) has received an endowment of £295,000,000 making a grand total of £14,291,113,645

Source :www.lottery.culture.gov.uk Updated on: 19/02/2004.

Distributors

96. Twenty–eight percent of Lottery revenue is paid into the NLDF. This money is split between the five good causes in the proportions shown in figure 1 below, with sport, arts, heritage and charity all receiving the same proportion and health, education and environment receiving twice that. There are at present 16 distributors of National Lottery funding which represent all five good causes. They each distribute Lottery money to organisations and projects within their individual remit. Some of the distributors were specifically set up to distribute Lottery money (e.g. Community Fund and New Opportunities Fund) whereas others are NDPBs which receive grant-in-aid as well as Lottery money to achieve their overall objectives (e.g. UK Film Council and Sport England). The amounts that each distributor draws down from the NLDF vary from year to year. The figures for 2002-03 are shown in table 10 below.

Figure 1: Pie chart to show the division of NLDF funds between the good causes



Source: www.lotterygoodcauses.org.uk

97. The distributors, the good causes that they fund and the amounts they draw down from the NLDF on an annual basis are set out in the table below:

Table 9: Income to the NLDF and amount drawn down by distributors in 2002-03

Income to the National Lottery Distribution Fund (NLDF) Total amount drawn down from the NLDF			1,591,781,000 1,892,799,000
Distributor	Good cause represented	Recipient of grant-in-aid funding	Amount drawn down from the NLDF
New Opportunities Fund	Health, education and environment	No	367,000,000
Community Fund	Charity	No	352,214,195
Sport England	Sport	Yes	307,958,000
Heritage Lottery Fund	Heritage	No	264,828,307
Millennium Commission	Cross cutting	No	190,477,000
Arts Council England	Arts	Yes	178,533,056
NESTA	Arts		95,000,000
UK Sport	Sport	Yes	25,842,042
UK Film Council	Arts	Yes	24,497,524
Sports Council for Wales	Sport	Yes	20,632,199
Scottish Sports Council	Sport	Yes	17,395,791
Scottish Arts Council	Arts	Yes	15,822,048
Arts Council of Wales	Arts	Yes	15,549,008
Arts Council Northern Ireland	Arts	Yes	7,173,681
Sports Council of Northern Ireland	Sport	Yes	5,665,747
Scottish Screen	Arts	Yes	4,210,613

98. Each individual distributor is charged with a specific task within each of the five good causes. The Community Fund is aimed at the most disadvantaged in society through grants to charitable, benevolent and philanthropic organisations. It has distributed £2.6 billion in over 56,000 grants allocated to all four UK countries and the nine regions within England on the basis of population weighted by socio-economic factors. It distributes a number of different sized grants (large (over £60,000); medium (up to £60,000); strategic; research; and international). It has six priority beneficiary groups: children and young people; older people and their carers; disabled people and their carers; black and ethnic minority communities; refugees and asylum seekers; and people living in communities, including both urban and rural areas, disadvantaged by economic and social change.

99. The New Opportunities Fund provides National Lottery funding for health, education and environmental projects across the UK. Since 1998, it has granted £2.4 billion to over 10,500 projects, allocated on the basis of population weighted by deprivation.

100. The Heritage Lottery Fund, created in 1995, has committed over £2.8 billion to more than 15,000 projects in the UK. The HLF strategic plan for 2002-07 sets out three main aims: to encourage more people to be involved in and make decisions about their heritage; to conserve and enhance the UK's diverse heritage; and, to ensure that everyone can learn about, have access to and enjoy their heritage.

101. Arts Council England is the national arts development agency, responsible for developing and implementing arts policy and funding with and on behalf of the DCMS, using Lottery and grant-in-aid funding. The current annual National Lottery income is about £180 million which makes a big contribution to the cultural sector of England. Arts Council England have funded over 2,300 projects with more than £1.7 billion. A similar role is taken on by the Arts Council of Wales, the Scottish Arts Council and the Arts Council Northern Ireland for each of the devolved nations. The UK Film Council and Scottish Screen and the National Endowment for Science, Technology and the Arts (NESTA) also distribute Lottery money for the arts.

102. The sporting distributors include: UK Sport which takes on a strategic role within the sector, particularly focusing on elite sport and with responsibility for creating a strategy for developing high-performance sport in the UK;[97] Sport England; Scottish Sports Council; Sports Council of Northern Ireland; and the Sports Council for Wales. The national sports councils are responsible for delivering the Government's objectives for sport through work at grass roots, community and national level.[98]

New proposals

103. The overall purpose of the new proposals is to achieve more effective, efficient and equitable distribution of National Lottery funds. The Department for Culture, Media and Sport proposes to achieve this aim through a number of changes to the principles behind, and the mechanisms used to distribute, the Lottery money for good causes. The DCMS believes that it can achieve these aims through:

- increasing public awareness of the National Lottery;
- increasing access to funding; streamlining the distributors;
- greater management of the NLDF;
- devolution of decision-making to the nations and regions of the UK; and
- creating a single Lottery identity.[99]

Increased public involvement

104. The Department wants to see increased public involvement in the funding decisions made by distributors. The DCMS is encouraging each of the distributors to involve the general public in priority setting and funding decisions through the establishment of

97 UK Sport website www.uksport.gov.uk.

98 Sport England website www.sportengland.org.

99 "National Lottery Licensing and Regulation Decision Document" July 2003

regional committees, which are made up of a range of types of Lottery players from society, and wider cooperation, with the media providing the general public with more opportunities to vote on which projects Lottery money should be spent on.[100] Standardisation of the application form, providing a common standard of service across all distributors and a common complaints procedure will also help to encourage more of the population of the UK to approach the Lottery for funding.[101]

105. We believe that the increased involvement of the public in the decision-making process should be managed carefully and provisions should be put in place to ensure that meritorious applicants do not lose out to publicly popular projects. The Secretary of State told the Committee that she believes "the decisions by which money is awarded to good causes should be much more directly influenced by people who play the Lottery" but she added that distributors should "continue to be courageous and true to the principle of the Lottery."[102] We believe that there may be tension between these objectives. It is imperative that the public involvement in decision-making does not compromise the ability of the distributors to make independent decisions on projects that deserve Lottery funding within their remit. We feel that the involvement of the public more widely in National Lottery funding decisions should be managed with care but we agree that such involvement could raise awareness of the benefits of the Lottery and increase public confidence in the institution, which in itself is a good thing, and might also lead to higher revenues and returns to good causes.

Increased accessibility

106. The DCMS wishes to see increased accessibility to Lottery money in order to achieve a more equal spread of funding throughout the UK. It proposes to achieve this through the introduction of a variety of new and extended funding streams and grants including: open grants (a demand-led programme for voluntary and community organisations) under the control of the new body; national programme funding; a Young People's Fund (initially of £200 million for children's groups and young people); an increase in the limit of the Awards for All programme grants to £10,000; and micro-grants (simplified application for funding of less than £500).[103] These funds are intended to enable more people to gain access to Lottery money by increasing the variety of funding available and by making it easier to apply for them.

107. The Department hopes that these changes will mean that contact with any of the Lottery distributors is easier for applicants, especially those without previous experience. These proposals were generally welcomed in the evidence that we heard, especially by the Coalfields Community Campaign, who believes that the reforms will help many in deprived areas to engage with the Lottery and benefit from its funding.[104]

100 "National Lottery Licensing and Regulation Decision Document" July 2003 p27

101 "National Lottery Licensing and Regulation Decision Document" July 2003 p30

102 Q 342

103 "National Lottery Licensing and Regulation Decision Document" July 2003 p 17-19

104 Ev 25

108. The Department stated that the distributors also need to work together in a more coherent way in order to make grants more accessible to all.[105] The distributors claim that they already work closely in a number of areas. An example of this is the five distributors currently jointly funding the work of the Awards for All programme. This programme currently gives small grants of under £5000. The application process for the scheme is quick, with a maximum turn-around of eight weeks, thus getting smaller amounts of money out in to the community quickly. In addition, the risk assessment is simpler, commensurate with the size of the grants.[106] The Awards for All programme prides itself in being

> "fast, transparent, and reasonably slick, particularly in terms of giving the assistance to the applications at the point where they are making an application, for many of whom that will be their first opportunity of accessing funding."[107]

109. We believe that the development of the Awards for All programme represents a positive step towards greater accessibility of funds. We are encouraged that the Government proposes to make the accessibility of grants even easier by the introduction of a number of new grants and funding streams that will target problem areas and take on many of the characteristics of the Awards for All programme. The Youth Fund and Olympic Lottery Fund have been created to focus on the needs of specific areas. The micro-grants programme will be set up to provide very small grants to a large variety of projects allowing many more people to benefit from Lottery money without the complication of too much paper work, which is a barrier to many people applying. This multi-pronged approach of the Department could cause greater confusion amongst applicants due to the number of funds now in existence, but the reforms have the potential to be effective if the existence of these new funding streams is clearly promoted to those who are eligible to receive it.

110. The need for simplification and increased access has been highlighted by the Coalfield Community Trust, which believe that the cost and complexities of the application process deter many people. The organisation calls for a single application form for all grants and increased support for applicants from the distributors, especially in cold spots, throughout the process so that organisations and community groups can gain access to their share of the Lottery funds available.[108] Lady Brittan, Chairman of the Community Fund, told us that the distributors are aware of the difficulties that small organisations, without sufficient resources, face trying to obtain Lottery funding and that they are trying to reach areas that traditionally miss out by sending staff to 'Fair Share' areas to raise awareness and increase applications in areas which really need the help to set up voluntary organisations and help them become sustainable.[109] **Proactivity in tackling the causes of the variation in funding levels across the UK is one of the key responsibilities of the new distributor once it is properly established. We hope that the new distributor will carry out this role with vigour, increasing accessibility to funding throughout the UK.**

105 "National Lottery Licensing and Regulation Decision Document" July 2003

106 Q 192 [Mr Wilkins]

107 Q 192 [Mr Wilkins]

108 Q 45 [Mr Flannagan]

109 The fair share initiative supports projects that have a sustainable impact on the lives of disadvantaged people in the areas that the New Opportunities Fund and Community Fund have identified as not having received a fair share of lottery money.

111. It is widely recognised that it is difficult for some, especially small, organisations to gain funding. Representatives from the new distributor told us that they "do understand that it is hard sometimes applying for Lottery money". [110] Therefore, it is important that applicants receive specific support to enable them to navigate the process successfully. It is envisaged by the Department that this support will be provided by the new distributor. We are encouraged that this problem has been tackled by the new proposals and we hope that more applications are stimulated by these provisions for increasing accessibility. **We welcome the DCMS proposals to increase accessibility to Lottery funding for all and hope that the measures taken will stimulate increased levels of application, especially from 'coldspots' and areas of great need.**

112. Having said this, the Committee does not believe that spreading Lottery money equally throughout the country, in a mechanistic way, would necessarily represent the best use of the funds. We appreciate the reasons why the spread of funding has been skewed towards major conurbations where large projects have been located. These large projects can benefit a considerable number of people, not only those residing nearby.

The new distributor

113. The New Opportunity Fund (NOF), which has responsibility for funding health, education and environmental projects, and the Community Fund (CF), with responsibility for allocating grants to charitable and voluntary sector organisations, will merge to create a single distributor with the Millennium Commission's ability to support large projects.

114. The proposed body, which is yet to receive a name or formal powers until primary legislation is passed, will control 50% of Lottery funds and will be able to handle funds from other sources.[111] The Department proposes that the new body will:

- provide a single point of entry for all new applicants that are unsure of where to seek advice;
- be the first port of call for projects that do not easily fit the remit of specific distributors;
- be a centre of excellence for managing major projects and be able to coordinate cross cutting projects;
- encourage joint working between distributors and disseminate best practice;
- lead on giving pre-application support to organisations building up capacity in the community and;
- help to simplify the procedures used for organisations which need to apply to more than one distributor at a time.[112]

This body is intended to be the strategic leader for Lottery distributors and therefore it is vital for the recipients and the distributors that it is an "intelligent distributor".[113]

110 Q 192 [Lady Brittan]

111 "National Lottery Licensing and Regulation Decision Document" July 2003

112 "National Lottery Licensing and Regulation Decision Document" July 2003

Advantages

115. There are clearly some potential advantages to the merger, which are primarily the increased simplicity of applying and the creation of economies of scale due to the amalgamation of staff and resources from the two organisations. The new body will be able to distribute a range of funds of different sizes from very small to major capital projects, helping a large number and range of applicants and it will have the ability to handle non-Lottery funds for joint-funded projects. It will also be responsible for disseminating best practice to all distributors, helping to increase cooperation between them.[114]

116. The Coalfields Community Campaign (CCC) was very keen to see this single point of entry for all Lottery applications and sufficient development support to enable their communities, and many others like them, to apply for Lottery grants without having to spend money on advice or be put off by the complicated processes in place.[115] The CCC welcomes the new distributor's roles in these areas, as does the Committee.

117. Overall, the new distributor is supposed to be more than the sum of its parts.[116] The Department envisages it as "a true community distributor, funding projects to revitalise and regenerate communities."[117] We believe that the distributor has the potential to improve the distribution of funds within its area of responsibility.

