# Allocation of Electronic Gaming Machine Entitlements

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# Allocation of Electronic Gaming Machine Entitlements

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VAGO

Victorian Auditor-General's Office

*Auditing in the Public Interest*

The Hon. Bruce Atkinson MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Ken Smith MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my performance report on the *Allocation of Electronic Gaming Machine Entitlements.*

Yours faithfully

Dr Peter Frost
*Acting Auditor-General*

29 June 2011

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# Audit summary

## Background

Gambling in its various forms is a significant source of state revenue, generating $1.63 billion through taxes in 2009–10. In clubs and hotels electronic gaming machines (EGM), or ‘poker machines’, contributed 60 per cent of this revenue.

In April 2008 the government announced that the two gaming operators’ licences to acquire, distribute, operate and monitor EGMs in clubs and hotels would not be renewed when they expire in 2012. Instead, as part of the new venue operator industry structure, clubs and hotels would be able to buy an entitlement for each EGM they want to operate in their venues. Restrictions on the number and location of EGMs prescribed by social policy would continue through distribution limits and ownership caps.

The catalyst for this change was the policy objective to ‘establish a venue operator industry that meets the government’s gambling guiding principles’. The guiding principles at the time of the April 2008 announcement were to:

- provide consumer choice and service in a competitive and innovative marketplace
- ensure the legitimate financial benefits of gambling are transparent, recognisable and fairly distributed to the community
- reduce the harm caused by problem gambling
- maintain high standards of transparency, probity, integrity, accountability and community engagement.

Besides the primary policy objective, the allocation was expected to achieve other secondary financial, social and stakeholder engagement outcomes. These were largely aligned with the guiding principles for gambling policy.

One of the intended financial outcomes was to capture ‘supernormal profits’. Supernormal profits are the increased profits that arise when there are restrictions on competition and limits on the quantity of a good or service. Venue operators have the potential to earn supernormal profits from gaming due to the regulatory restrictions on industry participants, and the number and location of EGMs.

Consequently, the entitlements to operate these EGMs are significant assets in their own right—both to the state, as the creator and ‘seller’ of the entitlement; and to the entitlement holder, who acquires exclusivity in terms of a ten-year income stream from its EGMs.

The process of allocating these entitlements to venue operators was managed by the Gambling Licences Review (GLR) project team in the Department of Justice (DOJ). A steering committee, chaired by DOJ and with representation from both the Department of Premier and Cabinet (DPC) and Department of Treasury and Finance (DTF), provided advice to government and directed the project team in its implementation of government policy and the project objectives.

The GLR project team managed the sale of the entitlements in two phases:

- **in October and November 2009**—a fixed price, pre-auction club offer (PACO) available only to existing clubs
- **in April and May 2010**—a two-stage auction for all hotel entitlements and the remaining unsold club entitlements.

Combined, PACO and the auction raised $980 million from the 27 300 entitlements that were allocated. Hotel operators paid $546 million for their 13 750 entitlements, all of which were purchased at auction. Club operators paid a total of $434 million for the remaining 13 550: $366 million at PACO and $68 million at auction.

The allocation was particularly complex to manage and involved significant risks. The project had numerous external stakeholders, tight time lines and constraints imposed by government announcements, such as the decision to sell the entitlements by auction. The auction design and implementation were technically complex and probity requirements were stringent.

A probity auditor was engaged to advise the project team and an Independent Review Panel (IRP) was established in 2007 under an amendment to the *Gambling Regulation Act 2003.* The purpose of both roles was to provide third-party assurance on the probity of the project. The IRP's reports are tabled in Parliament.

## Conclusion

The allocation of the EGM entitlements was achieved within very tight time lines. However, the project failed to achieve a satisfactory financial outcome and there were serious shortcomings in the project management.

The revenue obtained from the sale of the entitlements was around $3 billion less than the assessed fair market value of these assets. As a result of this very significant difference, the allocation largely failed to meet its intended financial outcome of capturing a greater share of the industry's supernormal profits. This was due to the lack of demand at auction, combined with a low reserve, inadequate information and training for venue operators, and poor decisions made during the auction. Large venue operators, rather than the community, are the beneficiaries of this windfall gain.

Successfully allocating entitlements while maximising revenue within the social policy framework was undoubtedly a challenging proposition. These two objectives were not, however, mutually exclusive. A lower financial outcome may have been acceptable, or even desirable, if it meant that the project achieved better results in its intended social and stakeholder engagement outcomes. This was not the case. From a social policy perspective, the financial benefits of gaming have not been widely redistributed among the community as a result of the initial allocation. Stakeholder engagement outcomes also were only partly met, as the industry repeatedly raised concerns about the information provided by DOJ.

A series of project management weaknesses contributed to these unsatisfactory outcomes.

Foremost, there has been a blurring of the lines of authority and accountability by DOJ. This is especially evidenced by its misconstrued assertion that VAGO is ‘actively criticising the policy decisions of a previous government’. The ‘policy decisions’ to which DOJ refers are, however, operational and implementation matters. Responsibility for these rests with DOJ.

With respect to the implementation of PACO and the auction, DOJ’s advice to government was not robust. It was not subject to adequate quality assurance and did not take into account material changes in context.

DOJ failed to carry out adequate due diligence before acting on the advice provided by specialists that formed the basis for the design and operation of the auction. DOJ described the move to the venue operator structure as the most significant change for the gaming industry since the licences were awarded to the original gaming operators. Given the high stakes and the complex and technical nature of the undertaking, it was incumbent upon the department to demonstrate it had appropriately understood and appreciated the implications of specialist advice before accepting and acting on it. This was not the case. Much of the advice DOJ sought from specialists was conflicted, unduly restricted in scope or based on limited expertise.

There was a lack of decision review points, particularly when significant unplanned changes occurred. PACO was one such unexpected change that further complicated this already large and complex project by reducing demand for entitlements at auction. Proposals to remove barriers to entry were not accepted for social policy reasons, which also reduced demand for the auctioned entitlements. In these circumstances, there is a need for decision-makers and advisers to challenge or reaffirm the wisdom of continuing with agreed courses of action. DPC and DTF appropriately raised concerns on the merits of proceeding with the auction with their respective ministers. However, no formal review was undertaken.

Although DPC and DTF advised their ministers, it is not evident from the minutes of the project's interdepartmental steering committee that they discussed their concerns about the auction with DOJ. DOJ did not make a similar recommendation to its minister regarding the auction. This lack of transparency resulted in decision-makers being provided with different advice.

DOJ provided contradictory advice on the purpose of the allocation. Prior to the auction DOJ advised the Minister for Gaming that the intention of the auction was to 'achieve the allocation that maximises financial value subject to policy determinations aimed at social value'. However, the department asserted during the course of the audit that 'maximising revenue was not the primary, or even secondary objective of the allocation'. This lack of clarity regarding the purpose of the allocation of EGM entitlements points to serious administrative failure.

There were major concerns with other aspects of the management of the project. These concerns particularly related to DOJ's procurement practices, where contracts worth $4.2 million were awarded to the two principal consultants without a competitive process. Cost control of the project was poor and significant cost overruns were incurred. Data integrity issues were created by weak knowledge management practices. The overzealous application of probity adversely affected stakeholder engagement.

# Findings

## Financial outcomes

The sale proceeds from the allocation fell significantly short of the fair market value of the entitlements. The industry paid $980 million for the right to operate EGMs over a ten-year period. This is equivalent to around a third of the total revenue generated by EGMs in a single year, and a quarter of the estimated fair market values of the entitlements.

We valued the EGM entitlements in the range of $3.7 billion to $4.5 billion, with a mid-point of $4.1 billion. This fair market value reflects the upper limit that existing venue operators would have been prepared to pay to acquire entitlements, taking into consideration the financial effect of the venue operator model and the existing social policy framework. This framework is intended to minimise the harm caused by problem gambling through measures such as regional caps and ownership restrictions. The fair market value also takes into account the industry environment at the time of the auction, including the uncertainty over future measures to combat problem gambling.

### The Department of Treasury and Finance's economic modelling

DTF carried out economic modelling between December 2007 and May 2009 to estimate the value of the entitlements. This modelling produced a range from $504 million at the low end to $4.2 billion at the high end. However, no further valuation was performed during the year leading up to the auction in 2010 that took into account the potential financial impact of PACO. This meant that government was not provided with the most appropriate and current advice.

DTF's most detailed estimate produced a figure of $964 million in 2008. The proximity of this estimate to the amount of revenue raised at auction is entirely coincidental for several reasons. The main reason is the purpose of this estimate was to calculate the level of supernormal profits in the industry, not to forecast the amount of revenue the allocation was likely to raise. Such a forecast would not have been possible at that time, as the details of the auction had not been decided and PACO was not announced until the following year.

Furthermore, DTF's 2008 calculation of supernormal profits was not comprehensive, as it failed to include supernormal profits at the venue operator level. This was because DTF decided at that time it could not establish with any degree of confidence the level of local competition between venues, or their costs. These factors affect the amount of supernormal profits venues earn. This information could have been reasonably estimated, however, had industry consultation taken place.

DTF subsequently decided in 2009 that it would attempt to produce an estimate that did include supernormal profits at the venue operator level. This estimate of $4.2 billion is similar to our fair market valuation. However, the robustness of DTF's calculation cannot be confirmed because of the lack of documentation on the method and assumptions it used.

DTF would have benefited from a third-party review to test the robustness of the assumptions it used. This did not occur and was a significant oversight.

## Factors affecting the auction result

It is reasonable to expect some difference between the fair market value and sale revenue. Market constraints, the level of competition, expectations of future earnings and individual attitudes towards risk are all key determinants of sale price.

However, the very substantial difference between the estimated fair market value of the entitlements and the total PACO and auction proceeds is a strong prima facie indication that there were significant issues in the design and implementation of the allocation process.

The major reasons for the difference between the price paid for entitlements and their estimated fair market value were:

- the prior allocation of entitlements to clubs through PACO and the regulatory restrictions on the industry reduced demand for the entitlements at auction
- the reserve was set at a low price in a situation where the number of bidders was small and competition was lower than expected
- the auction design was not adequately reviewed by appropriately qualified specialists and led to unrealistic expectations of the duration of the auction
- the conduct of the auction did not serve to maximise financial value subject to policy determinations
- there were shortcomings in the information and training provided to the industry.

## Reduced demand at auction

There was a substantial difference in the actual number of bidders at auction compared to the number of potential bidders. The low number of bidders resulted in reduced demand and competition for the auctioned entitlements. From DTF's perspective, this constituted an 'adverse outcome' for the state.

While 236 club operators purchased entitlements at PACO, only 149 club operators took part in the auction. Of the 4 838 entitlements sold at auction to clubs, 72 per cent were sold at the reserve price of $5 500. The average price clubs paid for entitlements at auction was a third of the average price paid at PACO.

The gaming industry's regulatory approval processes also affected demand at auction.

The regulatory processes and the associated costs involved in obtaining Victorian Commission for Gambling Regulation (VCGR) approval for new venues limit the number of new industry entrants. Of the 345 venue operators who took part in the auction, only 47 were new entrants.

Approval is also required for existing venue operators to change the number of EGMs on their licence. This deterred venue operators from bidding for more entitlements. Of the existing venue operators who had EGMs at the time of the auction, 61 per cent bought the same number of entitlements as the number of EGMs in their premises immediately prior to the auction.

DOJ, DPC and DTF recognised that the regulatory and financial burden had the potential to limit the amount of revenue the allocation would raise, and these departments briefed the government accordingly. However, for social policy reasons, the existing approvals process was largely unchanged. The lower number of participants reduced demand at the auction, which meant DTF's advice to reconsider the decision to auction the entitlements was prudent.

To deal effectively with these types of scenarios, which were to be expected in such a lengthy and complex project, it would have been prudent to build decision review points into the process. Significant unplanned events have the potential to adversely affect project outcomes or require the rationale for continuing with a previously agreed course of action to be questioned. When these events occur, all relevant parties need to satisfactorily consider and resolve such issues if the project is to be successfully delivered.

## Low reserve

The decision to largely retain the approvals process was made before the reserve was set. Therefore, it was known that the number of potential bidders in certain markets was likely to be low because these barriers to entry remained. As a consequence, prices at auction could not be expected to—and indeed did not—rise significantly above the reserve. The setting of an appropriate reserve price was, therefore, particularly critical in determining the price paid for entitlements.

The reserve was low: $5 500 for clubs and $11 000 for hotels. The hotel reserve was set at double the club reserve because hotels earn twice as much from EGMs as clubs. These prices equated to $550 per year for clubs and $1 100 per year for hotels over the ten-year period of the entitlements. This is less than 1 per cent of the average revenue generated per club EGM and per hotel EGM in 2008–09.

The rationale for the auction reserve was not robust. The reserve was based on the lowest price paid by a club at PACO. This particular club was the least profitable gaming venue in the state and closed shortly after the auction.

When compared to the range of PACO prices, the price that formed the basis for the reserve was clearly an ‘outlier’. There is no evidence that this was communicated in the advice provided on the reserve prices. The lowest price paid at PACO was $5 743 per entitlement. The second lowest PACO price was $9 165, which is 60 per cent higher than the lowest price. The average PACO price was $42 014, or more than seven times the lowest price.

The club sector largely accepted the PACO prices, as 96 per cent of eligible club opertors bought entitlements before the auction. This indicates they were prepared to pay more for their entitlements than the auction reserve of $5 500.

## Auction design

There was inadequate analysis of the most appropriate mechanism to allocate entitlements. DOJ did not consider a wide enough range of possible sale mechanisms, nor did it subject the chosen auction format to sufficient third-party review before accepting and acting on the advice provided by the auction specialist.

There are more widely recognised types of auctions than the format chosen for the EGM entitlements. The ‘uniform pricing rule’ meant that the price participants paid was not necessarily the amount they bid. The price paid for the entitlements was based on the computed ‘market’ price, or the lowest accepted bid in a particular market. There were 176 markets, which were based on venue type and geography. Bidders in the same market paid the same price for the entitlements allocated to them in that market.

Consequently, although the total value of the successful bids was $855 million, the amount actually raised by the auction was $614 million. The difference between the value of the bids and the price paid indicates bidders were willing to pay more for their entitlements. Although participants would have acted differently if another type of sale mechanism had been used, it is possible that a different sale mechanism would have raised more than $614 million.

DOJ did not, however, adequately explore whether any other sale mechanism could have achieved better overall outcomes—namely higher revenue and/or lower cost—than the chosen auction format. DOJ selected this particular sale mechanism following specialist advice that an auction using a uniform pricing rule would ‘arrive at the bidder’s maximum willingness to pay sooner and so the auction will conclude quicker…there are no expected revenue differences between the uniform price auction and the ‘pay your bid’ auction’.

DOJ did not exercise due diligence before accepting this advice. The auction specialist’s advice led to unrealistic expectations of the duration of the auction, which affected how it was conducted.

## Auction conduct

More revenue could have been raised at auction had it been allowed to continue for longer.

The $855 million value of bids placed is likely to be a conservative figure. One of the reasons for this is the auction was ended prematurely. The auctioneers took steps after 46 rounds to bring the auction to a close. The auction continued for another 17 rounds and generated a further $108 million. Although it is not possible to authoritatively quantify how much more revenue would have been raised if the auction had been allowed to continue, analysis of the auction data revealed that the average increase in revenue for each of the last five rounds was $11 million. The amount of revenue raised in round 59 of 63 was the highest of any round: $21.4 million. Bidding in the final round was $4.5 million greater than in the penultimate round. The auction was closed while bids were still being placed.

That bidders were willing to pay more is further confirmed by comparing the prices paid at PACO with the prices achieved at auction. For example, metropolitan clubs paid an average of $41 796 per entitlement at PACO, but only $9 544 at auction.

Our survey of bidders also indicated that 61 per cent of respondents expected to pay more at auction.

### Information and training

There were shortcomings in the information and training provided to the industry to prepare them for the allocation process. As a consequence, the intended outcome of an ‘informed and confident community and industry’ was not achieved.

The information provided to the public was limited, following probity advice that providing more extensive information would favour larger and better-resourced commercial operators. Meetings with peak bodies were discontinued and individual questions were not answered if information was not already publicly available. Generalised responses were provided on the project’s website, which may or may not have addressed individual bidder concerns. DOJ did not attempt to establish whether bidders found these responses adequate.

The probity advice was overzealous and applied too rigidly by the GLR project team. With appropriate safeguards, such as publicly releasing transcripts of peak body meetings, additional information could have been provided to the industry without compromising probity. Since this did not occur, industry participants were unclear about a number of aspects of the allocation process.

The explanation of how prices would be calculated during the auction was ambiguous, with bidders particularly confused about how the price in other markets would affect the price in their own market. On auction day, 34 per cent of participants’ queries on the conduct of the auction related to the movement in prices.

The auction rules did not explain how the system would determine partial allocations, which occurred when participants’ bids were equal to the market price. Participants whose bids were equal in price and quantity were not allocated the same number of entitlements. In one scenario, a bidder received its full complement of entitlements, but the other only received a partial allocation.

There was no confirmation that the training had given participants an adequate understanding of auction rules and processes. This was particularly critical given the complexity of the auction software and the associated rules.

## Project management and oversight

The management of the allocation of EGMs was successful in that both PACO and the auction were conducted within very short time lines. This was, however, at the expense of due process.

### Procurement practices

Procurement was poorly planned, which resulted in a lack of competition in the engagement of consultants and non-compliance with procurement policy.

The auction specialist/software provider was engaged by DOJ on an initial contract of $35 000 without a competitive process. Although the appropriate exemption was provided for this initial contract, the approvals required under procurement policy were not obtained when a further five contracts were created with the same party. The total value of these six contracts was $3.5 million. DOJ did not follow better practice in this procurement, as none of these contracts was awarded under a competitive process. While auction theory and the associated software is a very specialised area of expertise, there are other providers in this field.

Similarly, the information technology (IT) adviser engaged to advise on hardware and software was awarded an initial contract for $36 000. This was increased twice, first to a cumulative value of $200 000 and then to $420 000.

Although the appropriate approvals were sought in this instance, the increases were a sign of poor planning. There was no testing of the market at any stage to demonstrate taxpayers were receiving value for money from these arrangements. In October 2010 the same IT adviser was awarded a further contract for $150 000 to provide advice on the wagering and betting component of the GLR, once again without a competitive process.

In summary, there were eight contracts, two financial variations and a deed of settlement totalling $4.2 million for the auction specialist/software provider and the IT adviser, and no competitive process.

## Specialist advice

The engagement of specialists to advise the project team was problematic. The roles and responsibilities of specialists lacked independence because they were not appropriately delineated and defined, and oversight arrangements were not robust.

The specialist engaged to provide advice on the auction design also provided the software to run the auction. This resulted in the auction specialist making recommendations on the auction design and then implementing these recommendations. This arrangement was inherently conflicted.

This lack of independence could have been overcome if appropriate third-party assurance had been sought on the auction design and software. This was not the case, as DOJ did not appropriately define the roles and responsibilities of its other advisers.

The Technical Reference Group (TRG) was established by DOJ in November 2008 to advise on aspects of the auction design. The TRG was, however, restricted from advising on whether the proposed auction design and software were the most appropriate in the circumstances, which limited its effectiveness.

The IT adviser engaged to provide quality assurance lacked expertise in auction theory and was dependent on the advice of the auction specialist/software provider. Particular concerns with this arrangement were that:

- the test plan was based on the auction specialist/software provider's contract requirements and software design specifications rather than an independently derived end-to-end test plan developed by third-party specialists.
- there was insufficient third-party assurance that the algorithm would work as expected, especially in regard to the ranking rules that prioritised bids.

The IT adviser's responsibility for providing quality assurance was compromised by an expansion of its role to include collaboration with the auction specialist/software provider on the development of the technical specification. The IT adviser subsequently tested the specification for functionality and compliance with the auction objectives. This was another inherently conflicted arrangement, as it meant that the IT adviser was quality assuring its own work.

## Cost control

There was insufficient control over the project costs. In the 2007–08 and 2008–09 budget cycles, DOJ sought funding of $20 million. This was to cover the department's costs of allocating all five gambling licences for the three years to 30 June 2010. By October 2010, shortly after the allocation of EGM entitlements had been finalised, the department's total project expenditure was $41 million; double the original budget.

Costs were managed at a whole-of-GLR level. There was no separate cost reporting for the different licences within the GLR, which covered EGMs, monitoring, Keno, wagering and lotteries. These licences were substantial projects in their own right with separate requirements and time lines.

The GLR project team estimated the cost of the EGM component of the GLR between July 2007 and October 2010 was $19 million. Since there were no detailed records of the amount of staff time assigned to the various licences over this period, it was not possible to confirm the accuracy of this figure.

## Knowledge management

Knowledge management is particularly important in a project environment, where contractors often make up a significant portion of the team. Since a large number of contractors or staff can leave both during or immediately after a project has finished, effective knowledge management is critical for retaining corporate memory.

Sound knowledge management principles were applied in producing end-of-stage reports after major project milestones and establishing a dedicated website to disseminate information to the public. This website was regularly updated in the lead-up to the auction.

However, data quality and reliability were impaired by inconsistencies in the information recorded on venue operators. These inconsistencies indicated data management rules were not well defined or applied, which increases the likelihood of gaps and duplication in data. Discrepancies in naming conventions were found not only between the different records kept by VCGR and the GLR project team, but also often within the same document.

It is crucial that accurate master data on venue operators is maintained to allow VCGR to monitor compliance with the regulatory framework. Complete and accurate details of ownership arrangements are necessary for VCGR to carry out probity assessments on industry participants.

## Probity

There is insufficient documentary evidence and third-party assurance for VAGO to definitively conclude that there were no major breaches of probity in the allocation process.

DOJ did not keep sufficient documentation to allow an independent verification to be performed on the auction results. As such, we are unable to confirm that each venue operator received their correct entitlements for the correct price.

There has still been no public assurance that the probity requirements were met. To date, the IRP has not tabled its report on the probity of the allocation of EGM entitlements. Given the elapsed time and proximity to August 2012, when the venue operator structure takes effect, it may be difficult for DOJ to respond to any adverse findings of the IRP.

This delay occurred because the GLR project team requested that the IRP and probity auditor give priority to other, more time-critical GLR licensing processes. As a result, the probity auditor's report was only produced in May 2011, a year after the auction took place. This report is an internal DOJ document and has not been released publicly.

Although the probity auditor's report noted 36 issues, none was considered material. The probity auditor concluded that the GLR had complied in material aspects with the probity requirements. However, this report needs to be treated with caution, primarily because there are several important omissions in terms of the evidence considered to support its findings. For example, the report did not assess whether venue operators were disadvantaged by an inadvertent breach of the regulatory framework, or by a lack of clarity on the auction rules. Furthermore, the IRP has previously questioned the adequacy of the oversight provided by this particular probity auditor.

# Recommendations

| Number | Recommendation | Page |
|---|---|---|
| **1.** | For issues that are significant and material, the Department of Treasury and Finance should apply a more rigorous approach and obtain specialist third-party assurance so that the advice provided to government to inform key decisions is robust. | 24 |
| **2.** | The Department of Justice should obtain appropriately tailored third-party assurance over the robustness of specialist advice where this advice is critical to the success of a strategy or project. | 48 |
| **3.** | The Department of Justice should develop processes to provide assurance that training participants have gained sufficient knowledge to fulfil the intentions of the training program. | 48 |
| **4.** | The Department of Justice should build effective decision review points into projects to allow re-evaluation or re-confirmation of particular courses of action. | 69 |
| **5.** | The Department of Justice, together with other members of the interdepartmental steering committee, should develop communication protocols regarding the sharing of information. | 69 |
| **6.** | The Department of Justice should establish improvements in contract management so that consultants' roles and responsibilities are independent, appropriately scoped and performed by consultants with relevant expertise. | 69 |
| **7.** | The Department of Justice should improve procurement practices by:<br>• promoting more stringent oversight by the Accredited Purchasing Unit of compliance with procurement policy<br>• providing more effective procurement planning at the project management level. | 69 |
| **8.** | The Department of Justice should manage probity in a manner that balances information provision with safeguards over fair, equitable and impartial treatment. | 69 |
| **9.** | The Department of Justice should provide cost reporting for the Gambling Licences Review project on an individual licence basis. | 69 |
| **10.** | The Department of Justice should establish knowledge management processes to address not only knowledge retention but also concerns with inaccurate or inconsistent information. | 69 |

## Submissions and comments received

In addition to progressive engagement during the course of the audit, in accordance with section 16(3) of the *Audit Act 1994* a copy of this report was provided to the Department of Justice, the Department of Treasury and Finance, the Department of Premier and Cabinet, the Victorian Commission for Gambling Regulation and the Independent Review Panel with a request for submissions or comments.

