AHA (NSW) Application for Authorisation A90837

Economic Report prepared on behalf of

Tab Limited and SKY Channel Pty Ltd

October 23, 2002

Contents

1 Introduction

This submission has been prepared by Network Economics Consulting Group on behalf of Tab Limited and SKY Channel. It should be read in conjunction with the two background documents which describe the history and operations of Tab Limited and SKY Channel respectively. Those details are not repeated here. The submission begins with a basic analysis of the economics of racing and wagering in NSW. It then proceeds to consider the merits of the AHA (NSW)'s application for the authorisation of joint negotiation and primary boycott activity in terms of the 'future with and without' authorisation test established by the Tribunal and followed by the Commission.

2 Some Basic Economics of NSW Racing and Wagering

2.1 Demand for Wagering and Gambling

Wagering is one of a range of gambling products available to consumers, including lotteries, poker machines and casinos.[1] To some extent, all these gambling opportunities compete with each other for the consumer's discretionary dollars. The share of wagering in total gambling turnover has declined in recent years as other forms of gambling, particularly poker machines, have become more widely (legally) available. According to Tasmanian Gaming Commission (TGC) data, racing's share of total gambling turnover in NSW has declined from 31.6 per cent in 1975-76 to 9.6 per cent in 2000-01.[2] However, the absolute level of real racing turnover, at least for the off-course totalizator sector, has been essentially

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1 See Productivity Commission (1999), Australia's Gambling Industries, Inquiry Report No.10. Wagering and gaming are distinguished by the fact that the former involves gambling on 'live' events, principally racing but increasingly other sports as well, whereas gaming involves gambling on a random game of chance, where the operator has a greater degree of control over the outcome.

2 See Tasmanian Gaming Commission, Australian Gambling Statistics 197-76 to 2000-01, Tables 5.

steady, with some fluctuations, over the last decade and growing prior to that.[3] On-course totalizator and bookmaker turnover levels have, however, been declining.[4]

Reliable estimates of the price elasticity of demand for total gambling, particular types of gambling and cross price elasticities between different types of gambling are limited.[5] However, it seems likely that total demand is relatively inelastic and substitution between types of gambling is somewhat limited. The Productivity Commission reviewed various estimates of price elasticity, which had tended to suggest that demand was elastic. However, they had reservations about the robustness of these estimates and concluded that overall demand was likely to be inelastic.[6] There are at least three good reasons to accept this proposition. First, the 'price' of gambling products, in terms of the net outlay (expenditure[7] as a proportion of turnover), is often difficult for gamblers to observe, making it likely that demand will be insensitive to changes in price.[8] Second, prices are capped by legislation: since demand elasticity generally increases with price, it is more likely that demand will remain in the inelastic range. Third, 'heavy' and 'problem' gamblers account for a large proportion of expenditure on gambling. According to Productivity Commission estimates, ten per cent of gamblers account for 70 per cent of expenditure on gambling, while 'problem' gamblers account for 33 per cent of expenditure.[9] It seems reasonable to assume that demand for gambling by these people will be relatively insensitive to price.[10]

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3 Ibid., Table 161.

4 Ibid., Tables 163 and 165.

5 See Productivity Commission, op.cit., Appendix D.

6 Ibid, p.53 and p.5.16.

7 'Expenditure' equals turnover minus payouts and is equivalent to revenue from the gambling operator's perspective.

8 Productivity Commission, op.cit, p.40 and p.3.7.

9 Ibid, p.12 and p.22.

10 Ibid, p.5.17.

However, in the current context, it is the extent to which different types of gambling are substitutable for one another, increasing the elasticity of demand for wagering as compared to total gambling, and hence constraining the exercise of any market power by Tab Limited, that is most relevant. It is to be expected that the elasticity of demand would be higher at the level of individual gambling products, such as wagering, depending on the extent of that substitution. Some of the econometric estimates suggesting that demand is price elastic were made at the individual product level, particularly for lotteries, and are consistent with this expectation.[11]

Nevertheless, it is clearly the case that gambling is a differentiated product, in terms of the size of upfront outlays involved, the nature of the risk/return relationship and the social context in which the product is supplied; varying from lottery tickets sold through newsagents, to gaming and wagering supplied through hotels, clubs and TAB agencies, to casinos. This is reflected in the divergence of prices across the spectrum of gambling products, including between wagering and fixed odds betting on races. Productivity Commission calculations of the imputed price (expenditure as a percentage of turnover) suggest that the 'price' of gambling varies from five per cent for on-course bookmakers to 16 per cent for the TAB, ten per cent for gaming machines and 30-50 per cent for various types of lottery products.[12] Furthermore, the difficulties of observing and comparing prices apply as much across gambling products as between gambling and non-gambling products. Totalizator wagering also has the peculiar characteristic that the odds of winning and the likely size of the prize cannot be known when a bet is placed, because it depends on the size of the pool for that event and the proportion of people wagering on the same outcome as you.

Wagering through the TAB involves gambling on the outcome of real events and provides the opportunity for 'professional' gamblers to exercise skill and judgement by studying the form of horses and jockeys, while more 'social' gamblers may simply enjoy the excitement of wagering while socialising with friends and the associated excitement of watching the event

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[11] However, the Productivity Commission's reservations regarding the robustness of the estimates remain valid, particularly because of the difficulty of disentangling the impact of deregulation.

[12] Productivity Commission, op.cit, Table 3.1, p.3.8.

unfold on SKY Channel.[13] Data from the Productivity Commission's national gambling survey, indicates that 24 per cent of the adult population participates in wagering on races, but only 15 per cent of these (i.e. 3.6 per cent of all adults) do so at least every week and only two per cent of them do so more than three times per week.[14] A similar proportion, 33 per cent, of expenditure on wagering as total gambling, is estimated to be by 'problem' gamblers. This means that the majority of gamblers may be classed as 'social' gamblers, albeit that some of these will be 'professional' studiers of form and may be spending large amounts of money on wagering. Nevertheless, there is plenty of scope here for social gamblers to switch between wagering and other forms of gambling, which suggests that demand for wagering is likely to be more elastic than demand for total gambling. This is particularly the case for those wagerers who access the product through hotels and clubs, where gaming machines are also located.

While demand for particular types of gambling products may be insensitive to price at any given time, gambling operators clearly compete on the non-price characteristics of their products, which translate into a closer price/quality trade-off, resulting in greater demand side substitution over the longer term. Demand from the existing stock of wagerers may be relatively unresponsive to price. However, the extent to which new gamblers are attracted to wagering may depend importantly on the quality of the product, which in turn depends on the extent to which there is a flow of funding for promotions and for other forms of investment in product quality. Maintaining such an inflow of new gamblers would seem to be especially important as wagering is to some extent an acquired taste, in which some investment in human capital (for example, in learning to read the form) is necessary. Looking at the market over the longer run, demand-side considerations may therefore constrain Tab Limited to the extent that reducing product quality restricts the pool of consumers from whom wagering revenues can be drawn.