Disadvantages

118. Much of the evidence we have received has welcomed the merger. However, there have been a few key concerns raised through the course of the inquiry principally by some of the specialist distributors: Sport England, Arts Council England and the UK Film Council. They are worried that the new body may take over as the centre of excellence managing major projects and coordinating cross-cutting projects, roles which they have traditionally carried out.[118] The established distributors have had a large amount of experience managing these projects and have gained skills and built up relationships with many of the key organisations in their specialist fields. They do not wish to see the new distributor taking over the management of projects which they have administered in the past as this would ignore the skills currently available and be an unnecessary duplication of effort.[119] Mr Stephen Dunmore, Chairman of the New Opportunities Fund and the community Fund, believes that a variety of distributors are needed and that they must continue to work closely together to achieve common aims rather than further reducing the number of distributors.[120] However, he believes that it is right for the new distributor to take a lead role in some areas such as transformational projects and helping other distributors to learn from each other and work together. **We believe that the new body**

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113 Q 45

114 "National Lottery Licensing and Regulation Decision Document" July 2003

115 Q 37

116 "National Lottery Licensing and Regulation Decision Document" July 2003

117 "National Lottery Licensing and Regulation Decision Document" July 2003 p 6

118 "National Lottery Licensing and Regulation Decision Document" July 2003 decisioin docs/ Specialist distributors evidence.

119 Ev 100, 117, 227.

120 Q 183

could usefully take on an overarching role, coordinating efforts in cross-cutting projects, but should also allow those distributors with established skills, experience and relationships to take the lead on projects whenever appropriate. The Department must take steps to allay the fears of some of the specialist distributors over the role of the new body as a 'centre of excellence', making clear to everyone the exact role that the merged body will take on and how this will combine with the work already undertaken by others.

119. Another concern is that the merger will not actually create any extra funds for good causes because the costs associated with the extra responsibilities of the new body will eradicate any savings made through economies of scale. The Secretary of State told us that she expected the merger of the NOF and the CF to create savings "within a range of 10 to 20%'"[121] However, she confirmed, this may not bring about extra grants. The new distributor would provide extra services and take on an increased role, being more proactive, building capacity in poor communities, supporting applicants, providing a single point of entry for all applications and managing transformational and cross-cutting projects.[122] The NCVO stressed to us that it is important that any costs associated with the extra roles and responsibilities of the new distributor do not "eat into the fund for the good causes."[123] **We agree that the extra services provided under the merged body will enhance the distribution process but very much hope the cost of these will not erode the grants given by the new body. DCMS must ensure the merger of the New Opportunities Fund and the Community Fund is properly managed so that expertise is not lost and maximum savings are achieved.**

Management of the National Lottery Distribution Fund

120. The Department is concerned, alongside many commentators, about the current balances held in the NLDF by the Lottery distributors, especially the level of the balances held by the Heritage Lottery Fund and the New Opportunities Fund.[124] The Department is concerned at the implication that NLDF balances are high because the allocation of funding is not being managed quickly enough therefore delaying the benefits of Lottery grants being felt by the public. The DCMS wants to see the reduction of current balances through greater efficiency by the distributors in allocating resources.

121. The distributors argue that most of the money held in the NLDF is already allocated. We have received evidence from the Heritage Lottery Fund (HLF) which states that all of the money they are at present holding in the NLDF, and £188 million extra, is not being badly managed but has already been allocated to specific heritage projects that are underway but not completed.[125] The HLF emphasises that all of the interest earned on the balances whilst held in the NLDF is also committed to projects, many of which are major capital works that take a long time to complete and require the commitment of Lottery funding, but not the cash itself, before they can secure any matched or additional funding that is needed. The HLF evidence, and other written evidence that we have received from

121 Q 352

122 Q 352

123 Q 35

124 Q 343

125 Ev 140

HLF-funded organisations, all stress the importance of long term funding for many heritage projects, meaning that NLDF balances are unavoidable.[126] The HLF has suggested a number of possible ways that it could reduce balances so that the funding is not taken away for use on other projects. These include: encouraging speedier draw-down by recipients; allowing 50% of smaller grants to be paid up front; and taking advantage of its cash flow flexibility by over-committing funds at prudent levels ahead of time.[127] Although these measures will ensure that Lottery money will reach projects more quickly, they also create the risk that the HLF may not being able to cover its commitments in the future if Lottery revenues fall, with the inevitable loss of some funds that have been paid up front.

122. The Department has asked the National Audit Office (NAO) to look into the balances and flows out of the NLDF in respect of each of the distributors. The Department expects an interim report by April and a final report in July,[128] which should advise the Secretary of State "on the prudent level at which the balances can be run down and the prudent level at which distributors should commit ahead of time."[129]

123. **We believe that long term or future projects should not suffer from this policy change and that NLDF balances should not be reduced just for the sake of it. If money is found not to be flowing effectively to worthy projects through the distributors then this must be dealt with. However, if funds need to be held for legitimate reasons then they should certainly be held in the NLDF where they earn higher interest, tax free, than in the accounts of individual distributors or projects. There are, presumably, significantly fewer risks associated with money being held centrally in the NLDF rather than dissipated amongst the many bank accounts of projects with variable degrees of governance and experience.**

Devolution

124. The Department proposes to retain the UK structure of Lottery distribution but as part of the reforms wishes to give more influence to Scotland, Wales and Northern Ireland over setting specific priorities and strategies for their areas and local communities. Many of the distributors are country-specific (for sport and film) or allocate specific proportions to the devolved nations for spending (NOF and CF). It is important that these reforms build on the present situation and that Lottery players and applicants in Scotland, Wales and Northern Ireland have access to funding and influence over funding decisions in their areas. **We agree that funding decisions should be made, wherever possible, at the most appropriate level, whether national, regional or local, so that the needs of the area are known and met.**

Single Lottery identity

125. The DCMS proposes the creation of a single Lottery identity to ensure Lottery-funded projects are easily identifiable as such. This has already been initiated through the creation of the National Lottery Promotion Unit (NLPU) and the establishment of a National

126 Ev 194, 196, 201, 203-4, 222.

127 Ev 140

128 Q 344

129 Q 343

Lottery Day.[130] The Department believes that it is important for all of the Lottery distributors to work together to promote the benefits to good causes which the National Lottery delivers.[131] The DCMS has suggested that all projects that have received Lottery money should be identified by a single lottery logo and has introduced a 'blue plaque' scheme which provides an instantly recognisable symbol that can be used nationwide to help create the link in people's minds between buying a Lottery ticket and tangible benefits to the community they live in. **We believe that it is important for the public to be able clearly to identify projects that have received Lottery funding, but we urge the Department, to monitor the costs and benefits of schemes set up to do this so that value for money is achieved.**

126. **DCMS must specifically carry out a full cost and benefit analysis of the proposed National Lottery Day before the event to ensure that it actually adds value to the work of distributors and does not bring about a significant diversion of costs away from grant giving**.

127. Some evidence suggests that when players are aware of the good causes supported by the Lottery they are less likely to pull out of playing. The NLC believes that promotion of the Lottery projects is important because "the better Lottery good cause money is promoted, the more positive people feel about that and the more positive they are likely to feel about gains".[132] However, it acknowledged that this may not necessarily give rise to increased sales but may sustain levels of participation for longer periods.[133] Representatives from the NOF, CF and Awards for All agreed that the general public are not aware enough of what Lottery money has funded and Baroness Pitkeathley OBE, Chairman of the New Opportunities Fund, pointed out that "almost every community throughout the United Kingdom has some improvement as a result of the Lottery."[134] The NLC informed us that at present the NLPU "are doing a range of research to work out what people want and how people can be helped to make that association [between buying a Lottery ticket and benefits to good causes] most effectively"[135], working towards raising awareness of what the Lottery funds in order to boost sales. It is, however, widely acknowledged that the main driver of sales is the possibility that the player will be able to win a large prize. Whether, in fact, good causes have any demonstrable effect on sales is widely debated. **We welcome the creation of the NLPU and believe that promoting the benefits to good causes of the Lottery is positive. However, we note that Camelot has both a responsibility and an incentive to promote National Lottery sales and suggest that the operator of the National Lottery should fully fund the work of the NLPU, as it will benefit from any increased sales.**

128. The NCVO, although it agreed that people should be made aware of the benefits to good causes from the Lottery, was concerned that playing it should not be promoted as an effective way of giving to charity because "a pound given directly to charity, tax effectively, is worth £1.28 to the charity, whereas only 28 pence in each Lottery pound goes to the good

130 "National Lottery Licensing and Regulation Decision Document" July 2003

131 "National Lottery Licensing and Regulation Decision Document" July 2003

132 Q 108

133 Q 108

134 Q 179 [Baroness Pitkeathley]

135 Q 103

causes."[136] **We agree with the NCVO and believe that whilst the National Lottery and the benefits it gives to good causes should be publicised, it should not be promoted as an effective way of giving to charity. The percentage of the amount spent on a Lottery ticket that actually goes to good causes should be made clear to players.**

136 Q 35

6 Olympics

Lottery funding for a London Olympics in 2012

129. We reported in January 2003 on the case for a bid for the 2012 Summer Olympics by London.[137] In May of that year the Government announced that it would give its full backing for such a bid and, in June 2003, announced the details of its funding and for the staging of the Games in the event that they are awarded to London[138]. It is clear that without a substantial contribution from the Lottery — indeed the establishment of a specific new 'Olympic good cause' (with its own distribution fund) — the Government would not have felt able to support the bid. The Secretary of State told us: "The Lottery is paying or underwriting a large share of the public cost of the Olympics because this is something that, were that funding not available, it is very unlikely that the Government would have supported".[139] Tessa Jowell went on to disagree that the Lottery was being "raided".[140] We discuss this in relation to the Lottery's founding principle of "additionality" to Government spending in the next section of the Report.

130. What is clear is that funding the 2012 Games, should the bid be successful, constitutes a potentially huge drain on the total funds available for the existing good causes, including grassroots sport (especially outside London where expected legacies will presumably be less). This is at a time when total Lottery ticket sales are only just poised to come out of a 5 year decline and the importance of promoting sport and a generally more active life (especially for children) in relation to public health is racing up the Government's agenda.

131. The Government estimates the total level of public subsidy necessary within a robust funding package for a London Games to be £2.375 billion. DCMS states that this figure includes significant provision for risks and contingencies to cater for all reasonably foreseeable eventualities and that "anticipated allocation of public funds to the budget will be significantly lower than this". The Government breaks down this total as follows:

Source	Contribution
London Council tax	£0.625 billion
London Development Agency	£0.250 billion
National Lottery	£1.5 billion
Total	£2.375 billion

137 Third Report, *A London Olympic Bid for 2012*, 2002-03, HC 268

138 Cm 5867

139 Q 355

140 Q 356

132. The total contribution from the National Lottery was set by the Government. The breakdown of the £1.5 billion to be found from the Lottery, between 2005 and 2012, is as follows:

Source	Contribution
Existing sports distributors for England, Wales, Scotland and Northern Ireland as well as Sport UK	£340 million
New Olympic Lottery Game	£750 million
Possible changes to the existing shares between 'good causes' after 2009-2012	up to £410 million
Use of the provision in the Horserace Betting and Olympic Lottery Bill for the transfer of funds from the NLDF to the Olympic Lottery Distribution Fund in "exceptional" circumstances	unknown
Total Lottery funding	up to £1500 million

Impact on existing plans

133. In reply to the Committee's Olympics Report the Government stated: "This far ahead it is difficult to assess what the effect [of the Olympics] might be on individual programmes, but the objective will be to ensure than any adverse impact is minimised and that the anticipated benefits arising from the staging of the Olympics are shared as widely as possible."[141] The Government emphasised that the Olympics will be a national, and not just a London event, and the potential opportunities arising from it will flow to all levels and well beyond the sports sector. The potential for such benefits exists, as we have seen from the highly acclaimed Manchester Commonwealth Games. However, plans and preparations to ensure that these effects are realised, maximised and spread around the country need to be kept in mind from the outset.