Agency views have been considered in reaching our audit conclusions and are represented to the extent relevant and warranted in preparing this report. Their full section 16(3) submissions and comments, however, are included in Appendix B.

# 1 Background

## 1.1 Gambling in Victoria

In total, 73 per cent of Victorian adults engaged in some form of legal gambling in 2009, the latest year for which data is available. Gambling takes many forms, including:

- electronic gaming machines (EGM), also known as poker machines, in clubs, hotels and the casino
- public lotteries
- casino table games, such as roulette and blackjack
- wagering, which encompasses betting on racing, Trackside and sports betting
- Club Keno.

#### Electronic gaming machines

EGMs were introduced into Victoria in 1992 after the government awarded licences to two gaming operators. The gaming operators acquire, distribute, operate and monitor EGMs in approved clubs and hotels. The licences expire in 2012.

At 30 June 2010, the Victorian Commission for Gambling Regulation's Annual Report 2009–10 showed 26 682 EGMs were approved to operate in 514 venues, excluding the casino.

### 1.1.1 Gambling revenue

Gambling-related taxes represent a significant source of state revenue. According to the *Financial Report for the State of Victoria 2009–10*, in that year they totalled $1.63 billion, or 12 per cent of the government's tax revenue, and 4 per cent of the state's total revenue.

This same report shows that EGMs in clubs and hotels generated $985 million, or 60 per cent of gambling taxation revenue. These taxes were primarily used to fund health services, community projects, problem gambling services, community education initiatives and gambling research.

Gambling is also a significant source of revenue for those businesses with gambling licences. 'Player loss' is the total amount lost by players gambling. In 2009–10 player loss from all forms of gambling was $5.1 billion, equivalent to 2 per cent of the gross state product. Of this, $2.6 billion—more than half of the total player loss—was from EGMs in hotels and clubs.

**Figure 1A**
**Electronic gaming machine data**

| Measure | Total ($mil) | Per EGM ($) |
|---|---|---|
| Player loss from EGMs in hotels and clubs 2009–10 | 2 597.2 | 97 339 |
| Taxes and levies | 985.0 | 36 916 |
| Player loss net of tax | 1 612.2 | 60 423 |

*Source:* Victorian Auditor-General's Office using data from the Department of Treasury and Finance.

While gambling is a large industry in its own right, it is also important in attracting customers and revenue for the hospitality and allied industries.

## 1.1.2 Legislation, policy and regulation

### Legislation

The *Gambling Regulation Act 2003* is the main gambling Act in Victoria. The legislation governs the conduct of gambling, the licensing of gambling industry participants and the enforcement of licensees' legal obligations.

This legislation reflects the guiding principles for gambling policy, which promote responsible gambling, accountability, transparency, and an industry that is honest and free from criminal influence and exploitation.

### Guiding principles

The guiding principles for gambling policy, updated in 2008, were to:

- provide consumer choice and service in a competitive and innovative marketplace
- ensure the legitimate financial benefits of gambling are transparent, recognisable and fairly distributed to the community
- reduce the harm caused by problem gambling
- maintain high standards of transparency, probity, integrity, accountability and community engagement.

These guiding principles were intended to inform the then government's policy decisions relating to gambling, including the licensing arrangements and regulatory framework for EGMs.

### Regulatory framework

Measures were put in place to regulate the structure of the gaming industry. The purpose of these measures is to minimise the harm caused by problem gambling:

- The maximum number of EGMs permitted in hotels and clubs is 27 500.
- No more than 50 per cent of the total entitlements may be allocated to either clubs or hotels. This is referred to as the '50:50 rule'.
- No less than 20 per cent of the available entitlements may be allocated outside metropolitan Melbourne. This is referred to as the '80:20 rule'.

- Regional caps restrict the number of EGMs in 20 regions, which are based on local government areas, or parts thereof.
- The density of EGMs is limited to a maximum of ten per 1 000 adults.
- There is a maximum limit of 105 EGMs per venue.
- No licensed club venue operator can hold more than 420 entitlements.
- Under the new venue operator structure, no hotel operator may own, or have a prescribed connection to, more than 35 per cent of the hotel entitlements.

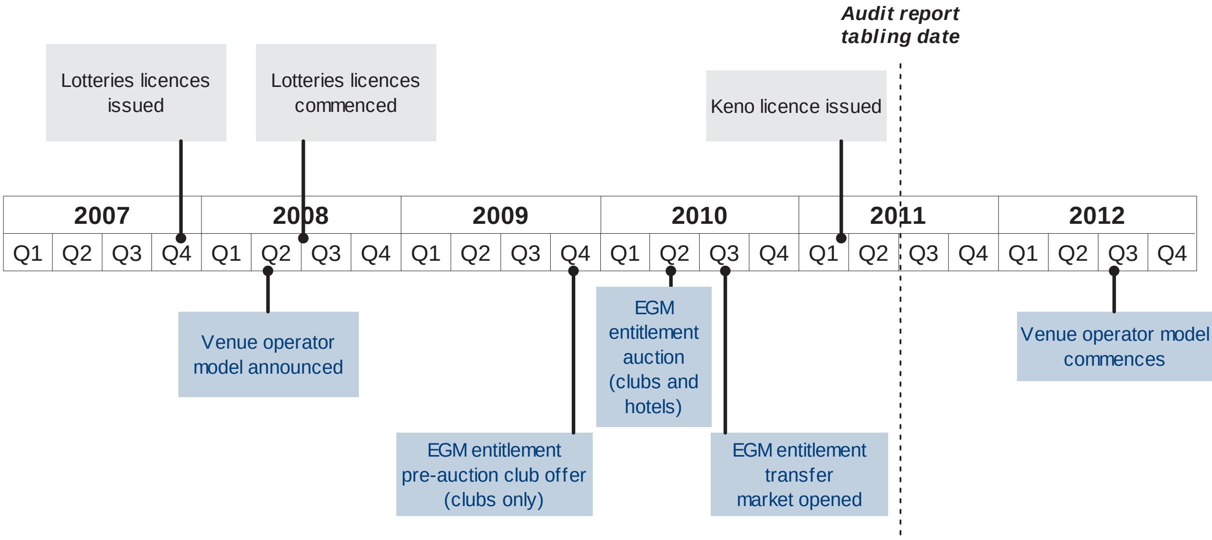

## 1.2 The Gambling Licences Review

The Department of Justice (DOJ) started a review of the gambling industry in 2004. The purpose of this review was to make recommendations that would shape the industry for the next generation and introduce more competition. The review led to changes in policy, legislation and operating arrangements.

In 2005 the government announced changes to the public lotteries licensing arrangements. Changes to the other types of licences were announced in 2008. Previously, the licences to operate gaming, wagering, Keno and lotteries were held by the two gaming operators.

Under the new arrangements, these licences would be split into five categories—EGMs, EGM monitoring, Keno, wagering and lotteries—and awarded separately. The new public lottery licences came into effect in 2008. The other changes will take place from April 2012 for Keno and August 2012 for EGMs, EGM monitoring and wagering. To date the wagering and monitoring licences have not been awarded.

**Figure 1B**
**Time line**




*Source:* Victorian Auditor-General's Office.

## 1.2.1 Policy objectives for electronic gaming machines

The overarching policy objective for EGMs was to end the gaming operator structure and introduce greater competition in the gambling industry. A National Competition Policy review in 2000 found this structure was anti-competitive and no longer appropriate for a mature industry.

After considering several possible options for the new industry structure, the government resolved to offer interested venue operators the opportunity to bid directly for EGM entitlements. The venue operator structure was deemed to deliver the greatest net benefits to the Victorian community and provide the best fit with the guiding principles for gambling policy. Accordingly, the purpose of the EGMs component of the Gambling Licences Review (GLR) was to 'establish a venue operator industry that meets the government's gambling guiding principles'.

## 1.2.2 Venue operator industry structure

The replacement of the dual gaming operator structure with a venue operator model was described by DOJ as the most significant event for the gaming industry since the licences were originally awarded.

In April 2008 the government announced the following major changes:

- The two gaming operators' licences to operate EGMs in hotels and clubs would not be renewed when they expire in 2012.
- Instead, an entitlement would be created for each of the 27 500 EGMs.
- The entitlements would be valid for ten years.
- Clubs and hotels could buy these entitlements.
- Restrictions on the geographic distribution and density of EGMs would continue through distribution limits and ownership caps.

Similar venue operator models were introduced in New South Wales in 2002, South Australia in 2004, and Queensland in 2009.

## 1.3 Allocation of electronic gaming machine entitlements

The purpose of the allocation was to implement the policy objective of establishing 'a venue operator industry that meets the government's gambling guiding principles'.

The GLR project team in DOJ managed the implementation. The GLR project team had to deliver four high-level outcomes as part of this process.

### 1.3.1 Intended outcomes from the allocation

A regulatory framework that gives effect to the industry for the future, that will:

- promote a competitive and innovative industry
- ensure the financial benefits of gaming are transparent, recognisable and fairly distributed to the community
- establish an appropriate regulatory framework to maintain the highest standards of probity, transparency and accountability
- complement the government's responsible gambling strategy.

An informed and confident community and industry, that will:

- enable industry engagement by managing expectations of stakeholders to prepare them for the behavioural and industry changes as they occur throughout the implementation and transition process
- ensure venue operators, their consumers and the community understand the implications and benefits of the new industry structure
- allow venue operators the opportunity to take part in the post-2012 gaming industry
- ensure consistent messages across the industry, media and community about the new gaming industry structure to facilitate a smooth transition
- ensure venue operators understand the requirements to enter the allocation process, are prepared for the bidding and able to participate on the day.

A competitive and transparent allocation of gaming machine entitlements, that will:

- allocate entitlements within government's policy determinations to maximise benefits for society
- provide for sustainable competition within the industry
- provide an opportunity for all venue operator licensees who choose to participate in the bidding process to do so
- ensure high standards of probity, integrity, transparency and objectivity are maintained
- seek to capture supernormal profits from the gaming machine industry
- provide process efficiency, minimising participation costs for both the bidders and the state.

A plan for a seamless transition to the new industry structure, that will:

- ensure industry participants exiting or entering the market have a clear understanding of their obligations
- provide process efficiency for industry participants involved in the transition
- minimise disruption to industry and consumers during the transition period
- position the GLR project team to transition the ongoing responsibilities to the Office of Gaming and Racing and the Victorian Commission for Gambling Regulation (VCGR).

To achieve these outcomes, the GLR project team had to design and implement an effective, efficient and economic allocation. This involved creating a sales process that would encourage participation and generate the highest prices within the constraints of the regulatory framework. The regulatory framework restrictions, such as regional caps, apply to both the existing gaming operator structure and the new venue operator structure.

Of the 27 500 EGM entitlements that were available, 27 300 were sold for a total of $980 million. One club bid for more entitlements than it was permitted by the regulatory framework, leaving 200 entitlements unallocated.

### 1.3.2 Allocation mechanisms

The EGM entitlements were allocated in two stages.

The government originally decided to allocate the EGM entitlements through an auction, which would take place in early 2010. An auction was chosen because a competitive bidding process would allow the state to derive 'an appropriate financial return' and 'mitigate against the potential for concentration of ownership, or misuse of market power'.

The government subsequently decided to give existing clubs the opportunity to buy a capped number of entitlements at a set rate. Clubs are community organisations and are often financially dependent on EGMs to remain operational. As such, the pre-auction offer in October and November 2009 was intended to give all clubs that were already operating EGMs some degree of certainty over the number and cost of EGM entitlements they could buy. This process was called the pre-auction club offer (PACO).

After the allocation results were finalised, a transfer market opened. This allows venue operators to buy and sell EGM entitlements.

## Pre-auction club offer

The PACO was completed on 23 November 2009. It enabled existing eligible clubs to buy an entitlement for each EGM they were operating as at 4 June 2009, up to a maximum of 40 entitlements per venue. Not all clubs paid the same price for their entitlements. This was because the purchase price was a percentage of individual venues' historic gaming revenue.

Of the 247 club venue operators that were eligible for PACO, 236, or 96 per cent, took up the offer, buying 63 per cent of the 13 750 entitlements available to clubs. This represented 84 per cent of revenue raised in total from clubs and 37 per cent of the overall revenue generated by the allocation.

The average price of an entitlement purchased at PACO was $42 014.

## Auction

The remaining 5 038 club EGM entitlements, and all of the 13 750 hotel entitlements, were auctioned in two stages during April and May 2010. Venue operators had to submit a bid in the first stage in order to be eligible for stage two. In the first stage, orders were submitted via a secure internet site over ten business days. In the second stage, operators submitted their bids on state-supplied consoles at a Melbourne venue on one day.

Prospective bidders had to meet a number of eligibility requirements. These included possessing a current venue operator's licence and attending a training session.

The auction divided the state into 176 markets: 88 club markets and 88 hotel markets. These were based on local government areas.

Of the 4 838 club entitlements that were sold, 72 per cent were purchased at the opening bid of $5 500. The opening bid level was also the reserve and was based on the lowest price paid for an entitlement at PACO. The hotel reserve was set at $11 000, twice the club reserve, on the basis that hotel venues generally earn twice as much as clubs from EGMs.

The average price of entitlements sold at auction was $39 686 for hotels and $14 134 for clubs.

### Transfer market

The transfer market opened in September 2010. This is the ongoing process for venue operators to trade entitlements, subject to legislative and regulatory conditions. Venue operators submit their offers to buy and sell on a website managed by VCGR.

## 1.3.3 Project management

The transition to the venue operator model is being project managed by the GLR project team, which is part of DOJ. This team is separate from the Office of Gaming and Racing, which manages the day-to-day operation of the industry.

A steering committee was established to oversee the project team. The steering committee is chaired by the Secretary of DOJ and has representation from the Department of Premier and Cabinet, Department of Treasury and Finance, and Department of Planning and Community Development.

## 1.3.4 Probity

Probity auditing provides assurance that a process has been conducted fairly and that all participants have been treated equitably.

A probity auditor was engaged to advise on the probity of the GLR project. Communication with industry stakeholders was informed by this advice.

An Independent Review Panel was established in 2007 under an amendment to the *Gambling Regulation Act 2003*. It will report to Parliament on the project's probity practices with regard to:

- fairness and impartiality
- consistency and transparency of the process
- security and confidentiality
- identification and resolution of conflicts of interest.

The Independent Review Panel report has not been tabled to date.

## 1.3.5 Electronic gaming machines industry stakeholders

The industry changes will affect the role of many of the major stakeholders.

### Industry operators

Licensed club and hotel venue operators will have more control over decisions regarding gaming machines in their venue, subject to regulatory constraints.

The two current gaming operators can bid for the other gambling licences and/or offer ancillary support services to the venue operators with EGMs. They may operate EGMs after the end of their gaming operator licences if they obtain a venue operator's licence.

There are restrictions on the combination of roles: for example, the EGM monitor, which is described in more detail below, cannot be a venue operator, nor offer ancillary support services.

### Regulation and monitoring

VCGR is an independent statutory authority that administers the gambling legislation through functions including:

- licensing venue operators
- approving premises as suitable for gaming
- approving equipment (such as EGMs and EGM games)
- compliance monitoring and enforcement
- educating and advising members of the gambling industry and the general public.

VCGR will continue to regulate industry participants and gambling activities.

Local councils will continue to have the opportunity to provide input into VCGR's consideration of applications to establish new gaming venues or for additional EGMs at already approved venues situated within their municipality.

Separate from the functions of VCGR is the role of the monitor. The monitor will oversee the integrity of EGM transactions in gaming venues from 2012 and provide data about EGMs for regulation, tax and research. Venue operators will link their EGMs to the electronic monitoring system and pay a fee to be monitored. The monitoring licence is one of the five licences being awarded under the GLR.

## 1.4 Audit objectives and scope

The audit objectives were to determine whether:

- the financial outcomes from the allocation represented best value for money
- the allocation process was managed in an effective and efficient manner.

The audit focused on the pre-auction club offer and auction phases of the allocation. This audit was requested by the Legislative Council of Parliament on 26 May 2010.

## 1.5 Structure of the report

The rest of this report is structured as follows:

- Part 2 analyses the financial outcomes from the allocation.
- Part 3 assesses the major factors in the allocation process that contributed to the unsatisfactory outcomes.
- Part 4 examines the project management challenges and issues.
- Appendix A outlines the method and assumptions used to calculate the fair market value of the EGM entitlements.

## 1.6 Audit method and cost

The audit was performed in accordance with the Australian Auditing and Assurance Standards. The total cost of the audit was $900 000.

# 2 Financial outcomes

## At a glance

### Background

A total of 27 500 electronic gaming machine (EGM) entitlements were offered for sale to club and hotel venue operators. Existing club operators could buy entitlements at a fixed price through a pre-auction club offer (PACO) in 2009. A subsequent auction in 2010 was open to both clubs and hotels.

One of the government's intended outcomes from the sale was to capture the gaming industry's 'supernormal profits'. These are the increased profits that arise when there are restrictions on competition and limits on the quantity of a good or service.

### Conclusion

The sale proceeds from the allocation did not reflect the fair market value of the entitlements. The allocation did not achieve the desired financial outcome of capturing a significant share of supernormal profits. In particular, hotels and some of the larger clubs have benefited from the windfall gain instead of the community in general.

### Findings

- The amount of revenue raised by PACO and the auction was a quarter of the total estimated fair market value of the EGM entitlements. This fair market value reflects the upper limit existing venue operators would be prepared to pay to acquire entitlements.
- Advice to government on the potential value of the entitlements varied significantly.
- Clubs paid a comparatively higher price than hotels for their EGM entitlements.

### Recommendation

For issues that are significant and material, the Department of Treasury and Finance should apply a more rigorous approach and obtain specialist third-party assurance, so that the advice provided to government to inform key decisions is robust.

## 2.1 Introduction

As part of the implementation of the venue operator industry structure, 27 500 electronic gaming machine (EGM) entitlements were offered for sale to club and hotel venue operators. Existing club operators could buy a limited number of entitlements for a fixed price in a pre-auction club offer (PACO) in 2009. The price was based on the amount individual venues earned from gaming in 2008–09. A subsequent auction in 2010 was open to both clubs and hotels.

A number of financial, social and stakeholder engagement outcomes were intended to be achieved as part of the allocation. Although the Department of Justice (DOJ) has given conflicting advice on the allocation's financial goals, project documentation and interdepartmental advice prior to the auction clearly demonstrate that the allocation process was intended, inter alia, to capture a large part of the supernormal profits from the gaming industry.

Supernormal profits is a term used by economists to describe the increased profit that arises when there are restrictions on competition, usually because there are a small number of suppliers and limits on the available quantity of a good or service. They are the profits in excess of the minimum acceptable level of profit, which economists commonly refer to as normal profit.

Under the gaming operator industry structure, both gaming operators and venue operators earn supernormal profits because:

- the number of EGMs state-wide is limited to 27 500 by ministerial determination
- only two gaming operators are permitted under legislation, until the new venue operator structure takes effect in 2012
- there is a limited number of gaming venues. This is due to the gaming industry's significant regulatory and financial barriers to entry.

Under the new venue operator industry structure, the gaming operators' share of supernormal profits will largely transfer to the venue operators.

This Part examines whether the results of the allocation achieved fair market value for the entitlements within the regulatory constraints imposed by government; and to what extent the intended financial outcome from the allocation process was achieved. In this Part we:

- analyse the revenue received from the allocation of EGM entitlements
- set out VAGO's fair market valuation of these entitlements to existing venue operators
- evaluate the soundness of agency advice to government on the financial outcomes
- assess to what extent the allocation succeeded in capturing supernormal profits.

## 2.2 Conclusion

The revenue raised by the allocation of EGM entitlements was only one quarter of the fair market value of the entitlements. The allocation therefore failed to achieve the desired outcome of capturing the greater part of the supernormal profits potentially available to the government through the sale of the entitlements.

The calculation of supernormal profits provided to government significantly underestimated the value of these entitlements. Consequently, decisions were not appropriately informed.

The allocation also resulted in perverse and uneven outcomes for venue operators. The price paid for the entitlements ranged from 3 per cent to 215 per cent of individual venues' revenue from gaming in 2008–09. Despite this extreme variation, on the whole, clubs and hotels bought entitlements at auction for a price that was well below their fair market value.

## 2.3 Purpose of the allocation

By way of background, a report by a consultant engaged by DOJ in May 2009 concluded that:

> 'For the State of Victoria, an efficient auction result would maximise revenue from the sale of EGM entitlements. This surplus can subsequently be reallocated within the Victorian population through state government policies and programs. Maximising the revenue from the sale [of EGM entitlements] is therefore in the broad interest of the Victorian population, and is also consistent with the state's objective of realising a fair and broad distribution of the financial benefits of gaming to the Victorian community.'

DOJ has provided conflicting advice on the purpose of the allocation, and in particular the purpose of the auction. DOJ advised the Minister for Gaming in October 2008, 17 months before the auction, that the intention of the auction was to 'achieve the allocation that maximises financial value subject to policy determinations aimed at social value'. It gave the same advice to the Department of Premier and Cabinet (DPC) and the Department of Treasury and Finance (DTF).

DOJ changed its position after the auction, advising that 'the department strongly reiterates that maximising revenue was not the primary or even a secondary objective of the allocation'. These comments are contrary to the general obligation on public sector agencies to achieve value for money for taxpayers from the sale of valuable public assets.

One of the stated goals of the auction process was to capture supernormal profits. DOJ's post facto attempt to reposition the purpose of the auction is inconsistent not only with this objective but its actions leading up to the auction.

DOJ's contract with the specialist engaged to design the auction stated that 'the auction system developed by the contractor must, within the framework of the government policy determinations and resulting rules, identify the allocation of gaming machine entitlements that *maximises the value of accepted bids'*. [Emphasis added.] The fact that an estimated $7 million was spent in designing and implementing what was described as a 'competitive bidding process' further contradicts DOJ's post-auction statements.

DOJ's post-auction comments are also inconsistent with written advice provided to government by DPC and DTF before the auction. Neither of these departments disputes that their advice to government recommended ways to increase revenue from the allocation.

In December 2007, when the venue operator model was short-listed as an option for the new industry structure, DPC advised that: 'a key goal of the industry structure and allocation process is for the government to capture a greater share of both the value of the entitlements and the 'supernormal' profits currently received by the two operators'. This is consistent with DTF's advice to government in September 2008 that an adverse outcome for the state would be one where venue operators paid 'minimal prices for the entitlements'.

The allocation of EGM entitlements, rather than the subsequent tax regime over the life of the entitlements, was the primary mechanism for capturing supernormal profits. In March 2009 DTF advised the Treasurer that:

> 'when considering the level of taxes to apply, DTF did <u>not</u> recommend a level of taxation that perfectly targeted the identified level of supernormal profits as this would have introduced the risk of setting taxes too high or too low (due to information asymmetries). Setting taxes too high would have the effect of discouraging participation and result in considerable revenue risk to the state. The same risk applies for setting reserve prices too high or too low'.

## 2.4 Revenue from the allocation

The amount of revenue raised by PACO and the auction was $980 million. When the ten-year life of the entitlements is taken into consideration, the initial investment required from venue operators is low, compared to the expected return.

