POTENTIAL DETRIMENTAL IMPACTS OF THE PROPOSED RACING BILL ON THE NEW ZEALAND THOROUGHBRED RACING INDUSTRY

Prepared For A Concerned Group of Thoroughbred Industry Stakeholders Comprising

The New Zealand Thoroughbred Breeders' Association
The New Zealand Thoroughbred Owners' Association
New Zealand Trainers' Association
The Wellington Racing Club
Hawkes Bay Racing Incorporated

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FOREWORD TO INDEPENDENT ECONOMIC REPORT PREPARED FOR CONCERNED GROUP OF THOROUGHBRED INDUSTRY STAKEHOLDERS

January 2002

The attached report – Potential Detrimental Impacts of the Proposed Racing Bill on the NZ Thoroughbred Industry – was commissioned by a concerned group of thoroughbred industry stakeholders[1] to give an independent assessment of the economic impacts of the proposed Racing Bill. Racing is a BILLION dollar industry with annual distributions (which are artificially set) of $57 million. We understand[2] the Bill has been through the Select Committee process without an assessment of the economic impacts of making the artificial distribution policy law (Clause 15). This is of concern to stakeholders. The drafting and decision-making processs of the Bill appears to be based on rhetoric rather than facts. The attached report discards rhetoric, looks at the impacts – based on facts - over the last 10 years and (using the last three years as a trend indicator) forecasts the impacts on racing in a three and five year timeframe.

The report concludes that:

- The proposed new Racing Bill, whilst intended to improve the governance and operational efficiency of the whole racing industry in New Zealand, creates potential inefficiencies and inequities with respect to the proposed governance structure and distribution of overseas racing betting profits.

- Because both of these aspects are dealt with in the Racing Bill in a manner inconsistent with what might be expected in normal commercial markets, the potential exists for anomalies to arise and inefficient incentives to be created. In particular inefficient expansion of GR may occur at the expense of TR and to a lesser extent HR.

- In the longer term this may have significant detrimental impacts for the whole racing industry in New Zealand.

The report gives facts, independent specialist assessments and reasoned projections. So what is the rhetoric?? Rhetoric those industry leaders and Select Committee members justify for putting current distribution policies into law. Legislation that can neither be circumnavigated nor easily changed.

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1 Comprising NZ Thoroughbred Breeders Association. NZ Thoroughbred Owners Association, New Zealand Trainers Association, Wellington Racing Club and Hawkes Bay Racing Incorporated

2 The Minister's office and Department of Internal Affairs advised no such report has been prepared

Industry rhetoric	Response
A lack of horse numbers is thoroughbred racings concern and reason distributions are reducing.	Superficial analysis. Lower TR horse numbers are a SYMPTOM not a root cause. The root cause is artificial distribution policy that cross-subsidises other codes thereby reducing returns to TR, thereby making investing and racing a thoroughbred horse less economic/attractive. Why are more people racing greyhounds? Answer; the returns are artificially high (50% as per report).
Harness and greyhound racing make significant concessions in dates and profitable times to provide space for domestic and overseas thoroughbred racing and this is to the detriment of greyhound and harness racing.	- GR has never raced on Saturday daytime (therefore how can this be a concession). Domestic TR has always been mid-week (therefore how can this be a concession). - HR has traditionally raced at night – turnover on Saturdays falls well short of Friday night turnover (therefore how can this be a concession) - Domestic TR has made concessions (Thursdays, Fridays, Saturdays and Sundays) to accommodate overseas racing - Economic report shows that the only code that has suffered detrimentally is TR

A principle objective of the Bill is to promote the long-term economic wellbeing of racing – surely this will only be achieved if the Bill is based on mainstream economics.

We encourage interested parties to read the attached report, form their own conclusions and (if you too are concerned with the future of the reports findings) encourage those that vote on the proposed Racing Bill (your local MP) to future-proof thoroughbred racing by amending Clause 15.