Contribution from sports distributors

134. The decision that the sports distributors contribute £340 million of sports lottery funding (in the period 2004 to 2012) towards the Olympics was taken by Government without, it seems, any prior consultation with the distributors themselves.[142] Whatever the debate about the new Olympic Lottery Game, in effect a further good cause to be established by Parliament via primary legislation, this fiat from DCMS, pre-empting the allocation of substantial funds, seems high-handed and betrays a somewhat insouciant attitude to the arms-length status of distributors. This is not to say that the sports distributors do not support the bid for the Olympics whole-heartedly, as our evidence shows, but we believe that this support could have been nurtured far better by the DCMS

141 Cm 5867

142 Ev 124 and Ev 244

rather than simply assumed. This is not a good start in view of the Government's stated aim of minimising 'adverse impacts'.[143]

135. In addition, so far, there has been no guidance on the share of this burden between the sports distributors,[144] with Sport England at least assuming that the direct burden will fall according to the existing shares of sports lottery funding income between the various distributors.[145] UK Sport said that on this basis there was £60 million to be found from the rest of the sports distributors across the UK. Mrs Liz Nicholl, Chief Executive of UK Sport, suggested that this was a concern because, alongside staging costs, "we must ensure that there is appropriate investment in our athletes to perform".[146]

New Olympic Lottery

136. The Horserace Betting and Olympic Lottery Bill, currently going through the Lords, establishes the first hypothecated Lottery games for a specific good cause; the 2012 Olympics (provisions that come into force in the event that London is awarded the Games). Camelot was clear that its research indicated a great deal of enthusiasm for such a game and it was the link with the Olympics that would persuade punters to buy Olympic Lottery tickets.[147]

137. The estimated total to be raised from this strand of Lottery game-playing is £750 million, as set out above. Camelot told us that, on pessimistic estimates, up to 59% of this revenue would be constituted by the switch of play — termed 'cannibalisation' — from other Lottery games to the Olympic game; £442 million in total or about £64 million per year (about 5%). This, of course, has the effect of reducing the funds raised for the other good causes (including sport's existing share). Ms Diane Thompson, Chief Executive of Camelot, told us: "Of course there will be some cannibalisation from existing games because virtually every game that we do has some cannibalisation and it depends on the nature of the game as to what that level is."[148]

138. The existing distributors said that the direct impact of the Olympic lottery, the uncertainty over the reconsideration of the shares of good causes after 2009, and the existence of a provision in the Olympics Lottery Bill to transfer funds out of the NLDF into the OLDF, were of some concern. This was especially true in view of an overall decline — albeit with recent signs of reversal — in Lottery sales and hence returns for good causes. However, there was also the view that the Olympics represented an opportunity, across nearly all the good causes, that could be built on.[149]

143 Cm 5867

144 Ev 244

145 Sport England receives 83% of the share of Lottery money allocated to Sport. See Q 238

146 Q 285

147 Q 125

148 Q 115

149 See QQ 177, 204, 238, 281 and 290

The distribution of Olympic Lottery funding

139. The key to minimising the adverse impacts of the significant drain that the Lottery's contribution to the Olympics represents — within the sport sector at least — would appear to be how those funds are distributed and what account is taken of the synergy with existing programmes, priorities and, of course, the all-important legacy issues.

140. The Government proposes to establish a new and distinct distributor for the funds raised by the Olympic Lottery game (and these are to be held in a separate distribution fund, presumably managed in the same way as the NLDF but with separate accounting arrangements). This would mean that, of the Lottery funds earmarked for the Olympics by the Government, £340 million is likely to be distributed by the 5 existing sports distributors, perhaps according to their income formula (leaving Sport England providing the major contribution), and £750 million by a new and separate body. In the light of the Government's objectives in this area, as set out in its strategy *Gameplan*, this appears to be an unhappy outturn. *Gameplan* says that: "For sporting bodies, particularly Sport England and UK Sport, there should be less duplication of function; a clear separation between fund distribution and service delivery; better cooperation and co-ordination; better accountability to government and customers; and increased organisational effectiveness." It is difficult to see how the creation of what will be in effect a new sports distributor, no matter how streamlined, fulfils the aspirations set out in the Government's strategy for sport.

141. The proposal for another distributor was questioned — perhaps unsurprisingly with £750 million up for grabs — by both Sport England and UK Sport. Sport England was concerned with the potential for: a lack of the coordination necessary to deliver a long-lasting legacy from the investment in Olympic facilities (as was achieved out of the Manchester Commonwealth Games); unnecessary duplication; and the inefficient use of scarce resources.[150] Sport England pointed out that, as the Bill stood, the new distributor was not even required to consult with the other sports distributors in coming to decisions.[151] Mr Patrick Carter, now Chairman of Sport England, but with experience of reviewing Picketts Lock, Wembley National Stadium and, the Manchester Commonwealth Games, suggested that it would be far better for the lessons of the past not to have to be relearned in preparing for an Olympic Games. Sport England's supplementary memorandum pointed out that when the Government contributed a last-minute £30 million to the Commonwealth Games it was not passed through a dedicated distributor, but through Sport England to marry with its own investment in the Games under a single funding agreement with Manchester City Council.[152]

142. UK Sport voiced similar concerns but stressed the importance of its UK-wide remit in bidding for the role of Olympic sports distributor.[153] UK Sport emphasised its experience in working in partnership with the British Olympic Association and UK sports governing bodies. It asserted that the BOA had confirmed UK Sport as its natural partner in managing the lottery investment in UK/British athletes. UK Sport conceded its lack of

150 Ev 124 and QQ 267-9

151 Ev 125

152 Ev 125

153 Ev 143

experience in capital projects and said that this aspect of delivery would be managed in partnership with other distributors, "in particular Sport England".[154]

143. **We believe that creating a further lottery distributor to manage the £750 million to be raised via the Olympic Lottery is unnecessary, wasteful of resources and against the thrust of the Government's own strategy for sport. The proposal has the potential to fragment the required investment in facilities to the detriment of the long-lasting and sustainable legacy that is an extremely significant factor in wishing to host the Olympics in the first place. We strongly endorse the Chairman of Sport England's argument that the lessons and experience of the recent past — in relation to Picketts Lock, Wembley National Stadium and the Manchester Commonwealth Games — must be built ineluctably into the arrangements that are eventually agreed.**

154 Ev 143

7 Tax regime

Background

144. Since its introduction under the Finance Act 1993 Lottery Duty has been calculated as a percentage of gross receipts from ticket sales. The 12% rate, which has remained unchanged since 1993, was set to maintain tax revenues in the light of consumer spending diverted to the Lottery from other gambling, and general consumer, products.

145. In 2001, when giving evidence to the previous Committee, the Treasury acknowledged the difficulties in calculating precisely what the revenue-neutral rate would be but concluded that 12% remained within a range of reasonable estimates. In written evidence to this inquiry the Treasury states that it is now impractical, and increasingly irrelevant, to calculate a theoretically 'neutral' rate of Lottery Duty and, because the Lottery has been in place for so long, this difficulty will only increase with time.[155] This was emphasised by Mr John Healey MP, Economic Secretary, in oral evidence: "it is not the 12% that is out of date but essentially the approach of looking for tax neutrality as the one and only reference point for decisions about Lottery duty and its future."[156]

146. The Treasury highlighted the significant changes that have affected the gambling sector. Gross profits tax (GPT) had been introduced in place of General Betting Duty, Pool Betting Duty and Bingo Duty. Amusement Machine Licence Duty is also under consultation for change. Mr Healey told us that GPT was the preferred option in the opinion of Camelot, as it marries up with their strategy for high volume, low margin games in the future.[157]

155 Ev 145

156 Q 308

157 Q 310

147. The table below shows the amount of Lottery Duty paid since the creation of the National Lottery:

Year	£m	% change	% total gambling tax receipts from Lottery Duty
1994/95	104		
1995/96	612		39%
1996/97	558	-9%	39%
1997/98	675	21%	43%
1998/99	628	-7%	41%
1999/00	609	-3%	40%
2000/01	596	-2%	39%
2001/02	580	-3%	40%
2002/03	550	-5%	43%

Source: HM Treasury. See Ev 146.

148. The Government believes that judgments about Lottery Duty should now be developed on the same basis as for other gambling. Gambling tax should be:

- efficient and fair — the regimes should be economically efficient, delivering a fair revenue yield to the Exchequer and ensuring that this contribution is divided between different activities in an appropriate manner;
- sustainable – provisions should be sufficiently flexible to cater for changes in the environment, for example new social law, market changes and technological innovation; and
- business-friendly – compliance costs should be minimised.[158]

149. These principles are argued to allow consistency in methodology and analysis across gambling; build in recognition of, and adaptability to, future developments; and take into account how the structure and rate of tax can affect displacement of expenditure within and between different forms of gambling and other expenditure to a greater degree than before the reforms. Under this new framework the Government would consider any proposals for changes to rates or structure of Lottery taxation, including GPT, taking into account developments in licensing the Lottery, the proposal for an Olympic Lottery and implications of changes in other gambling tax regimes and reforms of gambling regulation.[159]

158 Ev 146-7

159 Ev 146-7

150. Mr Healey confirmed that the 1993 approach to taxation of the Lottery - "revenue neutrality" - was now impossible to implement and that the Treasury was very much in 'listening' mode.[160]

A new approach

151. We note the Treasury's view that, for the purposes of tax, the Lottery should be treated in the same way as the rest of the gambling sector. In contrast, we note that the DCMS believe that, for the purposes of regulation, the unique characteristic of the National Lottery – raising funds for good causes – necessitates special treatment. We believe this to be an inconsistency that should be rectified.

152. The defining feature of the Lottery is that it raises funds for good causes and that those funds – as we discuss below – are distributed, at the very least, in "synergy" with other Government policy priorities (with the Olympics as a prime example).[161] The NCVO proposes that Lottery Duty be abolished altogether and that the released resources be split between the prize fund and the good causes. We agree with the thrust of this proposal.

153. **The Exchequer has received nearly £5 billion in Lottery Duty since 1994/95 – about a third of the funds raised for good causes. We believe that this enormous sum, taken in conjunction with Lottery spending in line with Government priorities, represents a double hit on the money paid out for tickets by the public.**

154. We note the introduction by the Chancellor, and recent widening and deepening, of initiatives to make giving to charity more attractive – principally by allowing charities to claim back the basic rate of tax on donations received from taxpayers. We see no good reason why this principle should not be applied to the funds raised by the National Lottery for good causes. When questioned about this possibility, Mr Healey said:

> "to be honest, I have not considered a potential link between Lottery duty and a system of charitable Gift Aid…If the Committee wanted to develop that point and make recommendations in its report it is clearly something that I would consider."[162]

155. We suggest that the principle under-pinning the Government's approach to charitable donations and tax could be applied to the Lottery in one of the following ways:

a) the 12% Lottery Duty could be abolished in favour of extra funds for prizes and good causes (as recommended by the NCVO);

b) Lottery Duty could be abolished, dis-applied or rebated for the 28% of sales revenue that the operator hands over to the NLDF for good causes; or

c) Lottery Duty be abolished, dis-applied, or rebated for the percentage of good causes revenue that is subsequently distributed to charities that are otherwise eligible for Gift Aid.

160 Q 308

161 See Ev 157. DCMS states that where distributors also have responsibility for giving out Government grants they will try to ensure synergy between Government and Lottery funding but they "must ensure that Lottery funding is doing something different from grant–in–aid".

162 Q 311

156. **However, we can think of no better way of achieving a palpable hit with the Lottery-ticket-buying public than for the Government to eschew Lottery Duty entirely with the aim of dividing the funds thereby released between prizes (thus enforcing the principal driver of sales) and good causes (a significant factor in keeping players playing over the longer term).**

8 Additionality

Background

157. From the inception of the National Lottery, the Government has stated its commitment to the principle of additionality. In the 1992 White Paper it was stated that the Lottery would fund only projects additional to those that would otherwise be funded by the public through general taxation.[163]

158. DCMS, in written evidence to this inquiry, defines the principle of additionality as not allowing Lottery funding to "become a substitute for funding that would normally fall into mainstream Government spending" and states that it "remains firmly committed to the principle."[164]

159. The Committee has concerns that funding from the National Lottery has meant that there has been an erosion, in real terms, of the DCMS core funding. The Secretary of State, however, disputed this and told us:

> "I think that if you look at my department's baseline over the period for which it has both been administering Lottery income and also the Exchequer-generated base line you will not find evidence that there has been an erosion of our baseline and substitution by Lottery funding."[165]

160. Trends in local government discretionary funding and the use of lottery funds have also been questioned.

161. Many of the distributors of Lottery funding find the additionality principle increasingly difficult to administer as the line between Government and other funding becomes more and more blurred. The NOF told the Committee that:

> "The concept of additionality I think becomes increasingly complex as you have multiplicities of providers. The line that the New Opportunities Fund has always taken about additionality is that there should be no substitution: no substitution for current or planned government expenditure. That is how we always approach the concept of additionality. But I think it does become difficult to untangle, as you have not only public and private sector providers but also the voluntary sector as a very major provider. I think a more helpful way to look at it is really the concept of added value: What value is it that it comes from lottery money rather than from government spending?"[166]

162. Arts Council England, in written evidence, stated that it fully supports the principle of additionality but it continues to use Lottery money and core grant-in-aid funding together to "make intelligent use of all our investment to raise the profile, and maximise the impact of the arts".[167] The Heritage Lottery Fund also supports the principle but finds it difficult in

163 Cm 1861, para 41

164 Ev 157

165 Q 331

166 Q 187 [Baroness Pitkeathley]

167 Ev 101

practice and has supported applications in new areas that often involve working with other public funders.[168]

Current situation

163. Many witnesses told the Committee that the principle of additionality was becoming increasingly eroded. The Lotteries Council told us that "additionality is something we take a strong line on, and we think that line is getting blurred"[169] and that "there is a great deal of concern about the erosion of the additionality principle."[170] The NCVO believed that "Lottery funding should be independent from government but accountable to Parliament; that it should be additional to what should be properly spent by government and not a substitute for it."[171] It was concerned that this was not happening.

