

CULTURE MEDIA AND SPORT COMMITTEE INQUIRY INTO REFORM OF THE NATIONAL LOTTERY : WRITTEN EVIDENCE SUBMITTED BY THE NATIONAL LOTTERY COMMISSION

Introduction

1. We are grateful for the opportunity to submit evidence to the Committee. We have no direct remit regarding the distribution of Lottery funds to Good Causes and therefore do not comment upon this aspect of the Committee's inquiry.
2. We made a response to the consultation undertaken by the Department of Culture, Media and Sport in respect of lottery licensing and regulation. Much of that is relevant to the Committee's inquiry and we attach a copy for the Committee's information.
3. In this submission, we first set out as background a summary of the statutory framework within which the National Lottery is presently regulated. We then address the questions posed by the Committee as they relate to licensing and regulation. These are as follows:
 - Should the responsibilities for awarding licences, on the one hand, and regulating their implementation, on the other, be divided between different bodies?
 - Is the Lottery Commission the right body to regulate the National Lottery?
 - What advantages, disadvantages or risks, are there in a system of multiple licences for different aspects of the lottery operation potentially run by different companies?
 - Will multiple licences increase competition? Should, and/or could, any tender arrangements include a mechanism to prevent one company winning all available licences?
 - Will the proposed changes ultimately lead to more resources for good causes?
4. We also comment briefly upon the impact on the existing good causes of the Olympic funding stream being created to provide resources in the event that London wins the 2012 bid, as this is an issue upon which we were asked for a view by the Government.

Background

5. The National Lottery etc Act 1993 created a dedicated regulator for the National Lottery. The regulator was given powers to grant a single licence to operate the National Lottery; to grant separately licences in respect of each lottery which forms part of the National Lottery; to enforce the conditions in those licences; and to take action where it considers the licensee or a key supplier not to be fit and proper.
6. The Act also gave the regulator three overriding duties. These are to exercise its functions in the manner that it considers most likely to secure:
 - that the National Lottery, and every lottery that forms part of it, is promoted with all due propriety;

- that the interests of every participant in a lottery that forms part of the National Lottery are protected; and
- subject to both the above, to do its best in exercising its functions to secure that the net proceeds of the National Lottery are as great as possible ('the duty to maximise returns to good causes').

7. We take it as common ground that the National Lottery has a special position within the wider gambling market. This was recognised by the Committee in its report *The Operation of the National Lottery*¹ and the Government has since confirmed this in *A Safe Bet for Success* and the *National Lottery Licensing and Regulation Decision Document*.

Should the responsibilities for awarding licences, on the one hand, and regulating their implementation, on the other, be divided between different bodies?

Principles

8. The special position of the National Lottery as a public institution has two consequences that impact on its model of regulation.

9. First, players have a right to expect that the National Lottery, as a public institution, will be conducted to the highest standards. Such standards may, on occasion, differ from or exceed those expected of purely commercial operations. This is reflected in the first two of our overriding duties.

10. Second, we have always taken the view that the third of our overriding duties is not tied to the immediate effect of proposals by the operator, but rather requires us to take a long term view. As a consequence, the regulator undertakes a wider 'ownership' role in respect of the operation of the National Lottery. This addresses the fact that a private operator is being granted a licensed monopoly for a limited period in order to achieve a public benefit. The wider responsibilities of the regulator are necessary to protect the continuing, longer-term public interest and to provide continuity between licence periods. This is somewhat similar to the role undertaken by the society in the case of society lotteries. It is not a role that can be left to the operator of the National Lottery.

11. We do not perceive a conflict of interest between the different elements of our overriding duties² (propriety and protecting the interests of players on the one hand and maximising returns to good causes on the other). The 1993 Act makes clear that the first two of our overriding duties take priority over the third.

The work we undertake

12. Our overriding duties apply both to the selection of a new operator and to the day-to-day regulation of the lottery. There are, broadly speaking, three elements to our present regulatory responsibilities. These are:

- *Conduct of periodic competitions:* we are responsible for the design and conduct of the competition, the decision to award the licence and the finalisation of the conditions on which the licence is awarded;

¹ At paragraph 123

² See CMS Committee report *The Operation of the National Lottery* at paragraph 19.

- *Day-to-day licensing functions:* there are two aspects of these. The first involves the grant of licences for games forming part of the National Lottery. At present, there are eight licences in force in respect of draw based games, eight licences (including a class-licence under which 20 scratchcard games are available) in respect of scratchcards and one class licence in respect of instant win games. The second aspect involves the updating of all licences (including game rules, codes of practice and player information) where potential improvements are identified, or where new circumstances arise or where developments in technology require changes to be made;
- *Regulation of licences:* this includes compliance work to ensure licence conditions are complied with, monitoring the payment of funds by the operator to the NLDF, vetting of individuals and companies involved in the lottery, handling player protection issues and player queries and monitoring the performance of the operator.