STOP PRESS

TAB turnover data to the end of November has just been released and shows anecdotal support to the three and five year projections detailed in Table 7. Respective share of turnover - with 2000/01 share in brackets – for the four months to November are: Thoroughbred racing domestic 54% (55.5%), harness racing 32% (32.8%) greyhound racing 14% (11.7%) overseas racing as a percentage of total TAB turnover 34% (26.1%). The projections in Table 7 had overseas turnover reaching 34% by 2003/04 – therefore the projected demise of thoroughbred racing in NZ will happen quicker (under current distribution policies) than outlined in the attached report.

Concerned Group of Thoroughbred Industry Stakeholders

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1. INTRODUCTION

Background

- The proposed new Racing Bill will merge the Racing Industry Board (RIB) and the Totalisator Agency Board (TAB) into a single statutory body, the New Zealand Racing Board (the Board).

- The explanatory note to the Racing Bill indicates that the objectives of the new legislation include the following:

    1. To simplify the governance of the racing industry;
    2. To encourage industry performance;
    3. To provide a cohesive and streamlined administration reducing inefficient duplication;
    4. To encourage the industry to adopt a strategic approach having regard to the interests of the wide range of industry participants; and
    5. To enable the racing industry to be responsible for its own affairs.

- These objectives embody the principles of efficiency and equity (or fairness).

- However, two aspects of the proposed legislation are potentially inconsistent with the principles of efficiency and equity.

- Firstly, the proposed governance structure, as it relates to the composition of the Board itself, may give equal control to each of the three codes of thoroughbred racing (TR), harness racing (HR) and greyhound racing (GR) which is disproportionate to their respective contributions to the aggregate industry.

- Secondly, it is proposed to write into legislation the current allocation arrangements for the Board surpluses arising from betting on overseas racing; that is the surpluses will be distributed among the three racing codes in the same proportions to which the codes contributed to the New Zealand (domestic) turnover of the Board for that racing year. This is in spite of the fact that the vast majority of these surpluses will be generated from betting on overseas thoroughbred racing, which it is argued has displaced betting on New Zealand thoroughbred racing rather than either of the other two codes.

- This overseas betting profits distribution policy is “artificial” in the sense that it is not determined by a market mechanism. Therefore there is a need to carefully examine its future implications in case inefficient incentives for industry participants are created.

Objectives of This Report

- The objectives of this report are to:

    1. Comment on the efficiency and equity implications of these two aspects of the proposed legislation;

    2. Outline the likely implications for TR over a five year time horizon should these two provisions be enacted by the legislation as is proposed; and

    3. Assuming that in pursuing objectives 1 and 2 above deficiencies are identified, identify superior alternative sector control and profit distribution mechanisms, specifying their implications for each of the three racing codes.

Report Format

- The next section of this report considers the potential inefficiencies and inequities arising from the sector control provisions of the proposed Racing Bill and suggests possible improvements.

- Section 3 of the report considers the inefficiencies and inequities arising from the overseas racing profit distribution provisions of the proposed Racing Bill and suggests possible improvements.

- The reports conclusions are contained in Section 4.

Nature of Study

- The basis of the information for this study has been data provided by New Zealand Thoroughbred Racing Inc.

2. GOVERNANCE STRUCTURE

- The explanatory note to the Racing Bill explains that the governing body of the Board will consist of 7 members – an independent chairperson; 3 members, 1 nominated by each of the 3 racing codes; and 3 members appointed on the advice of a panel (chaired by the Minister, and comprising the independent chairperson of the Board and the 3 code chairpersons).

- There is some debate as to the potential outcome of such a selection process and as to whether the 3 members selected by the panel will in fact each be an additional representative for each code.

- Should this be the case, the 2 minority codes are effectively able to dictate important outcomes such as the allocation of racing days. Such an alignment of voting powers is not consistent with the respective contributions of each code to the turnover and profits of the Board.

- The profits generated by each code for the Board are a reflection of the "equity" each code contributes to the Board. A governance structure giving the 2 minority codes the ability to outvote the major code would be out of step with the representation typically found on commercial boards.