The growth in new forms of gambling has largely resulted in an expansion in total gambling expenditure, rather than a switch from existing forms of gambling, prompting the Productivity Commission to suggest that gambling products are not, or have not been in the

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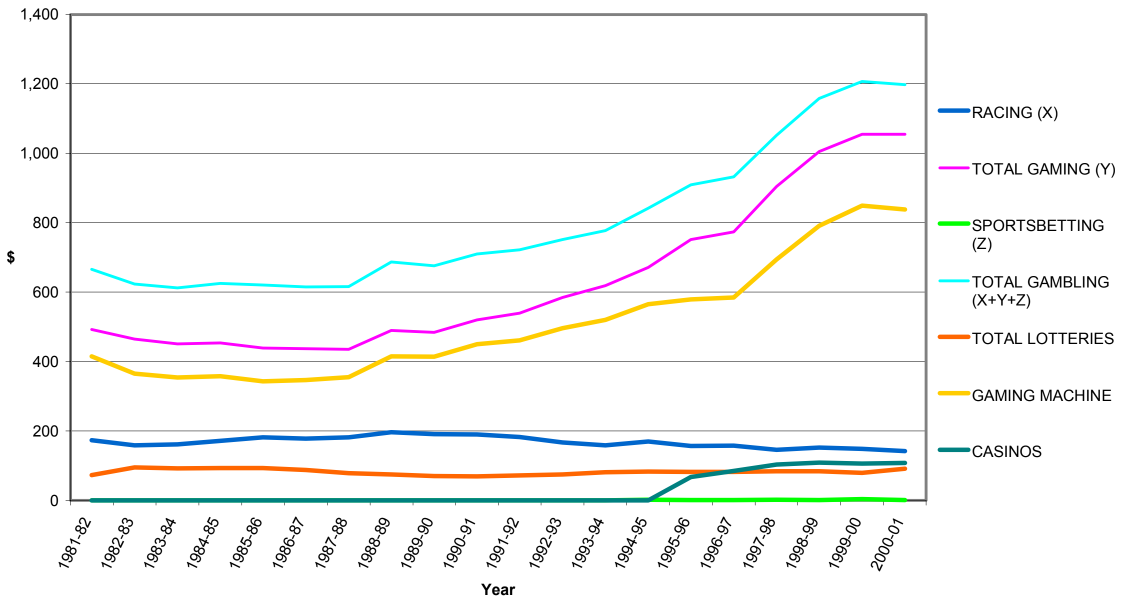
13 Productivity Commission, op.cit, p.3.11.

14 Productivity Commission, op.cit., Table 1, p.10.

past, highly substitutable.[15] However, a closer look at the data reveals that while total real wagering turnover has been essentially steady, real expenditure *per capita*[16] has been declining, while per capita expenditure on gaming, and particularly gaming machines, has been increasing (see Figure 1 below).

Figure 1: Real Per Capita Gambling Expenditure in NSW 1981-82 to 2000-2001



Source: Tasmanian Gaming Commission, Australian Gambling Statistics 1975-76 to 2000-01

According to TGC data, real per capita expenditure on racing in NSW has declined from a peak of $196.82 in 1988-89 to $141.74 in 2000-01.[17] Over the same period, real per capita

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15 Productivity Commission, op.cit, p.2.22.

16 Per capita expenditure in the gambling context refers to the adult population.

17 Tasmanian Gaming Commission, op.cit., Table 10.

expenditure on gaming machines has increased from $414.64 to $838.06[18], while real per capita expenditure on casinos has increased from nothing to $107.62.[19]

Clearly the growth in per capita expenditure on gaming machines (and other forms of gaming, particularly casinos) has exceeded the decline in expenditure on racing. However, it remains the case that demand for wagering has suffered in the face of the increased availability of new forms of gambling. Furthermore, it may well be the case that demand for wagering has only been maintained in the face of this new competition by increasing the quality of the racing and wagering products and the quantity of racing on which wagering is offered (equivalent to a price reduction). For example, the number of race meetings on which Tab Limited conducts wagering has increased from 3,854 in FYE 1998 to 5,467 in the FYE 2002, new totalizator products such as 'Flexi' and 'First 4' have been introduced, TAB agencies have been refurbished and electronic delivery and new terminals have been introduced in wagering outlets.[20]

In conclusion, while demand for total gambling is likely to be inelastic, demand for wagering is likely to be much more elastic, particularly over the longer term. While the existing pool of consumers may be relatively unresponsive to price changes, their custom is retained in the face of competition from new gambling products, and new consumers are attracted to the product, through increasing its quality and attractiveness (and hence reducing the effective price) compared to other gambling products (and other non-gambling products).

2.2 Racing and Wagering: public goods, externalities and complements

The racing and wagering industries are closely interrelated, both economically and legally. Racing has been described as a 'gambling industry'[21] because most of the consumer welfare derived from it is via the activity of wagering. While some consumers may simply enjoy a

18 Ibid., Table 225.

19 Ibid., Table 231.

20 See the Tab Limited background paper for further details.

21 Australian Racing Board, quoted in Productivity Commission, op.cit, p.14.24.

day out at the races, similar to the consumption of other sports, this benefit is far exceeded by the benefit derived from wagering on the outcome of the races. This is reflected in the requirements of the NSW racing industry legislation[22] for Tab Limited to provide substantial funding to the racing industry, the details of which are established through the Racing Distribution Agreement (RDA).

It is also important to recognise that racing, at least in relation to demand for wagering, has significant public good characteristics and problems of non-excludability. A 'public good' is characterised by the absence of opportunity costs in consumption: if one person wagers on a race, this does not prevent another person from wagering on the same event.[23] The socially efficient level of production for a public good is determined where the *sum* of all consumers' marginal willingness to pay covers the cost of supplying the marginal unit, rather than where *each* consumer's willingness to pay equals the marginal cost of supply. Furthermore, as with many (but not all) public goods, absent legal restrictions, it is difficult to exclude people from consuming the product for the purpose of wagering. Both these characteristics are recognised by the racing industry legislation and the RDA, which provide for the pooling of TAB expenditures by all wagerers and require that a substantial proportion of TAB Limited earnings from wagering are paid to the NSW racing industry for the use of its product.[24]

The various pieces of racing industry legislation[25] and associated agreements and licences establish a series of exclusive rights over the organisation of racing and off-course wagering

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22 As well as similar legislation in other States.

23 Indeed, wagering, particularly in the form of a totalizator, requires a critical mass of wagerers to be viable. If the pool is too small, one wager can significantly alter the odds for all participants in the totalizator.

24 This comprises two payments: the 21.64% of TAB revenue (turnover minus payouts) paid as a 'product fee' and the 25% of Tab Limited's bottom line earnings (after costs and gambling tax) paid as a 'wagering incentive fee'.