164. A specific example given of this alleged erosion is the creation of the Olympic Lottery, as some witnesses believed that an Olympic Games should be funded fully by Government expenditure. Mr Healey, when discussing the funding of the Olympics if held in London in 2012, told us "I do not accept that it breaches the additionality principle."[172] He said:

> "the additionality principle has consistently been that Lottery money should add to, it should not substitute or supplant services that are already provided by Government and it should allow things to happen that would not happen if it depended simply on Government funding alone"[173]

He added that the Olympics is not something that the Government could or should fund alone. The Secretary of State confirmed that point to the Committee:

> "The lottery is paying or underwriting a large share of the public cost of the Olympics because this is something that, were that funding not available, it is very unlikely that the government would have supported."[174]

165. **We believe that the additionality principle is being eroded, especially with the establishment of the Olympic Lottery. This Committee deplores this erosion. Therefore, we shall consider returning to the additionality principle before the end of this Parliament. In the meantime, we call on the Secretary of State to make an annual report to Parliament on how the additionality principle has been applied.**

168 Ev 130

169 Q 11

170 Q 14 [Mr Mollett]

171 Q 35

172 Q 315

173 Q 316

174 Q 355

9 The future of the National Lottery

166. We believe that the National Lottery is a good thing. Since 1994, the Lottery has raised over £15 billion for good causes. Projects have been wide ranging and have varied greatly in scale and the benefits of the National Lottery have been felt in all parts of the UK.

167. In order to achieve a prosperous future for the National Lottery the Department and the NLC must:

- ensure that sales are maintained and increased;
- increase competition for the licence (or within the licence), ensuring that the operator of the National Lottery is maximising returns to good causes and that good causes are receiving the best possible share of the revenues;
- keep abreast of technological changes so that the Lottery is operated efficiently;
- make all decisions transparent in order to maintain public confidence;
- maintain effective regulation; and
- deal effectively with the consequences of the deregulation of the gambling sector so that potential losses in Lottery sales are minimised.

168. The Government is aware of its policy-setting role and aims to keep abreast these issues by the proposed reforms of the National Lottery that were announced in July 2003. The Department's vision for the future of the National Lottery primarily consists of:

- enabling the NLC the flexibility to award multiple licences to operate the National Lottery if it believes it would be in the interests of the well-being of the National Lottery to do so in 2009;
- the creation of a mega-distributor by merging the New Opportunities Fund and the Community Fund and by transferring the powers of the Millennium Commission to the new body as part of wider reforms to the distribution of Lottery funds;
- encouraging the Treasury to re-evaluate the principles behind the taxation of the Lottery which will most probably lead to the creation of an alternative tax regime for the National Lottery; and
- creating the first specified good cause games through the establishment of a hypothecated Olympic Lottery.

169. We believe that the proposed changes to the National Lottery licensing and regulation are key to the future success of the National Lottery and that changes in the system must be considered carefully before implementation. As we have concluded above, we feel that the Department's proposals are not the right course of action and that it must look again at how it can attract more competition for the third licence.

170. We believe that the changes proposed by the Department in relation to National Lottery funding and distribution do not constitute fundamental changes to the present system and we welcome, with caution, most of their proposals. The exception to this is the introduction of an Olympic Lottery, which is a significant development and has implications for the future of the National Lottery and its use to fund specific major national projects in the future.

171. This Report has highlighted the need to improve the method used to tax the National Lottery in the future. The Treasury has told the Committee that it is prepared to leave behind the principle of tax neutrality and we hope that Camelot, the DCMS and the Treasury will be able to work together to introduce a new tax regime which will be sustainable without taxation of good causes - reflecting the Government's approach to charitable giving.

Conclusions and recommendations

1. The primary aim of DCMS is to increase the total resources available to the good causes. We support this objective. (Paragraph 32)

2. Although consultation appeared to rule out three of the proposed changes suggested by the Department, we conclude that this does not amount to overwhelming support for the third option which has now been put forward for implementation, namely, the break-up of the single operating licence. (Paragraph 35)

3. We believe that due to the unique and proper responsibility of the National Lottery Commission (NLC) to maximise returns to good causes, the regulation of the National Lottery should remain the responsibility of the NLC. (Paragraph 62)

4. We agree that a representative from the NLC should have a seat on the proposed Gambling Commission proposed within the draft Gambling Bill. (Paragraph 63)

5. We agree that public resources should be used to gather relevant and timely information but we think that it is critical, at this time, for the Department and the NLC to have a clearer idea of how the proposals to establish a multiple licence system will affect the amount of competition for the licence and the role of the NLC. We therefore recommend that resources are made available for research to be carried out into the effects of the proposals so that the Department can judge adequately the likely effects of its decisions. The Department and the NLC must also consider examples of use of the multiple licence system by overseas lotteries and aim to learn from the experiences abroad. (Paragraph 82)

6. We therefore urge the Department to consider fully all of the implications of introducing (or giving the NLC the flexibility to introduce) a multiple licence system, at the same time weighing up the multiple licence system against alternative solutions available . (Paragraph 84)

7. We recognise that there is a need to stimulate more competition for the third National Lottery licence. However we note that the proposed reforms, as they stand, do not have the support of obvious potential bidders and we believe the Department must look again at how it can attract more competition for the third licence. (Paragraph 85)

8. When considering the advantages and disadvantages involved with the retention of the present system or evolution to a multiple licence system, Mr Simon Burridge representing TPL made a clear and bold statement to the Committee that "faced between the choice of Camelot in perpetuity and the Government's new proposals, with the greatest reluctance I think I would volunteer for Camelot in perpetuity as the lesser of two evils." Looking at the evidence presented to us in this inquiry, including on the limitations of the NLC, we have to agree. (Paragraph 88)

9. We feel that competitive tendering would effectively introduce the attractive elements of competition to the National Lottery but would also encourage bids for the overall licence because a better package would be offered to potential operators

containing significantly less uncertainty than is associated with the multiple licence system. (Paragraph 93)

10. Proactivity in tackling the causes of the variation in funding levels across the UK is one of the key responsibilities of the new distributor once it is properly established. We hope that the new distributor will carry out this role with vigour, increasing accessibility to funding throughout the UK. (Paragraph 110)

11. We welcome the DCMS proposals to increase accessibility to Lottery funding for all and hope that the measures taken will stimulate increased levels of application, especially from 'coldspots' and areas of great need. (Paragraph 111)

12. We believe that the new body could usefully take on an overarching role, coordinating efforts in cross-cutting projects, but should also allow those distributors with established skills, experience and relationships to take the lead on projects whenever appropriate. The Department must take steps to allay the fears of some of the specialist distributors over the role of the new body as a 'centre of excellence', making clear to everyone the exact role that the merged body will take on and how this will combine with the work already undertaken by others. (Paragraph 118)

13. We agree that the extra services provided under the merged body will enhance the distribution process but very much hope the cost of these will not erode the grants given by the new body. DCMS must ensure the merger of the New Opportunities Fund and the Community Fund is properly managed so that expertise is not lost and maximum savings are achieved. (Paragraph 119)

14. We believe that long term or future projects should not suffer from this policy change and that NLDF balances should not be reduced just for the sake of it. If money is found not to be flowing effectively to worthy projects through the distributors then this must be dealt with. However, if funds need to be held for legitimate reasons then they should certainly be held in the NLDF where they earn higher interest, tax free, than in the accounts of individual distributors or projects. There are, presumably, significantly fewer risks associated with money being held centrally in the NLDF rather than dissipated amongst the many bank accounts of projects with variable degrees of governance and experience. (Paragraph 123)

15. We agree that funding decisions should be made, wherever possible, at the most appropriate level, whether national, regional or local, so that the needs of the area are known and met. (Paragraph 124)

16. We believe that it is important for the public to be able clearly to identify projects that have received Lottery funding, but we urge the Department, to monitor the costs and benefits of schemes set up to do this so that value for money is achieved. (Paragraph 125)

17. DCMS must specifically carry out a full cost and benefit analysis of the proposed National Lottery Day before the event to ensure that it actually adds value to the work of distributors and does not bring about a significant diversion of costs away from grant giving (Paragraph 126)

18. We welcome the creation of the NLPU and believe that promoting the benefits to good causes of the Lottery is positive. However, we note that Camelot has both a responsibility and an incentive to promote National Lottery sales and suggest that the operator of the National Lottery should fully fund the work of the NLPU, as it will benefit from any increased sales. (Paragraph 127)

19. We agree with the NCVO and believe that whilst the National Lottery and the benefits it gives to good causes should be publicised, it should not be promoted as an effective way of giving to charity. The percentage of the amount spent on a Lottery ticket that actually goes to good causes should be made clear to players. (Paragraph 128)

20. We believe that creating a further lottery distributor to manage the £750 million to be raised via the Olympic Lottery is unnecessary, wasteful of resources and against the thrust of the Government's own strategy for sport. The proposal has the potential to fragment the required investment in facilities to the detriment of the long-lasting and sustainable legacy that is an extremely significant factor in wishing to host the Olympics in the first place. We strongly endorse the Chairman of Sport England's argument that the lessons and experience of the recent past — in relation to Picketts Lock, Wembley National Stadium and the Manchester Commonwealth Games — must be built ineluctably into the arrangements that are eventually agreed. (Paragraph 143)

21. The Exchequer has received nearly £5 billion in Lottery Duty since 1994/95 – about a third of the funds raised for good causes. We believe that this enormous sum, taken in conjunction with Lottery spending in line with Government priorities, represents a double hit on the money paid out for tickets by the public. (Paragraph 153)

22. However, we can think of no better way of achieving a palpable hit with the Lottery-ticket-buying public than for the Government to eschew Lottery Duty entirely with the aim of dividing the funds thereby released between prizes (thus enforcing the principal driver of sales) and good causes (a significant factor in keeping players playing over the longer term). (Paragraph 156)

23. We believe that the additionality principle is being eroded, especially with the establishment of the Olympic Lottery. This Committee deplores this erosion. Therefore, we shall consider returning to the additionality principle before the end of this Parliament. In the meantime, we call on the Secretary of State to make an annual report to Parliament on how the additionality principle has been applied. (Paragraph 165)

Formal minutes

Tuesday 9 March 2003

Members present:

Mr Gerald Kaufman, in the Chair

Mr Chris Bryant
Mr Frank Doran
Michael Fabricant
Mr Adrian Flook
Mr Charles Hendry
Alan Keen
Rosemary McKenna
Ms Debra Shipley
Derek Wyatt

The Committee deliberated.

Draft Report (*National Lottery Reform*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 83 read and agreed to.

Paragraph 84 read, amended and agreed to.

Paragraphs 85 and 86 read and agreed to.

Paragraph 87 read, amended and agreed to.

Paragraphs 88 to 90 read and agreed to.

Paragraph 91 read, amended and agreed to.

Paragraphs 92 to 109 read and agreed to.

Paragraph 110 read, amended and agreed to.

Paragraphs 111 to 121 read and agreed to.

Paragraph 122 read, amended and agreed to.

Paragraphs 123 to 140 read and agreed to.

Paragraph 141 read, amended and agreed to.

Paragraphs 142 to 152 read and agreed to.

Paragraph 153 read, amended and agreed to.

Paragraphs 154 to 161 read and agreed to.

Paragraphs 162 and 163 read, amended and agreed to.

Paragraphs 164 to 171 read and agreed to.

Resolved, That the Report, as amended, be the Fifth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (reports)) be applied to the Report.

[Adjourned till Tuesday 30 March at 10.00am

Appendix 1

National Lottery licensing and competition

An independent report prepared for Camelot by Frontier Economics Ltd, London (Executive Summary)

1. In July 2003 the Government announced that it had decided that a radical new approach to licensing the National Lottery is needed, both to increase competition for licences, and also to allow more companies to participate in the Lottery.[175] The Government therefore proposes to replace the current "single licence" model, whereby the National Lottery is run by a single operator, with a "multiple licence" model in which the National Lottery Commission (NLC) may offer one or more operating licences to run different parts of the Lottery.

2. Camelot asked Frontier Economics to carry out an independent economic assessment of the government's proposal to adopt a multiple licence model, focusing in particular on the likely impact of this on the money raised for good causes.

Key assumptions

3. The impact of the multiple licence model on good causes will depend on the specification of the licences that are offered by the NLC, and also on the details of the licence award process. The NLC has not announced a final decision on these issues, but has given some indication of its likely approach. For the purpose of this report we have assumed that:

- there will be no significant change in the legal definition of a Lottery, and so the scope of activities that may be licensed by the NLC in future will be similar to now;
- operating licences will be "full capacity" licences as defined above. That is licences will cover specified games or classes of games, and also the means to deliver them;
- the NLC will continue to regulate the design of individual games (or classes of game) promoted by operating licensees in a similar manner to the current Section 6 licences; and
- the NLC will award operating licences by competitive tender to the bidder(s) who (subject to meeting probity and player protection conditions) offers the best deal for good causes.

4. Subject to these assumptions, our analysis is not predicated on a particular view of the operating licences that the NLC might offer. Instead, we have focused on examining the key issues and trade-offs that are inherent to the multiple licence model as compared to the single licence model. As a consequence, our main conclusions do not depend on the exact nature of the operating licences offered.

5. In the two previous licence competitions commercial gambling firms have been prevented from bidding by the requirement that the National Lottery be operated by a single purpose company. It is possible that the government could relax this restriction in order to encourage bidding competition in future licence competitions. This would,

175 Foreword to DCMS Decision Document (July 2003).

however, blur the distinction between the National Lottery and harder forms of commercial gambling in the public eye. In addition, Camelot would be placed at a disadvantage relative to commercial gambling firms unless it was allowed to diversify beyond the National Lottery.