The amount paid for entitlements was equivalent to 36 per cent of the total revenue from gaming in 2008–09, and less than the amount of taxation revenue generated by EGMs in each of the past five years. The audit has used revenue from gaming in 2008–09 as the primary basis for comparison because it was the financial year immediately prior to PACO and the auction.

We estimated the total fair market value of the EGM entitlements at the time of the allocation was between $3.7 billion and $4.5 billion, with a mid-point of $4.1 billion. This figure is consistent with DTF's $4.2 billion estimate in March 2009, which was the only estimate DTF completed that appropriately included supernormal profits at the venue operator level. Our estimation is also consistent with the $4.6 billion to $5 billion range quoted by DOJ's economist consultant in May 2009.

This consultant noted that the actual revenue raised by the auction—bearing in mind PACO had not been agreed at the time it produced its report—was likely to be lower than the estimated value range, as the consultant had not factored the effect of regional caps into its analysis. These caps would result in some entitlements flowing to lower priced markets.

DOJ's consultant correctly identified that it is reasonable to expect some difference between the estimated fair market value of an asset and the price paid for that asset. Market constraints, the level of competition, expectations of future earnings and individual attitudes towards risk are all key determinants of price.

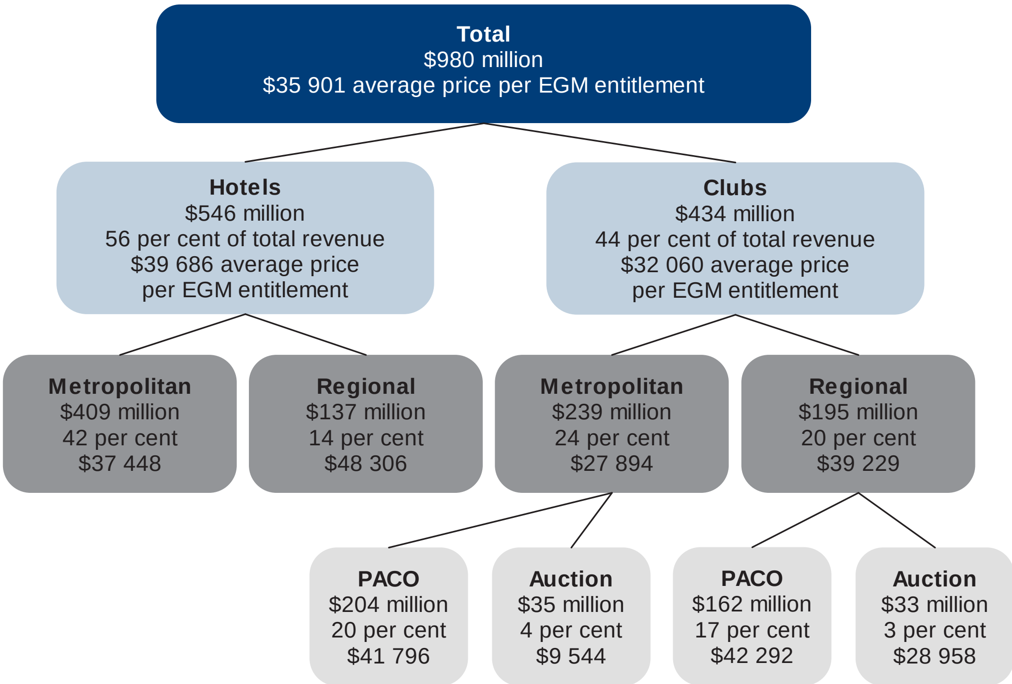
However, the very substantial difference between the estimated fair market value of the entitlements and the total PACO and auction proceeds is a strong prima facie indication that there were significant shortcomings in the design and implementation of the allocation process. These, combined with significant imbalances between demand and supply, and the low reserve, resulted in an adverse outcome for the state.

The shortcomings in the design and implementation of PACO and the auction are explored in more detail in Part 3, as is the potential trade-off between auction revenue and longer-term taxation revenue.

### 2.4.1 Summary of results

The revenue received from clubs and hotels in metropolitan and regional Victoria through PACO and the auction, the percentage of revenue raised, and the average price paid per entitlement are outlined in Figure 2A.

**Figure 2A**
**Allocation revenue**




*Source:* Victorian Auditor-General's Office.

Analysis of the allocation revenue revealed that the prices paid for the entitlements varied according to the sale mechanism, the type of venue operator, the geographic location and whether or not the area was subject to a regional cap on the number of entitlements.

This analysis identified that entitlements were sold for higher prices in capped areas, which is consistent with the theory that prices tend to be higher if supply is constrained. Other trends observed in the financial results were less consistent with expectations: regional areas and club operators paid a higher price for their entitlements as a percentage of their revenue from gaming than metropolitan areas and hotel operators. These trends are explored in more detail below.

## Pre-auction club offer or auction

PACO raised $366 million and the auction $614 million. Clubs paid a significantly higher price at PACO than at the later auction. The difference in price was particularly marked in metropolitan areas, where auctioned entitlements were sold for less than a quarter of the average PACO price. The low level of demand at auction, combined with the low reserve price, meant that 72 per cent of the club entitlements auctioned were sold at the reserve price.

The eight club operators that bought all of their entitlements at auction paid an average of $7 402 per entitlement. The top three club venues in the state, based on total gaming expenditure, are run by two of these eight operators. These clubs generated $42 million from their gaming operations in 2008–09. They paid an average of $6 911 per entitlement at auction.

### Hotel or club

At face value, hotels paid more per entitlement than clubs. However, hotels earn more per EGM than clubs. Based on gaming revenue figures from 2008–09—the financial year prior to the auction—hotels actually paid a smaller percentage of their annual revenue from gaming than clubs for their entitlements: 31 per cent as opposed to 47 per cent.

### Regional or metropolitan

Prices were generally higher in regional areas. Eight of the top ten areas, ranked by the average price paid for entitlements, were in regional areas. Regional venue operators not only paid more per entitlement than metropolitan venue operators, but also paid a significantly higher percentage of their gaming revenue for the entitlements than metropolitan venue operators: 56 per cent as opposed to 31 per cent.

### Capped or uncapped

Restrictions on the number of EGMs in each area are applied through a regulatory framework of regional caps and density limits. This framework is driven by social policy, which is aimed at minimising the harm caused by problem gambling. It also reflects the desire to distribute the EGMs throughout the state. Prices tended to be higher in capped regions, where bidders were competing for a more strictly limited supply of entitlements.

The factors that created these differences, namely the level of demand for the entitlements, the auction reserve price, and whether the entitlements were purchased at PACO or auction, are analysed in more detail in Part 3.

## 2.5 Audit’s valuation of the entitlements

There were limitations in DTF’s valuation of the EGM entitlements due to assumptions that were based on out of date or incomplete information. These limitations are covered later in this Part. Since the audit could not reasonably rely upon DTF’s analysis, we performed our own calculation of the fair market value of the entitlements.

### 2.5.1 Calculated valuation of club and hotel entitlements

The audit found that the total fair market value of the EGM entitlements ranged from $3.7 billion to $4.5 billion, with a mid-point of $4.1 billion. The range of values, rather than a single value, appropriately reflects both the subjective nature of assessing value and the degree of variation in the industry. One indicator of the extent of the variation is gaming revenue from 2008–09. In that year, clubs earned between $108 380 and $16 644 275, while hotels earned between $266 305 and $20 293 182.

This variation is driven by different:

- types of venue (club or hotel)
- geographic locations
- venue sizes, in terms of number of EGMs
- venue operators' business models and approaches to gaming.

These factors all have an effect on the amount of profit venue operators earn from EGMs.

The range of fair market values for the 13 750 club and 13 750 hotel entitlements, as at 31 March 2010, is in Figure 2B. It should be noted that the 'per entitlement' figures are averaged across the diverse range of venue operators.

**Figure 2B**
**Value of electronic gaming machine entitlements**

| | Total industry ($bil) | | | Per entitlement ($'000) | | |
|---|---|---|---|---|---|---|
| **Range** | **Club** | **Hotel** | **Total** | **Club** | **Hotel** | **Average** |
| High | 2.1 | 2.4 | **4.5** | 150 | 179 | **164** |
| Mid | 1.9 | 2.2 | **4.1** | 137 | 163 | **150** |
| Low | 1.7 | 2.0 | **3.7** | 125 | 145 | **135** |

*Source:* Victorian Auditor-General's Office.

The difference in fair market value between clubs and hotels is primarily driven by the following factors:

- Hotels' revenue from EGMs is approximately double that of clubs: this increases the value of hotel entitlements relative to club entitlements.
- Clubs do not pay income tax whereas hotels pay up to 30 per cent: this decreases the value of hotel entitlements relative to club entitlements.
- Clubs receive a discount on state gaming taxes of 8.33 per cent: this increases the value of club entitlements relative to hotel entitlements, as the clubs are able to retain more profit.

The valuation was based on an accepted method that was similar to that used by DTF. However, unlike DTF, VAGO tested its major assumptions with industry participants to confirm their reasonableness.

### 2.5.2 Valuation method and assumptions

In performing the valuation, the audit used the following method and assumptions:

- To determine the value of an asset, business valuers in Australia typically adopt a 'fair market value' definition, which is 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing but not anxious parties in an arm's length transaction'. This definition has been used in the audit. In this instance, the asset is the entitlement, which gives the holder the right to operate an EGM for ten years.
- The audit used a net present value approach to value the EGM entitlements. This produced a valuation as at 31 March 2010, based on venues' forecast net profit from gaming over the ten-year life of the entitlements.
- The valuation date of 31 March 2010 was chosen because this was just prior to the date of the auction. It allows a timely comparison with the revenue raised in the auction and PACO.
- The valuation is based on information that was available to bidders at that time. Appropriately, it does not reflect information that only became known after the auction, such as subsequent unforeseen changes in gambling policy or the location of EGMs, which may affect the value of the entitlements.
- The existing social policy parameters designed to limit gambling-related harm, such as the limit of 27 500 EGMs and regional caps, have been factored into the valuation. The historical revenue used to forecast future revenue, and thus determine the fair market value, already reflects these parameters.
- The range of discount rates used reflects venue operators' different attitudes towards risk and the uncertainty in the industry regarding the impact of recently introduced and proposed responsible gambling measures.

More detail on the method and assumptions is in Appendix A.

## 2.6 The Department of Treasury and Finance's valuation

DTF was responsible for providing advice to government on the likely financial outcomes of the allocation process.

Any economic modelling for government of the estimated fair market value of assets is dependent on the policy context, the market information available at the time and the assumptions used. Although DTF used an appropriate valuation approach, the department's analysis had three main weaknesses:

- Its estimate of supernormal profits varied significantly, ranging from $504 million to $4.2 billion between 2007 and 2009. The single most material item in this variation was supernormal profits at the venue operator level, which were worth $3.3 billion in value.

- It was out of date, as no detailed economic analysis was performed after 2009. Significant changes that occurred after 2009, such as the introduction of $5 maximum bet limits, were not taken into account.
- Its advice was informed by assumptions of revenue and costs that were not soundly based. The discount rate used did not adequately affect the varying levels of risk and uncertainty in the industry.

For such a material transaction as the sale of the EGM entitlements, it would have been prudent for the department to have maintained a current and comprehensive valuation. This did not occur.

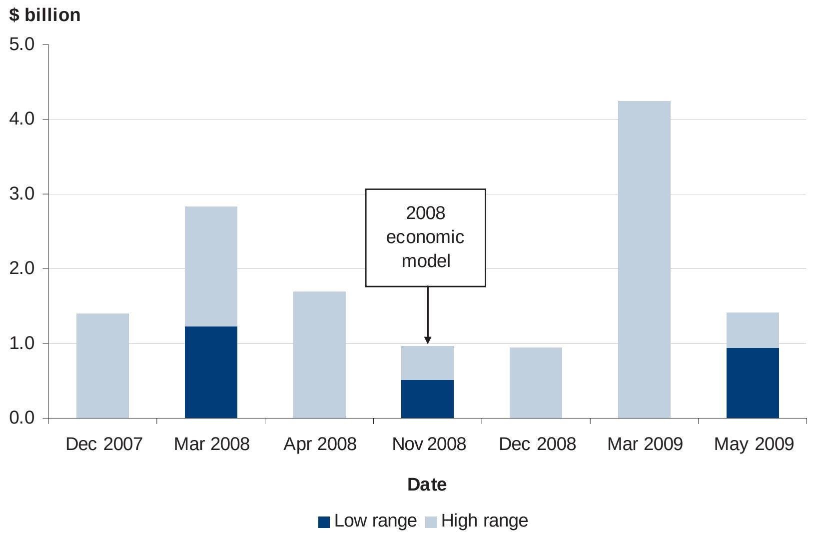
### 2.6.1 Evolution of advice

There were significant variations in advice provided by DTF on the value of EGM entitlements. Figure 2C shows how DTF's valuations changed over time.

If the original basis of the analysis had been sound, adjustments to the assumptions would have been minor and only based on changes in policy or new information becoming available. However, four different levels of forecast revenue growth were used within a ten-month period, which is excessive for such a short period of time. The April 2008 and May 2009 figures were not accompanied by a clear explanation of the supporting analysis. The most detailed analysis, an economic model, dates from November 2008.

The fact that no detailed economic analysis was performed in the year before the auction was a significant oversight, given that one of the intended outcomes from the allocation process was to capture supernormal profits. Consequently, the government did not have comprehensive and up-to-date information on which to base its deliberations.

**Figure 2C**
**The Department of Treasury and Finance's analysis of supernormal profits**




*Source:* Victorian Auditor-General's Office.

Figure 2D contains a detailed explanation of the reasons for differences in DTF's valuations over time.

**Figure 2D**
**Rationale for changes in the Department of Treasury and Finance's analysis**

| Date | Amount | Comment |
|---|---|---|
| December 2007 | More than $1.4 billion | Based on the agreement with the gaming operators. |
| March 2008 | $1.2–$2.8 billion | Based on 2.5–5.4 per cent growth forecasts and existing tax regime. |
| April 2008 | $1.7 billion | No supporting information, part of modelling performed to assess the impact of a potential reduction in EGM numbers. |
| November 2008 | $504–$964 million | Based on 3.6 per cent growth forecast using 2007–08 actual and forecast data and progressive tax options. |
| December 2008 | $943 million | Rounded estimate based on 0 per cent growth. |
| March 2009 | $4.2 billion | Included $3.3 billion venue operator supernormal profits. |
| May 2009 | $943 million–$1.4 billion | The amount that the market could interpret as a signal of the value, based on the PACO formula. |

*Note:* VAGO has converted Department of Treasury and Finance figures into 2010 dollars.
*Source:* Victorian Auditor-General's Office.

### 2.6.2 The Department of Treasury and Finance's 2008 economic model

To estimate the value of the entitlements, DTF prepared a high level, whole-of-industry model during 2008 that formed the basis of advice to government in November 2008. This was DTF's most detailed analysis of the supernormal profits in the gaming industry. The range of $504 million to $964 million was produced because two tax rate options were being considered at the time. The higher amount of $964 million relates to the government's preferred tax option.

The model attempted to calculate the level of supernormal profits in the industry, as DTF considered that this represented the potential licence value for EGM entitlements post-2012. DTF's supernormal profits approach is similar to the net present value approach used in the audit's valuation in that:

- the purpose of both methods is to determine whether or not a project is worth doing financially
- both methods make assumptions about future revenue and costs
- both discount future net profit to its present value.

However, the two approaches differ in the assumptions adopted. DTF used some data from the existing gaming operator industry structure, and then adjusted these where possible to reflect the differences it expected would exist under the venue operator industry structure. Had DTF used the same assumptions as VAGO, which are set out in Appendix A, it would have arrived at the same values.

The similarity between DTF's figure of $964 million and the $980 million raised by the allocation is coincidental for four reasons:

- When responding to audit findings, DTF informed VAGO that it 'estimated that the EGM allocation would raise about $1 billion in premium revenue, and this proved to be correct'. However, this misrepresents the purpose of DTF's estimate. DTF was attempting to estimate the supernormal profits earned by gaming operators, and subsequently adjust that figure to establish the likely value of the entitlements to the industry under the venue operator structure. It was not attempting to forecast the amount of revenue the allocation was likely to raise.
- DTF's own advice acknowledges that the potential level of supernormal profit is just one consideration to factor into any forecast of sale revenue. The amount of revenue actually generated from the sale would be subject to a number of influencing factors, most particularly the level of competition at auction, given the government policy settings. At no stage did DTF attempt to quantify the effect of these factors, but did consider they would exert unspecified 'downwards pressures' on prices.
- At the time DTF produced its central November 2008 estimate, the details of the auction had not been finalised and PACO was not announced until June 2009. DTF's claim that its estimate was sound because it matched auction results is not valid.
- There were issues with the assumptions DTF used in its model. These are explored in more detail in the next section.

## 2.6.3 Assumptions used in the Department of Treasury and Finance's model

### Venue operator supernormal profits

DTF considers that the fair market value estimated by VAGO was unachievable within the regulatory and policy environment prescribed by government. This contradicts DTF's advice in March 2009. This advice indicated that the potential supernormal profits, which could materialise as sale revenue, could be up to $4.2 billion, which is similar to our valuation. As part of DTF's calculation, the department estimated the venue operator supernormal profits were $3.3 billion. The method and assumptions that support this figure of $3.3 billion were not documented in detail.

This $3.3 billion difference between DTF's advice in March 2009 with its November 2008 valuation was due to the department's failure to include the supernormal profits earned by venue operators in the earlier valuation. DTF did not attempt to calculate venue operators' supernormal profits before March 2009 because of significant gaps in its information. DTF decided it could not establish with any degree of confidence the level of local competition between venues, or their costs, which affects the amount of supernormal profits these venues earn. This information could have been reasonably estimated had industry consultation taken place.

DTF communicated this revised figure of $4.2 billion to the Treasurer in 2009, with the caveat that there was no guarantee the allocation process would achieve this amount of revenue, as to do so would require very high levels of competition.

VAGO's findings support this view: the allocation was not strongly competitive for a number of reasons detailed in Parts 3 and 4. This lack of competition resulted in a significant difference between the value and the revenue received from the allocation process.

DTF did not update its economic model with this revised figure, nor did it communicate it to the Gambling Licences Review steering committee. The steering committee was chaired by the DOJ and had representation from DTF, DPC and the Department of Planning and Community Development.

## Understatements and overstatements of value

In addition to the most significant understatement of value relating to the omission of the supernormal profits earned by venue operators, we identified issues with DTF's treatment of:

- **capital and operating expenditure**—DTF assumed venue operators would purchase rather than lease EGMs. Industry consultation carried out as part of the audit indicated that it was more likely venue operators would lease EGMs. DTF did not account for the remaining value of the assets—the physical gaming machines—at the end of the ten-year entitlement period. The department's model was originally based on a 12-year entitlement period. When this was reduced to ten, the capital costs were not adjusted accordingly. DTF assumed it was unlikely there would be a material level of cash inflows from the sale of machines at the end of the ten-year term. Instead, it assumed that the condition of the assets would be factored into the amount the venues would bid for the next licence. This is not a prudent assumption, as significant government policy changes may occur before the entitlements expire in 2022. The remaining asset value, and therefore also the value of the entitlements, were understated.
- **extended payment terms**—DTF did not reflect the benefit of extended payment terms over four years rather than full upfront payment for the entitlements from venue operators. The decision on this policy had not been made at the time the model was developed. Neither the model nor the financial advice to government was updated. This resulted in an understatement in value.

- **taxation**—DTF's model did not take income tax into account. This meant that the valuation of hotel entitlements—clubs do not pay income tax—was overstated. DTF agrees that the model would be 'enhanced' by taking into account income tax rates.
- **discount rates**—DTF's discount rate was too low to adequately reflect the range of costs of capital and attitudes towards risk within the venue operator industry structure. The use of a single rate did not take into account the broad range of industry participants. This meant that the discounting of future profit was not conservative enough, based on the level of risk and uncertainty in the industry, which resulted in an overstatement of value. It also did not reflect the extent of the variation among industry players.
  Although economic models do to some extent rely on simplified assumptions to reduce subjectivity by the valuer, it would have been more appropriate in this case to apply a spread of discount rates to an industry whose participants range from small, rural sporting clubs with a handful of EGMs, to publicly listed companies.
- **regulator supervision fee**—the model excluded the cost of the supervision fee charged by the Victorian Commission for Gambling Regulation. This meant that value was overstated.
- **monitoring costs**—the model understated the cost of the monitoring fee. This meant that value was overstated.

The shortcomings in DTF's analysis point to a lack of rigour in the process, which could have been mitigated by a more robust approach and a third-party specialist review.

Although DTF did test its modelling method and assumptions with the Gambling Licences Review project team, it did not seek advice from industry specialists external to government. The reasons given by DTF for this were the strict probity requirements and the commercially sensitive nature of the policy and financial information. DTF has not provided authoritative advice to support this position. Furthermore, these reasons are inconsistent with DTF's own view on the release of information. Both DTF and DPC raised concerns that not enough information on the allocation process was being released to the public by DOJ. This is explored further in Part 3.

## Recommendation

1. For issues that are significant and material, the Department of Treasury and Finance should apply a more rigorous approach and obtain specialist third-party assurance so that the advice provided to government to inform key decisions is robust.

# 3 The allocation process

## At a glance

### Background

A total of 8 712 electronic gaming machine entitlements were sold for $366 million in the pre-auction club offer. This left 18 788 available for venue operators to purchase in the auction: 13 750 for hotels and 5 038 for clubs. A total of 345 hotel and club venue operators took part in the auction, which raised $614 million.

### Conclusion

The revenue raised by the allocation was low compared to the fair market value of the entitlements. The chosen auction format was not subject to adequate review by suitably qualified third-party specialists to confirm it was the most appropriate sale mechanism. The auction proceeded despite advice to reconsider this approach. The auction failed to maximise revenue.

### Findings

- Venue operators were prepared to pay more for their entitlements.
- There was inadequate confirmation of advice and assumptions.
- Expectations of the demand for the auctioned entitlements were overly optimistic.
- The auction reserve was too low, given the low demand at the auction.
- Advice regarding the auction design led to unrealistic expectations of the auction duration.
- This in turn contributed to the auction ending prematurely, which meant that revenue was foregone.
- There were shortcomings in the information and training provided to prepare the industry for the allocation.

### Recommendations

The Department of Justice should:

- obtain appropriately tailored third-party assurance over the robustness of specialist advice, where this advice is critical to the success of a strategy or project
- develop processes to provide assurance that training participants have gained sufficient knowledge to fulfil the intentions of the training program.

## 3.1 Introduction

The purpose of the allocation was to achieve the policy objective of establishing 'a venue operator industry that meets the government's gambling guiding principles'. A number of different sale mechanisms could have been used to achieve this objective.

The government announced in 2008 that venue operators would have the opportunity to bid for ten-year electronic gaming machine (EGM) entitlements in an auction in 2010. In order to secure the passage of changes to the *Gambling Regulation Act 2003* through Parliament, an additional sale mechanism was created: the pre-auction club offer (PACO). The purpose of PACO was to provide certainty for existing clubs by giving them the opportunity to purchase entitlements for a fixed price in 2009, five months before the auction.

The auction and PACO raised $980 million from the sale of 27 300 of the available 27 500 EGM entitlements. The fair market value of the entitlements at the time of their sale has been estimated by VAGO to be in the range of $3.7 billion to $4.5 billion. While it is reasonable to expect some variation between the value of and the price paid for the entitlements, the magnitude of the discrepancy reflects adversely on the effectiveness of the sale process.

This Part examines the factors that influenced the auction results and the achievement of the project's intended outcomes. These outcomes covered a range of financial, social and stakeholder engagement considerations.

## 3.2 Conclusion

A number of factors contributed to the low revenue received at auction; the most important being the low demand for the entitlements. These factors were identified as risks before the auction, but actions to mitigate them were either not effective or not taken.