25 Specifically, the *Racing Administration Act 1998*, the *Thoroughbred Racing Board Act 1996*, the *Harness Racing NSW Act 1977*, the *Greyhound Racing Authority Act 1985* and the *Totalizator Act 1997*.

in NSW. Wagering is only allowed on the three specified codes of thoroughbred, harness and greyhound racing and certain declared sporting events. Races are organised by the three relevant boards for thoroughbred, greyhound and harness racing and their associated clubs. Another relevant feature of these racing organisations is that they are all non-profit organisations, so that all their income is ploughed into the racing industry, expanding output through the provision of race facilities, infrastructure and services, and the payment of prize money, which in turn is used to pay jockeys, drivers, trainers and others.

Only the holder of a licence under the *Totalizator Act* may conduct a totalizator in NSW. Tab Limited has a 99 year licence to 2097, exclusive for 15 years, to organise off-course totalizators. In practice it is also the only provider of on-course totalizators in NSW.[26] Interstate wagering by telephone and internet is permitted, but inter-state advertising is restricted. Fixed odds wagering by bookmakers must be licensed by the relevant board and can only be conducted on-course during race meetings, with a minimum $200 bet requirement for telephone wagering on racing events. Despite having more favourable odds and tax treatment, fixed odds wagering on racing is a relatively small and declining proportion of total wagering activity on racing in NSW. According to TGC data, the share of bookmakers in NSW racing expenditure has declined from around 22 per cent to less than four per cent in the last twenty five years.[27] Tab Limited's 'price', in terms of the take-out rate on totalizators, is regulated to a maximum of 25 per cent on any particular totalizator and a maximum of 16 per cent across all totalizators in a twelve month period.

A similar set of statutory arrangements for the provision of racing and wagering exist in each state and territory. Each state's racing industry is substantially funded by that state's TAB. While each state's TAB is largely confined to the provision of wagering within its own state, it accepts bets from its customers on races conducted across the country, as well as internationally. Each state's totalizator operator uses racing in other states as an input to its

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[26] While the racing clubs also have licences to conduct on-course totalizators, if Tab Limited is running a totalizator on a race, they are required by statute (*Totalizator Act* s.17(3)-(4)) to act as agents for Tab Limited. Furthermore, Tab Limited has acquired the two former operators (on behalf of the clubs) of on-course totalizators. The second of these acquisitions was cleared by the Commission.

[27] See Tasmanian Gaming Commission, op.cit., Table 136.

wagering activities. Instead of each state paying a separate fee to each other state as well as it's own state's racing industry for the use of their racing products, by virtue of a 'gentlemen's agreement' between the states, each state TAB funds that state's racing industry.

There have been two separate reviews of the statutory arrangements underpinning the NSW racing and wagering legislation: a 1998 review of the *Totalizator Act* by the Centre for International Economics[28] and a 2001 review of the remaining legislation by the Department of Gaming and Racing.[29] These reviews have endorsed the current regimes as providing a net public benefit which cannot be achieved by alternative means. Hence, the current arrangements seem set to continue for the foreseeable future, which is relevant when considering the merits of the AHA's application for authorisation of its conduct.[30]

The provision of racing coverage by television has strong complementarities with the provision of wagering on racing, and may be conceptualised as an 'input' to the provision of wagering. While systematic evidence is limited, conventional wisdom in the industry, supported by anecdotal experience, is that the provision of television coverage in hotels, clubs and agencies boosts TAB turnover by 40-60 per cent. In Australia, this coverage is supplied by SKY Channel.

SKY Channel has no exclusive statutory rights and is not subject to price controls. However, it has acquired extensive broadcasting rights for all codes of racing in every state in relation to transmission to commercial premises (clubs, hotels and TAB agencies) and for subscription television broadcast services. These rights are then used to produce the 'SKY Channel' programming, distributed to hotels, clubs and TAB agencies, and 'SKY Racing', distributed to home viewers via various subscription television providers. Both these products provide a national service, with coverage of racing in each state.

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28 Centre for International Economics (1998), The proposed TAB privatisation – A net public benefit case to the NCC with respect to the enabling legislation.

29 Department of Gaming and Racing (2001), National Competition Policy Review of NSW Racing and Betting Legislation.

30 Specifically, the 'future with and without' test discussed in section three below.

In principle, it would be possible for another broadcaster to acquire rights and supply racing channels in competition with SKY. However, these rights are obtained at the club level and rights from different clubs expire at different times, which raises issues for a new entrant seeking to acquire a critical mass of racing rights. The full set of rights to Australian racing is likely to have greater value, especially to a wagering-related entity, than would any subset of those rights. Nonetheless, a broadcaster could bundle some rights with other content and on that basis supply a service to hotels. The large scale of major broadcasters, when compared to SKY, and their ability to distribute a service to hotels, makes this threat of entry more substantial. FoxSports is already being supplied to hotels and clubs and could readily add racing to its programming content once the non-compete agreement associated with the sale of SKY to Tab Limited expires in 2003. Furthermore, Victorian thoroughbred racing bodies retain rights for 'new media', which may provide another avenue through which live coverage of racing events can be broadcast.

2.3 The Distribution of Wagering and SKY Channel

Tab Limited distributes its product through a number of different channels: hotels, clubs, agencies, telephone and Internet. The role of these different channels has changed since privatisation and the lifting of restrictions. Hotels now account for 24 per cent of TAB turnover, compared with 18 per cent four years ago. While this share has been increasing since privatisation (see Table 1 below), the number of such outlets has increased even faster, such that the turnover per outlet has declined as the TAB has spread to smaller hotels (and clubs). By contrast, while the share of TAB agencies in turnover has declined, the number of TAB agencies has declined even further and turnover per agency has increased. Tab Limited owned outlets have been eliminated, along with their share of turnover, while telephone and internet wagering have expanded.

Table 1: Distribution of TAB Outlets and Turnover 1998 and 2002

	Share of Turnover (%)				**Number of Outlets**		
	Hotels	***Clubs***	***Agencies***	***Other***	***Hotels***	***Clubs***	***Agencies***
FYE1998	18	13	49	20	586	371	508
FYE2002	24	15	42	19	990	604	336

Source: Tab Limited.

Hotels, clubs and agencies provide a distribution service to Tab Limited, an input into the delivery of the final product to consumers. Hotels do not acquire ownership of a product for resale to consumers, rather they provide the venue and staff through which Tab Limited supplies its product to consumers, the price of which is determined by Tab Limited (subject to the caps discussed above). However, it is also important to recognise that PubTABs, and gambling more generally, also make a broader contribution to hotel revenues and profitability as part of the overall entertainment package provided to patrons, boosting sales of liquor and food. Hence, while Tab Limited initially had to promote PubTABs to hotels, hotels now actively seek these and want to retain them despite the fact that they may not break-even on a stand alone basis.

Hotels (as well as clubs and agencies) receive a commission for providing a distribution service to Tab Limited, which is determined as a percentage of the TAB turnover at that outlet, with a two tier structure of commission rates (a higher percentage at higher turnover levels). Tab Limited covers the capital, installation and repair costs of the terminal equipment used by hotels to supply TAB services - the current 'Eureka' terminals have a capital cost of around $13,000 each – as well as costs relating to communications, tickets, consumables, form guides and race lists, while the hotels provide the venue and staff through which the service is provided.