Government policy and the effects of competition

6. The Government has made it plain that the promotion of effective competition is one of its key policy goals. Competition is recognised to be a powerful mechanism for delivering consumer benefits, in terms of lower prices, higher quality and innovation.[176]

7. So far as the National Lottery is concerned, the multiple licence model may appear to offer a way of pursuing this policy goal by adding competition "within the market" (between Lottery operators, for customers) to competition "for the market" (between bidders for one or more licences to run the Lottery itself). The NLC could encourage competition "in the market" by using tendering processes that make it difficult for a single firm to win all the licences, or by reserving one or more licences for a new entrant. By making it easier for entrants and/or small bidders, the multiple licence model is seen by some of its advocates as a way of also increasing competition "for the market".

8. There a number of problems with this argument. First, the conventional consumer-based rationale for promoting competition is not directly applicable to the National Lottery. This is because the primary purpose of policy with respect to the Lottery is to raise funds for good causes, rather than to maximise the consumer benefits enjoyed by those who play the Lottery, in terms of lower prices or higher payouts. Competition should therefore be seen as an objective only in so far as it protects or enhances these funds.

9. Second, as explained below, competition "in the market" may actually reduce the money available for good causes, absent any increase in bidding competition.

10. Finally, it is questionable whether the multiple licence model would in fact increase competition "for the market" (e.g. by increasing the number of bidders) by enough to compensate for the negative impact of competition "in the market", or indeed whether it would lead to any significant increase in competition for licences at all.

Key conclusions

11. We have reached five key conclusions as follows.

Multiple licence holders competing "within the market" could reduce funds for good causes.

12. The funds available to good causes depend upon the economic value of the Lottery (defined as the net value of Lottery sales less costs) and its distribution between licensees and good causes. Allowing a number of operators to run different parts of the Lottery could result in lower net Lottery sales revenue, and higher costs, compared with those achieved by a single operator, resulting in a reduction in the economic value of the Lottery.

176 See, for example, the OFT guidelines (February 2002).

This is because a single operator has both the incentive and the ability to develop the Lottery more efficiently than multiple operators.

13. There are a number of specific ways in which the economic value of the Lottery could be undermined with multiple competing operators:

- licensees may develop products that cannibalise rivals' sales rather than expand the market;
- product launches may be undermined by a lack of co-ordination between licensees;
- free-riding by some operators may result in under-investment, notably in the Lottery brand and infrastructure; and
- there may be a loss of economies of scale and scope that cannot be effectively remedied by access agreements and the sharing of infrastructure, which would increase total operating costs.

14. The NLC's role would change radically in the multiple licence model in terms of both scale and complexity. In particular, the NLC would be required to intervene in key areas such as product development, marketing and brand management in order to reconcile operators' competing interests and ensure the efficient development of the Lottery. This would be a very challenging regulatory role, and it is doubtful that the NLC currently has the commercial and technical expertise that would be needed to fulfil this role. Moreover, the increased level of regulatory intervention in the multiple licence model would be costly in itself, and could stifle product innovation, particularly if operators seek to use the regulatory process to inhibit product development by rivals.

The multiple licence model would only increase funds for good causes if competition "for the market" were increased significantly.

15. Since the economic value of the Lottery is likely to be lower in the multiple licence model than in the single licence model, the multiple licence model would generate more money for good causes only if the share of the economic value of the Lottery that goes to good increases by enough to offset the fall in the economic value of the Lottery. This would be the case only if the multiple licence model leads to a significant increase in competition "for the market" in the form of stronger bidding for licences.

Moving from a single to a multiple licence model might not increase competition "for the market"

16. To assess the impact of changing to the multiple licence model on bidding competition for licences, it is necessary to assess the degree of competition that is likely under the single licence model. It is far from clear that there will be an absence of competition for the third licence. The changes made to the conditions of the second Lottery licence (such as asset and intellectual property ownership) should significantly reduce or remove any incumbency advantage enjoyed by Camelot. Moreover, it does not appear that Camelot has any significant brand advantage, exclusive contracts or relationships, or any proprietary technological knowledge that would inhibit competition. A further important factor is that

the Lottery will be more mature and hence easier to value in 2009 than at previous bidding rounds

17. It is also unclear that the multiple licence model would in fact lead to stronger bidding competition. This is because bidders would face a significantly more complex and uncertain strategic environment when developing their business plans and preparing bids. For example, bidders would have to take into account the potential impact of market competition in the event that there are multiple operators. This will depend on the eventual outcome of the licence award process, and also on whether the NLC decides to issue additional licences sequentially. The increased market and regulatory risk, combined with the likely increase in the cost and complexity of bidding may deter some bidders, thus decreasing rather than increasing bidding competition.

18. It might be argued that the multiple licence model, by allowing for "bite-sized" licences could attract small bidders who would be unwilling to bid for the entire Lottery. This is not necessarily the case. For example, it is possible that a firm bidding for all (or most) of the licences would be able to take advantage of synergies between the licences and outbid small competitors bidding for single licences. In this case, small bidders could be deterred by this "large operator" advantage and may rationally decide not to enter the competition in the first place. The NLC could guard against this by reserving licences for entrants or small bidders, but this would run the risk of imposing an inefficient outcome to the detriment of the development of the Lottery and the good causes.

Competition "for the market" can be increased within the single licence model

19. There are a number of ways in which the bidding process for a single licence could be modified, in order to encourage competition against the incumbent. For example:

- gambling and gaming firms could be allowed to operate the Lottery through a subsidiary (although as noted earlier this could affect the National Lottery brand, and also place Camelot at a disadvantage unless it is permitted to diversify beyond the National Lottery);
- the Lottery operator could be permitted to select different suppliers during the course of the licence;
- bidding costs could be underwritten; and/or
- the incumbent could be required to submit a final binding bid before others are asked to bid.

A reserve price based on the incumbent's historic performance could also be incorporated to protect against the risk of weak competition.

20. The evaluation of these and many other techniques, familiar in the fields of economic regulation and auction theory, is outside the scope of this study. At this stage it suffices to note that there are a number of possible ways in which the single licence model could be modified to provide a more efficient and less risky way of increasing the money available to good causes than moving to the multiple licence model.

Offering multiple licences would be a complex option with significant risks and no clear benefits to good causes.

21. We therefore conclude that the multiple licence model is complex and risky, and that it could lead to a significantly worse outcome for good causes. As explained above, the multiple licence model could result in competition between operators and a significant increase in regulation, both of which could undermine the development of the Lottery to the detriment of good causes. For this reason, we think that the multiple licence model is only likely to increase the money for good causes if it leads to stronger bidding competition than the single licence model. On the evidence we have seen, we think that there are good reasons to doubt that this would be the case.

Recommendations

22. We recommend that the Government should consider the following issues before the next licence is awarded.

- First, the government should undertake a rigorous assessment of the risk of weak bidding for a third single licence in 2009. This will require a careful analysis of the size and competitive impact of any incumbency advantage enjoyed by Camelot (along the lines well-established by UK competition authorities), taking into account the conditions in the Second Licence, the range of potential bidders, and the maturity of the Lottery market.

- Second, if this assessment indicates that there is a risk that competition for a single third licence would be weak, the government should assess the alternative options that could be used to negate any residual incumbency advantage and encourage competition within the single licence model.

- Third, the government should consider whether the contribution to good causes in the single licence model could be increased by modifying the shape of the retention schedule. This influences the marginal incentives to grow Lottery sales, and it may be better (for good causes) to move from the current declining schedule to a flatter or upward sloping schedule in future.

- Fourth, if the Government decides to proceed with the multiple licence model it should take steps to mitigate the risk to good causes. For example, the government should:

    - ensure that the bidding process permits a single operator to win all licences. In this way a multiple licensing approach would not rule out the possibility that the Lottery could continue to be operated by a single operator, if this is the most efficient approach; and

    - ensure that licences are designed so that competition between different operators would be limited, and economies of scale and scope are preserved.

- Fifth, the Government should recognise that moving to the multiple licence model would require the NLC to intervene in complex commercial and strategic aspects of the Lottery, as well as to adjudicate on access pricing and allocating risk and investment between licence holders. This would be a very significant increase in the scale and complexity of the NLC's remit, and it will be important to ensure that NLC is properly resourced to meet this challenge effectively.

Appendix 2

Report by NERA on the Frontier Economics Report *National Lottery Licensing and Competition*

Introduction

1. This document provides NERA's review of the Frontier Economics report, National Lottery Licensing and Competition, which was prepared by Frontier for Camelot and dated December 2003. We understand that this report was submitted to DCMS, and that the Culture, Media and Sport Select Committee (CMS Committee) has passed it on for comments to the National Lottery Commission, who have in turn asked NERA to provide an independent review.

2. The Frontier Economics' National Lottery licensing and competition study prepared for Camelot is a clearly written report that covers some of the issues involved with competition in the lottery market. The report also draws attention to some issues that merit examination by NLC before the Lottery is rebid. For example, there may be a case (cf paras 22, 55, 142) for examining whether a different form of retention schedule might generate higher revenues than the current "progressive tax" model (although we note that it is open to bidders to offer different degrees of progressivity in their proposed payment schedules within the existing progressive tax model). The suggestion (para 22) that the government should consider the impact of weak bidding for the third licence also seems an obvious one – this clearly needs to be done, but it would seem sensible that this should include a consideration of how the possibility of multiple licences would impact on the strength of the overall bidding process. However, the report exhibits a clear bias in favour of the status quo, and contains numerous assertions that are not backed up by evidence.

Major concerns

3. NERA has **three major concerns** with the Frontier report.

- First, the report is not clear enough in defining the form of multiple licence model that is being assessed. In particular, it fails to distinguish between the case where separate exclusive licenses are offered for different types of lottery product (Lotto/ Scratchcards/Interactive games), and the case where each type of product is supplied by more than one licensee. NERA's work for the NLC has demonstrated that Lotto and Scratchcards can be regarded as almost completely separate products, since the introduction of Scratchcards had no significant effects on sales of the Saturday draw (the only other Lottery product offered when Scratchcards were introduced). If there is little competitive interaction between product clusters, as this evidence suggests, then the problems of cannibalisation, uncoordinated product launches and free riding highlighted by Frontier are potentially far less serious than Frontier appears to imply.

- Second, the report fails to consider a potential advantage of separating the bidding of different groups of Lottery products. Under the current single licence model, bidders are required to offer a single retention schedule covering revenues from all types of product. However, the marginal costs vary between product groups, and it is possible that the existing retention schedule may not offer strong incentives for the licence holder to expand the sales of Scratchcard products, where marginal costs are relatively high. If different products were separately bid, retention schedules might better reflect the marginal cost characteristics of each product group, and so encourage higher sales.

- Third, the report ignores the benefits of dynamic competition. It argues that competition for licences will inevitably reduce sales (and hence revenue for good causes) from levels with a single operator, but it does not make any allowance for the impact of competition "in the market" on innovation in game design, in marketing and in cost reduction. Under the present system there is competition at the time of licence renewal between a limited number of bidders, but the impacts of competition are dulled between licence renewals. With multiple licences, each operator will have an incentive to develop their own market niches, and while they will not take direct account of cannibalisation on other operators' sales, they will nevertheless be concerned that their own product is positioned so as to be relatively immune to cannibalisation from their rivals.

Unsupported assertions

4. The Frontier report contains a number of assertions that are not backed up by evidence;

- the "current licensing approach…appears to have worked well" (para 26). However, sales have been falling over time despite the introduction of new games, and a different operator or a number of operators might have been able to generate greater sales through product innovation and marketing. Frontier's judgment could only be validated if it could be benchmarked against the counterfactual of what the sales and revenues could have been in an alternative system, and possibly one where competition within the market of the National Lottery had been allowed. Given the difficulty of doing this, an alternative approach would be to benchmark against performance of lotteries in other countries.

- ".. the economic value of the Lottery is likely to be lower in the multiple licence model than in the single licence model" (para 15). This is at the heart of the whole argument between single and multiple licence models, and therefore needs to be analysed in detail – particularly in relation to (1) the way that the market would be split up between different licences so as to minimise inter-operator cannibalisation and (2) the dynamic impacts of competition "in the market" (see above).

- Small bidders would not be attracted in a multiple licence system (eg para 123). This depends in part on the way that the system would to be devised.

- The winner in a single licence competition will be able to assemble all the skills needed (para 96). We do not think that the winner of the bid would necessarily provide the optimum combination of skills.

Other points

- The report underlines the **risks involved with changing the present situation** but these risks are not weighted against the costs of not changing the present arrangements, especially in a context of declining sales.

- We believe that the Frontier Economics report **undervalues the role that NLC regulation can effectively play** to avoid undesirable outcomes (such as unco-ordinated timing of launches) and its ability to rely on experts' advice for issues of particular complexity. We believe that the report should not dismiss the ability of regulators to cope with a market with more operators and licenses.

- The Frontier report is also dismissive of the **prospects for effective regulation of access to national distribution networks**. This situation is now common in many regulated industries, including telecoms, electricity distribution, railways and posts. While there are difficulties in determining conditions for access and in determining access prices, there is now also substantial regulatory experience in the United Kingdom in this area upon which the National Lottery Commission could draw.