There was insufficient analysis of the different mechanisms that could have been used to allocate the entitlements and inadequate testing of advice to confirm assumptions were robust and that the process would deliver the best outcome for the state.

The Department of Premier and Cabinet (DPC) and the Department of Treasury and Finance (DTF) provided sound advice about the importance of competition for an auction to be successful. DTF advised government that competition at auction was likely to be reduced as a result of PACO and that there was a strong financial case in favour of reconsidering whether the auction should still proceed. No review was undertaken.

DPC and DTF also recommended reducing the regulatory burden and associated costs of the planning and premises approvals process for venue operators, as they considered these to be barriers to entry. The departments advised that reducing these barriers would encourage more industry participants and, therefore, bidders at auction. This advice was not accepted as government considered the approvals process a critical part of its social policy framework.

DPC recognised the link between providing good quality information to the market and potentially higher auction revenue. However, information on the auction process was limited, primarily due to overly restrictive probity considerations. More information could have been released to better inform bidders without breaching the probity requirements.

The basis of the reserve price was not robust. The low reserve, combined with the low demand at auction, meant that entitlements were, on the whole, sold for prices that were unrepresentative of the return that could be generated by venue operators over the ten-year life of the entitlements.

The auction specialist recommended a uniform price format on the basis that it would ‘arrive at the bidder’s maximum willingness to pay sooner and so the auction will conclude quicker […] there are no expected revenue differences between the uniform price auction and the ‘pay your bid’ auction’. The Department of Justice (DOJ) acquiesced in relation to this advice and did not seek a third-party review to confirm that the uniform price format was the most appropriate.

This uncorroborated advice led to unrealistic expectations of the duration of the auction. As a consequence, the auction was ended prematurely, before all bidding activity had stopped. More revenue would have been raised if the auction had been designed to end after it was apparent that all bidding activity had ceased.

As a consequence of all these factors, the auction did not, therefore, meet the Gambling Licences Review (GLR) project team’s definition of a successful competitive bidding process, ‘that is, one that maximises financial value within the government’s determined policy constraints’.

## 3.3 Insufficient competition at the auction

The relatively low revenue received at auction was primarily due to a lack of demand. Generally, the higher demand is relative to supply, the higher the overall auction revenue. This is due to competition among bidders, who increase the value of their bids until they are either successful or reach the maximum amount they are prepared to pay.

The low level of competition at the auction was driven by four key factors:

- The high regulatory and financial barriers to enter the gaming industry deterred new participants.
- The regulatory framework reduced existing venue operators' willingness to significantly change their number of EGMs, which reduced both demand and competition in the auction. This framework is part of social policy, intended to minimise the harm caused by problem gambling.
- Of the 247 existing club operators, 38 per cent bought entitlements at PACO but did not register for the auction. PACO effectively removed 95 potential bidders from the auction.
- There was spare capacity in the number of entitlements available.

The potential impact of some of these factors was known, such as the likelihood that high barriers to entry would reduce the number of bidders in the auction and that a reduction in the number of entitlements sold may affect longer term taxation revenue. These factors were reflected in departments' advice to the government at the time. However, more could have been done to confirm and quantify the impact that demand and supply would have on the intended outcomes of the allocation.

## 3.3.1 Analysis and advice

An interdepartmental steering committee was created to provide advice to government on the GLR. The project team in DOJ was responsible for managing the allocation process and was accountable to the interdepartmental steering committee. The three main departments represented on this committee were DOJ, DPC and DTF. These departments also briefed their ministers separately, outside of the steering committee framework.

### Demand

An economist advised the GLR project team in 2007 that there were two primary drivers of competition at the auction: new venue operators entering the market and existing venue operators increasing the number of EGMs they had. The GLR project team, DPC and DTF agreed with this advice.

The economist was not, however, asked to quantify the level of demand for entitlements in the industry. No robust analysis of the level of demand for EGM entitlements was, therefore, carried out before the decision to auction the entitlements was made.

In November 2008, during the early stages of the auction system development, the auction specialist/software provider recommended that DOJ survey the industry to estimate the level of demand. Although probity clearance was granted in February 2009, the GLR project team decided in June 2009 not to conduct the survey. The reasons for this were:

- the elapsed time
- the introduction of PACO
- the estimated $70 000 cost
- the four weeks the survey was expected to take.

This was not a prudent decision as it had, meanwhile, become apparent that the strategies to increase competition at the auction had largely failed.

In January 2010 the auction specialist/software provider expressed concern at the low number of bidders who registered for the auction. There were fewer bidders than anticipated because there were fewer new entrants, and club operators had already purchased entitlements through PACO.

Both of these factors meant that demand at the auction would inevitably be lower than originally expected, which would have an adverse impact on the financial outcomes of the auction. Although the GLR project team was aware of this, it did not reassess its position on whether an auction was still justified.

## Supply

The government publicly announced in April 2008 that all 27 500 EGM entitlements would be made available in the allocation: 13 750 for clubs and 13 750 for hotels. The number and location of entitlements are controlled by a regulatory framework that is intended to minimise the harm caused by problem gambling.

Reducing the number of entitlements for sale was expected to increase the price paid per entitlement. DOJ, DPC and DTF all noted in their advice to government that such a decision would, however, have other consequences for overall revenue in terms of future taxation receipts. The long-term impact on revenue would need to be factored into any decision on the number of entitlements to be offered at auction.

In April 2008 DTF attempted to quantify the impact on future taxation revenue of a potential reduction in the number of entitlements. It was estimated that a reduction of 10 per cent (2 750) would reduce taxation revenue by a lesser figure, between 3.8 per cent and 8 per cent. DTF noted that revenue had actually increased over time in South Australia, where one entitlement is cancelled from every four traded. DTF advised this indicated that ‘reducing the number of machines allows for some substitution of gambling behaviour and has limited overall impact’.

A June 2008 GLR steering committee paper noted that ‘not allocating all entitlements may reduce social costs of gaming machines’. This is consistent with one of the government’s gambling guiding principles, which is to reduce the harm caused by problem gambling.

The government decided not to reduce the number of entitlements, and consequently all 27 500 were made available for purchase, of which 27 300 were sold.

## 3.3.2 Factors that reduced competition at the auction

The project was intended to deliver a competitive and transparent allocation of EGM entitlements. The level of competition was significantly lower than expected for the reasons outlined below.

### Barriers to entry reduced the number of bidders

One of the reasons why the gaming industry earns supernormal profits is because its high regulatory and financial barriers to entry deter potential new operators. A venue operator who wishes to establish a new gaming venue must obtain the appropriate liquor licence, planning permits from the local council and premises approval from the Victorian Commission for Gambling Regulation (VCGR). These approval processes are administered separately and are subject to separate appeal processes at the Victorian Civil and Administrative Tribunal (VCAT). Proposals to reduce these barriers were, for the most part, not accepted by the government for social policy reasons.

As a consequence, the number of potential bidders was limited primarily to existing operators. Of the 345 venue operators who participated in the auction only 47 were new entrants. Although no targets were set for the number of new entrants, the number of bidders who registered for training was 35 per cent lower than the numbers DOJ provided to government and quoted in the contract with the training service provider.

Those new entrants who did participate were disproportionately represented among venue operators that were unsuccessful in obtaining entitlements. Of the 25 venue operators who did not succeed in buying any entitlements, 15, or 60 per cent, had only held a venue operator licence since July 2009 or later.

The barriers to entry had been identified as a risk to the success of the auction early in the project. The GLR project team, DPC and DTF appropriately advised the government that, for the auction to be successful, it was necessary to increase competition by encouraging new parties to enter the gaming industry.

The economist engaged by the GLR project team in 2007 observed that the main hurdle to increasing competition was obtaining approval from VCGR to open a new venue or increase the number of EGMs. Consistent with legislation, VCGR is properly required to assess the social and economic impact of these applications before approving or rejecting them. The process is costly and there is no guarantee an application will succeed.

DTF advised the government in March 2009 that reforming the approvals process to attract new market entrants was essential if the project was to meet its desired outcomes of capturing supernormal profits through the auction and increasing industry participation and consumer choice. DTF also said the allocation would result in an 'adverse outcome' for the state if there was low competitive tension in the auction, if existing operators paid minimal prices and if a limited number of new entrants participated. This 'adverse outcome' would be lower auction revenue, and, in the longer term, lower taxation revenue.

Although the length of time taken to approve or reject applications for venue operator licences and premises approval was reduced, no substantive reforms were passed. The amount of revenue generated by the auction confirms that the advice highlighting the importance of encouraging new entrants was sound.

## Existing operators did not increase their number of electronic gaming machines

In addition to the barriers to entry, the regulatory framework for gaming also had a significant impact on the auction. Because of limitations such as regional caps, there was very little movement of EGMs between locations. This should, however, have been foreseeable, as there was just 2 per cent change in the location of EGMs between 2000 and 2007.

In this regard, the allocation failed to achieve one of its intended outcomes, which was to 'ensure the financial benefits of gaming are transparent, recognisable and fairly distributed to the community'. The GLR project team measured this outcome in terms of the spread and volume of EGM entitlement holders.

Of the venue operators who had EGMs at the time of the auction, 61 per cent bought the same number of entitlements as the number of EGMs they had in their premises immediately prior to the auction, while 73 per cent bought within 10 per cent of their existing number. There was, therefore, little change in the demand for and location of EGMs.

## The pre-auction club offer reduced the number of bidders at auction

There were 247 club operators eligible to buy EGM entitlements through PACO, and 248 were eligible for the auction. Of these, 236 club operators purchased entitlements at PACO, while only 149 took part in the auction.

The total number of entitlements available for clubs to purchase was 13 750. Two-thirds, or 9 288 entitlements, were offered at PACO during October and November 2009. The number of entitlements offered to each club was limited to the number of EGMs on their venue operator's licence as at 4 June 2009, up to a maximum of 40 entitlements.

The price paid was calculated by:

- taking the total annual gaming revenue for the club in 2008–09
- dividing this figure by the weighted average number of EGMs permitted in the venue over the year
- dividing this new figure by one-third, which represented the share of gaming revenue per EGM that was retained by clubs.

Then, for:

- each of the first 20 entitlements purchased, multiplying the revenue figure by 180 per cent
- each of the second 20 entitlements offered, multiplying the revenue figure by 200 per cent.

PACO met some of the demand for entitlements before the auction. As a consequence, this reduced both the demand and the supply of entitlements at the auction, as well as the number of bidders. Since 8 712 of the available 13 750 entitlements were purchased at PACO, this left 5 038 entitlements for sale at the auction. Of the 4 838 entitlements that were sold at auction, 72 per cent sold for the reserve price of $5 500. The average price clubs paid at auction was a third of the price paid at PACO.

A total of 100 respondents were interviewed in a survey commissioned as part of our audit. These respondents were selected at random from a list of 526 club and hotel venue operators. The survey found that the number one reason why club respondents did not participate in the auction was because they had already purchased the number of entitlements they wanted at PACO.

DPC and DTF strongly advised against PACO on the grounds that:

- allowing existing, underperforming clubs to buy entitlements would entrench industry inefficiencies and adversely affect the long-term sustainability of the industry
- there was a lack of clear policy logic in how the pricing formula was determined
- the pricing formula did not reflect the likely ten-year return and would most likely result in entitlements being allocated cheaply
- PACO would reduce competition at auction because venue operators would buy their entitlements in the fixed-price offer instead of participating in the auction
- PACO disadvantaged hotels and new club entrants because they were ineligible for the offer
- PACO favoured high-income clubs because they would be pre-allocated entitlements at a price that was predicted to be lower than the prices at auction. The departments believed these clubs had the resources available to bid aggressively at a competitive auction.

DTF recommended to government that, if clubs were allocated entitlements outside the auction process, the decision to auction the remaining entitlements should be reconsidered because this was likely to adversely affect the ability of the allocation to capture supernormal profits. No review was undertaken.

The absence of formal decision review points is one of the major failings in the management of the project.

### Spare capacity in the supply of entitlements reduced competitive tension

Supply was also a factor that influenced the results of the allocation. If measures to increase demand are not successful, restricting supply can increase competition in an auction.

The possibility that there was excess supply of entitlements was identified as early as 2007 by DTF. The department noted that 'a small number of machines […] are not allocated to venues, suggesting supply may be greater than demand, thus there may be a lack of 'scarcity' in the allocative process, which would be a detriment to the capture of competitive pressures'.

The GLR project team gave similar advice to government, based on a consultant's report. The consultant advised in May 2009 that supply exceeded demand in the club sector. Although it was likely that all 13 750 club EGM entitlements would be sold, the total revenue raised would be lower than if supply was scarce.

This advice proved to be accurate. Bidders did not have to compete aggressively against each other for the entitlements, thereby reducing the amount of revenue that could have been achieved by the auction.

## 3.4 Low reserve

The reserve in the auction of EGM entitlements was not based on a robust rationale and was not representative of the return that could be expected from the ten-year period of the entitlements.

An auction does not necessarily require a reserve price if the seller anticipates there will be enough competition to drive prices up to an acceptable level. If the number of bidders is low or difficult to estimate, a reserve introduces competition by allowing the seller to set the minimum price it will accept for the items it is auctioning. In an auction where there are few bidders relative to the number of items available for purchase, prices will not rise significantly above the reserve.

The level of demand at an auction can be analysed by dividing the number of items bid on in a round by the number of items offered for sale to calculate the activity ratio. For an auction to achieve higher prices than the reserve, the industry benchmark activity ratio is 1.5:1. This means that for every item sold, there is enough demand amongst bidders to sell another 0.5 items, or 50 per cent more. For the first round of the EGM entitlements auction, this ratio was a very low 1.04:1. It is, therefore, unsurprising that 72 per cent of the club entitlements sold at auction were sold at the reserve price.

The amount of the reserve was, therefore, critical in influencing the financial result of this particular auction. The basis of the reserve was not, however, reviewed by an appropriately qualified third-party specialist who was independent of the GLR project team and the auction specialist/software provider.

Although the steering committee advised that there was ‘limited economic rationale for having reserve prices’, a reserve was set as a precaution to mitigate possible negative perceptions that could arise if entitlements were sold at very low prices.

An auction with a reserve below, but close to the estimated value of the entitlements could have better mitigated the risk of low prices. The downside of this approach would have been that the higher reserves may have reduced demand in some markets, leaving some entitlements unsold after the auction. These could have been sold subsequently through the online transfer scheme administered by VCGR.

It does not necessarily follow, as DOJ has asserted, that overall revenue would have been significantly lower if a higher reserve had been set, which could have resulted in some entitlements not being sold. The South Australian experience, where the government has progressively withdrawn licences from the industry, has resulted in a comparatively ‘limited’ decline in tax revenue. In Victoria, entitlements sold at higher prices, due to higher reserve prices, may have compensated for any revenue foregone from unsold entitlements, in both the auction and future taxes.

DOJ did not, however, attempt to perform such robust modelling to inform its advice on setting the reserve. The entitlements were sold at very low prices relative to their value and to the prices paid by clubs at PACO.

## 3.4.1 Basis for the reserve

The auction theory specialist/software provider recommended that the reserve price be set slightly lower than the PACO price. DPC and DTF believed the PACO price was set below the market value of the entitlements. The impact of the reserve on the financial outcome of the auction was underestimated.

The reserve for the auction of EGM entitlements was set at $5 500 for clubs and $11 000 for hotels. This was $550 per year for clubs and $1 100 per year for hotels over the ten-year period of the entitlements. This is less than 1 per cent of the average revenue generated per club EGM and per hotel EGM in 2008–09.

The club entitlement reserve was based on the lowest price paid by a club operator at PACO ($5 743), rounded to the nearest $500. This was not a rigorous basis for setting the reserve, because it was based on the least profitable gaming venue in the state. Shortly after the auction, this venue closed.

The second lowest PACO price was $9 165, which was 60 per cent higher than the lowest price. A total of 90 per cent of clubs were offered entitlements for prices greater than $22 633 at PACO. The average price paid at PACO was $42 014, or more than seven times the lowest PACO price. The club sector evidently deemed the PACO prices were acceptable, as 96 per cent bought the entitlements for the offered price.

This analysis demonstrates that the lowest price paid at PACO is clearly an 'outlier' when compared to the range of PACO values. There is no evidence that this was specifically communicated in advice that led to the setting of an appropriate reserve price.

The hotel entitlement reserve was set at double the club reserve. This was because VCGR data shows that the hotel industry earns twice as much as clubs from EGMs.

### Other options considered

Another option considered was to set a club and hotel reserve price for each area, based on previous earnings from gaming. This would have been technically feasible. However, the GLR project team was concerned that this would encourage bidders to buy entitlements in areas where prices were lower, and subsequently attempt to move entitlements to higher priced areas.

The GLR project team engaged a consultant in May 2009 to provide advice on the likely level of demand, and an appropriate reserve. The second requirement was later dropped as the auction specialist/software provider recommended that the scope of this other consultant's work be restricted so that there was no risk of conflicting advice. The GLR project team did not ask its Technical Reference Group to review the reserve prices, even though the members had the appropriate expertise. These were two missed opportunities to confirm that the reserve was appropriate.

## 3.5 Information and training

The allocation process was intended to achieve a number of outcomes regarding stakeholder engagement:

'An informed and confident community and industry, that will:

- enable industry engagement by managing expectations of stakeholders to prepare them for the behavioural and industry changes as they occur throughout the implementation and transition process
- ensure venue operators, their consumers and the community understand the implications and benefits of the new industry structure
- allow venue operators the opportunity to take part in the post-2012 gaming industry
- ensure consistent messages across the industry, media and community about the new gaming industry structure to facilitate a smooth transition
- ensure venue operators understand the requirements to enter the allocation process, are prepared for the bidding and able to participate on the day.'

The project only partly achieved these intended outcomes.

This is significant because there is a clear link between providing bidders with good quality information and achieving auction results that reflect the market valuation. Research by international auction theory specialists has consistently demonstrated that ‘information provided by the auctioneer decreases uncertainty, which […] increases the seller’s revenues. These positive effects of public information disclosure are stronger the more precise the information’.[1]

## 3.5.1 Industry communication

The GLR project team developed an information, training and bidder support strategy to prepare the industry for PACO and the auction. The GLR project team did not, however, quality assure its training to verify that participants had an adequate understanding of the auction rules and process.

The communication with industry was strongly influenced by concerns that the probity of the process would be compromised if any participants were unfairly advantaged or disadvantaged. Although well-intentioned, these probity requirements were unnecessarily restrictive.

The GLR project team acknowledged in its lessons learned report that there were deficiencies in its process of quality assuring documents, including those that were provided to the industry. Better quality review processes and a more balanced application of probity may have reduced the number of issues with information and training. The information and training provided was not clear, sufficient, reliable or timely.

### Impact of probity

The probity auditor recommended that the GLR project team restrict communication with the gaming industry to public submissions in order to avoid any possibility or perception of unfair advantage. As a consequence, meetings with peak bodies, who could have supported their members through the change process, were stopped. The Independent Review Panel, which is charged with reporting to Parliament on the adequacy of the probity arrangements in the GLR licensing processes, advised the audit that these meetings could have been recorded and transcripts publicly released to mitigate any probity issues. The audit findings support this view.

DPC was concerned that the project’s application of probity was overzealous and prevented questions from the industry being appropriately answered. DPC advised that webcasting the statewide information sessions or providing transcripts from them would overcome probity issues.

[1] Goeree, J. K. and Offerman, T. (2003), *Competitive Bidding in Auctions with Private and Common Values. The Economic Journal*, 113: 598–613. doi: 10.1111/1468-0297.t01-1-00142

This approach was not adopted. Any questions from people who attended the statewide information sessions and bidder training that could not be answered using publicly available information were noted by the GLR project team, consolidated and generic responses posted on the website.

The chosen approach meant that individual circumstances could not be addressed specifically, even if this information was released publicly. The generic nature of the responses meant that bidders may not have been able to identify questions they had asked. It also increased the risk that the bidders' questions would be interpreted in a different way from that intended. Bidders were still unclear in many cases, as was demonstrated by the repetition of similar questions on the website.

## Information

Both DPC and DTF briefed the government on the link between adequate information and the financial outcomes of the auction:

- DTF raised concerns in January 2009 about the GLR project team's failure to release venue revenue data. DTF was concerned that the viability of the auction would be compromised as it was 'largely dependent on an informed market'.
- DPC advised in May 2009 that the EGM entitlements would have a greater value 'if the fundamental aspects of the scheme that creates and regulates them [were] known and certain', such as the details of the bidding process and subsequent transfer mechanism.
- On 13 May 2009, the government approved the auction as the allocation method, and also the broad features of the auction. DPC was concerned that this information was not communicated publicly in a comprehensive manner.

In June 2009 the Premier wrote to the Minister for Gaming requesting comprehensive information be released to address a major concern relating to the lack of information disseminated to industry stakeholders.

More information became available to the industry in July 2009, when the statewide information sessions were held. DPC remained concerned that all relevant information on the auction was not released to the market prior to these sessions to address industry uncertainty.

As well as the lack of comprehensive information, information that remained outstanding at the time of the auction also had the potential to adversely affect how much venue operators were prepared to pay. DOJ noted in June 2009 that the monitoring licence was supposed to be awarded before the auction to 'provide certainty of arrangements and costs to potential bidders'. As at June 2011, the monitoring licence has not been awarded.

## Training

One of the major challenges faced by the GLR project team was how to explain the auction in simple, easy to understand terms. The difficulty of this task was compounded by the complexity of the chosen auction format, and the associated rules and processes.

It was, therefore, essential to obtain assurance that the training had adequately prepared bidders for the auction. However, the GLR project team advised that it did not implement its plan to survey bidders to confirm that the training sessions were meeting attendees' needs for probity reasons.

No persuasive documentation has been provided to VAGO by DOJ to support its decision not to conduct the survey. Any probity issues that may have arisen could have been addressed once responses had been received. The demonstrated link between an informed market and auction revenue should have been a compelling reason to confirm bidders' understanding of the auction rules and mechanics.

A number of key auction concepts and rules were not transparent. Even the auction specialist/software provider commented that the training manual contained poor wording of the auction rules. If bidder representatives were unclear how auction rules worked, they were less likely to understand the full impact of the orders they submitted. A lack of understanding was more common for clubs than hotels.

Only 50 club operators increased their bid above the reserve. Of these 50, several experienced unintended consequences such as:

- a club operator entered bids for double the number of entitlements it wanted to buy. It had to apply to the auctioneer to withdraw from one of the markets it had bid in
- a club operator did not understand why the hotel market price in its area was increasing, and ended up bidding against itself
- a club operator breached the permitted limit of 420 entitlements.

Furthermore, a club operator bid in a hotel market in stage one. The auction system configuration should not have permitted this bid to be placed.

Technological features of the auction could have been made more user-friendly so that all participants were equally able to navigate the system. Improvements could have included clearer indicators of the status of bids, and warning messages to help bidders understand the impact of their inputs. Bidder representatives with limited technological knowledge and experience would have been particularly disadvantaged and may not have purchased the number of entitlements they wanted.

The training manuals and classroom-based bidder training sessions had a number of deficiencies:

- **There were gaps in the information**—the auction rules did not explain how the system would determine partial allocations, which occurred when participants' bids were equal to the market price. In such a 'tie-breaking' situation participants whose bids were equal in terms of price and quantity were not all allocated the same number of entitlements. This situation occurred during the auction. One bidder would receive its full complement of entitlements, while another only received a partial allocation.
- **Information was not clear**—the explanation about how the market price was calculated was unclear. The details of the highly technical mathematical algorithm were not released to bidder representatives. On the day of the auction, bidders were confused about how the price and quantity of entitlements in other markets affected the price within their market. There were 31 bidder queries recorded on the auction day relating to market prices.
- **The rules regarding competition were not transparent**—it was unclear who bidders would be competing against for entitlements. Bidders competing in more than one market could potentially bid against themselves and drive their own prices up. This issue was not adequately addressed in the documentation.
- **Information was inconsistent**—the probity auditor noted in its report that over 30 per cent of the auction rules announced in October 2009 were amended one month before the auction. This report also identified one change that was communicated to bidders just five days before stage one of the auction opened. This rule originally stated that the auction system would only accept bids that were <u>greater</u> than the opening bid price of $5 500 for clubs and $11 000 for hotels. The system had actually been configured to also accept bids that were <u>equal</u> to the opening bid price.
- **Information was out of date**—the training DVD that explained how to bid for entitlements did not indicate how many of the maximum permitted 27 500 entitlements were still available after PACO. This was despite the fact that PACO closed on 23 November 2009 and the DVD was not released until January 2010.

