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## National Lottery Bill Regulatory Impact Assessment (Licensing)

Revised December 2005

### 1. Title of proposal

Review of National Lottery licensing and regulation (licensing changes). This Regulatory Impact Assessment assesses the impact of the measures to be included in the National Lottery Bill.

### 2. Purpose and intended effect

#### (i) Objective

The Government published a consultation document in June 2002, which set out options for changes to the arrangements for licensing and regulating the National Lottery. This was subject to further review in May 2004. These set out three specific objectives, which are:

- Ensuring that the National Lottery raises as much income as possible for good causes without weakening necessary protections;
- Ensuring effective competition for its operation; and
- Maintaining public confidence in the National Lottery and the arrangements for running it.

This document sets out the Government's conclusions in relation to licensing. A separate RIA has been prepared on changes to the machinery of regulation. In line with the approach set out in the consultation documents, the Government does not envisage changing the basic concept of the National Lottery. It will remain the only large-scale lottery allowed in the United Kingdom, whose purpose is to maximise income for good causes that would not otherwise be supported from public funds. Nevertheless, the changes to legislation that the Government intends to make would introduce greater competition into the licensing of the National Lottery, thereby ensuring that it raises as much as possible for good causes.

#### (ii) Background

The 1993 and 1998 National Lottery Acts set down the framework within which the UK National Lottery is operated and established the National Lottery Commission (NLC) to licence and regulate the operator. The Acts do not prescribe the design of the Lottery: it is for companies wanting to run the Lottery or promote games within it to develop their own proposals. So, for example, game design, prize structure and distribution mechanisms are all left unmentioned in the legislation. What the Acts do is lay down the control framework within which the Lottery is to be managed. Since then the Horserace Betting and Olympic Lottery Act has introduced the Olympic Lottery.

This framework recognises four key parties:

- The Secretary of State, whose overriding duty is to ensure that the Lottery is run properly and that players' interests are protected and subject to that, to maximise the income for good causes. The Secretary of State has the power to give directions

about how the Lottery is to be licensed, and to make regulations about how it is run.

- The NLC whose duties mirror those of the Secretary of State. The key function of the NLC is to issue and enforce licences for the operation of the Lottery. There are two kinds of licence: a licence under section 5 of the 1993 Act, which is granted to a company to run the National Lottery; and one or more licences under section 6 of that Act, granted to companies to promote lotteries as part of the National Lottery.
- The section 5 licensee: currently Camelot Group plc. The present law allows for only one section 5 licence to be issued. It is the responsibility of this licensee to provide the technical, retailing and marketing infrastructure within which section 6 licensees can operate, and for ensuring that payments to prize-winners, the National Lottery and Olympic Lottery Distribution Funds, and the Exchequer are made.
- The section 6 licensee(s), responsible for the games. At present Camelot holds all section 6 licences.

Following publication of the Gambling Review Body's report, the Government's response – **A safe bet for success** – and the publication of the National Audit Office's (NAO) report into the award of the last licence<sup>1</sup>, the Government has reviewed the structure of licensing and regulation through the consultation documents issued in June 2002<sup>2</sup> and May 2004. In reaching its decisions the Government has also had the benefit of the Committee of Public Accounts' report into the award of the last licence<sup>3</sup>, the Culture, Media and Sport Select Committee's report into the reform of the National Lottery<sup>4</sup> and the Joint Committee on the Gambling Bill's report on the draft Gambling Bill<sup>5</sup>, which is now the Gambling Act 2005.

### (iii) Risk assessment

There is a risk that, in the absence of the proposed legislative changes, there will not be effective competition for the licence to run the National Lottery when the current licence ends in 2009. Eight applications for the first seven-year licence were submitted. The NLC decided to run a competition for the second licence along the same lines as the first, which resulted in only two compliant bids, although several companies had expressed an interest in bidding. The NAO report on this process considered how successful the NLC had been in achieving genuine competition for the second licence. It concluded that, while there had self-evidently been a reduction in the number of bidders from 1994, the level of competition was comparable with that of other countries who run a national lottery on a similar basis. The Committee of Public Accounts has also expressed its concern about the risk that there will be no effective competition for future licences.

## 3. Options

The range of options is set out below.