- We believe that the **discussion of the bidding process** is rather superficial. The report concludes (para 69) that some of the greater difficulties can be avoided by use of a sealed bid, first price, tender, without noting that this is in any case the most commonly used form of bidding process.

- Most of the **arguments about costs** in a market where there is more than one firm (duplication of functions like finance and HR; loss of synergies in marketing or market research, decreased buying power) would apply to any market (para 112), but are not normally used as generic arguments to justify lack of competition.

- The **"illustrative model of competition"** used in the Annex is superficial and does not add anything to the report's arguments. The Salop model is a variation of the simple Hotelling location model. It is a static model that also involves very specific assumptions that are not valid in this case: namely that all operators' costs are symmetric, that products are similar enough to allow cannibalisation to take place, that the whole market can be covered, that demand is fixed and cannot expand, and that consumers only purchase **one** unit by picking a single product in the lottery.

Conclusions

5. This review has highlighted NERA's main concerns with the Frontier report. These include in particular the way that the report ignores the dynamic benefits of competition, the way that the report fails to take account of the role of effective regulation in licensing new products and their launches and in devising systems of competition that can minimise the impacts of cannibalisation between different operators, and the way that the report fails to make clear the possibility that competition between some forms of Lottery products (in particular between weekly draws and Scratchcards) may not lead to losses of market in any case.

NERA Economic Consulting, January 28th 2004

Appendix 3

National Lottery licensing and competition

Comments on the responses from the NLC and NERA

1. The NLC has sent Camelot a briefing note (the NLC note) that concerns Camelot's submission to the Culture, Media, and Sport Select Committee and our report National Lottery Licensing and Competition (January 2004).177 In addition, the NLC has sent Camelot a critique of our report that was prepared by NERA (the NERA critique).
We have seen nothing in the NLC note or the NERA critique that makes us change the conclusions of our report.

2. The conventional consumer-based rationale for competition is not directly applicable to the National Lottery (NL). This is because the primary economic purpose of the Lottery is to raise funds for good causes. Accordingly, competition between Lottery operators is only desirable to the extent that it enhances the funds for good causes. This could be because it increases the economic value of the Lottery and/or because it intensifies bidding competition between potential operators.

3. The starting point is that the current structure of the NL has a proven track record of success, and any move to a new, and by definition, untested structure is risky. For example, having multiple lottery operators could result in:

- destructive competition, resulting in cannibalisation and reduced value;
- uncoordinated activities, reducing the value of product launches;
- wasteful expenditures (e.g. on marketing);
- loss of scale and scope economies across different games/activities;
- increased bidding complexity, leading to higher bidding costs (risks) and/or a reduction in bidding competition;
- increased regulatory complexity, increasing costs to both the regulator and the (potential) operators.

4. Most importantly, the main argument for offering multiple licences is based on the assumption that this would somehow lead to an increase in bidding competition. However, there is no evidence to substantiate this view. In particular:

- the first two licences were awarded following competitive (and successful) bidding competitions;
- there is no compelling evidence to suggest that bidding competition would be more limited for a single third licence;

177 Note on the risks and benefits associated with a power to grant multiple licences to operate the National Lottery.

- bidding competition could well be reduced in the multiple licence model if firms who would have bid for a single licence are deterred from bidding by the additional cost and complexity of bidding for multiple licences and/or if no additional bidders are attracted.

5. In any case, the suggested benefits of moving to a new structure are unproven and/or unrelated to the number and type of licences that are offered by the NLC. For example:

- it is suggested by NERA that multiple licences might permit more than one retention curves, but this can easily be accommodated under a single licence model;
- both the NLC and NERA suggest that multiple licences might reduce any incumbency advantage on the part of Camelot, but such an advantage has not been demonstrated. In any case, even if there is an incumbency advantage, this could be addressed through less risky mechanisms before multiple licences need to be considered;
- the NLC asserts that product innovation is likely to be limited in the future – in which case it is unclear what advantages increased competition (even if it resulted from multiple licences) would bring in this area;
- NERA claim that cannibalisation can be reduced by offering licences which do not directly compete – in which case, again, it is unclear what advantages increased competition (if it resulted from multiple licences) would bring.

6. There seems to be a fundamental confusion and/or inconsistency in the NLC/NERA notes on the risks and potential benefits from increased competition. They argue that cannibalisation/destructive competition might not be such a great risk, whilst the Frontier report has understated the potential benefits of dynamic competition. In reality, the risks and benefits are closely related: any dynamic benefits derive from a competitive battle between players, but this is exactly when cannibalisation (and the other risks) will occur. It appears illogical to argue that cannibalisation will be limited by creating niche players whilst simultaneously arguing about dynamic benefits.

7. Whilst the NLC appear to accept our recommendations for further research and analysis (into the existence of an incumbency advantage, for example), they claim that this cannot be done until closer to the next round. We do not understand this position and reiterate our view that research (specifically into Camelot's potential incumbency advantage) should be completed before any new powers are given the NLC.

8. In the remainder of this note we:

- briefly recap the purpose of our report, and summarise the rationale for our key conclusion that the multiple licence option is risky;
- set out our detailed comments on NERA's critique of our report; and
- set out our detailed comments on the NLC's note.

The Frontier report

Our remit and approach

9. Camelot asked Frontier Economics to carry out an independent economic assessment of the government's proposal to adopt a multiple licence model, focusing in particular on the likely impact of this on the money raised for good causes.

10. Our report was based on four key assumptions:

- no significant change in the legal definition of a lottery;
- the NLC will offer 'full capacity' licences;
- the NLC will regulate individual games; and
- the NLC will award licences by competitive tender.

11. These assumptions are in line with the NLC's summary of the government's proposal in its note.

12. Our analysis was not predicated on a particular view of the operating licences that the NLC might offer. This was because at the time of writing the NLC had not reached a decision on which licences would be offered, beyond stating that it would "expect to group types of lotteries together, linking these to the associated technologies as far as possible, and to recognise that the main jackpot game is a natural monopoly."[178]

13. For this reason we focused on examining the key issues and trade-offs that are inherent to the multiple licence model as compared to the single licence model, taking into account that the extent to competition in the market will depend on the design of the licences and that actions of the NLC. As a consequence, our main conclusions do not depend on the exact nature of the operating licences offered.

Our key argument

14. The central point in our analysis is that a single integrated Lottery operator has both the incentive and the ability to develop the Lottery more effectively than multiple operators.

There are a number of reasons for this conclusion:

- first, a single operator can better coordinate product development, optimising the design of the entire portfolio and internalising any cannibalisation effects without regulatory intervention;
- second, a single operator can better coordinate product launches to maximise the impact on net lottery sales;

178 NLC response to the Review of Lottery Licensing and Regulation, paragraph 16 (2002).

- third, a single operator has a stronger incentive to invest in developing the Lottery market, since it will enjoy a larger share of the benefits than with multiple operators. Moreover, a single operator cannot free-ride on the efforts of other operators;
- fourth, a single operator can fully exploit all of the available economies of scale and scope.

15. We explained in our report that the significance of these issues will depend on the precise design of the licences. For example, if it is possible to design licences in such a way that there is no impact on product development, product launches, market investments, or costs, then there may be little to choose between the single operator and multiple operator scenarios in terms of the development of the Lottery. It is unclear, however, that this would be possible or even desirable.

16. For this reason, we concluded that it is likely that a single operator outcome is preferable in terms of the development of the Lottery. It follows that there is no reason to adopt the multiple licence model unless it can be shown that this would lead to a sufficiently large enough increase in bidding competition to generate a better return to good causes than the single licence model. We do not think that any compelling reasons have been identified to suggest that this is likely to be the case.

17. We acknowledge that little robust empirical evidence is available to quantify the advantages and disadvantages of any proposal. This is why our implicit methodology is one of identifying the risks of moving away from the current (and successful) model of licensing. We cannot easily quantify those risks, nor can we say what will happen if the current model is retained; but we can identify areas where we think Government needs to undertake further analysis before changing its licensing policy.[179]

18. Given the success of the single licence model to date, and the ways in which apparent concerns about competition for licences could be addressed without multiple licences, the single licence model would appear to be a lower risk option for the NLC and for good causes. By contrast, the multiple licence model could be costly to implement, have no impact on competition for licences, and risks damaging the value of the Lottery and reducing contributions to good causes.

Comment on Nera critique

NERA's three major concerns

19. "First the report is not clear enough in defining the form of multiple licence model that is being assessed. In particular, it fails to distinguish between the case where separate licences are offered for different types of lottery product (Lotto/Scratchcards/Interactive games), and the case where each type of product is supplied by more than one licensee. NERA's work for the NLC has demonstrated that Lotto and Scratchcards can be regarded as completely separate products, since the introduction of Scratchcards had no significant effects on sales of the Saturday draw. If there is little competitive interaction between

179 In this sense, our approach is more akin to a Regulatory Impact Assessment, as undertaken by all government departments before proposing policy changes.

product clusters, as this evidence suggests, then the problems of cannibalisation, uncoordinated product launches and free riding highlighted by Frontier are potentially far less serious than Frontier appears to imply."[180]

20. At the time of writing our report it was unclear what multiple licence model would be adopted by the NLC. For this reason we did not base our report on a specific form of the multiple licence model. Instead, we focused on assessing the key trade-offs that are inherent to the multiple licence model as compared to the single licence model. As a consequence, our conclusions are not specific to any particular form of the multiple licence model (see paragraphs 35 to 38 of our report).

21. The extent of competitive interaction depends on the specification of the licences. It is true that if there is little competitive interaction between product clusters then the problems of cannibalisation and uncoordinated product launches would be less significant than otherwise. There could, however, remain a free-riding problem in relation to common investments such as the NL brand, however. More importantly, if competitive interactions are minimised, to reduce cannibalisation, the suggested benefits from increased competition (if it were to occur) must also be minimised.

22. The NLC and NERA claim that Scratchcards are, essentially, in a different market to jackpots. This may be true, but such comparisons simply capture the results of a single licence operator's strategy. The relevant question is whether products that are currently differentiated would continue to be differentiated if the respective suppliers were in competition. Camelot has a strong incentive to reduce competition between different Lottery products, but this may not be the case for competing licensees (paragraph 89 of our report).

23. "Second, the report fails to consider a potential advantage of separating the bidding of different groups of Lottery products. Under the current single licence model, bidders are required to offer a single retention schedule covering revenues from all types of product. However, the marginal costs vary between product groups, and it is possible that the existing retention schedule may not offer strong incentives for the licence holder to expand the sales of Scratchcard products, where marginal costs are relatively high. If different products were separately bid, retention schedules might better reflect the marginal cost characteristics of each product group, and so encourage higher sales." 181

24. We accept that the marginal costs from different products are likely to be different and this might warrant different retention schedules. However, achieving different schedules via the separation of licences is akin to cracking a walnut with a sledgehammer. Any licence model could either allow (or require) bidders to submit different retention schedule for each product type if they thought that this was attractive. Alternatively, the bidding process could require bidders to specify multiple schedules. For this reason, we believe that splitting licences to achieve different retention schedules is unnecessary and does not represent a valid argument for movement to multiple licences.

180 NERA, page 1.

181 NERA, page 2.

25. “Third, the report ignores the benefits of dynamic competition. It argues that competition for licences will inevitably reduce sales (and hence revenue for good causes) from the levels of a single operator, but it does not make any allowance for the impact of competition “in the market” on innovation in game design, in marketing and in cost reduction. Under the present system there is competition at the time of the licence renewal between a limited number of bidders, but the impacts of competitions are dulled between licence renewals. With multiple licences, each operator will have an incentive to develop their own market niches, and while they will not take direct account of cannibalisation on other operator’s sales, they will nevertheless be concerned that their own product is positioned so as to be relatively immune to cannibalisation from their rivals.” 182

26. We do not argue that competition for licences will “inevitably reduce sales” – in fact, we would agree that in theory competition between operators could well increase sales (for example if prize-payout ratios are increased by competition between operators, and this increases sales volumes). Rather, we point out that the economic value of the Lottery could be lower with multiple operators than with a single operator, and that as a consequence, the funds for good causes will only be higher in the multiple licence model if there is a large enough increase in the strength of bidding competition.

27. We argue that competition “in the market” between operators is unlikely to increase the economic value of the Lottery (paragraph 92 to 97 of our report). This is because a single operator has both the incentive and ability to develop the Lottery more effectively than multiple operators. Multiple operators have an incentive to maximise the economic value of their own licensed operations, and will take no account of the impact of their actions on other operators’ costs and profits.

28. With multiple licences, each operator may well have an incentive to develop its own product niche and to minimise competition as NERA suggest. But, as noted above, in this case the benefits from competition in the market in terms of product innovation are likely to be muted. Competition will be more intense when operators compete head-on. These are exactly the circumstances when the problems of cannibalisation are greatest. In short, the “dynamic benefits” suggested by NERA cannot be separated from the potential impacts of cannibalisation.

29. A further point is that competition between licensees could lead to excessive marketing as operators compete for market share (paragraph 105 of our report). This competitive escalation of marketing expenditure would increase costs and reduce the funds available to good causes.

30. We also note that the NLC does not appear to see large scope for dynamic competition based around product innovation (as discussed above).