The different distribution streams are part substitute and part complement for Tab Limited. If the product is unavailable through one type of outlet, some consumers will acquire it through another type of outlet, but others will simply forego consumption or find another outlet of the same type. Table 1 indicates that the rationalisation of agencies has not been accompanied by a matching decline in their share of turnover, nevertheless the reduced number of agencies (and elimination of Tab Limited owned outlets) and increased number of PubTABs and ClubTABs has clearly resulted in some shifting of turnover in the same direction. Tab Limited has plainly seen the hotels and clubs as an alternative distribution stream to its agencies, and has invested in developing them as such.

Tab Limited, as a privatised corporation, will seek to maximise its profits, which are a function of revenues and costs. Revenues (or expenditure by wagerers) are largely a function of the volume of wagering, since the price (the take-out ratio) is capped. Tab Limited's costs are a mixture of fixed and variable. Fixed costs consist primarily of the costs of running its service and operations centre, capital costs, lump sum payments to SKY for the distribution of SKY Channel to TAB agencies and opening fees to agencies. However, it should be noted that while capital costs are fixed, they are not entirely sunk, since the equipment can be relocated to another agency at relatively low cost. Variable costs are principally the commissions payed to hotels, clubs and agencies for the distribution of its product, payments to the racing industry and taxes.[31]

Additional outlets will be profitable to Tab Limited as long as they cover the cost of capital invested in that outlet by Tab Limited and the (opportunity) cost of any lost revenue (to Tab Limited, i.e. net of commissions) diverted from other TAB outlets.[32] In assessing the viability of additional outlets, Tab Limited uses an internal rate of return requirement to reflect this. Tab Limited is currently considering ways to enable more hotels to meet this rate of return requirement, either by reducing commissions or by using smaller and less costly terminals. The existing two tier commission structure already promotes this goal by providing for lower rates of commission on low turnover PubTABs.

As discussed above, SKY Channel is strongly complementary with wagering. Some hotels without a PubTAB acquire the SKY Channel service as an entertainment service for their patrons, but in many instances these hotels have a TAB agency on the same premises (but not operated by the hotel) or close by, so that patrons can place the bet at the agency and then watch the race in the hotel. SKY's business is characterised by largely fixed costs, principally the rights fees paid to racing clubs, program production costs, transponder costs, decoders and dishes (as with the TAB terminals, the latter can be relocated to other premises). SKY Channel's customers pay the cost of the screens on which the picture is displayed. SKY Channel's prices are unregulated and it will seek to maximise profits by maximising revenue from this fixed cost service. Revenue will be maximised if SKY Channel can extract as much of the value, or consumer surplus, in excess of the marginal cost of supply (essentially the decoder and dish) from all potential users of the service.

SKY Channel's major customers are hotels, clubs, TAB agencies and racing tracks. Revenue for the SKY Channel service consists of two major streams: the lump sum annual payments for the service delivered to TAB agencies in each state; and the variable payments received

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31 Other variable costs include telephone charges and consumables such as tickets and toner.

32 The extent to which this opportunity cost arises will depend on the 'closeness' of competition between hotels, in both product and geographic dimensions – see below. Even where this competition is close, hotels build up a loyal patronage, such that almost any new hotel TAB agency will increase total TAB turnover to some extent.

from individual hotels and clubs. The former essentially try to capture the value or surplus generated through the provision of the SKY Channel service to TAB agencies, with negotiations for contract renewals trying to capture as much of the growth in that surplus as possible. The situation of hotels and clubs is more complicated, however, since SKY Channel is complementary not only to wagering but to beer (or liquor more generally) and food sales in the hotel, as well as other gambling services such as gaming machines. It can be seen as an input to the total hotel business, not just the PubTAB in the hotel. Indeed, it should be noted that originally the SKY Channel service was a broader sports broadcasting service, designed to boost beer sales rather than TAB income. However, over time it has changed to a service more complementary to wagering.

Historically, charges to hotels and clubs were uniform prices, regardless of the value added derived from the service. This was clearly not efficient. The uniform price would have had to exceed marginal cost in order to cover the large fixed costs. Some hotels, for whom the value of the service would exceed the marginal cost of supply to that outlet, would not have subscribed to SKY Channel where the uniform price exceeded the value added. Hence, consumption of SKY Channel was restricted below the optimal level. Partly as a result of pressure from the hotels, charges were changed to a variable basis, initially calculated in relation to liquor licensing fees, which in turn reflected hotel sales of liquor. This basis for calculating fees had to be changed as a result of the High Court challenge to liquor licensing fees. The current fee structure reflects the dual complementarity of SKY Channel with both hotel sales of liquor (and food) and TAB turnover, with SKY Channel fees tiered in relation to both beer litreage and TAB turnover. This represents efficient pricing, at least in a 2nd-best sense, since it extracts surplus from all potential users by discriminating between them on the basis of the value they receive from the service, while minimising marginal losses in consumption. A minimum price is required to cover the marginal costs of supplying a hotel (principally the dish and decoder). Hence, while profits are maximised, losses to allocative efficiency are minimised, subject to the commercial constraints of the business.[33]

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[33] In an ideal world, SKY would extract surplus through fixed fees that reflected each hotel's ability to pay for the service. This is plainly unrealistic in a setting where SKY does not know individual hotel's ability to pay and would incur substantial transactions costs in attempting to gauge it. The pricing approach SKY adopts represents a cost-efficient alternative in the face of information and transactions costs constraints. Beer litreage

While hotels provide a distribution service to Tab Limited, sale of other products, particularly liquor and gaming, continue to be their main source of income.[34] Indeed, wagering and SKY Channel services are in part used to boost those sales. Table 2 below provides data on the sources of income for hotels with gambling Australia wide.

Table 2: Australian Hotels with Gambling Facilities, Sources of Income 2000-01

	$m	**%**
On premises beverage sales	2,174.9	28.5
Off premises beverage sales	2,431.6	31.8
Total Beverage Income	*4,606.5*	*60.3*
Net takings from poker/gaming machines	1,658.5	21.7
Commissions for poker/vending machines	395.5	5.2
Commissions from TAB	53.4	0.7
Commissions from Keno	13.9	0.2
Total Gambling Income	*2,121.3*	*27.8*
Meals and food	642.7	8.4
Accommodation	122.1	1.6
Vending machine commissions	42.7	0.6
Catering commissions/concessions	1.9	-
Rent, leasing and hiring	22.2	0.3
Other sales of goods & services	50.1	0.7
Other income	31.0	0.4
Total Income	**7,640.5**	**100.0**

Source: Australian Bureau of Statistics, Clubs, Pubs, Taverns and Bars: Australia, 2000-2001, Catalogue No. 8687.0, Table 1.2.

provides the best universal and verifiable proxy for the general entertainment value generated by the SKY service.