The importance of the duty to maximise returns to good causes

13. The National Lottery is a regulated private monopoly operated primarily for the public benefit. It was created as an enduring institution that will continue to deliver benefits beyond the period of an operator's licence.

14. The lottery operator has an incentive to focus on the current licence period, as it has no certainty of being the incumbent for the next licence period. It also has a legal responsibility to its shareholders (or investors) which may conflict with the wider interests of the National Lottery. These factors could lead the operator to take decisions in areas such as game introduction, game design and investment that favour short-term rather than long-term considerations. It may also seek to retain assets created over the life of the lottery, such as intellectual property, which are important in delivering continuity between licence periods. These risks will increase towards the end of the licence period, especially if the operator believes there is a real risk that it may not retain its licence.

15. In addition, as there is not a direct source of competition during the licence period, the regulator has an important role to play in monitoring the operator's performance independently and, where appropriate, pressing for improvement.

16. It is essential, therefore, that the regulator ensures that the wider interests of the National Lottery are paramount by taking a longer term view in licensing new games, by securing assets (especially intellectual property) for the use of future operators and by monitoring the operator's performance.

Potential for separating the selection of a new operator from day-to-day licensing

17. As the operator identifies new games which it wishes to introduce, a wide range of regulatory issues may arise. The regulator will need to ensure that propriety considerations (including whether the proposal falls within the legal definition of a lottery) are met; that players' interests are protected; that the game will not attract under-age or excessive play; that introduction is likely to maximise returns to good causes and that the game can continue to be available beyond the end of the current licence period. The planned introduction of EuroMillions is an example. In such cases, the longer-term interests of the National Lottery may not always be the same as those of the operator.

18. As the Lottery matures, technology develops and the market changes, opportunities will increasingly arise which are outside the scope of existing licences. These require the negotiation of amendments to the operator's licences. We have, for example, undertaken a major review of licence provisions to accommodate the sale of tickets over the internet. We have also agreed changes to the mix of main and scratchcard-only lottery terminals, the minimum numbers of which are laid down in the operator's licence.

19. This day-to-day licensing work is based upon the three overriding duties in the same way as the selection of a new operator is. We see significant benefits in the same regulator undertaking the selection of operator(s) and day-to-day licensing. The regulatory knowledge built up in the continuing process of licensing new games and maintenance of existing licences is highly relevant to the structuring of the invitation to tender and then the judging of bids for a new licence. Once that licence has been awarded, day-to-day regulation can draw on the experience gained in the new licence award and ensure it is effectively implemented. This makes the most of relevant expertise, ensures consistency of judgement and develops wider market knowledge. It should help deliver the best outcome from the competition process. It should also ensure that the resulting licences can be enforced effectively.

20. The continuing licensing responsibility will become yet more significant if the regulator is given the ability to grant multiple licences of different durations. Transfer of our day-to-day licensing functions to a single gambling regulator would be likely to result in conflicts of interests, so long as those functions were associated with a duty to maximise returns to good causes. In addition, we believe that, given the close relationship between selection of a new operator and the day-to-day licensing functions, it would be counter-productive and inefficient to place these in different organisations.

21. During the selection of a new operator, the regulator's skills can be added to through the appointment of expert advisors and through the proposed changes to the arrangements for the Commission's constitution, which are referred to further at paragraph 29 below.

Separation of all licensing functions from other regulatory functions

22. In our view, the licensing function needs to be informed by the outcomes of other regulatory functions. Issues identified by compliance or player protection work highlight, from time to time, the need for licence amendments. The introduction of a new code of practice on the availability of top prizes for scratchcards is an example. Protection of the interests of players (including avoidance of under-age or excessive play) is a prime consideration in the licensing process. Similarly, licensing concerns may lead to compliance work taking a particular focus. Placing these functions in different organisations is likely to make these processes less effective and less well informed.

23. The National Lottery is a public institution, available on the high street and advertised widely. Players and the public have the right to expect high standards of player protection. On occasion, it may be appropriate for the National Lottery to apply different or higher standards of player protection than those applicable to commercial operators. This is reflected in the directions we have been given by the Secretary of State not to license games where we believe the price is unreasonably high or where the game is likely to encourage excessive or under-age play. As a consequence, we indicated in the last competition that we considered it unlikely that we would license fast-draw keno or video lottery terminals. We also required the operator to undertake an increased test-purchase programme to detect retailers who sell tickets to under-age players. It is likely to be more difficult to apply such standards to the National Lottery if these functions were contained in a separate regulator, especially if that regulator were also responsible for the rest of the gambling industry.