These issues had the potential to create doubt about the reliability of the information and affect bidders' confidence in the auction system.

## Bidder support

As well as information packs, the website and training sessions, the GLR project team:

- had a telephone hotline to answer queries up to the auction day
- engaged coaches to help bidders on the auction day.

The telephone hotline primarily dealt with queries on training session dates and accessing stage one of the auction, which was run remotely over the internet.

On auction day, only those questions that could not be answered by coaches were escalated to one of the supervisor coaches who had received more training in the system. Since the record of advice provided to bidder representatives was incomplete it is impossible to confirm whether bidders received helpful and transparent advice on a timely basis.

It is also unclear whether consistent advice was provided to all bidders by the various coaches. Parity of information had been a priority earlier in the project, due to the emphasis on probity and equal treatment, but this was not applied during the auction itself. Heavy reliance was placed on the quality of the training the coaches received to enable them to provide accurate information. This training was broadly similar to the training provided to bidders, which had several shortcomings that were not identified or remedied because the GLR project team did not quality assure its training.

## 3.6 Design and conduct of the auction

The allocation did not achieve the desired outcomes of the GLR to:

- **capture supernormal profits from the gaming industry**—the amount of revenue raised was a quarter of the fair market value of the entitlements.
- **provide process efficiency, minimising participation costs for both the bidders and the state**—it is possible that other types of sale mechanism could have achieved better outcomes—namely higher revenue and/or lower cost—than the chosen auction format. The GLR project team did not, however, properly evaluate other options, nor seek to confirm whether the chosen option was the most appropriate.
- **distribute the financial benefits of gaming fairly to the community**—the GLR project team measured this outcome in terms of the spread and volume of EGM entitlement holders. A comparison of the distribution of EGMs pre-auction with entitlements purchased at PACO and auction revealed there was not a significant degree of change in location.

Consequently, the auction did not provide value for money for taxpayers.

The following section discusses in more detail:

- the range of allocation options considered
- the advice on the auction options
- the factors in the auction design and conduct that influenced the amount of revenue raised.

### 3.6.1 Allocation options

There were two main issues with the process of selecting the mechanism to allocate the entitlements:

- There was inadequate analysis of other options besides an auction.
- The type of auction chosen was not subjected to sufficient third-party specialist review.

These factors meant that decision-makers were not fully informed about which option was most suitable in terms of maximising revenue within the regulatory constraints.

#### Options analysis of the allocation mechanism

The main drivers behind the GLR project team's recommendation to run an auction were:

- a fixed position that a market-driven approach was the most appropriate
- uncertainty over the value of the entitlements
- overly optimistic assumptions of demand for the entitlements.

The GLR project team's options analysis was guided by the steering committee's preference for a competitive allocation. The steering committee was chaired by the Secretary of DOJ and had representation from DPC, DTF and the Department of Planning and Community Development. The preference for a competitive allocation was expressed as early as the first steering committee meeting in February 2006. As a consequence, the GLR project team engaged an economist in 2007 to advise on the best type of auction to use, even though the decision on the preferred gaming industry structure—the venue operator model—was not made until 2008.

The terms of reference for this consultant were unnecessarily narrow, given the early stage of the project. The consultant was to provide advice on the type of auction that was most likely to achieve the desired outcome of distributing the benefits of gaming efficiently and fairly to the Victorian community. The consultant was not, however, asked to consider any other intended outcomes for the allocation, such as minimising participation costs for the state and participants. DOJ did not seek advice on the appropriateness of any other potential allocation mechanisms, such as a fixed price offer.

In September 2007, based on the preliminary findings of the economist, the GLR project team advised the steering committee that an auction would be suitable for the allocation of gaming machine entitlements because:

- there was considerable uncertainty regarding the value of entitlements
- it was thought that there would be many bidders for the entitlements
- it was believed there was strong demand for the entitlements
- it could accommodate non-financial objectives, such as minimising the harm caused by problem gambling, which was embodied in the regulatory framework.

Two of the reasons provided for proceeding to auction, namely the number of expected bidders and the likely level of demand for entitlements, did not eventuate.

### 3.6.2 Auction options

In a well-designed auction where revenue maximisation is a desired outcome, the higher the demand is relative to supply, the higher the overall revenue. A well-designed auction is one where participants bid aggressively and close to the maximum amount they are prepared to bid. This equates to their ‘willingness to pay’.

The most familiar type of auction is an ascending price English auction. Many houses are sold in this way. A sealed bid format is also widely recognised, and often used when tendering for government contracts. Some of the different types of auctions are outlined in Figure 3A.

**Figure 3A**
**Auction options analysis**

| Auction type | Definition |
|---|---|
| Ascending price English auction | Participants compete against one another until the highest bidder is left. The winner pays the price they bid. This type of auction can be used to sell a single item and modified versions can be used to sell multiple items. |
| First-price sealed bid auction | All bidders simultaneously submit a single, sealed bid. Participants do not know how much others bid. The winner is the highest bidder, who pays the price they bid. This type of auction can also be adapted to sell groups of multiple items. |
| Simultaneous combinatorial ascending auction | Participants simultaneously compete against one another for a group of several items until the highest bidder is left. The winner pays the price they bid. This type of auction can be adapted to sell groups of multiple items. |
| Ascending uniform price auction | A type of ascending price auction, where all lots attract the same price, typically either the lowest winning bid or the highest losing bid. This is to be contrasted with discriminatory price, or ‘pay your bid’, auctions, where different buyers pay different prices, typically the amount they bid. Bids are ranked according to price and items are allocated until supply is exhausted. |

*Source:* Victorian Auditor-General’s Office.

The GLR project team’s economist recommended a sealed bid auction for the venue operator model in 2007. This was because:

- a sealed bid auction had advantages over open auctions, such as being able to mitigate the market power of larger bidders
- other types of auctions can be highly complex and require bidder training, which may deter bidders.

The GLR project team engaged an auction specialist in May 2008 to do a feasibility study to assess whether it would be possible to run a successful competitive bidding process for the EGM entitlements. This engagement started after the announcement that the entitlements would be sold through an auction.

The auction specialist recommended a two-stage process of a sealed bid phase followed by an ascending price phase. After being awarded the contract to provide software to run the auction, the auction specialist recommended a uniform price rule be used. The specialist advised that this was because ‘the process will arrive at the bidder’s maximum willingness to pay sooner and so the auction will conclude quicker […] there are no expected revenue differences between the uniform price auction and the ‘pay your bid’ auction’.

The GLR project team did not have the skills in-house to verify this advice. The Technical Reference Group engaged by the GLR project team had the appropriate expertise but was asked to consider only whether the uniform price auction would satisfy the requirements. Inexplicably, the Technical Reference Group’s terms of reference specifically excluded it from considering whether the proposed design was the most appropriate type of auction to run.

There was, therefore, no third-party validation that the particular uniform price auction chosen was the most appropriate type of auction for the EGM entitlements. The basis for the recommendation, namely that the chosen auction format would achieve the same amount of revenue as another type of auction in a shorter period, was not tested. This led to the GLR having unrealistic assumptions about the duration of the auction, which in turn had an adverse effect on the amount of revenue raised.

It is not possible to opine on whether another sale mechanism would have raised more revenue because of the number of variables involved, such as the industry's level of confidence in and understanding of the process, which was likely to influence the number of bidders. However, the auction did not meet the GLR project team's definition of a successful competitive bidding process ‘that is, one that maximises financial value within government’s determined policy constraints’.

### 3.6.3 Auction revenue

More revenue could have been raised from the allocation.

This assessment is based on:

- **VAGO’s fair market valuation**—this estimated that the entitlements were worth between $3.7 billion and $4.5 billion.
- **VAGO’s survey of venue operators**—the survey revealed that 61 per cent of respondents had expected to pay more at auction. This response was even higher among the club operators that participated in both PACO and the auction, with 73 per cent stating the prices at auction were lower than they expected.

- **the PACO results**—these indicated that metropolitan clubs were prepared to pay on average $41 796 to secure an entitlement at PACO yet only had to pay $9 544 at auction. Even though PACO prices were considerably higher than those obtained at auction, DTF, DPC and DOJ all advised that PACO prices did not reflect the market value of the entitlements.
- **bidders' willingness to pay**—the auction results demonstrate that bidders valued the entitlements at $855 million, which was $241 million more than they actually paid. This is a conservative figure for reasons that are explained later in this Part.
- **the auction was stopped too early**—bidding had not ceased when the auction was stopped.

The amount of revenue raised by the auction was adversely affected by external factors, such as the low number of new venue operators entering the gaming industry, and poorly informed choices, such as the reserve price. However, decisions made during the auction also influenced the outcome.

## Auction stages

The first stage of the auction was run over ten business days in April and May 2010. Bidders submitted their orders on their own computer via a secure internet site. Bidders had to participate in stage one in order to be eligible for stage two. In the second stage, operators submitted orders on state-supplied computers at a Melbourne venue on 10 May 2010.

Not all of the 345 venue operators that placed a bid in stage one participated in stage two. A total of 680 bidders representing 332 venue operators took part in the second stage of the auction, which started at 10am and finished just before 8pm, ten hours later. The coaches logged 31 complaints from bidders frustrated with the duration of the auction. They also logged 84 requests from participants seeking permission to make telephone calls to change travel plans and childcare arrangements.

The GLR project team had been led to believe, based on the auction specialist/software provider's advice, that the auction would end sooner than it did. This was evidenced by the lack of adequate evening catering arrangements and comments made by the GLR project team.

## Mechanics of the auction

The auction system had to facilitate the simultaneous competition for entitlements on price and quantity, and by area and venue type. It had to process these bids in a way that would maximise the total revenue in accordance with the auction rules, and within the restrictions of the regulatory framework, such as the number of entitlements available in capped areas.

The state was divided into 176 ‘markets’, based on venue type and geography. There was a club market and a hotel market in each of 88 areas, which were based on local government areas, or parts thereof.

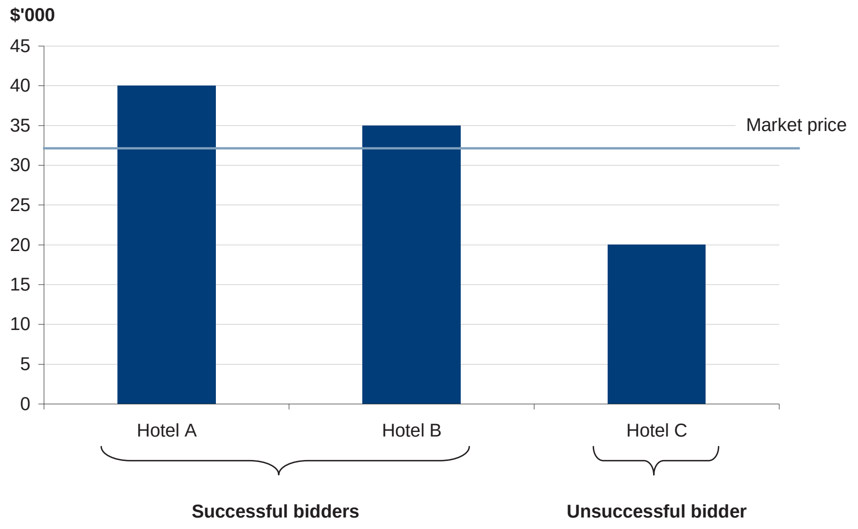
## Uniform pricing rules

The uniform pricing rules meant that the price participants paid for their entitlements was not necessarily the amount they bid. The amount that a participant bid was used only to determine whether or not they were successful in obtaining entitlements. At the end of each round, all of the bids were ranked according to the auction rules to determine who was successful.

All participants paid the market price, or the lowest accepted bid in that market. The market price was determined by a mathematical algorithm that took into account competition within the regulatory framework. Successful bidders in the same market paid the same price for the entitlements allocated to them in that market.

This is explained by way of example in Figure 3B, which shows the prices bid by three hotels. The hotels are first ranked in descending order of price bid. Hotels A and B are successful because the amount of their bid is higher than the computed market price. Hotel C is unsuccessful because it is lower. Hotels A and B both pay the market price for the entitlements.

**Figure 3B**
**Successful and unsuccessful bidders**




*Source:* Victorian Auditor-General’s Office.

## Bidding activity

Analysis of the bidding activity clearly demonstrates that the auction did not maximise potential revenue.

Since participants know that the price they bid for an item in a uniform price auction is not necessarily the price they will pay, the value of their bids can be a guide to how much they consider the items to be worth. The value of participants' bids is also known as their 'willingness to pay'.

Although the auctioneer cannot use the value of successful bids to extract more revenue in a uniform price auction, it can inform analysis of the auction results. This auction format contrasts with a typical ascending price English auction, where the winning bidder only needs to outbid the next highest bidder. The winning bidder's willingness to pay is therefore not revealed in an ascending price English auction.

The total value of the successful bids in the auction of EGM entitlements was $855 million. The amount of revenue actually raised by the auction was $614 million.

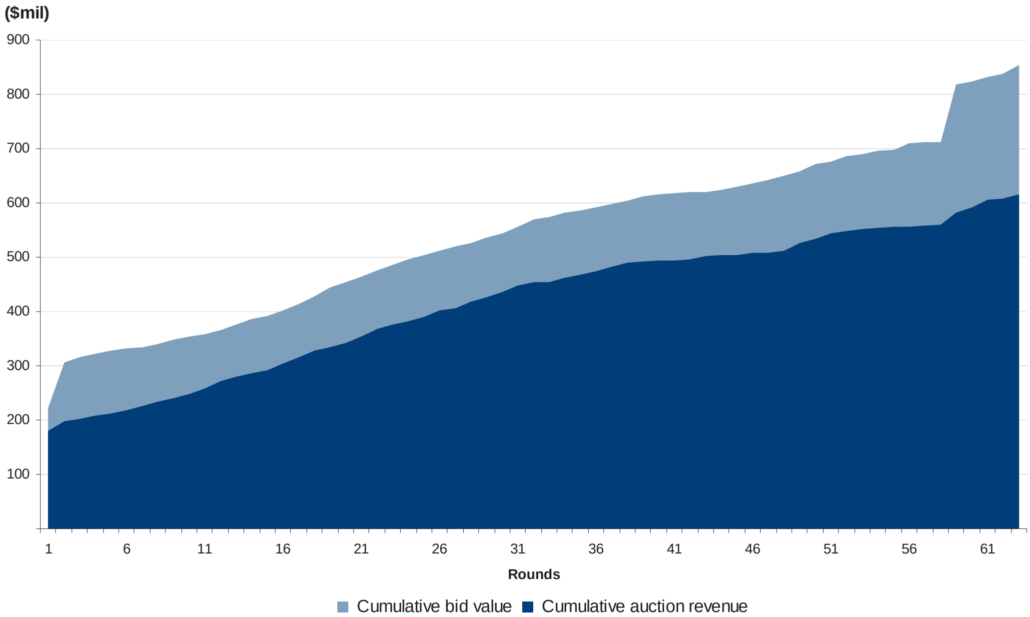
The figure of $855 million is a conservative estimate of the value bidders placed on the entitlements because:

- **the auction ended prematurely**—although the auction took longer than expected, revenue was still increasing in the later rounds.
- **low demand meant that the auction did not require bidders to reveal their true willingness to pay**—there was no need for bidders to increase the value of their bid if they were provisionally winning entitlements. This was due to the lack of competition in a number of markets, particularly those without regional caps.
- **the reserve was low**—the reserve was not representative of the return that could be expected from the ten-year period of the entitlements. Under the uniform price auction format, all bidders paid the lowest winning bid in that market. Of the club entitlements sold at auction, 72 per cent were sold at the reserve price. Those bidders who won an entitlement at the reserve had no need to increase their bids beyond the reserve.

It is not possible to calculate exactly how much revenue would have been raised if a different type of auction had been used. This is because venue operators would not have bid in the same way under different auction rules. What is clear, however, is that participants in the auction of EGM entitlements valued the entitlements at a minimum of $855 million, based on the value of their bids.

Figure 3C compares the auction revenue and the value of bids over the course of the auction rounds.

**Figure 3C**
**Cumulative bid value and auction revenue**




*Source:* Victorian Auditor-General's Office.

The graph shows an increase in revenue towards the end of the auction. This was the opposite of the circumstances described in the bidder information, which indicated that the auction was designed to close after bidding activity had declined. Over $108 million of the $614 million raised from the auction was generated after round 46, when the auctioneers amended the stopping rules to bring the auction to a close.

The stopping rules were part of the auction rules. The bidders' information pack explained that the stopping rules would be used at the auctioneers' discretion to end the auction, based on the level of bidding activity: 'when all bidders have presented their best offers, bidding activity will slow to a point where the results will not change from round to round'.

This definition was open to interpretation. Many other auctions are designed with a commonly accepted and easy to understand stopping rule: the auction will end once all bidding activity has ceased. This removes the auctioneers' discretion.

Bidding activity had not ceased in the auction of EGM entitlements. Figure 3D shows the revenue from the last five rounds of the auction.

**Figure 3D**
**Auction revenue**

| Round | Round revenue ($) | Cumulative revenue ($) |
|---|---|---|
| 59 | 21 371 586 | 580 066 729 |
| 60 | 10 786 014 | 590 852 743 |
| 61 | 14 935 852 | 605 788 595 |
| 62 | 1 910 118 | 607 698 713 |
| 63 | 6 367 858 | 614 066 571 |
| **Total** | **55 371 428** | **614 066 571** |

*Note:* Auction revenue figures have been adjusted to remove the 200 entitlements that breached the club ownership limit.
*Source:* Victorian Auditor-General's Office.

It is not possible to calculate how much more revenue could have been raised if the auction had been allowed to continue. However, more revenue would have been raised if the auction had only ended once all bidding activity had stopped. This is on the basis that:

- the average increase per round in the last five rounds of the auction was $11 million
- round 59, which was the fifth last round, raised more revenue than any other round during stage two of the auction
- the revenue generated in the last round was $4.5 million higher than the penultimate round
- the average revenue per round on auction day was $7 million. Of the last five rounds, three significantly exceeded this average and a fourth was just below.

This analysis indicates that bidders had not put in their 'best offer' bid, that is, the maximum amount they were willing to pay for entitlements. Bidder comments recorded by the GLR project team after the auction closed confirm this.

## Recommendations

2. The Department of Justice should obtain appropriately tailored third-party assurance over the robustness of specialist advice where this advice is critical to the success of a strategy or project.

3. The Department of Justice should develop processes to provide assurance that training participants have gained sufficient knowledge to fulfil the intentions of the training program.

# 4 Project management and oversight

## At a glance

### Background

An interdepartmental steering committee was established to provide advice to government and the Minister for Gaming, and to oversee the implementation of the Gambling Licences Review (GLR). A project team was created within the Department of Justice to manage the implementation.

### Conclusion

The pre-auction club offer and auction were conducted within tight time lines. However, there was a lack of due process and current indications are that the intended financial, social and stakeholder engagement outcomes have not been fully achieved. Inadequate decision review points were built into the management of the project to consider the potential impact of new information on these intended outcomes.

### Findings

- Differences in interdepartmental advice were not communicated and resolved.
- The engagement of consultants was neither transparent nor competitive.
- The roles and responsibilities of consultants were not appropriately delineated, defined and designed to provide sufficient oversight and avoid conflict of interest.
- There was a lack of timely assurance that probity requirements were met.
- There was insufficient cost reporting on the electronic gaming machine component of the GLR.
- Better practice knowledge management processes were not followed.

### Recommendations

The Department of Justice should:

- build effective decision review points into projects
- develop protocols on the communication of advice provided outside of the steering committee so all parties are informed of their respective positions
- improve procurement and contract management so that consultants' advice is demonstrably value for money, objective, and appropriately validated
- manage probity in a more balanced and businesslike manner
- improve cost reporting and knowledge management processes.

## 4.1 Introduction

The primary objective of the Gambling Licences Review (GLR) was to establish 'a venue operator industry that meets the government's gambling guiding principles'. The gambling guiding principles cover a range of financial, social and stakeholder engagement aspects. These are largely reflected in the financial, social and stakeholder engagement outcomes the project was intended to deliver.

The achievement of these outcomes and the implementation of GLR was the responsibility of:

- **the steering committee**—the interdepartmental steering committee provided advice to government and the Minister for Gaming, and exercised oversight and control over the project. It was chaired by the Secretary of the Department of Justice (DOJ) and had representation from the Department of Premier and Cabinet (DPC), Department of Treasury and Finance (DTF) and the Department of Planning and Community Development.
- **the GLR project team**—the steering committee created a project team in DOJ to implement the gambling industry reforms in line with government's policy objectives. This included managing the allocation of the monitoring, lotteries, Keno and wagering licences, as well as the sale of electronic gaming machine (EGM) entitlements.

Probity was flagged as a high priority from the outset of the GLR in 2004, with the intention of eliminating any potential for claims of unfair treatment. A probity auditor was engaged to advise the project team and an Independent Review Panel (IRP) was established in 2007 under an amendment to the *Gambling Regulation Act 2003*. The purpose of both roles was to provide third-party assurance on the probity of the project. The IRP's reports are tabled in Parliament.

This Part assesses the effectiveness and efficiency of the steering committee, project team and probity arrangements.

## 4.2 Conclusion

The GLR project achieved its key milestones of conducting both the pre-auction club offer (PACO) and auction process in a timely manner. However, other aspects of the project were clearly unsuccessful.

Advice to government provided by departments outside of the steering committee framework was not systematically shared with other steering committee members or the project team. This is incompatible with the public sector values of integrity and accountability in the *Public Administration Act 2004*, and resulted in inconsistent advice to decision-makers.

The extent to which the project's intended financial, social and stakeholder engagement outcomes were met can, in some cases, only be measured once the new industry structure has become embedded after the transition in 2012. However, early indications are that several of these outcomes have not been achieved.

There were deficiencies in the project management. Oversight could have been improved if decision review points had been built into the project. The range of expert advisers was too narrow to properly inform the steering committee on risk management and information technology (IT) and the steering committee did not establish sufficient controls over project expenditure.

DOJ breached Victorian Government Purchasing Board policy and did not use better practice principles in its procurement of consultants. The roles and responsibilities of consultants were not appropriately delineated and defined, and did not demonstrably avoid conflicts of interest.

While probity has been given a high priority by the project team, reporting was not timely. It is not possible to assure that the project's probity regime was adequate. Our ability to reach a conclusion after the auction on whether probity requirements have been fully met has been compromised by shortcomings in DOJ's knowledge management practices and the probity reporting.

## 4.3 Analysis of performance against desired outcomes

The extent to which the primary objective of establishing 'a venue operator industry that meets the government's gambling guiding principles' has been achieved is more appropriately measured after the new venue operator industry structure has become embedded after the transition in 2012. It is, however, possible to assess the project's performance against some of the desired outcomes and milestones from the allocation phase of the process. On the whole, the allocation phase of the project has only partly fulfilled the project's intended outcomes.

The GLR project team performed a self-assessment of its achievements against the desired outcomes after the auction. This assessment was an account of activities undertaken by the GLR project team, with no accompanying analysis of how effective those activities were in achieving the desired outcomes. The self-assessment failed to acknowledge deficiencies in the project management that were noted in other project review documentation.