**Option 1.** Make no change: retain existing legislation and look to the NLC to improve the arrangements for selecting a single licence National Lottery operator during the next licensing round.

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<sup>1</sup> "Awarding the new licence to run the National Lottery" Report by the Comptroller and Auditor General HC803 Session 2001-2002: 10 May 2002

<sup>2</sup> "Review of Lottery licensing and regulation: consultation document" DCMS June 2002

<sup>3</sup> "Awarding the new licence to run the National Lottery" Committee of Public Accounts' Sixty-Fifth Report of Session 2001-2002: HC881, 6 December 2002

<sup>4</sup> "Reform of the National Lottery" Fifth Session 2003-04 HC 196, 25 March 2004

<sup>5</sup> "Draft Gambling Bill" Session 2003-04 HL Paper 63 and HC 139, 7 April 2004

**Option 2.** Multiple licences: Under this option the NLC would be empowered, after consulting on its licensing plans, to offer a number of new-style operating licences covering different aspects of the delivery and marketing of the Lottery.

This option is based on the view that the gambling market is changing quickly and the Government is creating more business opportunities in this area as a result of the Gambling Act 2005. Hence, by the time the competition for the third licence is fully under way, the market for the Lottery may call for solutions that are not now obvious. It is not impossible that a wider range of infrastructure suppliers will be available, as doubts about the scalability of smaller systems are resolved. The growth of interactive platforms for gambling products could change the nature of the Lottery operation and the expectations of the public.

On this approach, amending legislation would remove the section 5 and section 6 licence requirements, and instead give the NLC discretion – after consulting on its licensing plans – the power to offer a number of new-style operating licences covering different aspects of the delivery of the Lottery. This option offers scope for much greater competition in the allocation and operation of the Lottery. The NLC would also have flexibility to offer licences for different time periods, taking account of the investment required and the rate of technological change.

**Option 3.** Combine 1 and 2: This would encompass initiating a competition for the third licence on the basis of the existing legislation but, where an existing competition for a single licence was not considered capable of delivering maximum returns for good causes, reserve the right to initiate a competition for more than one licence if this would offer the scope for greater competition at all stages.

**Option 4.** Other options: Under this option, an alternative solution to operating the Lottery in order to maximise returns to good causes would be considered. This might include:

- a. *Separation of infrastructure and Lottery products:* Under this, the NLC would offer separate licences for the provision of Lottery infrastructure, supplied and maintained to specific standards, and for the management of the Lottery using the systems supplied. The second licensee would therefore be responsible for game and prize design, marketing, the collection of sales income and all other functions. There would be separate competitions for distinct licences. If different companies held the separate licences, they would have to work together to develop and operate the portfolio of games comprising the Lottery.
- b. *NLC runs the Lottery through the private sector:* Under this option, the NLC would become more than the body responsible for licensing the operator or operators. It would follow most overseas lotteries and become responsible itself for the operation of the Lottery. There would not be a section 5 licensee in charge of the whole operation. The NLC would be in charge, and would therefore have to decide whether the games that it licensed should be marketed and sold by their licensees, within an overall strategy which it laid down, or whether it should itself be responsible for sales and marketing through a further private sector contractor; or
- c. *A National Lottery operating company:* This option would essentially involve the separation of the question of which company should operate the Lottery from the question of ownership of that company. There would be a permanent private sector operating company, holding a section 5-type licence; but it would not necessarily keep the same shareholders and top management. The NLC would run periodic competitions in which companies would bid to run the operating company. It would require Camelot's current shareholders to sell their interests in the company, at an agreed price, to a new set of shareholders, unless of course the incumbent owners and top management team put forward the best bid. A prospective new

franchisee does not have to develop a wholesale alternative to the incumbent's personnel and plant: the only things that have to change are the shareholders and top management, reflecting a different view of what the company should provide and how it should be directed. In the case of the Lottery the new shareholders would take over all contracts, including those of the staff working on sales, games, accounts, infrastructure and all other continuing operations. It would then be for the new owners to run the company as efficiently and effectively as possible, making such changes in staff or plant, as they judged necessary over time.

## 4. Risks and Benefits

This section sets out the risks and benefits of the options.