24. The operator(s) would also face difficulties in dealing with two regulators, one dealing solely with licensing, the other responsible for other regulatory functions. For example, there would be risks of the regulators taking different views on the scope and meaning of particular licence provisions. No single body would be responsible for taking a definitive view and there is a risk that their views would be played off one against the other. The operator would also need to maintain two sets of relationships.

25. For these reasons, we see merit in retaining the existing range of functions within a single regulator for the National Lottery.

Working with the Gambling Commission

26. We would expect the regulator of the National Lottery to work closely with the Gambling Commission. Close liaison and discussion on matters of common interest will be essential to ensure that decisions about the regulation of the National Lottery, society lotteries and other forms of gambling are properly informed. We would expect the regulators to work closely together on player protection issues to ensure consistency of approach. The work of the Gambling Industry Trust will be relevant to general issues of player protection within the National Lottery. It is important that the National Lottery learns from the work of the Trust and does not duplicate its efforts. We can also see benefits in joint working arrangements with the Gambling Commission, for instance in the area of vetting procedures.

Is the Lottery Commission the right body to regulate the National Lottery?

27. The duty to maximise returns to good causes gives the regulator a clear interest in the financial success of the National Lottery. We believe that it is important that this duty is retained (see paragraphs 13 to 16 above). If a single gambling regulator was also responsible for the day-to-day regulation of the National Lottery, then this duty to maximise returns to good causes could give rise to conflicts with the duty to treat other, purely commercial, operators even-handedly. However such conflicts were managed, the risk of perceived unfairness would remain.

28. We have indicated that we presently have a wider role in protecting the continuing interests of the lottery, both to provide a counterbalance to an operator's other interests and to provide continuity between licence periods. This might prove more difficult for a single gambling regulator. For example:

- we have taken the view that the single operator that has run the lottery up to now should be a single purpose entity so that it does not pursue other business opportunities which might either distract it from the operation of the lottery or, at worst, lead it into areas which conflict with the interests of the lottery. A single gambling regulator might have problems taking such a stance, given that it would not have a similar interest in the corporate structures of the other entities that it regulates.
- lottery assets (in particular intellectual property) need to be owned by an organisation other than the operator to provide continuity between licence periods. We are at times required to take action, through the operator, to protect our ownership of trademarks and intellectual property. Challenges and disputes are, perhaps, most likely to arise with competitors to the lottery, typically the organisations that a single gambling regulator will be regulating. Whilst this

might be avoided by transferring our responsibilities elsewhere, such as to the Secretary of State, this would further complicate the framework of regulation.

Constitution of the National Lottery Commission

29. We believe that the arguments set out above make a strong case for a single regulator for all aspects of the National Lottery. However, we consider that improvements can be made to our own constitution to make us a more effective regulator. These are to:

- end the present legislative requirement that the Chairman changes at least annually and is selected by the Commissioners themselves. This should be replaced with appointment of the Chairman by the Secretary of State for a term of years, with the possibility of reappointment;
- provide greater flexibility in the number of Commissioners, with a view, for example, to introducing additional expertise in connection with the competition for and award of new licence(s); and
- allow the appointment of up to two executives as Commissioners.

What advantages, disadvantages or risks, are there in a system of multiple licences for different aspects of the Lottery operation potentially run by different companies?

The risks associated with the current arrangements

30. It is widely recognised that periodic competition to operate all or part of the National Lottery is an important factor in maximising returns to good causes. Competition also encourages innovation. It provides an important challenge to the incumbent operator and allows others to come forward with alternative proposals.

31. Following the competition for the second licence, we reviewed the structure of that competition to identify what steps we might take within the existing framework to increase the likelihood of effective competition (such as making a contribution towards bidders' costs and the possibility of a two-stage process). The National Audit Office listed many of them in its report, *Awarding the New Licence to Run the National Lottery*. They could help strengthen a future competition of the kind we have had up to now.

32. We are also looking at the possibility of being able to offer bidders in a future competition the option of acquiring the operating assets of the incumbent company and, in the short term, of using its existing key contractors. Such an arrangement was endorsed by the Government in its decision document, but depends on negotiation with Camelot and its key contractors. If achieved, it should facilitate handover arrangements and allow some increase in flexibility in the design of the competition.

33. We do not believe that these steps, of themselves, will necessarily be sufficient to deliver an effective third competition. Your Committee stated, in *The Operation of the National Lottery*, that "We consider it very likely that, unless further legislative action is taken, the National Lottery will become a perpetual private monopoly for the licensee."³ The Public Accounts Committee, in its report *Awarding the New Licence to Run the National Lottery*, raised similar concerns. We share those concerns and believe that significant changes to the current framework are required.