34 Indeed, it is a statutory condition of a hotelier's licence that the primary purpose of a hotel is the retail sale of liquor.

While hotels receive an increasing proportion of their income from gambling[35], representing almost 28 per cent of income for those pubs with gambling, most of this is from gaming (or poker) machines, not from wagering on the TAB. If separate data were available for NSW, these would likely show an even greater dependence on gaming income.

Particularly with wagering representing a relatively minor source of their income, hotels have less incentive than Tab Limited to invest in the future of the racing and wagering product. Rather, where possible, it will be in the interest of individual hotels to increase the exploitation of the existing base of customers at the expense of the quantity and quality of racing and wagering output. This is of considerable importance in understanding the implications of the conduct the hotels are seeking to have authorised.

Hotels compete with one another in markets characterised by differentiation in both product and geographic space. The 'closeness' of this competition will be determined by the 'distance' from each other in product and geographic space. Clearly two hotels appealing to a similar type of patron in the CBD will compete much more closely than a country pub and a suburban local. That competition will be partly through prices and partly through the amenities provided and standards of service (all of which go to the effective price).

Entry to these markets is restricted through the liquor licensing laws, which require applications for new licences to go through the lengthy and costly exercise of applying to the NSW Liquor Licensing Court.[36] In particular, objections can be made, generally by incumbent licensees, to applications for new licences on the basis of 'need'. Furthermore, we understand that the Commission has for some time been investigating potentially anti-competitive agreements between existing licensees and potential entrants, by which entrants agree to restrict their competitive activity in return for the incumbent withdrawing objections to the issuing of a new licence.

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35 According to ABS data, the contribution of gambling income to industry income has increased from 16 per cent in 1997-98 to 24 per cent in 2000-01 (see Australian Bureau of Statistics, Clubs, Pubs, Taverns and Bars: Australia, 2000-2001, Catalogue No. 8687.0, p.5).

36 The NSW *Liquor Act 1982* is currently the subject of a National Competition Policy review. The Department of Gaming and Racing issued a Discussion Paper in June 2002.

In conclusion, while Tab Limited and SKY Channel each have a degree of exclusivity in the services they distribute, given the particular incentive structures they face and their ability to price discriminate, any adverse consequences for efficiency are minimised. For the hotels, who face varying degrees of competition, wagering is generally a relatively minor activity and their incentives will likely differ from those of TAB Limited and SKY Channel. If they are able to better exploit the existing base of consumers for their own benefit, even at the expense of the quantity and quality of racing and wagering output, they would likely do so.

3 The AHA Application

The AHA (NSW) has applied to the Commission for authorisation to negotiate TAB commissions and SKY Channel fees jointly on behalf of its members and to engage in primary boycott activity if necessary. This may involve one or more different groups of hotels. Furthermore, individual members would have the option to opt-out of the jointly negotiated fees and commissions and either accept the standard rates or negotiate individually.

AHA members represent a proportion of PubTABs and SKY customers, but not all of them: out of a total 1,078 hotels subscribing to SKY Channel in NSW, 981 are current AHA (NSW) members.[37] As discussed above, as at 30 June 2002 there were 990 PubTABs in NSW (see Table 1), which represent a subset of SKY Channel customers. Non members would presumably continue to receive TAB commissions and pay SKY Channel fees in accordance with the current standard rates.

The two elements of the conduct (joint negotiation and boycotts) for which authorisation is sought require the application of two separate tests under the *Trade Practices Act*. The Commission must be satisfied in all the circumstances that: the public benefits from authorising the conduct exceed the public detriments from reduced competition (s.90(6), relevant for anticompetitive agreements); and that the conduct would result in such a benefit to the public that it should be authorised (s.90(8), relevant for exclusionary provisions). In practice, these tests have been regarded as equivalent by both the Commission and the Tribunal. Following the Tribunal, the likely costs and benefits of the conduct must be assessed in a forward looking manner, by comparing the 'future with and without' the

[37] Data supplied by SKY Channel Pty Ltd.

conduct.[38] The onus is on the applicant, in this case the AHA (NSW) to satisfy the Commission that the test has been met, and that the necessary nexus exists between the conduct and the benefits claimed.

While the Tribunal has recognised anything of value to the community in general as a public benefit, it has placed particular emphasis on the goals of economic efficiency and progress.[39] Improving economic efficiency and progress involves increasing the community's total welfare from given resources, either through a reallocation of those resources to more valuable uses or increasing the productivity of resources through improved cost efficiency or research and development to produce new and better products and processes of production.

A mere transfer of resources, or income, from one group in society to another does not represent an increase in economic efficiency, since there has been no increase in total welfare or saving in real resources. Moreover, great caution needs to be exercised in respect of proposals that involve mere transfers. This is because authorising such proposals would reward and incent rent-seeking: that is, the search for opportunities to make one party better off at the expense of another party with no resulting gain in social income. Rent seeking inevitably reduces efficiency, both because it induces a wasteful use of resources in seeking the rents and because it leads to defensive investments being made by those whose interests would be harmed. As a result, authorising proposals that involve mere transfers is likely to cause a loss in output over the longer term.

We understand the main public benefits claimed by the AHA (NSW) to be the following:

- The creation of countervailing power resulting in reduced costs and increased commissions to hotels, which will be passed through to hotel customers in the form of lower prices and/or improved services;
- Increased viability of smaller, particularly rural, hotels to the benefit of local communities;

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38 See, for example, *Re John Dee (Export) Pty Limited* (1989), ATPR 40-938 at 50,206.

39 *Re Queensland Co-operative Milling Association* (1976), ATPR 40-012 at 17,242.

- Improved information flows, equitable dealing and reduced transactions costs from joint negotiation; and
- Increased confidence in the product and promotion of racing.

The following section analyses the likely outcomes, in terms of efficiency, income distribution, transactions costs and racing output in the future with the proposed conduct as compared to the future without the proposed conduct.

4 Likely Effect of the Conduct

The future without the proposed conduct would likely involve a continuation of current arrangements, whereby Tab Limited and SKY Channel consult with the AHA but ultimately adopt standard terms and conditions which hotels may either accept or reject. While consultation with the AHA has an important influence on the final outcome, it is not strictly a 'negotiation' in which the parties agree on the final terms and conditions of supply. Ultimately, these are determined by Tab Limited and SKY Channel and individual hotels decide whether or not to accept them. As discussed above in section two, while Tab Limited and SKY Channel both have exclusive rights, it is not obvious that any major economic inefficiencies, as opposed to distributional effects, arise from these arrangements. [40] Tab Limited's 'price' to consumers is capped and the proportion of earnings used to fund the 'public good' of racing is determined by statutory agreement: given these constraints, Tab Limited's incentives will likely be to expand the quantity of wagering towards the socially efficient level. SKY Channel is not so constrained, but is able to price its services in a manner which minimises distortions to allocative efficiency, by engaging in efficient price discrimination. Any monopoly profits derived by Tab Limited and SKY Channel will be largely extracted as a redistribution of surplus (consumer surplus in the case of SKY Channel and producer surplus in the case of Tab Limited) from the infra-marginal hotels.