**Option 1:** The Government has considered the option of making no change to the existing legislation and looking to the NLC to improve the arrangements for selecting a National Lottery operator next time. Such improvements could include a two stage bidding process, less detailed information during the early stages, a more prescriptive bidding framework, an extension of the licence period (perhaps based on performance standards) and key supplier phased competitions. A number of respondents to the consultation favour the current system. However, there remains significant concern on the part of potential bidders about the need to create a level playing field that addresses the existing operator's incumbency advantage. It should be noted that the NLC's discussion documents issued in 2005 have been aimed at maximising the level nature of the competition playing field. Nevertheless, on their own, there is a risk that the steps the NLC could take under the existing system may be inadequate to ensure that there is effective competition at the end of the current licence period in 2009.

**Option 2:** The Government has considered the option of allowing the NLC to offer for competition a range of new-style operating licences. This option would have the benefit of flexibility. It would offer scope for much greater competition at all stages, not least because a single section 5 licence is a large challenge which very few companies could contemplate taking on. The NLC would also have the flexibility offer licences for different time periods, taking account of the investment required and the rate of technological change. This would potentially allow a wider range of companies to participate in the Lottery than at present. It would also offer the opportunity for companies of varying sizes and with different specialisations to participate in the Lottery. However, this would place on the NLC a responsibility which would not only be onerous but arguably one which should be for Parliament. It would also be important that, in preparing proposals for new licensing arrangements, the NLC delivered competition for the market, whilst ensuring that the structure of the licences provided clear incentives to avoid the potentially adverse effects of competition within the market. Some have also questioned whether such a solution would reduce returns to good causes by losing the benefits of scale arising from a single operator e.g. in terms of marketing spend and because companies would compete with each other – though it would be the NLC's responsibility to structure the licences so as to make sure consistency of business operations.

**Option 3:** This would have similar risks and benefits to those at options 1 and 2 but, by allowing use of option 2 in certain circumstances, would reduce the risks arising from option 1, though the risks of option 2 would remain. Furthermore, in relation to the economic case for Lottery licensing, DCMS and an independent economist have reviewed the Frontier Economics (for Camelot) and NERA (for the NLC) papers about licensing. This case concludes that analysis of a number of lotteries in various parts of the world have found that there are specific characteristics of the demand for participation that point to a natural monopoly existing. Nevertheless, the case for competition in some aspects of the

Lottery appears valid to some degree: for example, the association with good causes and the Lottery brand could be used with a variety of products grouped in clusters. Some commentators question whether the proposals for multiple licences will stimulate competition for licences or deliver as much for good causes. However, the potential bigger risk is still that the single licence model will not deliver effective competition to maximise returns to good causes. Therefore the solution that will deliver the best outcome for good causes depends on the circumstances. If the case for treating any aspect of the Lottery during the award as a natural monopoly is valid, then the case for ensuring robust competition for the licence is overwhelming.

**Option 4:**

- a. *Separation of infrastructure and Lottery products:* The possible benefits and risks from this approach would include:
  - o *Benefits:* Separate companies would make it easier, on the face of it, for more companies to compete. The number of technology suppliers would no longer constrain the number of bidding consortia; and the NLC would be less likely to find itself in a situation in which it had to balance one bid which was strong on technology but weaker on game innovation against another where it was strong on game innovation but weaker on technology.
  - o *Risks:* There must be concerns that there could be scope for disputes about where responsibility lay for problems or poor performance and who should pay what for the action needed to address them. The separation of infrastructure has been less problematic in the case of the other industries; but the relationship between different Lottery licensees would be complex, and would have to be actively managed: the NLC would have to acquire a new capacity and expertise. This option could also restrict the ability of the Lottery to innovate and be flexible. The requirements sought of the infrastructure licensee at the time of the competition might be apt for circumstances applying and foreseeable then, but less apt for circumstances several years into the licence period. It is not clear what incentives or levers could be used to encourage improved responsiveness and willingness to innovate. This is partly because it is not clear under this option how and on what basis the infrastructure licensee would be paid. It would have no direct source of income: it would have to be paid either by the NLC or by the other licensee. It could be argued that in either case the relationship should be seen more naturally as one of contract rather than licence; and the requirement to have two licence competitions would lengthen the licensing process and potentially introduce more uncertainties into it.
- b. *NLC runs the Lottery through the private sector:* The possible benefits and risks from this approach would include:
  - o *Benefits:* This option, like 4a, would involve breaking the Lottery down into constituent parts, and so potentially bring about greater competition for smaller and more manageable elements of the operation. It would also be possible to see competition beyond the point of the licensing decision: if, for example, midweek and Saturday draws were run by different companies then their effectiveness in selling tickets could be compared; and the infrastructure would be provided on behalf of the NLC, so the NLC could drive changes to it – at a cost.
  - o *Risks:* This option would not avoid all the problems arising under 4a: The overall Lottery competition would become more complex than it is now, although not unmanageably so. The coordination of separate licences and contracts would be a substantial management challenge, not least because the NLC would want competition between the licensees to result in overall