- Among the objectives of the proposed legislation is to enable the racing industry to be responsible for its own affairs. This occurs to the extent that (a) the TAB and the RIB are merged together into a single entity and the powers are given to the new Board; and (b) each of the three codes (TR, HR and GR) are given considerable autonomy with respect to control of, and profit distribution among, their member clubs.

- However, if the proposed Board composition means that TR can effectively be outvoted by the other two codes, TR will have given up a measure of control of its own affairs, given its comparative size. This is to a Board, which may not always act in the best interests of the total racing industry in New Zealand because of its representative composition.

- Effectively this means a diminution of TR's control over its own affairs as compared to it operating as a stand-alone entity.

- Whilst there may be industry-wide advantages and advantages to TR of a co-ordinated and co-operative approach by the three codes, these may not materialise if the two minority codes are able to out vote the majority code.

- Two possible alternative governance structures exist:

    1. The seven-member board should consist entirely of independent directors. In other words none of the directors should have sector representative roles and all decision-making should reflect only aggregate industry interests; or

    2. The Board representation should be commensurate with the contributions by each code to the gross turnover of the Board, having regard to the adjustments proposed in the next section of this report (i.e. that turnover on overseas racing is apportioned on a code specific basis).

- Whilst the second of these two alternatives would ensure that TR did not give up its autonomy to the other two codes, even the first may be sufficient to provide the same level of comfort for the TR industry. Because of its much larger relative size, it is unlikely that decisions taken solely on the basis of the good of the total industry would be out of step with the interests of the TR industry.

3. DISTRIBUTION OF OVERSEAS RACING BETTING SURPLUSES

- Assuming the three racing codes do not agree otherwise, it is proposed that the Board will distribute the profits earned from betting on overseas racing in the proportions of the contributions to the New Zealand turnover of the Board for that year. This is set out in Section 15 of the proposed Racing Bill.

- Whilst Section 14 contains provisions for reserve funds to be established by the Board and distributed to the respective codes in a manner different from the provisions of Section 15, there is no certainty that such reserves will be established and distributed in a fashion which offsets the perceived anomalies associated with the distributions as set out in Section 15 of the Bill.

- The vast majority of the surpluses will be generated from betting on overseas thoroughbred racing and not overseas harness or greyhound racing (See Table 5).

- There exists a strong link between betting on overseas thoroughbred racing and the health and promotion of the New Zealand thoroughbred racing industry. The interest in, and betting on, overseas thoroughbred racing by New Zealanders is a function of the overseas industry's connections to the New Zealand industry – eg the involvement of New Zealand owners, breeders, trainers and jockeys. This is highlighted by the greater favouritism accorded by New Zealand bettors to thoroughbred horses racing overseas but having "New Zealand connections", as compared to the odds in the overseas country.

- Also to the extent that for many bettors, especially the larger more serious bettors, betting on racing is not considered just a game of chance. Quite obviously the skill and knowledge aspects will be code specific thereby linking overseas and domestic code specific racing. For example a serious TR racing bettor will now allocate part of their Saturday betting money for later in the afternoon to cover overseas (Australian) TR racing.

- To the extent this link exists and profits from betting on overseas thoroughbred racing are in fact a function of the efforts of the New Zealand thoroughbred racing industry, inefficient economic incentives are created by a profit distribution system, which fails to take this into account. Economic efficiency principles require profits to accrue to those who generate them.

- Whereas HR and GR will continue to receive a "windfall gain" from the proposed distribution of profits from betting on overseas (principally thoroughbred) racing, TR will be effectively cross-subsidising them. It is claimed that New Zealanders betting on overseas racing are essentially substituting overseas thoroughbred race betting for New Zealand thoroughbred race betting.

- Table 1 shows that domestic TR TAB turnover has declined in real terms from $684.3 million in 1991/92 to $443.9 million in 2000/01 (i.e. a fall of 35%), whilst over the same period overseas TR TAB turnover has risen from $26.7 million to $256.7 million. Over the period total domestic plus overseas TR TAB turnover has remained about the same - $710.9 million in 1991/92 falling to $700.0 million in 2000/01 (i.e. a fall of 1.3%).