In order to address the audit objectives of determining whether the financial outcomes of the allocation represented best value for money and how effectively and efficiently the project was managed, VAGO analysed the extent to which intended project outcomes have been achieved.

This analysis is summarised in Figure 4A. More detailed analysis is included in relevant sections of the audit report.

As the GLR project team did not assign any weighting to the outcomes to identify any that were deemed particularly important, each outcome has been assessed on an equal basis.

**Figure 4A**
**Assessment of performance against desired outcomes as at June 2011**

| Outcome | Performance assessment |
|---|---|
| A regulatory framework that gives effect to the industry for the future, that will: | |
| • ensure the financial benefits of gaming are transparent, recognisable and fairly distributed to the community | Not met.<br>The GLR project team measured this outcome in terms of the spread and volume of EGM entitlement holders. A comparison of the distribution of EGMs pre-auction with entitlements purchased revealed there was not a significant degree of change in location.<br>The 35 per cent ownership restriction on hotels was intended to achieve a wider distribution. Hotels can still, however, lease premises to club operators with EGMs without breaching this restriction. |
| • establish an appropriate regulatory framework to maintain the highest standards of probity, transparency and accountability. | Partly met.<br>Changes to legislation were made, although the former government had to make concessions to gain the necessary parliamentary support to pass the legislation. The most notable concession was PACO.<br>Probity: probity was not applied in a balanced or businesslike manner. There has been no timely public assurance that the allocation was conducted in compliance with probity requirements.<br>Transparency: the procurement of consultants was neither transparent nor competitive.<br>Accountability: the probity auditor criticised the GLR project team’s delays in responding to stakeholder queries as ‘unacceptable’. This was fair criticism. |
| An informed and confident community and industry, that will: | |
| • enable industry engagement by managing expectations of stakeholders to prepare them for the behavioural and industry changes as they occur throughout the implementation and transition process | Partly met.<br>DOJ developed a six-step education and training strategy, but did not quality assure the implementation of that strategy to confirm stakeholders had an adequate understanding of the auction.<br>The bidder queries recorded during the auction clearly indicated DOJ had not adequately explained how the system calculated prices, nor managed participants’ expectations of the duration of the auction.<br>Most industry changes will occur closer to, and after, the transition date. A full assessment will, therefore, only be possible after the introduction of the new structure in 2012. |
| • allow venue operators the opportunity to take part in the post-2012 gaming industry | Met.<br>Appropriately licensed venue operators could access the auction and, following the auction, participate in the entitlements transfer market. |

**Figure 4A**
**Assessment of performance against desired outcomes as at June 2011 – *continued***

| Outcome | Performance assessment |
|---|---|
| • ensure consistent messages across the industry, media and community about the new gaming industry structure to facilitate a smooth transition | Not met.<br>The probity auditor report highlights the fact that over 30 per cent of the auction rules originally published in October 2009 changed in the month before the auction. |
| • ensure venue operators understand the requirements to enter the allocation process, are prepared for the bidding and able to participate on the day. | Partly met.<br>DPC and DTF repeatedly criticised the GLR project team's failure to release information. Audit concurs with this criticism. Speculation in the media arose as a direct result of the lack of clear communication from the GLR. The uncertainty this created in the industry was one of the major reasons why club organisations petitioned for PACO.<br>Although participants were able to enter bids in the system, the GLR project team did not quality assure its information and training strategy so that it could gain comfort that auction participants were able to knowledgably bid for entitlements. |
| A competitive and transparent allocation of gaming machine entitlements, that will: | |
| • allocate entitlements within government's policy determinations so as to maximise benefits for society | Partly met.<br>The entitlements were allocated in line with the regulatory framework.<br>The definition of 'benefits for society' is unclear. The financial benefits were not maximised, as the sale proceeds represented only a quarter of the fair market value of the entitlements.<br>However, a full assessment of whether the allocation has maximised the benefits to society is only possible after the industry has had time to adjust following the introduction of the new structure in 2012. |
| • provide an opportunity for all venue operator licensees who choose to participate in the bidding process to do so | Met.<br>The auction was open to all appropriately licensed venue operators. |
| • ensure high standards of probity, integrity, transparency and objectivity are maintained | Partly met.<br>Probity: probity was not applied in a balanced or businesslike manner. There was an overly zealous application of probity, which prevented the release of information that could have been made public without breaching the probity requirements. There has been no timely public assurance that the allocation was conducted in compliance with probity requirements.<br>Transparency: the auction was complex, which made clear explanation of the rules difficult.<br>Objectivity: an automated auction system and pre-determined participation criteria for both the auction and PACO largely removed the need for subjective decisions to be made on who should receive entitlements. |

**Figure 4A**
**Assessment of performance against desired outcomes as at June 2011 – *continued***

| Outcome | Performance assessment |
|---|---|
| • seek to capture supernormal profits from the gaming machine industry | Not met.<br>The sale proceeds represented only a quarter of the fair market value of the entitlements. Based from advice from DTF, the allocation was the primary mechanism to extract the supernormal profits. Post-2012 taxes were not set at a level that 'perfectly targeted' all of the supernormal profits identified by DTF. |
| • provide process efficiency, minimising participation costs for both the bidders and the state. | Not met.<br>The auction is conservatively estimated to have cost the state $7 million.<br>The state originally estimated an auction would take six months to design. It actually took two years from the initial engagement of the auction expert to the auction taking place.<br>Besides attending the actual auction, bidders had to devote a significant amount of time to reading documentation and attending information and training sessions. This situation was exacerbated by the complexity of the auction.<br>The GLR project team did not give due consideration as to whether other sale mechanisms could have achieved better outcomes—namely higher revenue and/or lower cost—than the chosen auction format. |
| A plan for a seamless transition to the new industry structure, that will: | |
| • position the GLR project team to transition the ongoing responsibilities to the Office of Gaming and Racing and the Victorian Commission for Gambling Regulation. | Partly met.<br>Shortcomings in knowledge management practices have led to data integrity issues.<br>A full assessment will only be possible after the introduction of the new structure in 2012. |
| Provide existing clubs with certainty of outcomes by: | |
| • giving them the option to pre-purchase entitlements ahead of the bidding process. | Partly met.<br>PACO gave clubs certainty in the number they would be able to purchase and the amount they would have to pay.<br>However, PACO resulted in a perverse outcome for the allocation, as prices were higher in PACO than at auction. |

*Source:* Victorian Auditor-General's Office.

It will be appropriate to reassess performance against these outcomes once the industry has time to adjust following the introduction of the new structure in 2012. For a number of outcomes, an assessment will only be possible after this date. These are included for completeness in Figure 4B.

**Figure 4B**
**Post-implementation outcomes**

| |
|---|
| A regulatory framework that gives effect to the industry for the future, that will:<br>• promote a competitive and innovative industry<br>• complement the government's responsible gambling strategy.<br>An informed and confident community and industry, that will:<br>• ensure venue operators, their consumers and the community understand the implications and benefits of the new industry structure.<br>A competitive and transparent allocation of gaming machine entitlements, that will:<br>• provide for sustainable competition within the industry.<br>A plan for a seamless transition to the new industry structure, that will:<br>• ensure industry participants exiting or entering the market have a clear understanding of their obligations<br>• provide process efficiency for industry participants involved in the transition<br>• minimise disruption to industry and consumers during the transition period. |

*Source:* Victorian Auditor-General's Office.

## 4.4 Steering committee

The oversight by the steering committee was, for the most part, proactive. However:

- its advice to government did not reflect the impact of changing circumstances on the auction, which points to an issue with the transparency of advice provided by departments
- its members and advisers did not have a sufficiently broad range of expertise
- there was insufficient oversight of costs.

### 4.4.1 Advice to government

Unlike DPC and DTF, the steering committee did not advise government there was a need to review major decisions, based on new and emerging information.

Departments will sometimes have different perspectives on some matters and it is reasonable to expect that agreement will not be reached in all cases. However, the *Public Administration Act 2004* requires public officials to demonstrate:

- **integrity**—by being honest, open and transparent in their dealings
- **accountability**—by working to clear objectives in a transparent manner.

Although the steering committee met frequently and considered several hundred papers, the process did not always demonstrate these values.

DTF advised government against proceeding with the auction because of the impact PACO was expected to have on competition and, therefore, auction revenue. The steering committee did not adequately consider the material change in circumstances as a result of this, nor did it make a similar recommendation. The Executive Director, Office of Gaming and Racing, and the Project Director, GLR at DOJ have advised they were unaware of DTF's advice on the auction, despite the fact that DTF was represented on the DOJ steering committee.

DPC and DTF's submissions to government indicate that both departments had conferred on their respective advice. However, in the interests of greater transparency, there would be value in establishing communication protocols between interdepartmental representatives of the steering committee for this and other projects.

These protocols would include the circumstances under which relevant information provided or received outside of the steering committee framework is communicated to other steering committee members. They should provide for a more informed consideration of issues and, as may be necessary, the resolution of conflicting views. As a result, this would improve the comprehensiveness and consistency of advice to decision-makers.

In addition to the unclear communication protocols, the project management also suffered from a lack of decision review points. These are particularly important for large and complex undertakings, where the consequences of unplanned changes can be significant. The introduction of PACO, as well as the decision to leave the approvals process largely unchanged, were two examples where there was an obvious need for such a review.

In these and similar circumstances, decision-makers and advisers need regular opportunities to confirm that particular courses of action either still remain appropriate, or that alternative strategies are required to deliver project outcomes.

### 4.4.2 Steering committee expertise

The steering committee held regular meetings with members of the GLR project team and a range of advisers. These occurred at least monthly and included probity and legal advisers, as well as representatives from the project team within the regulator—the Victorian Commission for Gambling Regulation (VCGR). The GLR project team reported to the steering committee on standing items of probity, risks, time lines, and recent and upcoming activities.

There was, however, no dedicated IT adviser on the steering committee. The auction process required the large-scale use of IT hardware and sophisticated software, and the skills of multiple consultants. In short, it was a highly complex IT undertaking. IT advice was provided at a project team level, but there were issues with the role performed by this adviser, as explained later in this Part.

Internal audit played no role in the steering committee deliberations. The GLR project team did propose that the steering committee engage an internal auditor to review the project. This did not occur and the reasons for this are not documented. An internal auditor could have provided risk management advice to the steering committee.

### 4.4.3 Oversight of costs

In the 2007–08 and 2008–09 budget cycles, DOJ sought funding of $20 million to cover the department's costs of allocating all five gambling licences over the three years to 30 June 2010. Expenditure on the GLR covered licensing arrangements for monitoring, wagering, Keno and lotteries as well as EGMs. As at October 2010—by which point the allocation of EGM entitlements had been finalised—the total expenditure was $41 million, more than double the original budget. The GLR project team attributed these cost overruns to the allocation process being more complex than expected, and activities taking longer than anticipated.

The Standing Directions of the Minister for Finance under the *Financial Management Act 1994* highlight the importance of effective financial management reporting in supporting decision-making, financial management, risk management and performance measurement. Public sector agencies are required to maintain an effective internal control framework over expenditure, to appropriately manage and authorise disbursements.

The GLR did not have its own finance manager embedded in the team, but instead shared the resources within another area of DOJ. The Office of Gaming and Racing Finance team was restricted in providing close financial oversight by the GLR's organisation structure, probity arrangements and the decision not to split the licences into separate cost centres.

Although each licence process had its own specific needs, challenges and time lines, the steering committee did not seek separate cost reporting for the different licences. Funding was provided for the GLR project as a whole, and some staff worked across multiple licences. However, it would have been not only feasible, but also appropriate, for costs to be recorded separately and, where necessary, apportioned to the different licences.

The GLR project team was requested to calculate the cost of the EGM entitlements for the purposes of this audit. They estimated that the amount spent from July 2007 to October 2010 on the EGMs component was $19 million, or 45 per cent of the total spend on the entire GLR project over the same time period. Of this $19 million, $7 million is directly attributed to auction costs. As there were no corroborating records of the amount of time that staff spent on the various licences over this period, it was not possible to confirm the accuracy of these figures.

The lack of detailed cost reporting made controlling costs more difficult. This was evident in December 2009, when the Minister for Gaming was asked to retrospectively approve an overspend of $3.1 million on legal advice. This situation arose as a consequence of poor contract management, as evidenced by the minister's handwritten comments on the request for approval:

> 'I have little option but to approve given the priority of the GLR task. But if the previously agreed to expenditure cap was approaching its limit in September I am not sure why it has taken until December for the necessary further approvals to be sought. The last thing we want is our critical legal advice drying up but that is what non-payment delivers! Make sure it doesn't happen again.'

## 4.5 Project team

The steering committee established a project team to implement the GLR. The role of the GLR project team was to research and plan the project, provide advice, develop policies/proposals and recommendations, and action decisions made by the steering committee and the Minister for Gaming.

This project team was headed by a project director, whose responsibilities included the management of the allocation of EGM entitlements.

The EGMs component of the GLR project was complex to manage and involved significant risks to government. The project had a large number of external stakeholders, tight time lines and constraints imposed by public announcements, such as the decision to sell the entitlements through an auction. Probity requirements were stringent and the auction design and implementation were highly technical. There were also significant inherent risks due to the scale of change for the industry and the large amounts of public funds involved. The project team used the well established project management method PRINCE2 to run the project.

The project team met its principal objectives of conducting PACO and the auction in a relatively timely manner. Significant delays were experienced during the course of the project. For example, the auction logistics, which involved planning the venue set-up and staffing, as well as developing and testing the IT software and hardware, were finalised seven months late. However, the delays were largely recovered and the auction took place only one month later than scheduled. The time lines slipped again after the auction, as it took longer than expected to deal with queries and paperwork from venue operators. This meant that the announcement of the final allocation was three months late.

The project team's success in largely meeting its major milestones of PACO and the auction event within very tight time lines was a significant achievement, but came at a price particularly in adhering to due process. There were significant gaps in:

- the procurement of consultants
- the roles and responsibilities of advisers
- knowledge management practices.

## 4.5.1 Procurement of consultants

The Victorian Government Purchasing Board (VGPB) sets policies and guidelines to establish the minimum standards for procuring goods and services in departments and agencies. They are intended to achieve 'value for money in Victorian Government procurement, while maintaining the highest standards of probity, minimising risk and maximising opportunities for local businesses'. Non-compliance with these policies and guidelines exposes departments to the risk of financial loss and reputation damage.

VGPB policy normally requires three quotes to be obtained for purchases over $25 000 and a public tender to be used for expenditure over $150 000.

VGPB has created a number of whole-of-government panels of specialist service providers to improve departments' efficiency in engaging consultants. One of these panels is for 'eServices', or IT consultants. At the time the GLR was setting up its major contracts, only one written quotation was needed for eServices procurement under $100 000.

Each department has an Accredited Purchasing Unit (APU), which is responsible for overseeing procurement processes and monitoring compliance with VGPB policy. Departments have financial delegates whose expenditure authorisation limits increase with the seniority of their position.

Two of the more significant contracts established by the project team are outlined in Figure 4C. Other major consultancies were for the provision of event management services, training and legal advice.

**Figure 4C**
**Procurement of consultants**

| Role | Description of services | Date of contracts | Amount ($) |
|---|---|---|---|
| Auction specialist/ software provider | Contract 1: Feasibility testing | May 08 | 35 000 |
| | Contract 2: Further feasibility testing | Aug 08 | 96 000 |
| | Contract 3: Small scale design | Nov 08 | 633 176 |
| | Contract 4: Large scale design | Jan 09 | 564 595 |
| | Contract 5: Prepare and run auction | Jun 09 | 2 026 715 |
| | Contract 6: Post-auction queries | Nov 10 | 99 000 |
| | | **Total** | **3 454 486** |
| IT adviser | Contract 1: Assist with the review and development of the software specification, and validate the delivered software | Jun 08 | 36 000 |
| | Variation 1: Advise on the auction specialist/software provider's contract | Oct 08 | 164 000 |
| | Variation 2: Quality assure other consultants' work, including acceptance testing | Feb 10 | 220 000 |
| | | **Total** | **420 000** |

*Note:* The contract amounts do not necessarily represent the amounts paid. Deeds of settlement are excluded from the table.

*Source:* Victorian Auditor-General's Office.

## Auction specialist/software provider

The auction specialist/software provider was awarded six contracts totalling $3.5 million without a competitive process. The first contract was for $35 000, which would normally have required the GLR project team to obtain three quotes. It was, however, granted an exemption by the financial delegate. The project team subsequently sought an exemption from public tender from the APU when it later became apparent that the cumulative spend would be more than $150 000. The reasons given to support the applications for exemption were:

- time constraints meant the project specification needed to be completed by the end of June 2008 for the auction to be conducted in April 2010
- that due to the highly technical nature of the services, there were no local experts and few other international experts with the ability to provide advice in a timely manner
- the consultant had previously undertaken work for another department.

The reasons given to support the exemption from a competitive selection process were not robust:

- While it is acknowledged that time lines for the project were tight, there is no evidence of effective procurement planning. Better planning would have not only consolidated the number of individual contracts, thereby resulting in administrative efficiencies, but also allowed the time for a competitive engagement process to occur. The GLR project team informed the steering committee and the relevant Cabinet Committee that the third contract would be the last. However, three further contracts were entered into with the same provider. All six contracts were entered into without a competitive process.
- Although auction theory and software is a niche area of expertise, there are several highly regarded specialists. DTF suggested some possible alternatives to the government. The GLR project team appointed one of these to its Technical Reference Group (TRG) and invited another to give a presentation of its software. However, this presentation occurred after the exemption from obtaining three quotes had been granted for the successful consultant.
- The GLR project team engaged an international consultant that had advised on other auctions overseas. Its only previous assignment with the Victorian Public Service was, however, not comparable to the scale and complexity of the EGM auction process. The consultant had conducted an auction in 2006, which involved 16 bidders competing for 18 sites, and generated $575 000 in revenue. In comparison, the auction of EGM entitlements involved 345 venue operators competing for 18 788 entitlements and raised $614 million.

Despite the exemptions, procurement guidelines required the GLR project team to obtain APU approval for all subsequent contracts and for a deed of settlement. It did not do so.

The deed of settlement was for $211 278. It was paid by DOJ for work performed outside of the contract in place at the time, including additional testing on the auction software. This was the second time work was performed outside a contract. In mid-2008 the GLR project team allowed the auction specialist/software provider to carry out work after the first contract had ended. This work started before signed approval was obtained from the financial delegate, and without a contract or insurance in place.

## IT adviser

There were shortcomings in the engagement of another key adviser. This consultant was awarded an initial contract for $36 000 to provide IT advice on the auction software and hardware. As the adviser was on the eServices panel, only one written quotation was needed. However, this contract subsequently increased to $420 000 without a competitive procurement process. Although the appropriate approvals to vary the contract were sought, it is not sound practice. The fact that two material variations were required demonstrates a lack of effective planning. The market was not tested to confirm that the IT adviser was the most appropriate and cost-effective specialist for the task.

In October 2008, three months after the contract was signed, DOJ’s APU approved a variation to the contract. This increased its total value from $36 000 to $200 000. The GLR project team applied for the variation without testing the market because ‘due to the politically sensitive nature, complexity and time frames of the work to be completed it is highly unlikely that a better and more capable resource could be sourced by approaching the eServices panel again’. In February 2010 the APU approved a further variation to increase the total contract value to $420 000.

Similar to the auction specialist/software provider contract, the basis for the exemption was not robust. Issues of political sensitivity can be adequately managed through contractual confidentiality provisions, and the statement of the unlikelihood of a better or more capable resource being available is not soundly based, as the chosen consultant had no prior auction experience.

The IT adviser’s association with the GLR continues. In October 2010 DOJ’s financial delegate approved an exemption from public tender for the $150 000 contract to provide technical advice to assist with the process of awarding the wagering licence. This brings the total value of the GLR contracts awarded to the IT adviser without a competitive process to $570 000.

In summary, there were eight contracts, two financial variations and a deed of settlement totalling $4.2 million for the auction specialist/software provider and the IT adviser, and no competitive process.

## 4.5.2 Roles and responsibilities of advisers

There were issues with three of the advisers used on the project because:

- they lacked independence because of conflicting roles
- the roles were inappropriately limited in their coverage
- they lacked expertise, which prevented them from fully discharging their roles and responsibilities.

### Auction specialist/software provider

The specialist engaged to provide advice on the auction design also provided the software to run the auction. This resulted in the auction specialist making recommendations on the auction design and then implementing these recommendations. The GLR project team did not consider using an alternative provider for the implementation phase.

When asked about whether such an arrangement merited a greater separation between design and implementation, DOJ advised that it did not believe there was a demonstrable need for separation of responsibilities, given the interdependencies in the provision and implementation of advice.

DOJ's view fails to recognise that a conflict of interest can arise when an adviser is making recommendations on a course of action and is subsequently paid to implement these recommendations. This situation was inherently conflicted in the sense that the auction specialist had a strong self-interest in obtaining the contract to provide the auction software. It is the department's responsibility to manage any such conflicts. In this instance, DOJ failed to adopt processes that would have demonstrated its procurement arrangements represented value for money.

This lack of delineated responsibilities could have been overcome if appropriate third-party assurance had been sought on the auction design and software. This did not occur, due to the overly restrictive scope of the TRG. Consequently, DOJ did not confirm the veracity of specialist advice that was fundamental to determining whether the allocation of EGM entitlements would achieve sound financial outcomes.

### Technical Reference Group

The TRG consisted of three members with expertise covering economics, game theory, and mechanism design and industrial organisation. Game theory, mechanism design, and industrial organisation are branches of economics, which use applied mathematics to predict strategic behaviour in competitive situations, such as an auction. This range of expertise was appropriate to provide advice on the technical aspects of the auction.

The TRG was established in November 2008 to confirm that the state's objectives for the auction design were met, namely:

- the regulatory framework had been translated into formal mathematical statements and concepts
- the EGM entitlements would be allocated in a way that maximised the value from the auction
- successful bidders would be identified according to agreed pricing rules.

The TRG was also asked to advise whether any unintended major problems or loopholes may arise as a consequence of the proposed auction design, such as bidder dissatisfaction or legal issues.

The significant restrictions placed on the role and responsibilities of the TRG limited its effectiveness as a source of third-party specialist advice to the project team and steering committee on the auction. These limitations were:

- the TRG's terms of reference restricted its members from advising on whether the proposed auction design and software were the most appropriate in the circumstances. Its last meeting was in March 2009, before the final auction system was developed. At this stage, the TRG reached an inconclusive opinion that 'loopholes in the auction design may exist'. Neither the loopholes, nor their significance, were documented in any further detail. It is unclear what action, if any, was taken to resolve these issues.
- the TRG was precluded from examining other factors, such as whether there was likely to be a sufficient level of competition to run a successful auction. The GLR project team considered that decisions regarding the auction were the responsibility of the specialist providing the auction design and software. No auction specialists took part in the final acceptance testing to ascertain the extent to which the software met the business objectives.

As a consequence, there was no expert third-party assurance on key decisions that would influence the auction results.

## IT quality assurance

The consultant providing IT quality assurance was hampered by a lack of relevant expertise and compromised in discharging their responsibilities by a conflict of interest.

The consultant had no previous auction expertise and was dependent on the advice of the GLR project team's auction specialist, who also supplied the software. This lack of expertise led to major issues:

- The test plan was based on the auction specialist/software designer's contract requirements and software design specifications, rather than an end-to-end test plan developed by third-party auction experts to assure that business outcomes would be achieved.
- There was insufficient third-party assurance that the algorithm, as configured in the software, would work as expected. Of particular concern was the limited testing of the ranking rules that determined how bids at the market price were prioritised.

In addition, the IT adviser's roles and responsibilities expanded during the project to such an extent that its principal role of quality assurer was compromised. The IT adviser collaborated with the auction specialist/software provider on the development of the technical specification, then subsequently tested the specification for functionality and compliance with the auction objectives. This meant that the consultant was, in effect, quality assuring its own work.