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40 Indeed, for reasons set out above, there are social gains associated with this way of organising wagering, as has been recognised in reviews of the current arrangements.

The future with the proposed conduct would be essentially one of 'bilateral monopoly'[41], in which the AHA negotiates the terms and conditions of supply with Tab Limited and SKY Channel, backed up by the threat of boycotts, on behalf of its members or various groups of members; while 'fringe' hotels, either non-members or members who opt-out of the negotiations, will either continue to accept the standard terms and conditions or negotiate variations individually. The likely outcome which the AHA (NSW) seeks from these negotiations, particularly with the threat of boycott by a large proportion of Tab Limited's distributors and SKY Channel's customers, would be some sort of increase in TAB commissions to hotels and some sort of decrease in SKY Channel fees paid by hotels.[42] To that extent, it is simply a transfer of income between one group in society and another.

This mere transfer might be viewed as involving neither public benefit nor detriment. Such a view, however, is likely to be overly optimistic. Creating a bilateral monopoly in the present circumstances could result in resource wastage through extensive negotiations (increasing transactions costs) and rent seeking activity. Furthermore, the creation of countervailing power may not simply result in the transfer of surplus from one group to another, but may also have consequences for efficiency and hence public benefit or detriment. Such consequences depend on the specific structure of the market and the extent to which price discrimination is possible, as well as the outcome of bargaining between the parties.[43] It is therefore necessary to trace through the likely consequences in the particular market circumstances at issue.

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41 'Monopoly' here is not used in the sense of a monopoly for trade practices purposes, but rather reflects the fact that to a greater or lesser degree the parties each supply a differentiated product and hence have some degree of market power, however small.

42 While the negotiated prices are only relevant to AHA members, they are likely to flow through, at least to some extent, to other hotels, to the extent that they are in competition with AHA members.

43 For a general overview of the welfare consequences of buyer power see Paul Dobson, Michael Waterson and Alex Chu (1998), The Welfare Consequences of the Exercise of Buyer Power, Office of Fair Trading Research Paper No.16.

4.1 Income Transfers from Tab Limited and SKY Channel to Hotels and Efficiency in Distribution

An increase in the commission paid to hotels for their TAB agencies represents an increase in the cost of distribution via hotels for Tab Limited. To some extent Tab Limited may be able to substitute other distribution streams for TAB outlets in hotels, i.e. clubs, shop-front agencies, telephone and internet wagering, in response to the increased cost of distribution through hotels. To this extent, increased commissions may result in some productive (distribution) inefficiency as Tab Limited switches to the use of a less efficient pattern of distribution. The extent of this effect will depend on the degree to which hotels and other distribution channels are substitutes, and on the extent of the increase in the costs of distributing through hotels. This degree of substitution is obviously likely to be greater over the longer run than in the short term.

As discussed above, Tab Limited applies a rate of return requirement on hotel TAB outlets, to ensure that individual outlets add to total profits. Hotels which are just meeting this rate of return (and those which are not) represent 'marginal' TAB outlets, while hotels that exceed this rate of return are 'infra-marginal' TAB outlets. The initial impact of an increase in commissions will differ as between these marginal and infra-marginal outlets.

An increase in commission rates to infra-marginal hotels will simply result in a transfer of income from Tab Limited to the hotel.[44] However, an increase in commissions paid to marginal hotels will render them unprofitable for Tab Limited. The consequence of such an increase in the marginal cost of distribution would be the withdrawal of the TAB outlet from those marginal hotels. If that were to occur, total consumption of wagering would fall, to the extent that TAB customers in those hotels did not acquire the product elsewhere. It would

44 Obviously, whether a hotel is marginal or infra-marginal in this respect will depend on the extent of the proposed increase in the commission and on the time frame involved. In the longer run, more hotels may be marginal as an increase in commissions induces Tab Limited to develop alternative channels of distribution. Additionally, the extent to which hotels become marginal in this respect will depend on the extent to which the commission structure determined under the conduct allowed for price discrimination by Tab Limited and SKY. The greater the uniformity of TAB commissions and SKY prices, the larger will be the long term social costs of the conduct.

also likely reduce the demand for SKY Channel, since it would not be required as an input to wagering in the marginal hotels which have lost their TAB agencies. However, such a result is unlikely to occur in practice, at least in the short run. Given the opt-out arrangements, marginal hotels would more likely agree to continue on the standard terms and conditions (or negotiate a further reduction in commissions if they are still not meeting the rate of return requirement), rather than give up a PubTAB which is presumably generating direct income and/or indirect income, from the sale of additional liquor, food and other services, for the hotel.

Accordingly, the initial consequence of the conduct for wagering consumption is unlikely to be significant.[45] Rather there will likely be a redistribution of income from Tab Limited to the infra-marginal hotels. However, over the longer term, the scope for substituting against hotels as a distribution channel is likely to be greater and taken up, inducing a productive efficiency loss. Additionally, there are likely to be longer term impacts on the output of the racing and wagering industries, which are discussed below.

Lower SKY Channel fees might increase demand for the service at the margin. However, this effect is unlikely to be significant, since SKY Channel fees are already designed to maximise consumption by efficient price discrimination. Again, the initial impact of lower fees is likely to be a transfer of income from SKY Channel to the infra-marginal hotels, with no expansion in consumption and hence no increase in economic efficiency. Lower fees to infra-marginal consumers hotels cannot increase their consumption of the SKY Channel service, given the binary nature of the consumption decision – you either subscribe to the service or you don't.[46] Furthermore, there is unlikely to be any impact on the consumption of SKY Channel as a result of the increase in TAB commissions paid to hotels: as discussed above the number of hotel agencies is unlikely to change and given the strong complementarity between SKY Channel and wagering turnover, these agencies will already be subscribing to the service and will likely continue to do so.

Accordingly, the initial impact of the conduct would likely be some reduction in productive (distribution) efficiency, no increase in allocative (or other) efficiency and a redistribution of

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45 Apart from any boycott or service disruption by hoteliers as part of the negotiation process.

46 With the minor exception of the pay-per-view boxing service.

income from Tab Limited and SKY Channel to infra-marginal AHA (NSW) member hotels (and their close competitors). Such a transfer does not represent a public benefit.