- Table 2 shows that domestic HR TAB turnover has declined in real terms from $334.7 million in 1991/92 to $262.0 million in 2000/01 (i.e. a fall of 21.7%), whilst over the same period overseas HR TAB turnover has risen from $1.3 million to $26.5 million. Over the period total domestic plus overseas HR TAB turnover has fallen from $336.1 million to $288.5 million (i.e. a fall of 14.1%).

- Table 3 shows that domestic GR TAB turnover has increased in real terms from $47.6 million in 1991/92 to $93.9 million in 2000/01 (i.e. a rise of 97.7%). Overseas GR TAB turnover is negligible - $0.3 million in 1999/00 and $0.2 million in 2000/01.

- The contrasting fortunes of the different codes over the last 10 years is reflected in the respective number of meetings held and gross stakes paid. The number of TR meetings held reduced from 337 in 1991/92 to 286 meetings in 2000/01 (i.e. a fall of 15.1%), whilst gross stakes paid in real terms fell from $37.8 million to $32.5 million (i.e. a fall of 13.8%). The number of HR meetings rose from 226 meetings to 230 meetings (i.e. arise of 1.8%), whilst gross stakes paid in real terms fell from $20.2 million to $17.5 million (i.e. a fall of 12.7%). The number of GR meetings held increased from 84 to 241 (i.e. an increase of 186.7%), whilst gross stakes paid in real terms increased from $1.25 million to $3.5 million (i.e. an increase of 275.5%).

- Whilst the contrasting fortunes of the racing industry codes will have been due to a number of factors, a significant contributing factor will have been the levels of payouts from the RIB and TAB, which are in part at least affected by the policy to distribute profits from (principally TR) overseas race betting in accordance with the code’s domestic race betting percentages. Table 6 shows the respective payouts to each of the 3 codes. For TR, the payout in real terms has fallen from $41.4 million in 1991/92 to $33.7 million in 2000/01 (i.e. a fall of 18.6%). For HR, the payout in real terms has fallen from $22.4 million to $18.8 million (i.e. a fall of 16.1%). For GR, the payout in real terms has increased from $2.3 million to $5.7 million (i.e. an increase of 147%).

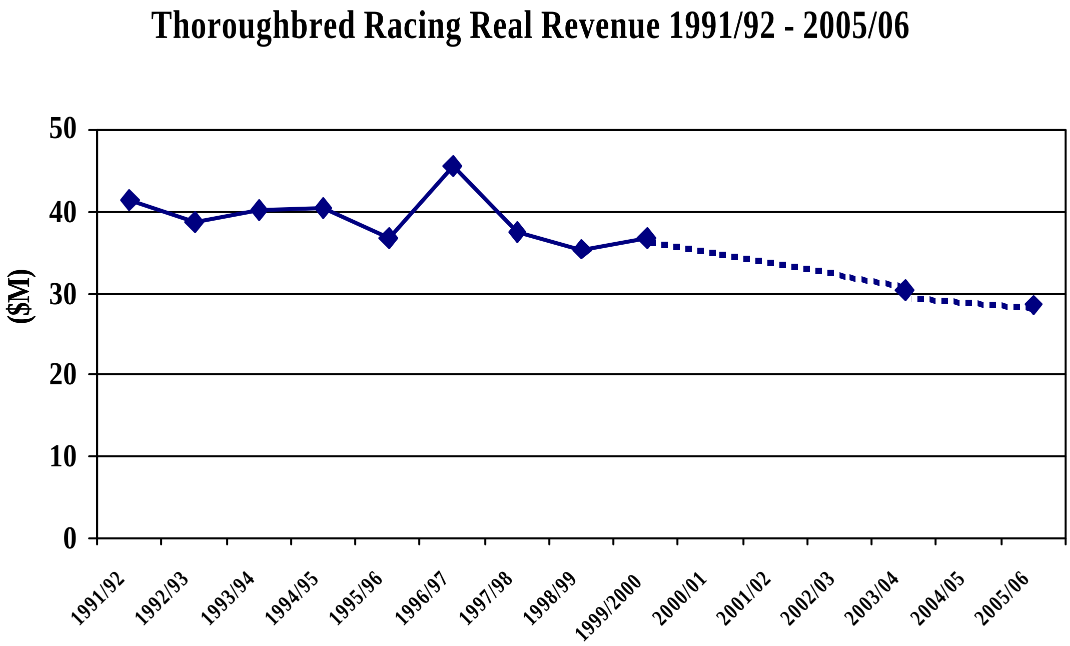
- These differences in the payout changes have seen TR’s share of total payouts decline from 62.6% in 1991/92 to 58.0% in 2000/01, HR’s share fell from