³ At paragraph 115

Proposed changes

34. We believe that the regulator should be able to decide when preparing for the next competition whether to offer one or more operating licences. It should take a strategic view on how the lottery should develop, including the timing of major developments, the market position and any significant developments in the technology, before deciding on the shape and length of licences. We would expect the regulator to:

- publish for consultation a draft scheme setting out how it proposed to run the competition and to take account of views expressed by interested parties before the scheme is finalised; and
- undertake extensive research and consultation prior to commencement of the competition to ensure that the structure of licences competed for reflected market conditions and technological development,

in order to generate as effective a competition as possible.

35. If it decided to grant more than one licence, we would expect the regulator to:

- group types of lotteries together, linking them with the associated technologies as far as possible;
- recognise that the main jackpot game is a natural monopoly;
- decide whether to offer a number of licences together, so making composite bids possible, or at different times after an initial licensing round, in order to ease handover problems. In either case the same bidder might, on merit, win more than one licence;
- have only a small number of licences running at the same time; and
- require bidders for particular licences, where appropriate, to provide services to other licensees (eg over use of the infrastructure) should the other licensees so wish, in return for appropriate remuneration. The regulator would set levels of remuneration and standards of service and take responsibility for establishing relevant design standards and obtaining assurances on security.

Advantages

36. We see these changes as making the licensing process more flexible and contestable, and as encouraging innovation in a more controlled way than the present process allows. At present, the Commission can only award game licences to independent promoters ('independent Section 6 licences') if they have first reached an agreement with the holder of the main licence to run the National Lottery (the Section 5 licensee). We have no power to require the main licensee to reach such an agreement. To date, there has only been one, and the game in question was not a success.

37. The increased flexibility that is proposed would allow the regulator to encourage bidders who may be well qualified to run particular parts of the National Lottery, but who would not want to offer the whole portfolio. They may well be able to offer innovative proposals that capitalise on developments in technology and respond to the changing competitive environment. The more limited scope of individual licences compared to the current section 5 licence should reduce the cost of bidding for those that do not wish, or lack capacity, to bid to operate the whole lottery.

Risks

38. Whilst there will undoubtedly be risks associated with a framework which allows more than one lottery operator, we consider that these risks can be mitigated by careful design of the framework to reflect market and technological conditions at the time of the competition, and to provide for joint working between operators. Whilst multiple licences are likely to create a healthy competitive tension between operators, their purpose is not to encourage operators to compete vigorously amongst themselves for the 'lottery pound'. Rather, their purpose is to obtain the best return from each discrete element of the lottery market.

39. Key risk areas are likely to include issues such as access to other operators' distribution and retailer infrastructures, common branding, co-ordination of marketing efforts, and avoidance of excessive competition between operators. In our view, these can be addressed through careful and well informed licence design and by effective regulation post licence award. Wide consultation and detailed analysis of the market and technological development should inform the number and scope of licences offered (see paragraph 34 above), and the provisions they contain to ensure co-operation between licensees. We also consider that the risks identified are outweighed by the risk of a failure to secure an effective competition inherent in the present structure of a single licence awarded to a single operator.

Will multiple licences increase competition? Should, and/or could, any tender arrangements include a mechanism to prevent one company winning all available licences?

40. The facility to award multiple licences brings much greater flexibility in the design of future competitions, by allowing organisations which would not wish to bid for a single licence the opportunity to bid for specific elements of the National Lottery. We have recognised that this facility will need to be used carefully, following extensive consultation and analysis of the market and technology. But without it, the likelihood of little or no effective competition would be increased.

41. Unless there were a change to our present overriding duties, we believe that an arrangement whereby a mechanism were included to prevent one company winning all available licences even if it produced the best bid on merit for all the available licences would be inconsistent with the duty to maximise returns to good causes.

Will the proposed changes ultimately lead to more resources for good causes?

42. We believe that the changes proposed by the Government in respect of the licensing and regulation of the National Lottery will enable the stimulation of greater competition for licences to operate the National Lottery. This greater competition should deliver better returns for good causes than would be generated by retaining the present arrangements.

What will be the impact on the existing good causes of the Olympic funding stream being created to provide resources in the event that London wins the 2012 bid? How realistic are the Government's estimates?

43. The estimates adopted by the Government are based on detailed work undertaken by Camelot. We were asked by the Government to comment on Camelot's work. Whilst there are inevitably uncertainties associated with forecasts made for such a long forward period, and when the state of the market in that period is uncertain, we concluded that the operator's forecast returns to the Olympic Lottery Distribution Fund of £750 million are achievable and provide a reasonable basis for forward planning. We also concluded that, on the basis of information presently available, the operator's forecast that roughly 59% of Olympic lottery sales will be diverted from existing National Lottery games over the same period is reasonable and provides a prudent basis for forward planning.