growth rather than simply transferring sales from one product to another. The available evidence suggests that national lotteries managed by some public bodies are less efficient than currently is the case, and the NLC has no track record of management of the kind required. Part-time Commissioners could not possibly run it as now. It has been argued – by Camelot amongst others – that any large lottery works best when run as a single integrated business with a clear unity of purpose, though there are successful lotteries that are exceptions to this rule. It might be difficult for reasons of conflict of interest for the NLC both to be responsible for the operation of the Lottery and its regulation in the public interest. Finally, having different companies running main draws could be confusing for some players, especially if they used different formats and were differently branded.

- c. *A National Lottery operating company:* The benefits and risks from this approach can be summarized as follows:
- *Benefits:* This option would provide a high degree of continuity for the Lottery operation. Camelot's workforce would be retained, and there would be no risk of a wholesale loss of experienced staff fearing that the company would lose its licence as a new licensing round approached. At the same time, competitions would be more inviting for prospective bidders: they would bid to take over a going concern, rather than starting from scratch. The NLC could keep its present form: indeed its task would be eased. Instead of having to make one very large decision every seven years, it would be able to evaluate a series of changes over time as the company's new owners brought proposals forward, so that the NLC's workload would have a less lumpy profile, as it would be responsible for checking key suppliers' competence and propriety at staged points during the licence period.
  - *Risks:* Against these benefits a number of drawbacks have to be considered. The option places a lot of weight on the premise that, while the Camelot operation might be capable of marginal improvement and innovation, the day-to-day operations are already close to being as good as they can be. It is not clear why another set of shareholders would have strong incentives to put the company's assets to more productive use; and the assurance of permanence could itself lead to a loss of edge and drive. It might be hard to assess what price Camelot (or future owners of the company) should receive. Camelot does not itself own substantial assets, and what it does own should fully written down by the end of the licence period. Nevertheless, the price paid could still prove controversial; and the basis for it would have to be agreed with Camelot during the current licence period. It might also affect the consideration of the incumbent, who would stand to gain from the price paid.

## Issues of equity and fairness

None have been identified.

## 5. Costs

This section estimates the regulatory and compliance costs attributable to the National Lottery Acts, and compares this with the estimated costs under the radical options discussed elsewhere in this RIA.

**Option 1 - No change option:**

The NLC is the regulator for the UK National Lottery. The main compliance costs associated with the current regulatory framework are:

- Bidding costs for section 5 licence;
- Bidding costs for section 6 licences; and
- Costs involved in complying with licence conditions.

The NAO report identifies that "based on reported experience from the competition for the first licence, the Commission believed that the direct costs of bidders were likely to be between £3 million and £4 million." This is consistent with the £3.3 million "win related costs" (excluding £8.7 million paid out in "win bonuses") reported by Camelot in securing the second operating licence<sup>6</sup>. In addition, TPL has said that the cost of bidding last time was over £15 million. Based on these estimates, the total cost of the second section 5 licence bidding round, in which there were two bids, is estimated at between £8-£10 million. In addition, the winning bid pays a licence fee, currently £70,000.

The compliance costs associated with bidding for section 6 licences are unknown. Of all the section 6 licences issued by the Commission during the first licence period and subsequently, all but one was issued to Camelot (the section 5 licence holder). The only identifiable bidding cost attributable to section 6 licences is the licence fee payable upon grant (which varies according to the type of game from £20,000 to £150,000).