33.8% to 32.3% and GR's share increased from 3.4% to 9.7% over this same period.

- The inequities of the current profit distribution model are highlighted by the fact that for GR, turnover from betting has increased by 97.7% over the past 10 years, whilst GR's payout or profit share has increased by 147% - i.e. an additional 50%. For TR turnover from betting (on both domestic and overseas races) has stayed about the same (a fall of 1.3%), whilst TR's payout or profit share has fallen by 18.6%. This is in spite of the fact that the production and training costs of thoroughbred horses far exceed those for greyhounds.

- Table 7 sets out some forecasts for payouts to each code and TAB turnover assuming the rates of change, which have occurred over the last 3 years, are maintained over the next 5 years. Under this scenario, TR's payout will by 2005/06 have fallen a further $5.2 million to $28.5 million (all amounts in constant September, 2001 prices). It share of total distributions will have fallen from 58.0% to 54.6%. HR's payout will have fallen $2.0 million to $16.8 million and its share of total distributions will have fallen from 32.3% to 32.2%. GR's payout will have increased by $2.2 million to $6.9 million and its share of total distributions will have increased from 9.8% to 13.2%.

- The past and projected future impacts of the rise in the popularity of betting on overseas racing and the current and proposed profit sharing arrangements on TR's real revenues are shown graphically below.



- TR’s domestic TAB turnover is forecast to fall from $443.9 million (55.5% of domestic race betting) in 2000/01 to $314.4 million (50.6% of domestic race betting) in 2005/06. HR’s domestic TAB turnover is forecast to fall from $262.0 million (32.8% of domestic race betting) in 2000/01 to $214.1 million (34.5%of domestic race betting) in 2005/06. GR’s domestic TAB turnover is forecast to fall from $93.9 million (11.7% of domestic race betting) in 2000/01 to $92.4 million (14.9% of domestic race betting) in 2005/06. Meanwhile betting on overseas racing is forecast to increase from $282.8 million (26.1% of total race betting) in 2000/01 to $413.7% (40.0% of total race betting) in 2005/06.

- At the present time TR and HR received a higher (8.225%) percentage share of TAB off-course domestic racing turnover as compared to GR (6.592%). Should this differential be removed in the future (and this is a distinct possibility given that the proposed new Bill prevents differential distribution rates, unless agreed by all codes) the implications in terms of reductions in revenue for TR will be even more pronounced than indicated by the forecasts in Table 7 and discussed above. In approximate terms GR would earn an addition $1.2 million per annum at the expense of TR (approximately $0.8 million) and HR (approximately $0.4 million).

- Should the forecast reductions in payout to TR materialise, then further reductions in stakes, race meetings, races, and starters is inevitable bringing with it reductions in profitability and incentives for all stakeholders in the industry. This means reduced funds for breeding, training, riding and other ancillary TR services. There will be an even greater incentive for the top industry performers to venture overseas.

- The New Zealand thoroughbred racing and breeding industries have for more than sixty years been a significant contributor to the New Zealand economy in terms of value added, employment and exports. In 1999 thoroughbred exports were worth $110 million (Source: Department of Internal Affairs Website). Industry sources suggest that this is a very conservative estimate due to possible under reporting of export values by overseas buyers.

- Any downturn in the New Zealand thoroughbred industry will negatively impact on these national economic benefits as exports, jobs and incomes are reduced.

- The comparative international appeal of the three racing codes is such that any offsetting gains made by HR and GR at the expense of TR will not compensate in terms of national economic benefits.