NERA’s other comments

31. “The ‘current licensing approach … appears to have worked well’ (para 26). However, sales have been falling over time despite the introduction of new games, and a different

182 NERA, page 2.

operator or a number of operators might have been able to generate greater sales through product innovation and marketing. Frontier's judgment could only be validated if it could be benchmarked against the counterfactual of what sales and revenues could have been in an alternative system, and possibly one where competition within the market of the National Lottery had been allowed. Given the difficulty of doing this, an alternative approach would be to benchmark again performance of lotteries in other countries."

32. We note that we were not asked to carry out an independent assessment of the historic performance of the current licensing arrangement relative to other possible alternative arrangements that could have been used. Our comment that the current licensing approach appears to have worked well is based on the following:

- Tessa Jowell, in the foreword to the Review of Lottery Licensing and Regulation, stated that "The National Lottery has been a great success", and "overall our Lottery is widely recognised as one of the most successful in the world";[183]
- the 4th Annual La Fleur Efficiency Study found Camelot to be amongst the top four lotteries worldwide in terms of cost efficiency, and the second Lottery in terms of returns to good causes; and
- Camelot's record of product innovation (paragraph 60 and 61 of our report).

33. We do not dispute that an alternative system might have been more successful. We only make the simple point that the single licence model has a track record of success, and that the untried multiple licence model carries a risk.

34. In principle, NERA is correct that a different operator or a number of operators might have been able to generate greater sales or revenues through product innovation and marketing. Even if true, however, it does not follow that the economic value of the Lottery, or the returns to good causes would have been greater, since costs would also have been higher.

35. The fact that Lottery sales have declined is irrelevant – as NERA point out, changes in sales must be benchmarked against a relevant counterfactual. We are not aware of any evidence (of the type they suggest or any other) suggesting that the National Lottery has not been a success

"*… the economic value of the Lottery is likely to be lower in the multiple licence model than in the single licence model' (para 15). This is at the heart of the whole argument between single and multiple licence models and therefore needs to be analysed in detail - particularly in relation to (1) the way the market would be split up between different licences so as to minimise inter-operator cannibalisation and (2) the dynamic impacts of competition 'in the market' (see above).*"

36. We agree that this is the heart of the problem but our findings are general because they are invariant to the structure of any future licensing system. We thus do not need to go into

183 Similar sentiments can be found in many other statements from the Secretary of State, including the Foreword to the *National Lottery Funding Decision Document*.

detail with regard to the many different ways in which the market could be split up, or the dynamic impacts of competition in each of these states of the world.
Further, and as noted above, NERA's suggestion that cannibalisation will be minimised by the creation of market niches clearly contradicts it's suggestion that competition will maximise dynamic benefits. If competition is to take place this requires firms to battle. If they don't battle what is the point of competition and thus where are the dynamic benefits?

37. "Small bidders would not be attracted in a multiple licence system (eg para 123). This depends on the way in which the system is devised."

38. We argue that small bidders who only want to operate part of the Lottery may be deterred in the multiple licence model if they are at a disadvantage relative to bidders who want to operate the entire Lottery. For this reason, it should not be taken for granted that multiple licences will attract more bidders (which appears to be one of the factors driving DCMS toward this model).

39. We also argue that it may be possible to attract small bidders if:

- licences are independent of one another;
- licences are designed to minimise any incumbency advantage enjoyed by Camelot; and
- one or more licences is reserved for a new entrant.

40. "The winner in a single licence competition will be able to assemble all the skills needed (para 96). We do not think that the winner of the bid would necessarily provide the optimum combination of skills."

41. We argue that the single licensee has the incentive and the ability to assemble all the skills needs prior to bidding and subsequently. It is conceivable that the actual winner, or winners, would not provide some theoretical optimum combination of skills. The relevance of this observation appears limited.

42. "The report underlines the risks involved with changing the present situation but these risks are not weighted against the costs of not changing the present arrangements, especially in the context of declining sales."

43. Factually, it is not yet clear to us that sales in the second licence period will be less than sales in the first period. However, we think that declining sales are only relevant to the extent that this would be changed by offering multiple licences. This is not obviously the case.

44. "We believe that the Frontier Economics report undervalues the role that NLC regulation can effectively play to avoid undesirable outcomes (such as uncoordinated timing of launches) and its ability to rely on experts' advice for issues of particular complexity. We believe that the report should not dismiss the ability of regulators to cope with a market with more operators and licences."

45. We do not form any views about the ability of the NLC to regulate. We simply draw attention to the increase in complexity that would be faced by the NLC. This could be extremely costly to implement, both for the NLC and the operators. This has been seen in every other regulated industry.

46. "The Frontier report is also dismissive of the prospects for effective regulation of access to national distribution networks. The situation is now common in many regulated industries, including telecoms, electricity distribution, railways and posts. While there are difficulties in determining conditions for access and in determining access prices, there is now also substantial regulatory experience in the United Kingdom in the area upon which the National Lottery Commission could draw."

47. See above for the main comment, relating to cost. Access pricing is probably one of the most contentious and expensive forms of regulation. This does not mean it cannot be done, but the regulators referenced by NERA are many times the size of the NLC.
Uncertainties about future regulatory intervention may actively deter bidders

48. "We believe the discussion of the bidding process is rather superficial. The report concludes (para 69) that some of the greater difficulties can be avoided by use of a sealed bid, first price, tender, without noting that this is in any case the most commonly used form of bidding process."

49. The remark made in paragraph 69 of our report that is quoted by NERA is meant to illustrate the well-known fact that the format of the bidding process can have important implications for the strength of bidding in some circumstances. This remark should be read in the overall context of this part of our report, and it is not intended to be a conclusion, or part of a detailed analysis of the bidding process as NERA seems to suggest. The fact that sealed bid, first priced auctions are commonly used tells us nothing about whether they are the most suitable form of mechanism for the NL. The key point is that the NLC should consider how bidding competition could be stimulated by appropriate design of the single licence award procedure.

50. "Most of the arguments about costs in a market where there is more than one firm (duplication of functions like finance and HR, loss of synergies in marketing or market research, decreased buying power) would apply to any market (para 112), but are not normally used as generic arguments to justify the lack of competition."

51. These potential costs increases are not used as generic arguments to justify the lack of competition. They are costs that need to be taken into account, along with all the other costs and risks, because they impact directly upon the level of funds that the Lottery can raise for good causes. While such costs clearly apply in many markets with more than one firm, there are few cases – other than the Lottery – where government's objective is to maximise the difference between sales revenues and costs.

52. "The 'illustrative model of competition' used in the Annex is superficial and does not add anything to the report's arguments. The Salop model is a variation of the simple Hotelling location model. It is a static model that also involves very specific assumptions that are not valid in this case: namely that all operators' costs are symmetric, that products

are similar enough to allow cannibalisation to take place, that the whole market can be covered, that demand is fixed can cannot expand, and that consumers only purchase one unit by picking a single product in the Lottery".

53. We make it clear that the model is intended to be illustrative only, that it is highly stylised, and that it is not intended to be a specific model of the UK lottery market. The purpose of the model was to illustrate the key proposition that competition in the market between operators could reduce the returns to good causes. The model is not intended to 'prove' this, but to aid understanding of the trade-off between competition in and for the market.

The NLC's Note

The nature of the proposal

54. In this section the NLC reiterates that it believes that effective competition for a third licence is likely to be very difficult to generate under the present arrangement. The government's proposal is that the NLC should therefore have the power to issue more than one 'full capacity' licence if this is considered appropriate nearer the time of the next licence competition.

55. The NLC confirms that no decision has been made on the licensing structure, and that it is possible that it could decide to issue a single licence. The NLC also confirms that if multiple licences are offered, these will be designed to limit competition between operators, and that applicants will be able to bid for (and presumably win) all licences. In other words, the multiple licence model could result in a single operator outcome.

56. The NLC states that by offering multiple licences it could encourage more competition for licences than in the single licence model, and also more innovation and specialisation than under a single licence. As discussed below, we do not believe that these claims are well supported in what follows in the NLC's note.

Flexibility and timing of detailed research

57. The NLC argues that legislation is required prior to the final determination of whether a single or multiple licence model is more appropriate since:

- it cannot dedicate resources to research and consultation on powers which have not been given to it by Parliament, and
- the required research should be carried out nearer to the next licence competition, since potential bidders will be more interested at this time, and changes in market conditions and/or technology can be taken into account.

58. We do not understand this position:

- the logic of the position appears somewhat circular – characterised as "we need the powers to do the research in order to understand if we need the powers";
- the NLC already appears to have "dedicated resources to research" by asking NERA to critique our paper;
- nonetheless, if the NLC cannot do the work, DCMS certainly could; and
- the required research does not need to "be carried out closer to the next licence competition" since the fundamental question is whether Camelot has an incumbency advantage. Without such an advantage, it is clear that there is no need for the single licence model to be changed. This question can be addressed now, in exactly the same way that competition authorities regularly investigate issues of entry barriers (and this does not rely solely on the views of other potential bidders, who themselves might have a vested interest).

59. Our report makes clear that we do not think there is evidence to support the view that a multiple licence model will be superior to a single licence model. Given this, it would appear wise to undertake further research before granting the NLC additional powers, which may be unnecessary and costly to implement.

Likelihood of competition if no change is made

60. The NLC argues that competition may be limited for a single licence at the next competition because:

- bidders may be deterred by the size and specialist nature of the Lottery operator's role;
- bidders may consider the likely returns of operating the Lottery are insufficient to justify the cost of bidding, the risk of handover, and the pressures of public scrutiny;
- bidders may be deterred by the opportunity cost of bidding (for example in terms of an inability to focus on other opportunities, or their core business activities);
- bidders may be deterred by the reputational risk associated with handover from Camelot;
- the number of gaming system suppliers may be limited.

61. These concerns are based on the views of bidders involved in the second licence competition. It is therefore unclear to what extent they remain valid in relation to the next licence competition. As we note in our report, there are reasons to believe that there could be more interest in the third licence given the changes made to Camelot's current licence, and the maturity of the Lottery market. In particular, the second licence ensures that:

- the NLC can require Camelot to cooperate with a new licensee for up to two years prior to the end of the second licence; and
- the NLC can require the transfer of property and rights that it regards as an integral part of the Lottery and that ought reasonably to be available for use by the subsequent licensee.

62. The first of these provisions should help to minimise concerns regarding handover from Camelot to an incoming operator. The second condition would, for example, enable

the NLC to ensure the transfer of National Lottery terminals to an incoming licensee, ensure that bidders obtain accurate retailer information, and require Camelot to transfer intellectual property to an incoming licensee.

63. In any case, the NLC does not explain how the multiple licence model would help overcome the factors that it has identified as potentially limiting effective competition for a single licence. Specifically:

- why does offering multiple licences reduce the specialist nature of the Lottery operators' roles?;
- why would offering multiple licences increase the likely returns of operating parts of the Lottery? Surely, if increased competition were to occur (as suggested), expected returns would fall. Similarly, why are handover risks and the pressures of public scrutiny any different under multiple licences than under a single licence?;
- why does the opportunity cost of bidding change when multiple licences are offered instead of a single licence?
- why would multiple licences have any impact on the number of gaming system suppliers?

64. Overall, then, it appears to us that the multiple licence model would not address any of the concerns expressed by the NLC. Indeed, it could in fact make entry less attractive since the NLC's proposals are intended to increase competition for licences, and hence reduce the likely return to bidders, and also likely to increase the cost and complexity of bidding. In addition, as noted in our report, if one operator is permitted to win all licences then firms who bid for a subset of licences (for example single-licence bidders) may consider that they are unlikely to win and hence decide to not participate.

Future developments in the lottery market

Continued proliferation of games

65. The NLC argues that the scope for introducing new games could be exhausted during the current licence periods, and that as a consequence:
"…whilst some new innovative opportunities will be identified, these will be comparatively rare. Operator(s) will focus much more on refreshment of existing games, and replacement of underperforming games with redesigned versions, which would fall within their 'full capacity' licences."
This appears to be inconsistent with the NLC's claim that the multiple licence model would give the opportunity to encourage greater innovation. If the scope for innovation is limited as suggested, then the key issue is whether multiple operators could better manage a mature portfolio than a single operator. A priori it is not obvious why this should be true.

Competition between games

66. The NLC confirms that it will only offer a small number of licences and ensure that games that substitute for one another are within the control of a single licensee. The NLC notes that the degree of cannibalisation is not necessarily uniform or high across the portfolio, and in particular that there is little cannibalisation between scratchcards and

draw-based games. As noted in paragraph 23 above, this may simply reflect the fact that a single operator has an incentive to position products so as to limit cannibalisation within the overall game portfolio.

67. The NLC does not consider the possibility of "creeping competition" between licensees. For example, a scratchcard operator could have an incentive to introduce a scratchcard game that more closely competes with a draw-based game. If licences are designed to prevent this, then game development could be stifled. If licences allow more flexibility then the licensee for draw-based games (for example) would face a risk of cannibalisation if the NLC were too lax when licensing games.

68. It is unclear whether the NLC would be able to carve out any other licences other than for draw-based games and Scratchcards.

Technological limitations

69. The NLC notes that it expects that any technological constraints that currently limit the scope for multiple operators will be eased by the time of the next licence competition. The NLC also notes that it will fully assess technological developments and take these into account in the design of the next competition.