### 4.5.3 Knowledge management

Effective knowledge management involves creating systems and processes that support the capture and transfer of knowledge, and aim to continuously improve the organisation's performance.

The inherently transient nature of project work and the need for specialist skills means that contractors often make up a significant portion of a project team. Since a large number of staff leave the organisation after a project has finished, effective knowledge management is critical for retaining corporate memory and achieving a smooth transition to business-as-usual.

The GLR project team did apply some principles of knowledge management effectively, including:

- producing end-of-stage reports after major project milestones, which is line with PRINCE2 project management methodology. Lessons learned were documented, but not all of them were captured, as discussed below.
- establishing a dedicated website to disseminate information to the public. This website was regularly updated in the lead-up to the auction.

There were, however, shortcomings in other areas of knowledge management:

- There were inconsistencies in information.
- Communication with venue operators was not appropriately managed.
- Inadequate documentation was retained.

## Inconsistent information

Data quality and reliability was reduced through inconsistencies in the information on venue operators maintained by the GLR project team and VCGR. These inconsistencies indicated that data management rules were not well defined or applied, thus increasing the likelihood of gaps and duplication in data. Discrepancies in naming conventions were found not only between the different records, but also often within the same document.

Accurate master data on venue operators is critical for VCGR to monitor compliance with the regulatory framework, which requires details of ownership structures for probity assessments to be carried out on industry participants. Poor quality data is more likely to produce poor quality analysis and decisions.

## Inappropriate communication with venue operators

DOJ advised VAGO that it believes it effectively and professionally managed all information it handled. This is not supported by the inconsistencies reported above and the evidence presented in the probity auditor's report.

The probity auditor noted that:

- there were probity breaches in the management of venue operators' information. There were six recorded instances of venue operators being sent other venue operators' information. This happened on two separate occasions in the allocation process, demonstrating that the GLR failed to learn from and address issues in its mail-out procedures.
- although it did not compromise the probity of the process, the GLR did not adequately respond to stakeholder queries. In the worst case, the venue operator wrote four letters and received a response from the GLR seven months later. This response advised the venue operator to direct its query to VCGR.

## Inadequate documentation

The GLR project team did not keep sufficient documentation to allow an independent verification of the auction results. As such, we are unable to confirm whether each venue operator received their correct entitlements.

The lack of documentation also means that the GLR project team is reliant on the auction specialist/software provider to resolve any queries, which incurs additional cost and time delays. It also exposes the GLR project team to the risk that this information may be inaccessible if the auction specialist/software provider, who is internationally based, is unavailable.

This situation could have been avoided if the GLR project team had developed an appropriate knowledge management strategy and identified an adequate set of outputs as part of the performance standards, which form part of the contract management process. These outputs should have included, as a minimum, a detailed explanation of how the auction software treated bids, including how it ranked bids.

## 4.6 Probity

Probity is critical to provide assurance that:

- all venue operators have been treated equally and impartially, and have been given the same opportunity to access information and advice about the allocation process
- all protected information has been managed to ensure its security and confidentiality
- all EGM entitlements have been allocated in a systematic manner in accordance with explicit pre-determined criteria
- every relevant entity involved in the process of allocating EGM entitlements has been required to declare any actual or perceived conflict of interest before participating in the allocation process
- any conflict of interest has been appropriately addressed
- there has not been any improper interference with the allocation process
- all recommendations and reports are free of any reasonable apprehension of bias.

The GLR steering committee and project team were advised by a probity auditor during the course of the project. The IRP was created under legislation to provide assurance to Parliament and the public on the probity of the licensing processes. The remit of both parties covered all of the gambling licences, not just the EGM entitlements component.

The probity auditor produced a report on the competitive bidding phase for EGM entitlements in May 2011. The IRP has not yet tabled its report. Consequently there is insufficient third-party assurance and documentary evidence for VAGO to conclude whether the probity of the allocation of EGM entitlements was appropriate.

In undertaking their roles, the IRP and probity auditor have been significantly hampered by the lack of timely action by the GLR project team.

### 4.6.1 Independent Review Panel

The IRP is required to report on the recommendations and reports produced by both DOJ and the probity auditor during the allocation process.

Given the elapsed time since the May 2010 auction and the proximity to the August 2012 transition date to the venue operator structure, it may be difficult for departments to respond to any adverse findings of the IRP, once it tables its report.

The delay in reporting on the allocation of EGM entitlements has occurred because:

- the GLR project team requested the IRP give a higher priority to other, more time-critical GLR licensing processes
- the GLR project team provided its report to the IRP in March 2011, nine months behind schedule
- the probity auditor's report was delayed due to the GLR project team's request for it to prioritise other licensing processes.

Although it has not tabled its report on the allocation of EGM entitlements, the IRP has been involved at various stages of the allocation process:

- Both the Chair of the IRP and the probity auditor attended the auction.
- The IRP wrote to all auction participants in November 2010 to inquire whether they had any issues of concern that fell within the IRP's remit. The IRP sought comment from the GLR project team on the issues raised by two respondents. This was only provided four months later.
- The IRP held a hearing before the auction on a potential breach relating to the 35 per cent ownership restriction on hotel entitlements. The IRP concluded that a breach was averted due to timely intervention.

The GLR project team did not, however, ask the IRP to consider if there were probity concerns over whether PACO would disadvantage any groups or individuals. The survey of venue operators conducted as part of this audit indicated that small hotels felt disadvantaged as they were not eligible for a similar fixed-price offer.

The IRP has tabled a number of reports on other aspects of the GLR, as shown in Figure 4D.

**Figure 4D**
**Independent Review Panel reports**

| Report | Date |
|---|---|
| Lotteries licence review | October 2007 |
| Regulatory structure review post-2012 | March 2008 |
| Regulatory structure review post-2012 supplementary report | April 2008 |
| Regulatory structure review post-2012 phase 2 | December 2008 |
| Registrations of interest in the grant of the Keno licence | January 2010 |
| Expressions of interest in the grant of a wagering and betting licence | July 2010 |
| Complaint by Intralot Australia Pty Ltd in relation to the public lotteries licensing process | October 2010 |
| Expressions of interest in the grant of the monitoring licence | December 2010 |
| Invitations to apply for the grant of the Keno licence | February 2011 |

*Source:* Victorian Auditor-General's Office.

The October 2007 IRP report on the lotteries licence review publicly criticised the GLR project team for its lack of protocols to manage risks associated with lobbying, breach of confidence, and improper interference or prohibited contact. Since that report, there has been an increasingly strong emphasis by all parties involved in the project on maintaining very high standards of probity for all aspects of the process.

The GLR project team and probity auditor have not however, applied probity in a balanced or businesslike manner. Information that could have reduced industry uncertainty over the operation of the auction was not released due to the overzealous and rigid approach to probity. With appropriate safeguards, this information could have been publicly provided. This view was shared by the IRP.

### 4.6.2 Probity auditor

VAGO cannot definitively conclude that there were no major breaches of probity in the allocation process, in terms of whether venue operators received equal and fair treatment in the entitlements they were allocated, and the price they paid for these entitlements. This is because there was a lack of relevant information as a consequence of poor knowledge management practices, which have already been covered in this Part, and issues with the scope of the probity auditor’s role and report. There were also concerns with the aspects of the process not addressed by the probity auditor. As a consequence, complete reliance cannot be placed on the probity auditor’s report.

The probity auditor report was issued in May 2011, eight months after the final allocation of entitlements was announced and 12 months after the auction. The report notes 36 issues on a range of matters including amendments to and the application of auction rules, correspondence with bidders, training and the two stages of the auction. It concludes that the GLR complied in all material aspects with the probity principles from the period 23 June 2009, the date of Royal Assent for the *Gambling Regulation Amendment (Licensing) Act 2009* to 22 September 2010, the date the final allocation was announced.

There is a gap of 15 months between the coverage of this probity audit report and the last report on the EGM entitlements component of the GLR project, which was produced in March 2008. As a consequence, any probity issues that may have arisen during this time have not been reported on, thus reducing the transparency of the process.

There are several omissions in the report:

- There is no consideration of whether hotel operators were treated equitably by being denied the same opportunity as clubs to purchase entitlements before the auction as part of a fixed-price offer. As mentioned previously, smaller hotel operators expressed dissatisfaction with this in our survey.
- There is insufficient analysis of whether all EGM entitlements were allocated in accordance with ‘explicit pre-determined criteria’, which was one of the probity requirements. It was, however, a limitation in the scope of the probity auditor’s remit that prevented consideration of whether these criteria were equitable for all participants.
- Most of the pre-determined criteria were explicit, as they were published in the auction rules. However, the auction software’s method of ‘breaking ties’, which occurred when two or more auction participants bid the same amount, was not made explicit in the information provided to bidders. Participants were therefore unaware that bids of equal value could be successful in some cases and unsuccessful in others. The probity report does not comment on this.

- The report did not consider whether other clubs were disadvantaged by an inadvertent breach of the regulatory framework. One club was provisionally allocated 200 more entitlements than the 420 limit. Other clubs bid the same amount for entitlements, but did not succeed in obtaining them. This is linked to the 'tie-breaking' process described in the previous point. These 200 entitlements have subsequently been withheld.

The adequacy of the oversight provided by the probity auditor was questioned by the IRP. In its March 2008 report on the regulatory review structure post-2012, the IRP raised concerns about the reactive nature of the probity auditor and identified the need to clarify the expectations of the probity auditor. The IRP has advised there is no evidence that these concerns with the probity auditor role were satisfactorily addressed by that auditor. The GLR project team appointed a new probity auditor for the remaining stages of the monitoring and wagering licence processes.

## Recommendations

The Department of Justice should:

4. build effective decision review points into projects to allow re-evaluation or re-confirmation of particular courses of action
5. together with other members of the interdepartmental steering committee, develop communication protocols regarding the sharing of information
6. establish improvements in contract management so that consultants' roles and responsibilities are independent, appropriately scoped and performed by consultants with relevant expertise
7. improve procurement practices by
   - promoting more stringent oversight by the Accredited Purchasing Unit of compliance with procurement policy
   - providing more effective procurement planning at the project management level
8. manage probity in a manner that balances information provision with safeguards over fair, equitable and impartial treatment
9. provide cost reporting for the Gambling Licences Review project on an individual licence basis
10. establish knowledge management processes to address not only knowledge retention but also concerns with inaccurate or inconsistent information.

# Appendix A. Valuation method and assumptions

## Purpose of valuation

The extent of potential supernormal profits is a major indicator of the amount of revenue the government might expect to obtain as a result of the allocation of electronic gaming machines (EGM) entitlements to operators through a competitive auction process. In principle, a competitive auction process would see the transfer of the bulk of supernormal profits to the government.

The calculation of potential supernormal profits performed by the Department of Treasury and Finance (DTF) was unreliable because:

- the numbers varied significantly over time
- the analysis was not kept up to date
- the underlying assumptions were not well-founded.

As a consequence, VAGO prepared its own valuation of the potential supernormal profits in the venue operator model adopted by the government. The purpose of this valuation was to provide a guide against which the revenue raised by the allocation of the EGM entitlements could be benchmarked.

The value of and price paid for an asset in a competitive market will generally be different, depending on the competition for assets and attitudes towards risk by participants.

The financial outcome from the sale of the EGM entitlements was ultimately determined by a range of issues, including the pre-auction club offer (PACO) price formula, the level of competitive tension in the market, the availability of information, and the auction design and operation. As neither DTF nor VAGO valuations incorporate the potential impacts of these factors on the proceeds from the sale, any estimate of supernormal profits should be considered to be an upper limit.

It is, however, necessary to estimate the valuation in order to measure the extent to which the Gambling Licences Review project team was successful in achieving the desired financial outcomes. These were to:

- achieve a competitive and transparent allocation of EGM entitlements that captured supernormal profits
- ensure the financial benefits of gaming are transparent, recognisable and fairly distributed to the community.

This appendix describes the method and assumptions used to produce our valuation. It also reconciles our valuation with the economic analysis performed by DTF in 2008.

# VAGO valuation

## Method

Figure A1 demonstrates the method used by VAGO to calculate the value of the EGM entitlements. The entitlements were valued between $3.7 billion and $4.5 billion, with a mid-point of $4.1 billion. The mid-point of the value range is also calculated in Figure A1.

**Figure A1**
**VAGO valuation method**

| Item | Year 1 ($mil) | Year 2 ($mil) | Year 3 ($mil) | Year 4 ($mil) | Year 5 ($mil) | Year 6 ($mil) | Year 7 ($mil) | Year 8 ($mil) | Year 9 ($mil) | Year 10 ($mil) | Total ($mil) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Forecast total revenue for all venues | 2 769 | 2 869 | 2 972 | 3 079 | 3 190 | 3 305 | 3 424 | 3 547 | 3 675 | 3 807 | 32 635 |
| Deduct GST | (252) | (261) | (270) | (280) | (290) | (300) | (311) | (322) | (334) | (346) | (2 967) |
| **Net revenue** | **2 517** | **2 608** | **2 702** | **2 799** | **2 900** | **3 004** | **3 112** | **3 224** | **3 340** | **3 461** | **29 668** |
| Deduct forecast total existing venue costs: | | | | | | | | | | | |
| • EGM leasing, maintenance, marketing and administration expenses | (401) | (411) | (421) | (433) | (443) | (454) | (465) | (478) | (489) | (501) | (4 495) |
| • Venue refurbishment | (16) | (16) | (17) | (17) | (18) | (18) | (19) | (19) | (19) | (20) | (179) |
| • Other operating expenses | (332) | (344) | (357) | (369) | (383) | (397) | (411) | (425) | (441) | (457) | (3 916) |
| Deduct forecast statutory costs: | | | | | | | | | | | |
| • State gaming taxes | (986) | (1 026) | (1 068) | (1 111) | (1 156) | (1 203) | (1 251) | (1 302) | (1 354) | (1 408) | (11 866) |
| • Victorian Commission for Gambling Regulation (VCGR) regulatory supervision charge | (15) | (16) | (16) | (16) | (17) | (17) | (18) | (18) | (18) | (19) | (169) |
| • Monitoring costs | (30) | (31) | (32) | (33) | (33) | (34) | (35) | (36) | (37) | (38) | (338) |
| • Community benefit statement expenses (clubs only) | (1) | (1) | (1) | (2) | (2) | (2) | (2) | (2) | (2) | (2) | (16) |
| • Income tax (hotels only) | (139) | (143) | (149) | (154) | (159) | (165) | (171) | (177) | (183) | (190) | (1 630) |
| **Net forecast cash flows** | **596** | **619** | **641** | **664** | **690** | **715** | **742** | **768** | **797** | **827** | **7 059** |
| **Discounted net cash flows at 16 August 2012 using mid-point of discount rate range (15.5 per cent for clubs and 14.5 per cent for hotels)** | **556** | **502** | **453** | **408** | **368** | **332** | **300** | **270** | **244** | **220** | **3 653** |
| Deflate risk-adjusted cash flows to the valuation date using inflation rate of 2.5 per cent | | | | | | | | | | | (207) |
| Add value of deferred payment plan | | | | | | | | | | | 671 |
| **The present value of the EGM entitlements as at the valuation date, assuming the mid-point of the discount rate ranges for clubs and hotels** | | | | | | | | | | | **4 117** |

*Note:* Differences are due to rounding. Cashflows are presented in nominal terms.
*Source:* Victorian Auditor-General's Office.

## Low and high ends of the value range

The types of venues operating EGMs vary greatly. Venue operators include non-tax-paying clubs with less than ten EGMs, and larger hotels and clubs operating between 50 and 105 EGMs in a more commercial manner. One hotel group bought 34.1 per cent of the hotel entitlements, just under the 35 per cent ownership restriction. In addition to the hotel entitlements it owns, this hotel group leases venues to club operators, which operate EGMs on its premises.

It is therefore appropriate, given the extent of the variation within the industry and the different risk profiles of venue operators, to adopt a range of discount rates to apply to venues' forecast cash flows over the ten-year life of the entitlements. The ranges of discount rates used are set out in Figure A2. This produced the range of $3.7 billion to $4.5 billion for the present value of the EGM entitlements.

The forecast net cash flows are discounted using the weighted average cost of capital (WACC). The WACC is the required rate of return on an investment, expressed as a percentage. It reflects the different costs associated with different sources of finance, and the level of risk and uncertainty regarding future cash flows.

The gaming industry has experienced periods of uncertainty, brought about by changes to regulation and taxes. Prior to the 2007 ban on smoking inside enclosed licensed premises, venue operators were unsure what effect the ban would have on the amount of revenue they earned from their EGMs. Uncertain conditions can affect financiers' assessment of risk, and therefore their lending decisions. This can make it more difficult to access finance.

The higher the costs, risks and uncertainty, the higher the WACC and the deeper the discounting of the future cash flows. This has the effect of reducing the net present value of the investment. The WACC takes into account:

- the time value of money, i.e. that a dollar in the future is worth less than a dollar today, as the dollar in the future is discounted by the cost of money
- the rate of return required by the particular investor.

## Assumptions

**Figure A2**
**Assumptions**

| Assumption | Value | Rationale/source |
|---|---|---|
| Valuation date | 31 March 2010 | Month end date immediately prior to the first stage of the auction. |
| Nominal weighted average cost of capital | Clubs: 13–18 per cent<br>Hotels: 12–17 per cent | Based on industry analysis, the details of which are explained in the discussion of the value range in the previous section. |
| EGM entitlement commencement date | 16 August 2012 | *Gambling Regulation Act 2003.* |
| EGM entitlement period | Ten years | *Gaming Machine Arrangements 2012*, published by the Department of Justice (DOJ). |
| Forecast EGM market revenue growth rate per annum prior to entitlement start date | FY10: -2.5 per cent<br>FY11: 3.3 per cent<br>FY12: 4.7 per cent<br>FY13: 4.3 per cent | As per DTF internal forecasts at 31 March 2010. These forecasts incorporated an expectation of a decline in EGM revenue for FY10 as a result of the introduction of a $5 bet limit from 1 January 2010.<br>The entitlement start date is 16 August 2012, 1.5 months into financial year 2012–13. |
| Forecast EGM market revenue growth rate for the ten-year entitlement period | 3.6 per cent per annum | As per DTF internal forecasts at 31 March 2010. |
| Total revenue for 26 653 EGMs for the year ending 31 March 2010 | $2 632 million | Based on information from VCGR. While 26 653 EGMs were licensed as at 31 March 2010, revenue has been extrapolated for 27 500 EGMs, by calculating the average EGM revenue per club and hotel EGM and multiplying it by the unallocated EGMs, up to the maximum EGMs allowed. |
| Operating expense growth rates | 2.5 per cent per annum | The mid-point of the Reserve Bank of Australia's inflation target range. It is supported by industry medium-term consensus forecasts for 2011 and 2012. |
| Gaming tax brackets and rates | 0–58.33 per cent | *Overview of the Victorian Gaming Industry: second edition,* September 2009, published by DOJ |
| Tax bracket indexation | 2.5 per cent per annum | It is assumed tax brackets will be indexed annually in line with CPI. |
| GST rate | 10 per cent | Commonwealth legislation |
| Maximum number of EGMs | 27 500 | Maximum allowed under ministerial determination. |
| Maximum number of EGMs available to clubs and hotels | Clubs: 13 750<br>Hotels: 13 750 | As per ministerial determination. |
| EGM lease, maintenance, marketing and administration expense | $39.95 per EGM, per day | Ancillary service providers' fees are publicly available. This value includes the provision and regular replacement of EGMs, ongoing maintenance and upgrades, marketing, promotion and other associated administration costs. It excludes venue refurbishment costs. |

**Figure A2**
**Assumptions – *continued***

| Assumption | Value | Rationale/source |
|---|---|---|
| Monitoring fees | $3 per EGM, per day | This value is higher than EGM monitoring fees in New South Wales, Queensland and New Zealand. It is also greater than the $2 per day assumed in the Toolkit produced by Small Business Victoria (SBV). This Toolkit was based on Queensland monitoring costs and was publicly available to venue operators. Industry sources conservatively estimate monitoring services would cost $3 per day. The actual monitoring costs are still not known, as the monitoring licence was not awarded prior to this report being tabled. The $3 figure would have been a prudent estimate as at 31 March 2010, particularly given the potential introduction of pre-commitment limits. These limits would add complexity, and therefore cost, to the monitoring process. |
| VCGR regulatory supervision charge | $550 per EGM, per annum | The SBV Business Toolkit used a VCGR cost of $550 per EGM per annum, escalating at 3 per cent per annum. DOJ's *Gambling Tax Forecasting Model* from February 2009 also refers to this amount. |
| Community benefit statement expense | $5 000 per club, per annum | This value only reflects the cost associated with having the community benefit statement externally audited. Any associated labour and administration costs are assumed to be included in the 'other operating expenses' category. |
| Community benefit expenditure | $0 | Clubs are required to spend 8.33 per cent of their revenue from EGMs on 'community benefits' in order to receive an 8.33 per cent discount on state gaming taxes. The definition of community benefits is sufficiently broad to allow clubs to claim costs such as wages as part of the benefits they provide to the community. Clubs are only required to report expenditure up to the 8.33 per cent. |
| Venue refurbishment expenses | $30 000 per venue, per annum | Based on discussions with industry sources, this figure assumes that a venue would spend, on average, $3 000 per EGM every 5 years on refurbishment. This equates to $6 000 per EGM, or $165 million in total for the life of the entitlements. The annualised venue figure is calculated by dividing this number by 533 venues and ten years. |
| Other venue operating expenses | 12 per cent of EGM gross revenue | The SBV Business Toolkit assumes labour costs and general operating costs of 5 per cent and 7 per cent of EGM gross revenue, respectively. Per discussions with the author of the Toolkit, these expense assumptions represent 'best practice' industry benchmarks. Other industry sources indicated that venues could currently expect to spend 20 per cent of EGM revenue net of gaming taxes on labour costs. Excluding any allowance for 'other operating costs', this value broadly equates to 12 per cent of EGM gross revenue. |
| Entitlement payment plan assumptions | Refer Figure A3 | *Overview of the Victorian Gaming Industry: second edition,* September 2009, published by DOJ. |
| Risk-free rate at 31 March 2010 | 5.78 per cent | The yield on long-term Australian government bonds was used as a guideline for prevailing risk-free rates. |
| Income tax rate | 0–30 per cent | Zero income tax assumed for clubs. A range of income tax rates from 0 to 30 per cent has been modelled for hotels. |

*Source:* Victorian Auditor-General's Office.

**Figure A3**
**Payment plan**

| Sale mechanism | Club | Hotel |
|---|---|---|
| First instalment payable within 28 days after the close of the gaming auction | 5 per cent | 10 per cent |
| Second instalment payable in 2012 prior to the entitlements coming into operation | 5 per cent | 10 per cent |
| Periodic instalments payable each quarter thereafter | 5 per cent each quarter | 5 per cent each quarter |
| Discount rate used to calculate the value of the payment plan (the risk-free rate as at 31 March 2010) | 5.78 per cent | 5.78 per cent |

*Source:* Victorian Auditor-General's Office.

## Sensitivity analysis

The purpose of sensitivity analysis is to determine the extent to which the overall estimated financial outcome is affected by changes in the value of a particular variable.

The key assumptions that impact the mid-point value and the sensitivity analysis relating to these assumptions are in Figure A4.

**Figure A4**
**Sensitivity analysis**

| Assumption | Base value | Sensitivity analysis range | Revised valuation ($mil) |
|---|---|---|---|
| Other venue operating expenses | 12 per cent of EGM gross revenue | 10–14 per cent of EGM gross revenue | 3 812–4 422 |
| EGM lease, maintenance, marketing and administration expense | $39.95 per EGM per day | $29.95–$49.95 per EGM per day | 3 553–4 681 |
| Forecast EGM market revenue growth rate | -2.5–3.6 per cent per annum | 0 per cent | 3 137 |

*Source:* Victorian Auditor-General's Office.