- Whereas it is possible for TR to manage the transition and ultimate consequences of new technology enabling bettors in New Zealand to follow overseas thoroughbred racing, the maintenance and enhancement of the New

Zealand industry is not possible if the profits from betting on overseas thoroughbred racing are diverted to other codes.

- Any gains from the cross-subsidy to HR and GR may ultimately only be short term in nature. Without a thriving New Zealand thoroughbred industry, New Zealanders' interest in overseas thoroughbred racing may wane. In other words the proposed cross-subsidy may in the end "kill the golden goose".

- There can be no suggestion that there is a need to artificially prop up HR and GR in order to create realistic competitive threats to TR so encouraging greater economic efficiency in the TR industry. TR already faces considerable competition for the leisure dollar from other forms of betting and non-betting entertainment in New Zealand and quite clearly from overseas thoroughbred racing.

- The proposal for the distribution of profits from betting on overseas racing contained in the Racing Bill is inconsistent with the Bill's proposed treatment of profits from sports betting. Sports betting profits are to be distributed between the three codes in proportion to their respective contributions to New Zealand turnover, but **after** a profit sharing arrangement with the national body of the sport involved.

- This means, for example, a negotiated share of the profits from betting on overseas games of rugby (which may or may not involve a New Zealand team) will accrue to the New Zealand Rugby Football Union, before any residual profits are put into the pool for distribution among the three racing codes.

- Therefore a better and more consistent apportionment model for the profits earned from betting on overseas racing might involve a similarly negotiated arrangement with each of the codes for their respective overseas racing using similar guiding parameters to those laid down in Section 55(1)(d) of the Racing Bill and pertaining to sports betting – i.e. (i) not less than 5% of totaliser sports betting turnover; and (ii) not less than 1% of fixed-odds sports betting turnover and 5% of gross profit (being gross revenue minus dividends paid, but not less than zero) from fixed odds betting.

- This would provide a benefit to TR for the majority of betting on overseas racing being on thoroughbred racing, before residual profits are distributed between the three codes in accordance with domestic betting turnover.

- Alternatively the profits from betting on overseas racing could be distributed to each of the codes in accordance with the overseas racing code involved.

- Finally, whilst this section of the report has addressed the inefficiency of the proposed distribution of TAB profits on overseas racing, there are two further existing and proposed future practices, which create inefficiencies.

- Firstly the additional royalty cost (3.8%) paid on overseas race betting is effectively funded out of the pool of profits for distribution to the three codes. There is an economic efficiency argument, which says that the returns to New Zealand bettors should be reduced relative to returns from betting on domestic racing to reflect the higher cost structure of betting on overseas racing.

- Secondly, the pool also earns profits from overseas betting on New Zealand racing, although individual racing clubs may also negotiate a profit share with only residual profits going into the pool. These residual profits, although at this stage very small, are distributed in accordance with the relative contributions to domestic turnover, rather than according to the particular code which attracted the betting. This is inefficient and anomalous.

4. CONCLUSIONS

- The proposed new Racing Bill, whilst intended to improve the governance and operational efficiency of the whole racing industry in New Zealand, creates potential inefficiencies and inequities with respect to the proposed governance structure and distribution of overseas racing betting profits.

- Because both of these aspects are dealt with in the Racing Bill in a manner inconsistent with what might be expected in normal commercial markets, the potential exists for anomalies to arise and inefficient incentives to be created. In particular inefficient expansion of GR may occur at the expense of TR and to a lesser extent HR.

- In the longer term this may have significant detrimental impacts for the whole racing industry in New Zealand.

- The advantages and disadvantages what is proposed under the racing bill and the alternatives identified in this report are summarised in the following table:

Issue	Racing Bill	Alternatives
Governance structure reflective of aggregate industry interests	✗	✓
Efficient profit distribution policy	✗	✓
Equitable distribution policy	✗	✓
Policy distribution policy consistent with the way other sports are treated in the Racing Bill	✗	✓
Profit distribution policy best for long-term TR industry prospects	✗	✓
Windfall gains to HR and GR at expense of TR	✓	✗

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