The Frontier Economics report

70. The NLC states that our report appears to be based predominantly on information provided by Camelot and would have been better informed had it been based on a wider range of views (para 18 of NLC note). The NLC does not appear to be claiming that any of the factual information provided by Camelot is incorrect. In addition to the information provided by Camelot, our report is based on economic theory and Frontier's experience of how competition works in a wide range of competitive and regulated markets.

71. The NLC makes a number of remarks on the recommendations we make in out report. We comment on these below under the headings used in the NLC note.

Undertake a rigorous assessment of risk of weak bidding for the third licence

72. We recommended that the government should undertake a rigorous assessment of the risk of weak bidding for the third licence, and that this should focus on an assessment of any incumbency advantage enjoyed by Camelot and other potential barriers to competition.

73. The NLC accepts that this assessment needs doing but proposes to carry out the necessary consultation and analysis after legislation has been passed to permit the NLC to issue multiple licences if it sees fit. As discussed in paragraph 60 above, we do not understand why the NLC cannot do the necessary research to determine whether it is sensible or necessary to issue multiple licences.

Consider alternative options to multiple licences to stimulate bids

74. We argued that the government should consider whether it is possible to modify the process to either encourage bidding competition, or to mitigate the impact of weak competition on good causes within the single licence model.
The NLC agrees that this work should be done, but states that at present it is of the view that there remains a significant risk that there would be no competition for the third licence. As discussed above, we do not believe that the NLC has made a convincing case that the multiple licence model is likely to increase bidding competition. It is unclear whether any of the factors identified by the NLC are significant barriers to entry, or that these would be mitigated by issuing multiple licences.

75. We identified a number of options that the government could consider within the single licence model to encourage bidding competition. As noted in our report, a detailed evaluation of these options was outside the scope of our study, and they were included to illustrate the type of thinking that needs to be done by the NLC before implementing the multiple licence model.

- The NLC states that Camelot is free to use competitive tendering to select suppliers during the course of the licence. We understand that this ability is restricted however, and that suppliers had to be identified in the bid for the licence. This restricts the licensee's ability to adapt to market circumstances and arguably makes the licence less attractive to bidders.

- The NLC states that gambling and gaming firms have been allowed to participate in both licence competitions to date through a single purpose vehicle. Our point was that if these firms were allowed to operate the Lottery through a subsidiary then rather than a single purpose vehicle, then this could reduce the cost of bidding (and potentially of operating the Lottery), and hence encourage them to bid.

- The NLC notes that the possibility of underwriting bidding costs is under consideration, but that it is not considered to be sufficient to encourage more bidding competition, and also carries its own risks. Our view is that the impact of financial support to bidders will depend on the level of the support given in relation to the actual (or perceived) barriers to entry. The key issue is whether the cost of encouraging increased bidding competition is outweighed by the increased benefit of this to good causes. We agree that there are difficulties in assessing the level of support that should be given to bidders, but simply argue that this possibility should be properly considered.

- The NLC states that it does not understand how our suggestion that Camelot should submit a final binding bid before others bid would work. The idea behind this option was that potential bidders would know what bid they had to beat before deciding whether to incur the costs of bidding. In theory, this would provide Camelot with a strong incentive to submit a bid that is just high enough to deter a rival bid. Of course, if Camelot succeeded in deterring other bidders, then it could appear that there was no competition, even though the outcome for good causes could be favourable. In addition, this would imply quite a rigid process in which the NLC was unable to negotiate with Camelot.

76. More generally, it is not possible to definitively prove that there would be effective bidding competition for a third licence under any particular licence structure. Accordingly, there is a risk that the NLC could be faced with weak bidding competition regardless of the number of licences offered. Given this, the key issue is what should be done to reduce this risk, and manage the downside for good causes. We suggested in our report that this could be done through some form of 'reserve price'. Reserve prices are commonly used in auctions and tenders processes to protect the 'seller' (in this case the NLC) against the risk of a poor outcome in the event that bidding competition is weak.

Modify retention arrangement

77. The NLC state that they do not understand why a flatter or upward sloping retention schedule could generate a stronger incentive to increase net Lottery sales revenue, as suggested in our report.

78. As explained in our report, the incentive to increase net Lottery sales revenue depends on the incremental profits that are earned by the Lottery operator (see paragraph 53-55 of our report). In Camelot's current licence the retention rate is lower at higher levels of net Lottery sales. Accordingly, Camelot's incentive to increase net sales decreases with the actual level of net sales that is achieved, particularly if it becomes progressively more difficult to grow the market. A flatter or upward sloping retention schedule would provide a stronger incentive to increase net sales.

79. The NLC also state that it is arguable that stronger incentives should be contained earlier in the licence period, both to allow the licensee to recover its capital costs and also to secure the benefits of game introduction earlier in the licence period, so that the returns flow throughout the licence rather than only for the later years.

80. We agree that a downward sloping retention schedule does have the advantage of reducing the licensee's exposure to market risk. This could lower the cost of capital for the licensee. However, it is unclear why a downward sloping retention schedule would provide a stronger incentive for licensees to introduce games early on in the licence period than an upward sloping schedule. It is true that a downward sloping schedule will give relatively high returns at lower sales levels. But with an upward sloping schedule the licensee has a strong incentive to try and increase sales as quickly as possible in order to get onto the higher yielding portion of the retention schedule.
We note that while NLC appears to argue that retention schedules are not that important, this position appears to be at odds with views expressed in the NERA paper.

Mitigate the risk of multiple licences

81. We argued that if the NLC decides to proceed with the multiple licence model, it should take steps to mitigate the risk to good causes, for example by allowing a single operator to win all licences, and by designing licences to minimise competition between operators (para 22 of our report).

82. As noted above, the NLC appears to have accepted that licences should be designed to minimise competition between operators, and also that a single operator should be allowed to bid for all licences.
The NLC states that it agrees that the design of the next competition should seek to minimise risks, but emphasises that these include the risk of no competition associated with a single licence model. We agree that the risk of no competition for a single licence is a relevant consideration. All we argue is that a proper assessment of this is carried out, including an evaluation of alternatives to deal with the consequences of weak bidding

competition (such as a reserve price) before any decision to offer multiple licences if taken.

Ensure that the NLC is properly resourced to address risks if a multiple licence model is adopted

83. We argued that the multiple licence model would result in a significant increase in the scale and complexity of the NLC's remit, and that the NLC would need to be properly resourced to meet this challenge (para 116-119 of our report).
The NLC states that the level of risk in the multiple licence model depends on the level of complexity introduced, such as the number of licences and the extent to which licences can be designed to minimise competition and promote cooperation between operators. Whilst this may be true in principle, the key issue is to what extent the NLC can minimise risk and complexity whilst retaining the putative benefits of the multiple licence model.

84. The NLC states that the Government has the ability to ensure that it is properly resourced. This may be true, but the issue is whether the additional resources required are warranted by the expected benefits from offering multiple licences. These costs and benefits should be properly assessed as part of a regulatory impact assessment before the multiple licence system is implemented.

85. The NLC also notes that its role would change significantly if the present licence model were retained and if there was no significant competition for the third licence. This may be true, but the level of regulatory complexity is likely to be significantly less in a 'monopoly' situation than one in which there are multiple competing operators, particularly if the NLC has to regulate the terms of access to infrastructure and other assets in the multiple licence model.

Camelot's submission

86. We have not seen Camelot's submission and thus only make the following observations on the NLC's comments which appear to relate toour own report.

Game plan

87. As noted above, if portfolio growth is not important in future (as alleged by the NLC), then any putatitve advantage that the multiple licence model may have in relation to product innovation appears irrelevant.
As noted in our report, even if different games require different types of skill and expertise, there is no reason why a single operator should not be able to either develop or aquire the requisite capabilities less effectively than multiple operators.

Marketing and brand management

88. The NLC does not appear to recognise that even if games are not substitutes, operators can influence the level of demand through their marketing activities. A single operator has the incentive and ability to optimise its marketing spend across the portfolio. By contrast,

multiple operators are likely to engage in competitive marketing, even where they offer games which are not substitutes for each other. This can be expected to lead to increased levels of marketing expenditure, which will reduce Lottery profitability and possibly weaken bidding competition.

Jackpots

89. It is true that more than one jackpot game may be operated under a single operator. The key point is that the single operator has the incentive and ability to ensure that jackpot games in the portfolio are designed so as to avoid destructive competition between them. This would not be the case with multiple operators of jackpot games, and the NLC would therefore have to play an active role in game design and portfolio management.

Interactive strategy

90. The NLC indicates that a separate interactive licence could be worth considering if it is the case that new interactive games can be successfully developed (as opposed to distributing existing games over interactive channels). We note that the NLC should also take into account the extent to which any new interactive games might compete with other types of games before issuing a separate licence.

IT and support services

91. We note that it may be significantly more complex and costly to achieve the type of cooperation that the NLC has in mind. This will depend on quite what the NLC has in mind. However, one has only to think of the problems that arose in the context of rail privatisation to see that this can be a very difficult area for regulation.

Role of the regulator

92. The NLC is implicitly assuming that it will be possible to design a set of licences that meets the goal of increasing bidding competition and the return to good causes without the need for complex regulation. It is not at all obvious that this will be achievable in practice.

Conclusion

93. The NLC concludes that Camelot has understated the potential benefits of the multiple licence model and overstated the risks. In particular, the NLC alleges that Camelot has not balanced the risk of change against the likelihood of, and risks associated with, the potential lack of competition under the existing arrangements.
As noted above, it is not possible to 'prove' that there will be strong bidding competition in the single licence model. However, the NLC has not made a plausible case that competition is likely to be strengthened by offering multiple licences by enough to outweigh the disadvantages of having multiple operators. The NLC relies on unsupported assertions that it will be able to design an efficient set of licences, but there are good reasons for thinking that there are underestimating the difficulties that will arise in a multiple operator world. For these reasons, we found in our report that it is in

fact the NLC that has overstated the potential benefits of the multiple licence model and understated the risks.

Witnesses

Tuesday 13 January 2004

Mr Alan Austin, Chairman and **Mr Clive Mollett,** Vice Chairman, The Lotteries Council	Ev 9
Mr Campbell Robb, Director of Public Policy, **Ms Helen Bush,** Policy Officer, National Council for Voluntary Organisations; **Mr Bill Flanagan,** National Chairman and **Ms Barbara Edwards,** Deputy Director, The Coalfield Communities Campaign	Ev 26

Tuesday 20 January 2004

Ms Moira Black CBE, Chairman and **Mr Mark Harris**, Chief Executive, The National Lottery Commission	Ev 39
Mr Michael Grade CBE, Chairman, **Ms Dianne Thompson,** Chief Executive and **Mr Tony Jones,** Operations Director, Camelot Group plc	Ev 51
Mr Simon Burridge, Former Chief Executive, The People's Lottery	Ev 64

Tuesday 27 January 2004

Baroness Pitkeathley OBE, Chairman, New Opportunities Fund, **Lady Brittan CBE**, Chairman, Community Fund, **Mr Stephen Dunmore**, Chief Executive, New Opportunities Fund and Community Fund; and **Mr Mike Wilkins,** Director, Awards for All	Ev 91
Mr Peter Hewitt, Chief Executive and **Ms Pauline Tambling,** Executive Director for Development, Arts Council England	Ev 102
Mr Patrick Carter, Chairman and **Mr Roger Draper,** Chief Executive, Sport England	Ev 118

Tuesday 3 February 2004

Ms Liz Forgan, Chair, **Ms Carole Souter,** Director, Heritage Lottery Fund; **Ms Sue Campbell CBE**, Chair and **Mrs Liz Nicholl MBE**, Interim Chief Executive, UK Sport	Ev 133
Mr John Healey, Economic Secretary, HM Treasury	Ev 148
Rt Hon Tessa Jowell MP, Secretary of State, **Rt Hon Estelle Morris MP,** Minister for the Arts, **Mr Simon Broadley,** and **Mr Colin Perry,** Department for Culture, Media and Sport	Ev 158

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Reports from the Culture, Media and Sport Committee since 2001

The following reports have been produced by the Committee during the last three sessions

Session 2003-04

First Report	Cultural Objects: Developments since 2000	HC 59
First Special Report	Privacy and media intrusion, Replies to the Committee's Fifth Report, 2002–03	HC 213
Second Report	DCMS Annual Report: Work of the Department in 2002-03	HC 74
Third Report	Broadcasting in Transition	HC 380
Fourth Report	Work of the Committee in 2003	HC 404

Session 2002–03

First Report	National Museums and Galleries: Funding and Free Admission	HC 85
Second Report	The Work of the Committee in 2002	HC 148
Third Report	A London Olympic Bid for 2012	HC 268
Fourth Report	The Structure and Strategy for Supporting Tourism	HC 65
Fifth Report	Privacy and media intrusion	HC 458
Sixth Report	The British Film Industry	HC 667

Session 2001–02

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Second Report	Testing the Waters: the Sport of Swimming	HC 418
Third Report	Arts Development	HC 489
Fourth Report	Communications	HC 539
Fifth Report	Revisiting the Manchester 2002 Commonwealth Games	HC 842
Sixth Report	The Government's Proposals for Gambling: Nothing to Lose?	HC 827