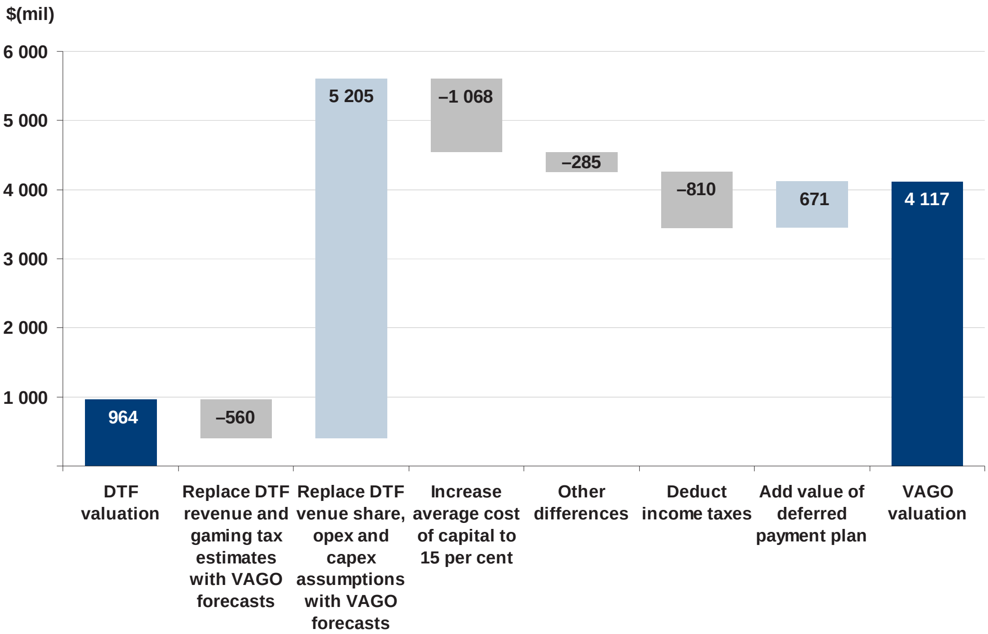
# Reconciliation between VAGO and DTF valuation

Figure A5 is a value bridge that reconciles the major differences between the DTF valuation figure of $964 million and the mid-point of the VAGO value range of $4.1 billion.

This is a high level analysis. It identifies the key issues that impact upon the values derived by DTF and the mid-point valuation derived by VAGO. Due to the differences between the valuation approach adopted by DTF and by VAGO, it is difficult to further segregate the impact of certain assumptions, in particular the operating and capital expense assumptions. As such, some assumptions are not directly comparable. For example, DTF's assumed that venue operators would purchase EGMs, whereas VAGO assumes, based on discussions with the gaming industry, that venue operators are more likely to lease EGMs as part of a package that includes a number of services, including installation, servicing, upgrades and marketing support.

It is important to recognise that the order in which the assumptions are changed impacts their quantum. If the order of the assumptions is changed—for instance, if the cost of capital is altered prior to altering the operating and capital expenditure assumptions—this will impact the amount of each reconciling item in the value bridge.

**Figure A5**
**Value bridge**




*Source:* Victorian Auditor-General's Office.

# Appendix B.

# *Audit Act 1994* section 16—submissions and comments

## Introduction

In accordance with section 16(3) of the *Audit Act 1994* a copy of this report was provided to the Department of Justice, the Department of Treasury and Finance, the Department of Premier and Cabinet, the Victorian Commission for Gambling Regulation and the Independent Review Panel with a request for submissions or comments.

Responses were received as follows:


- The Department of Justice .......... 80
- The Department of Treasury and Finance .......... 85
- The Department of Premier and Cabinet .......... 87
- The Victorian Commission for Gambling Regulation .......... 88


Further audit comment:


- Acting Auditor-General's response to the Department of Justice .......... 83
- Acting Auditor-General's response to the Department of Treasury and Finance.. 86


The submissions and comments provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

# Submissions and comments received

***RESPONSE provided by the Secretary, Department of Justice***

**Department of Justice**

Secretary

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Mr D D R Pearson
Auditor-General
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Our ref: CD/11/252013

17 JUN 2011

Dear Mr ~~Pearson~~ Des

**Proposed Audit Report on the Allocation of Electronic Gaming Machine Entitlements**

Thank you for providing me with the proposed audit report on the *Allocation of Electronic Gaming Machine Entitlements*. I have noted the recommendations and provide the following comments in relation to the matters raised in the report.

***Gambling Licences Review***

The allocation of gaming machine entitlements was part of the major review of Victoria's gambling licensing arrangements that was announced in 2004. The review looked at all aspects of the licensing arrangements for lotteries, keno, wagering and gaming machines.

The previous government specified terms of reference for the review, stating that the review was to have regard to:

- the Government's statement of principles to guide future gambling policy and legislative development
- trends and developments in the gambling sector
- the economic, social and community benefits and costs of the current and alternative licensing arrangements
- the transition and other issues involved in the implementation of new or revised licensing arrangements
- the Government's commitment to a viable and growing racing industry.

The previous government also set out the principles that would guide its gambling policy. These were:

- developing and reinforcing the government's commitment to responsible gambling through measures that assist and protect problem gamblers and those at risk of becoming problem gamblers, their families and the wider community
- developing and maintaining the state's commitment to the highest standards of probity for gambling service providers

State Government Victoria

***RESPONSE provided by the Secretary, Department of Justice – continued***

- accepting gambling is a valid activity for many Victorians who are entitled to expect ongoing high standards of service, transparency, and accountability from the gambling sector
- ensuring that the legitimate financial benefits of gambling (both private and public) are transparent, appropriately recognisable and fairly distributed to the Victorian community
- to the extent possible consistent with the other principles, gaming service providers operate in a competitive environment
- establishing proper consultative processes to ensure that appropriate information is given to, and input is received from, the wide variety of persons interested in gambling including stakeholders, affected parties, and, to the widest extent possible, the broader Victorian community.

The Department conducted the review and the subsequent allocation of gaming machine entitlements in accordance with the terms of reference and the principles articulated by the government of the day.

The size of the task was large, its scope far ranging and complex. The review resulted in a decision by the previous government to fundamentally restructure Victoria's gaming industry. The decision to abandon the gaming operator duopoly in favour of a venue operator model required the review to develop and then implement a strategy for allocating 27,500 gaming machine entitlements. An allocation process of this magnitude had never before been attempted in Australia.

The review and subsequent allocation process was made even more complex by the need to ensure that all potential purchasers were treated fairly and that the integrity of the process was maintained.

To this end, strict governance arrangements were put in place by the previous government. These arrangements included an onerous probity overlay with continuing oversight and interaction with the Independent Review Panel established in May 2007 and the establishment of a Gaming Review Sub-Committee of Cabinet. This committee met on more than 60 occasions and had responsibility for overseeing the review and allocation process and deciding the significant policy questions that arose during the review. The committee was extensively briefed by the Department through the provision of over 250 policy papers and reports.

The committee repeatedly affirmed the government's policy principles and its commitment to maintaining the existing gaming machine harm minimisation measures. These included the limit on the number of gaming machines permitted outside the casino (27,500), limiting the number of machines per venue to 105, the country-metro split, the club-hotel split, and regional caps and limits.

As the audit report notes: "The allocation was particularly complex to manage and involved significant risks. The project had numerous external stakeholders, tight time lines and constraints imposed by Government announcements such as the decision to sell the entitlements by auction. The auction design and implementation were technically complex and probity requirements were stringent."

***Financial outcomes***

*Fair market value*

The audit report states that the sale proceeds from the allocation "fell significantly short of the fair market value of the entitlements".

In arriving at its fair market value for entitlements, the audit has used earnings from gaming machines under the current gaming operator model and assumed that those earnings will be maintained under the new licensing arrangements. This assumption does not take into account the difference in profitability under a gaming operator model and a venue operator model.

***RESPONSE provided by the Secretary, Department of Justice – continued***

Under the gaming operator duopoly, each operator currently controls approximately 13,750 gaming machines. This gives the operators the capacity to move machines between venues to maximise profitability. The operators also have economies of scale that reduce costs and increase profits.

Under the new venue based licensing arrangements to be introduced in 2012, a club will be unable to operate more than 420 gaming machines and a hotel will be unable to operate more than 35 per cent of the machines available to hotels (4,812). In reality, most machines will be operated by small to medium sized venue operators who have limited capacity to move machines between venues or to benefit from economies of scale.

A comparison of player loss per machine under the Victorian gaming operator arrangements and venue operator arrangements in other states supports the Department's view that the assumption underlying the audit's assessment of fair market value is not sound.

This capacity of the duopoly operators to extract maximum player losses was a factor in the previous government's decision to dismantle the gaming operator model.

*The previous government's objectives*

In the Department's view, maximising revenue, capturing supernormal profits and obtaining a greater share of the profits from gaming were not explicit objectives of the review or the allocation process.

Rather than specify financial objectives, the previous government sought to restructure the gaming industry in a way that maintained its social policy and harm minimisation objectives while ensuring that the profits from gaming were distributed to local communities.

This view is supported by the previous government's decisions to maintain the existing harm minimisation measures and to introduce further measures (pre-commitment and reducing the maximum bet from $10 to $5), despite the impact these measures may have had on future competition for entitlements.

*Factors affecting the auction result*

A number of policy decisions had a significant impact on the financial outcome of the allocation process.

As acknowledged in the audit report, the Pre-Auction Club Offer (PACO) had a significant impact on the demand for entitlements. This offer was not part of the original allocation design but was a result of negotiations which occurred as part of the legislative process, and was, as the audit report points out, "...an unexpected change that further complicated this already large and complex project...". With 248 clubs purchasing entitlements as a result of the PACO, only 143 clubs participated in the auction. This, understandably, had a substantial impact on the auction outcome.

The audit report states that prices paid by clubs for entitlements under the PACO demonstrate that venue operators were prepared to pay more for entitlements. It should be remembered, however, that clubs who participated in the PACO were seeking certainty that they would be able to purchase the entitlements that were necessary for them to operate machines post-2012, thereby ensuring that the revenue they rely on to maintain their activities would be guaranteed. In this context, they were prepared to pay a price for that certainty, which resulted in a higher price being paid for club entitlements under the PACO than was obtained at auction. Indeed, the previous Minister emphasised in the Parliament that the prices set for the PACO "in no way bear a resemblance to possible prices in the competitive market phase" and that "prices in the competitive phase could be considerably lower than those they might have signed up to in the pre-allocation phase".

Similarly, the retention of barriers faced by those wishing to enter the gaming industry also affected the auction result. The retention of the requirement to obtain approval from the Victorian Commission for

***RESPONSE provided by the Secretary, Department of Justice – continued***

Gambling Regulation as well as a planning permit from the relevant council in order to open a new venue or increase the number of machines at an existing venue, is illustrative of this point.

***Procurement practices***

The Department considers that it has complied with the Victorian Government Purchasing Board's procurement guidelines when engaging external providers, and that all the necessary approvals and exemptions were sought and obtained for the engagement of contractors.

***Summary***

In summary:

- The Department was diligent in its advice to the previous government on policy options, having regard to the scope, size and complexity of the review and allocation task.
- The policy settings in existence at the time of the auction reflected an emphasis on social responsibility and harm minimisation ahead of revenue.
- The uncertainty of future policy impacts, including pre-commitment and the recommendations of the Productivity Commission, affected the value of entitlements.
- The audit's assessment of fair market value ignores these factors, as well as the difference between a duopoly driven by large listed companies and a gaming venue model involving hundreds of small community-based clubs and hotels.

Yours sincerely

**PENNY ARMYTAGE**
Secretary

***Acting Auditor-General's response to the Department of Justice***

*Fair market value*—cost structures and uncertainty of future policy impacts

Appendix A sets out audit's valuation method and assumptions. These have been extensively examined and agreed to by the Department of Treasury and Finance (DTF), whose role was to model the industry's supernormal profits.

Contrary to the Department of Justice's (DOJ) assertion, we have taken into account the difference in profitability under a venue operator model versus the gaming operator model:

- Historical revenue was the basis upon which fair market value was determined, adjusted for growth expectations. This is explained on page 19.
- Pages 75 to 77 outline the cost assumptions.
- Pages 19, 74 and 75 explain how the discount rates used reflect the uncertainty in the industry immediately prior to the auction.

Page 18 notes that we confirmed our valuation assumptions with industry sources.

***Acting Auditor-General's response to the Department of Justice – continued***

## *Fair market value*—comparison with other states

In new information not provided in the course of the audit, DOJ has sought to compare player loss per machine in the venue operator model in other states with the gaming operator model in Victoria.

DOJ's view is that the value of the entitlements should be lower because it assumes the player loss per machine will be lower under a venue operator model than a gaming operator model. In reaching this conclusion DOJ has:

- ignored other factors that influence the amount of player loss per machine besides the industry structure, such as demographics and the number and accessibility of electronic gaming machines (EGMs); all of which differ from state to state. Consequently, an interstate comparison is not meaningful.
- overstated the gaming operators' capacity to move EGMs 'between venues to maximise profitability', as the regulatory approval processes restrict movement. The auction resulted in relatively little change in the demand for and location of EGMs. The movement of EGMs is analysed on pages 30 to 31.
- contradicted the analysis performed by its own consultant, as described on page 15.

## *Government objectives*

Page 13 states that, prior to the auction, DOJ advised its minister, the Department of Premier and Cabinet and DTF that the purpose of the auction was to 'achieve the allocation that maximises financial value subject to policy determinations aimed at social value'.

Pages 5 to 6 and 52 to 55 describe the allocation's intended outcomes. These include 'a competitive and transparent allocation of gaming machine entitlements that will: […] seek to capture supernormal profits from the gaming machine industry'.

## *Factors affecting the auction result*—the pre-auction club offer

Page 32 highlights the advice provided to government that the pre-auction club prices would be lower than auction prices.

## *Procurement practices*

Page 60 describes DOJ's actions that contravened the procurement policy. DOJ has offered no evidence to support its claim that it obtained all of the necessary approvals and exemptions.

***RESPONSE provided by the Acting Secretary, Department of Treasury and Finance***

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MELBOURNE VIC 3000

Dear Mr Pearson

**RESPONSE TO PROPOSED AUDIT REPORT ON THE ALLOCATION OF ELECTRONIC GAMING MACHINE ENTITLEMENTS**

I refer to your letter of 3 June 2011 enclosing your proposed Auditor-General's Report (the Report), *Allocation of Electronic Gaming Machine Entitlements.* Thank you for the opportunity to provide formal comments for inclusion in the Report to be tabled in Parliament in June 2011.

This response is confined to some high level observations about supernormal profits in the industry and revenue raised in the context of government policy and regulatory settings. It also addresses the recommendation that, for issues that are significant and material, the Department of Treasury and Finance (DTF) should apply a more rigorous approach and obtain specialist third party assurance so that the advice to the Government is robust.

**Supernormal profits and premium revenue in the context of policy and regulatory settings**

The allocation of electronic gaming machine (EGM) entitlements formed part of the broader review of gambling licences, which involved significant changes to the industry's licensing structure.

The gambling policy and regulatory environment that existed at the time of the allocation was underpinned by the Government's guiding principles on gambling. As noted in the Report, these included to:

- provide consumer choice and service in a competitive and innovative marketplace;
- ensure the legitimate financial benefits of gambling are transparent, recognisable and fairly distributed to the community;
- reduce the harm caused by problem gambling;
- maintain high standards of transparency, probity, integrity, accountability and community engagement; and
- promote a sustainable and viable racing industry.

***RESPONSE provided by the Acting Secretary, Department of Treasury and Finance – continued***

DTF modelling was designed to achieve two things:

- Estimate potential supernormal profits in the market at a point in time to inform policy consideration of potential premium revenue subject to the policy and regulatory environment.
- Forecast the level of premium that would be paid. The potential level of supernormal profit was one consideration in DTF's determination of forecast premium. However, DTF's professional judgement was that other factors would influence the premium actually paid. Realising the full supernormal profit as premium depended on the Government making certain policy choices with respect to competition at auction, as is acknowledged in the Report. DTF advice indicated that the level of regulatory risk would also diminish the Government's potential to extract current levels of supernormal profit as premium (because it would reduce market expectations of future supernormal profit).

DTF considers that it realistically assessed how much revenue could be raised from the allocation of EGM entitlements within the regulatory and policy environment prescribed by Government at that time. DTF estimated that the EGM allocation would raise about $1 billion in premium revenue, and the actual premium revenue raised was $980 million.

**Specialist third party assurance**

The Report recommends that "*For issues that are significant and material, DTF should apply a more rigorous approach and obtain specialist third party assurance so that the advice provided to government to inform key decisions is robust*".

DTF accepts in-principle this recommendation, noting that this advice will be useful for any future modelling exercises that are as significant and complex as the EGM allocation. External peer review is a valuable tool to increase the robustness and contestability of advice.

In the case of the EGM allocation, DTF had close regard to the strict probity requirements of the Gambling Licences Review Project and the commercially sensitive nature of the information. DTF used available consultant reports and publicly available information to form its conclusions and tested its modelling methodology and assumptions with the Gambling Licences Review Project Team and the Department of Premier and Cabinet within those information constraints. DTF's modelling approach was documented and noted by the Gambling Licences Review Steering Committee and the relevant Cabinet Committee.

More generally, DTF considers that its valuation methodology and assumptions were sufficiently robust, relevant and appropriate for the time. DTF used its professional judgement and the best available information at the time. The nature of economic modelling and valuation is that it depends on the regulatory and policy context, the available market information and changes to assumptions.

Yours sincerely

D a Yates.

**Dean Yates**
**Acting Secretary**
17/6/11

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***Acting Auditor-General's response to the Department of Treasury and Finance***

## *The Department of Treasury and Finance's economic model*

See page 22 of the report. The similarity between DTF's most detailed estimate of the expected level of supernormal profits in the industry ('about $1 billion') and the amount of revenue actually raised at auction ($980 million) was entirely coincidental.

***RESPONSE provided by the Secretary, Department of Premier and Cabinet***

**Department of Premier and Cabinet**

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20 JUN 2011

Our Ref:
B11/2565

Mr Des Pearson
Victorian Auditor-General
Level 24, 35 Collins Street
MELBOURNE VIC 3000

Dear Mr Pearson

Thank you for your letter of 3 June 2011, enclosing the proposed report: *Allocation of Electronic Gaming Machine Entitlements*. I agree with the report's view that this is a significant and complex area and I thank you for the work reflected in the report. While the proposed report does not contain any recommendations that pertain directly or solely to the Department of Premier and Cabinet (DPC), it will provide a useful tool to consider possible improvements in licensing processes for large and complex projects.

While the report argues that there were windfall gains to auction participants instead of the community in general, the report also correctly identifies that $980 million in revenue was raised in the auction. The proceeds of the auction are being returned to hospital infrastructure for the benefit of the Victorian community.

Thank you again for the opportunity to comment on your proposed report.

Yours sincerely

**Helen Silver**
Secretary

Your details will be dealt with in accordance with the *Public Records Act* 1973 and the *Information Privacy Act* 2000. Should you have any queries or wish to gain access to your personal information held by this Department please contact our Privacy Officer at the above address.

Victoria
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***RESPONSE provided by the Chairman, Victorian Commission for Gambling Regulation***

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17 June 2011

Mr D D R Pearson
Auditor-General
Victorian Auditor-General's Office
Level 24
35 Collins Street
MELBOURNE VIC 3000

Dear Mr Pearson

I refer to your letter of 3 June 2011 enclosing a copy of the proposed audit report by the Victorian Auditor-General's Office (VAGO) on *Allocation of Gaming Machine Entitlements* (the Report). The Victorian Commission for Gambling Regulation (VCGR) is pleased to be offered the opportunity to provide its comments on the Report, which are set out below.

The VCGR notes the reference in the Report to the impact of the regulatory framework and the high barrier it creates to market entry thereby inhibiting competition. The Report goes on to note that proposals to reduce these barriers were for the most part not accepted by the previous government for social policy reasons.

The main objective of *Gambling Regulation Act 2003* is not only to foster responsible gambling but also to ensure that gaming on electronic gaming machines is conducted honestly and that the management of gaming machines and gaming equipment is free from criminal influence and exploitation.

Consistent with the legislation, the VCGR is properly required to assess the suitability of an applicant for a venue operator's licence and its associates in terms of probity, reputation and integrity. It is also properly required to assess the social and economic impact of applications for approval of premises as suitable for the conduct of gaming before approving or rejecting them. As the VAGO points out in its Report, the process is costly and there is no guarantee an application will succeed.

While the VCGR has adopted internal measures to ensure that the process is timely and cost effective, objections by local government or individuals and appeals against VCGR decisions to the Victorian Civil and Administrative Tribunal can and do affect the timeliness and cost of the assessment process.

In the Report, the need for accurate master data is highlighted as being critical for the VCGR to monitor compliance with the regulatory framework, and the VCGR agrees with this.

***RESPONSE provided by the Chairman, Victorian Commission for Gambling Regulation – continued***

The VCGR became aware of inconsistencies in some of its information recorded for venue operators, generally related to naming conventions. Discrepancies primarily occurred between the VCGR database established to record and report probity and structural matters, and the VCGR database responsible for receiving and reporting operational and financial transactions in relation to electronic gaming machines at approved venues. These databases were designed and developed independently for distinct and separate reporting purposes and, therefore, were not required to correspond or correlate.

The VCGR has sought to remedy this and has undertaken an upgrade of its systems, including linking its key databases. The upgrades were undertaken to ensure consistent information exists across its databases and reports. It is the VCGR's view that the upgrades to its systems offset concerns raised in the Report about reduced data quality arising from inconsistencies in the information on venue operators maintained by the VCGR.

The VCGR would like to extend its thanks the VAGO for the opportunity to comment on the Report.

Yours sincerely

**Bruce Thompson**
**CHAIRMAN**

# Auditor-General’s reports

## Reports tabled during 2010–11

| Report title | Date tabled |
|---|---|
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| Taking Action on Problem Gambling (2010–11:2) | July 2010 |
| Local Government: Interim Results of the 2009–10 Audits (2010–11:3) | August 2010 |
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| Public Hospitals: Interim Results of the 2009–10 Audits (2010–11:5) | September 2010 |
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| Security of Infrastructure Control Systems for Water and Transport (2010–11:15) | October 2010 |
| Auditor-General’s Report on the Annual Financial Report of the State of Victoria, 2009–10 (2010–11:16) | October 2010 |
| Restricting Environmental Flows during Water Shortages (2010–11:17) | October 2010 |
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| Acquittal Report: Results of the 2009–10 Audits (2010–11:19) | February 2011 |
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| Construction of Police Stations and Courthouses (2010–11:22) | February 2011 |
| Environmental Management of Marine Protected Areas (2010–11:23) | March 2011 |
| Managing Drug and Alcohol Prevention and Treatment Services (2010–11:24) | March 2011 |

| Report title | Date tabled |
|---|---|
| Local Community Transport Services: the Transport Connections program (2010–11:25) | March 2011 |
| Effectiveness of Small Business Victoria’s Support Programs (2010–11:26) | March 2011 |
| Facilitating Renewable Energy Development (2010–11:27) | April 2011 |
| Problem-Solving Approaches to Justice (2010–11:28) | April 2011 |
| Managing Student Safety (2010–11:29) | May 2011 |
| Revitalising Central Dandenong (2010–11:30) | May 2011 |
| Tertiary Education and Other Entities: Results of the 2010 Audits (2010–11:31) | May 2011 |
| Early Childhood Development Services: Access and Quality (2010–11:32) | May 2011 |
| Indigenous Education Strategies for Government Schools (2010–11:33) | June 2011 |
| Management of Major Road Projects (2010–11:34) | June 2011 |
| Victorian Life Sciences Computation Initiative (2010–11:35) | June 2011 |

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VAGO

Victorian Auditor-General’s Office

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