It follows that the AHA (NSW)'s claim that the proposed conduct would increase the viability of smaller hotels is unsupportable. Neither Tab Limited nor SKY Channel currently have any incentive to restrict demand or supply at the margin, since it does not affect their infra-marginal profits. They are able to price discriminate in favour of these marginal hotels, by offering lower commissions and lower SKY Channel fees to make the granting of a PubTAB outlet to those hotels by Tab Limited and the consumption of SKY Channel by those hotels profitable, consequently maximising the distribution of TAB and the consumption of SKY Channel. In any case, as seen in Table 2 above, wagering represents a marginal contribution to hotel income, at least directly, and SKY Channel fees similarly represent a minor element of hotel costs.[47] It is extremely unlikely that any hotel would fail as a consequence of SKY Channel fees and TAB commissions. Indeed, the fact that hotels are eager to obtain these services even when they are well below the stand alone break-even turnover calculated by the AHA (NSW)[48], because they enhance the overall attractiveness of the hotel as an entertainment venue, indicates that they are more likely to make a hotel viable than unviable. As discussed above, the current pricing and commission structures adopted by SKY and Tab Limited promote maximum distribution of both services.

Indeed, it seems likely that at least over the longer term, the conduct could reduce the viability of marginal hotels. This is because while Tab Limited and SKY Channel gain through the continued market presence of these hotels, no such inference can be drawn in respect of their larger rivals. Rather, it may well be in the interests of larger hotels to reduce the market presence of smaller hotels, especially if this is done in a way that results in direct transfers to the larger hotels. For example, a move away from the current price structure,

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47 See ABS, op.cit., Table 1.3, which does not even specify a separate item of expenditure for broadcasting services in general, let alone SKY Channel.

48 According to TAB Limited data (see separate Background Paper), less than half of PubTABs currently meet the stand alone break-even point nominated by the AHA (NSW). There are, however, issues about the basis of the AHA's calculations and underlying assumptions, details of which are set out in the Background Paper and other material submitted to the Commission.

which involves substantial price discrimination with the effect of taxing infra-marginal surplus, to one that was more uniform, could benefit the larger hotels while making it more difficult for smaller hotels to obtain equally favourable treatment. Over the longer term at least, this would tend to shift industry structure towards greater, rather than lesser, concentration.

Trade associations such as the AHA are likely to maximise the income of those of their members that account for the largest share of their funding, subject to retaining the support of their median member.[49] This implies that at best, they will weight decision-making towards the median member, rather than towards the marginal member. As a result, they will have less interest in pushing output to its extensive limit than would have an upstream input supplier that was capable of efficient price discrimination. There can therefore be no reason to believe that from an efficiency viewpoint, better outcomes will be obtained from terms negotiated by the AHA than from price setting by Tab Limited and SKY Channel.

4.2 Pass Through to Consumers

The AHA(NSW) argues that the lower fees and higher commissions will be passed through to patrons in the form of lower prices for food and beverages and higher levels of service and amenities in hotels. While this would still be largely a transfer from one group in society to another, and hence would not increase economic efficiency, it might arguably constitute a 'public benefit', since the income is spread more broadly throughout the community, or at least that portion of the community who patronise hotels. However, it is incumbent on the applicant to demonstrate that this is in fact likely to occur. There are a number of reasons to question whether this would be the case.

As discussed above, hotels are differentiated in product and geographic space. Accordingly, the degree of potential competition between them varies considerably. Where hotels are located in close proximity, the degree of competition may potentially be quite intense, but where they are located at some distance, potential competition will be quite limited and in some cases, particularly in rural areas, non-existent. Incumbents are not generally subject to

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49 This follows from the median voter models developed in Anthony Downs (1957), An Economic Theory of Democracy, Harper and Row: New York, and William Riker (1962), The Theory of Political Coalitions, Yale University Press: New Haven.

the threat of new entry, since licensing laws require a 'needs' test to be satisfied before an additional liquor licence will be issued in an area. Furthermore, as noted above, we understand that the Commission is continuing to investigate anti-competitive agreements between incumbents and licence applicants, directed at restricting the competitive activity of new entrants.

Given the relatively minor role of wagering in hotel income, any increase in commissions and/or decrease in SKY Channel fees will be relatively small compared to a hotel's overall cost structure. Additionally, because the fees for the SKY Channel service are calculated at the outset of each period, they are essentially lump-sum during the course of the period and hence will not affect marginal price and output decisions taken by the hotels. Combined with the small size of these fees, this means that any allocative inefficiency in beer consumption associated with the current charges is likely to be very small indeed, and hence reducing those charges would, even if fully passed on, have only very limited benefit. Against this would need to be set any other inefficiency the change in price level and structure would cause. The fact that prices tend to be sticky downwards makes it even less likely that any changes to fees and commissions would be passed through in lower beer prices. Recent experience with the excise reductions under the new tax system showed a reluctance by hotels to pass through those cost reductions, which related directly to the marginal cost of beer and where there was the threat of fines being imposed.[50]

Finally, there is also the possibility that allowing joint negotiation in relation to SKY Channel fees and TAB commissions may facilitate coordination, not necessarily unlawful, of output prices charged to hotel patrons.

4.3 Transactions Costs

The AHA (NSW) claims that joint negotiation would reduce the transactions costs associated with the acquisition of SKY Channel and PubTABs. Transactions cost savings can indeed be a valid reason to authorise joint acquisition of goods and services. They represent a real resource saving, reducing the cost of supply and, assuming competitive downstream markets, final prices to consumers. They underpin the United States approach to joint

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50 See ACCC (2001), ACCC Calls on Drinkers to Assist in Beer Excise Crackdown, Media Release 84/01, 11 April.

buying in the health sector[51] and have been an important rationale for previous authorisations by the Commission, which have often been supported by both sides of the market.[52]

However, there is no evidence to support an argument for reduced transactions costs in this instance. Under the current arrangements, both Tab Limited and SKY Channel discuss proposed changes to commissions and fees with the AHA prior to implementation. Once a new commission or price structure is finalised, this is then standard for all hotels, avoiding the need for separate negotiation of rates for each hotel. Under the proposed system of joint negotiation by the AHA (NSW) on behalf of members, the current consultation will be replaced by negotiation with the threat of boycott. If anything, this is likely to increase transactions costs, particularly if it involves negotiations with a number of different groups of hotels. Negotiations seem likely to become particularly protracted and bitter, resulting in higher transactions costs and greater waste of resources. Furthermore, the system allows individual members, as well as non-members, to continue to accept the standard terms and conditions or to negotiate individually. As discussed above, it is likely to be in the interests of marginal hotels to do so, in order to continue to viably operate a TAB and SKY Channel in their hotel. All of this suggests that transactions costs are more likely to increase rather than decrease. Furthermore, since the negotiations are essentially about transfers of income between different groups, the transactions costs are socially wasteful.

The only way in which transactions costs could decrease as a result of the conduct would be if commissions and/or fees were uncoupled from turnover, eliminating the need for hotels to provide data on beer and TAB turnover to SKY Channel and the need to calculate fees and/or commissions on an individual hotel basis. However, it should be noted here that data on litreage and TAB turnover are generally only required once for each five year contract period by SKY Channel, so the savings in transactions costs would likely be minimal in that case. Furthermore, any such reduction in transactions costs would be at the expense of reduced allocative efficiency. As discussed above, SKY Channel's tiered pricing structure

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51 See Roger D Blair and Jill Boylston Herndon (1995), "An Economic Analysis of the Joint Purchasing Safety Zone", Journal of Law, Medicine & Ethics, Vol.23, No.2, pp.177-85.