The section 5 and 6 licence conditions are comprehensive and detailed. While the costs associated with complying with these conditions are unknown, they are assumed to be significant.

**Option 2:**

This may result in higher or lower regulatory costs, depending on the choices made by the Secretary of State at the time.

**Option 3:**

Same as for options 1 and 2.

**Option 4:**

Under 4(a), the NLC would take on responsibility for operating the National Lottery, a function currently undertaken by the section 5 licence holder and whilst this may result in higher regulatory costs - estimates of this increase are difficult to make - this would not necessarily lead to an increase in total regulatory and compliance costs, because it involves a comparable reduction in compliance costs incurred by the section 5 licence holder. In terms of compliance costs, the average unit cost of bidding for a section 5 licence may decline under each of the proposed options (because of the potential for the section 5 licence to be broken up). However, the impact on total bidding costs is unknown because a greater number of bids is expected under each of these options. Assuming that each of the proposed options results in more competition for licences, the compliance costs associated with bidding for these licences may increase.

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<sup>6</sup> Camelot Annual Report and Financial Statements 2002

With the exception of 4(a), none of these options would necessarily result in different licence conditions and compliance costs (compared with the status quo). As noted above, option 4(a) would probably result in lower compliance costs because the section 5 licence holder would no longer be responsible for operating the Lottery.

In summary, there might be a slight bias upwards to total regulatory and compliance costs under these options. The magnitude of this change is unknown at this stage.

## **6. Consultation with small business**

The Small Business Service has been consulted about the proposed changes. The legislative changes proposed in this document do not directly affect small firms. Small firms are currently involved in the Lottery, mainly as ticket retailers, but decisions about which retailers receive Lottery terminals are a matter for the operator. Nevertheless, the proposed changes increase the potential for smaller companies to become involved in the National Lottery.

## **7. Competition Assessment**

The Office of Fair Trading has been consulted about the competition assessment. The proposed changes to the National Lottery licensing and regulatory regime increase the potential for competition for (a) the issue of Lottery licences, (b) the operation of the Lottery, and (c) the provision of specific Lottery products - the interrelated markets to which these proposals relate. Indeed, this is one of the primary objectives of the proposal.

Under current legislation, there can be only one operator of the National Lottery (i.e. section 5 licence holder). Further, while there can be more than one provider of Lottery games (i.e. section 6 licence holder), these can be granted only with the agreement of the operator. The NLC cannot currently require the section 5 licensee to admit other companies. During the first licence period Camelot had only one agreement with another company, when Vernon Pools were granted a section 6 licence to operate one game. It was not thought to be a success. Since then Camelot has held all section 6 licences.

Each of the other options (outlined above) provides the opportunity for more than one operator of the Lottery, and hence the introduction of competition to this market which is currently dominated by a single operator. Such changes should reduce barriers to entry and provide greater opportunities for new entrants to specialise in the provision of specific Lottery products. The outcome should enable a more open, dynamic market.

The existing operator may have an advantage over potential new entrants, in terms of having a proven track record (thereby providing a barrier to new entrants). This factor has to be balanced by the ability of the NLC to improve the arrangements for selecting the next National Lottery operator, especially if an effective competition for a single licence maximises returns to good causes. Nevertheless, the Government must take account of the circumstances prevailing at the time. Thus, if a single licence competition is unlikely to be effective in delivering the maximum returns to good causes, the Government has an obligation to consider alternative proposals that are more likely to lead to effective competition and so maximise returns to good causes.

## 8. Enforcement and sanctions

The proposal, as with arrangements under the current licence, will be enforced by the NLC, as regulator of the National Lottery. As part of the licence issued to the operator, it has a range of sanctions available for non-performance or non-compliance.

The proposal includes no new sanctions for future operators.

## 9. Monitoring and review

The key test for the effectiveness of the proposals will be the extent of effective competition for the next licence. The Government would expect the NLC to assess the effectiveness of competition following the conclusion of the next licence competition.

## 10. Consultation

In developing both the consultation document and this document, note has been taken of those who responded to the consultation exercise and recommendations put forward by the Culture, Media and Sport Select Committee, the Committee of Public Accounts and the National Audit Office.

Most responses broadly favoured options for change within the current framework, whereby the Lottery is delivered by the private sector.

**Option 1:** Most respondents favoured the current system arguing essentially that the National Lottery is a natural monopoly which benefits from economies of scale eg. in marketing spend and developing a balanced portfolio of games. However, there was significant concern on the part of potential bidders about the need for the NLC to create a level playing field and their ability to overcome incumbency advantage. Some potential bidders were so concerned about incumbency advantage that they would be prepared to consider a limited number of licences being issued.

**Option 2:** Although there was almost no support for the NLC to have complete flexibility in the number of licences to be issued, as outlined above, some potential bidders were so concerned about incumbency advantage that they would be prepared to consider a limited number of licences being issued. Retailer responses focused on concerns about multiple licences leading to them having multiple terminals and multiple sales people. However, they broadly conclude that if these can be overcome they would not oppose multiple licences.

There was general agreement that the Government would require some flexibility for the next licensing round, so that it could take account of market conditions prevailing at the time.

**Option 3:** Same as for options 1 and 2.

**Option 4:** The consultation exercises showed almost no support for any of the other options:

(a) *Separation of infrastructure and Lottery products:* There was no support for this option. There was general agreement that lotteries work best when run as integrated businesses

and there was a need to maintain a balanced portfolio of games that would deliver significant jackpots and avoid a large number of jackpot games reducing the level of the main jackpot game.

(b) *NLC runs the Lottery through the private sector*: There was no support for this option. The general view was that the private sector was best placed to plan and manage commercial activities requiring investment, innovation and risk.

(c) *A National Lottery operating company*: Most of the respondents opposed this option, seeing it as creating uncertainty without potential compensating benefits. However, one respondent saw it as creating certainty for continuation of the Lottery and minimising handover risks. But most respondents argued that this would restrict the ability of a new operator to develop their own approach and that by taking on an existing operation this might stifle innovation and introduction of new technology.

## 11. Summary and recommendation

The Government has concluded that, while there is scope for the NLC to improve the arrangements for selecting a National Lottery operator next time (and good progress has been made during 2005), this may still not be sufficient to go to the heart of the problem - that of ensuring that there is an effective competition for the Lottery licence in order to maximise returns to good causes.

The Government recognises that the consultation and economic analysis support the proposition that returns to good causes are likely to be maximised in circumstances where there is effective competition for a single licence offered to the private sector to operate the National Lottery. However, the Government also agrees with the conclusions of the NAO that, even with the improvements to the competition that the NLC could make under the existing legislation, this may not deliver an effective competition and so there is risk of not achieving the objective of maximising returns to good causes. This possibility, therefore, requires an alternative solution to be available in circumstances where a competition to maximise returns to good causes under the present arrangements has been considered unsuccessful, under option 3.

The Government therefore proposes that the NLC should offer for competition a single licence under the existing legislation. However, if the Secretary of State, following consultation with the NLC, considers that the competition is not likely to be a success in maximising returns to good causes, then she should have the reserve power to require competition to be held for a number of licences on a basis to be decided by her.

In that situation, the Government would end the requirement that the NLC issue just one operating licence. Instead the Government would empower the NLC to offer a number of new-style operating licences covering different aspects of the National Lottery. Decisions on what offers the best combination of efficiency and innovation would require an assessment by the Secretary of State, on advice by the NLC, nearer the time, taking account of the investment required and the rate of technological change.

The Government recognises that initiating a competition for a single licence, whilst retaining the option for a competition for more than one licence at a later stage, could give rise to market uncertainty. For that reason, the Government's firm intention is that there should be a competition for a single licence. However, if after a crucial stage in the competition (e.g. after the initial invitation to tender period has ended) the NLC concludes that there is no prospect of effective competition, it could ask the Government to exercise the provision for more than one licence. This should give sufficient time for an alternative

competition to be concluded before the end of the present licence in January 2009.

Such a proposal will meet the Government's intention to ensure greater competition in the operation of the Lottery to maximise returns to good causes by allowing a wider range of companies to participate in the Lottery. It would also offer the opportunity for companies of varying sizes and with different specialisations to participate in the Lottery – although the most important consideration will remain the amount any operator is able to raise for good causes. This should ensure that public confidence is maintained in the National Lottery and the arrangements for running it.

## 12. Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

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