52 See *Re Inghams* (1987), *Re CSR* (1987), *Re Premium Milk Supply* (2001) and *Re Australian Dairy Farmers Federation* (2002).

secures a revenue stream at minimum cost in terms of allocative efficiency. With price discrimination, it is profitable to charge the marginal cost of supplying an additional hotel to the marginal hotels, because the high fixed costs of supply can be recouped from infra-marginal hotels. However, a flat fee across all hotels would have to be set at least at average cost if the fixed costs of supply are to be recovered. Accordingly, marginal hotels would likely cease to receive the SKY Channel service, despite the fact that they are willing to pay the marginal cost of supply to them and such supply would be efficient.

In the case of TAB commissions, these are set as a percentage of TAB turnover, with a two tier percentage structure. This system is designed to provide an incentive for the hotel to maximise its efforts to promote TAB wagering to its patrons by giving them a share of the gains from increased sales. The two tier structure reflects the need for Tab Limited to recover the costs of investing in additional PubTABs, with a lower percentage commission applicable at lower turnover levels. If this system was replaced by a flat fee, the hotels would have no such incentive and consumption of wagering would likely fall below optimal levels. If a minimum commission were to be negotiated, this would put the viability of marginal hotels in doubt, as discussed above. The consequence of this would either be a reduction in the network of PubTABs or, more likely, that individual hotels would opt out of the minimum commission arrangements, increasing transactions costs, in order to retain their PubTAB.

4.4 Long Run Effects on Racing and Wagering Output

As discussed above, the initial impact of an increase in TAB commissions and/or a reduction in SKY fees would be a transfer of income from Tab Limited and SKY Channel to the infra-marginal hotels and some increase in productive inefficiency. However, there would also be a longer run negative effect on the funding of the racing industry and consequently on the production and consumption of racing and wagering.

As discussed above, in section two, racing has significant public good and non-excludability (free riding) characteristics. Government policy has dealt with this by a regime of statutory endorsement of certain bodies to conduct racing for wagering purposes on a not-for profit basis, substantially funded, in the case of the NSW racing industry, by Tab Limited, as set out in the Racing Distribution Agreement. The NSW racing industry receives two different payments from Tab Limited in respect of its wagering business. The first payment, the

'Product Fee' is calculated at 21.64 per cent of TAB totalizator revenue (turnover net of payouts), while the second payment, the 'wagering incentive fee' (WIF), is payed as 25 per cent of Tab Limited's net earnings from wagering under its NSW wagering licences.[53] These payments reflect the level of funding, and hence output, which has been determined by public policy to be appropriate for a product with the public good and free riding characteristics described above. Other sources of income which help to fund the production of racing are licence fees paid to individual clubs by radio and television (e.g. SKY Channel), starting fees, gate fees and payments for catering services and the use of race course facilities.

Because these different payments enter the racing industry at different points in the industry structure, e.g. Tab Limited payments are made to NSW Racing, which then distributes them to the three racing code boards, who in turn distribute them to the clubs that run the races, while broadcasting licence fees and most other income is derived at the club level, it is not straightforward to derive an overall breakdown of income to the racing industry. However, we understand that the contribution of Tab Limited fees under the RDA to the NSW racing industry's income is in excess of 75 per cent. While the exact composition of TAB payments between the 'product fee' and the WIF vary from year to year, approximately 13 percentage points of the 75 per cent can be attributed to the WIF, while the remaining 62 percentage points can be attributed to the 'product fee'. Additionally, a further proportion of income, in the order of 4-5 per cent across the NSW racing industry, comprises fees paid by SKY Channel for the right to broadcast races on their SKY Channel and SKY Racing services.

The transfer of income from Tab Limited to the hotels will not initially affect the 'product fee' paid to the racing industry, since this is calculated as a percentage of earnings before commissions have been paid.[54] However, there will be a direct impact on the WIF. For every dollar transferred to hotels, 25c will come off the WIF fee paid to the racing industry. Furthermore, the reduction in income to SKY Channel will affect the amount they are willing and able to pay racing clubs for broadcast rights. The combined effect of these reduced payments could be a few percentage points reduction in the payments for the running of races, which will be directly reflected in a reduced quantity and quality of the racing

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53 These fees apply to revenue and earnings derived by Tab Limited from its wagering activities under any NSW wagering licences.

54 The 'product fee' will, of course, be temporarily affected in the event of boycott activity.

product, given the not-for-profit nature of the racing industry. Given the nature of racing as a 'gambling industry', this will likely have some further impact on Tab Limited turnover, which will in turn reduce both the product fee and the WIF payments to racing and further reduce the quality and quantity of racing and wagering output and consumption.

These second round effects on the quantity and quality of the racing product will also affect the bottom line of the hotels to the extent that their TAB commissions fall in line with turnover. However, as discussed above, these commissions are a minor part of hotel income. Hotels can benefit from restricting output if this involves a higher commission on remaining sales. Even if the AHA (NSW) were able to act as a profit maximising monopolist/monopsonist, such that the net increase in hotel commissions was maximised, this would still involve a net reduction in the output and consumption of racing and wagering, through reduced payments to the racing industry. Hotels collectively, and even more so any individual hotel, can maximise their TAB income by exploiting existing consumers at the expense of future investment in the racing industry.

By contrast, as discussed in section two, Tab Limited has strong incentives to optimise the output and consumption of racing and wagering in order to maximise its own profits subject to the price cap. While it is unlikely that the resulting output levels represent the exact social optimum, given all the problems of market failure associated with free riding and public goods, it is much more likely to approach that level than would be the case if the AHA (NSW) members were allowed to act as monopolist/monopsonists, increasing their own income at the long run expense of racing industry output. Moreover, the funding of the public good of NSW racing has been determined under the RDA as the outcome of public policy and it is inappropriate, and certainly not a public benefit, for the AHA (NSW) to distort that allocation of resources.

5 Conclusions

In conclusion, there is no economic basis to justify authorising the AHA (NSW) to engage in collective negotiation and primary boycott activity in relation to Tab Limited commissions and SKY Channel fees. The analysis above has demonstrated that the net result of such conduct would likely be:

- some decrease in productive efficiency associated with any switching to alternative means of distributing Tab Limited's wagering product;
- a transfer of income from Tab Limited and SKY Channel to infra-marginal hotels;

- an increase in transactions costs; and
- a reduction in the output and consumption of racing and wagering in NSW.

Authorisation of mere transfers of income from one group in society to another would reward rent-seeking activity and encourage further wastage of resources in identifying and exploiting further rent-seeking opportunities. Accordingly, such conduct should only be authorised where there are clear public benefits from doing so. In this instance the opposite is likely to be the case. There is no evidence that the transfer of income to hotels would be passed through to consumers and there are likely to be real public detriments associated with productive inefficiency and under investment in the racing and wagering industry. The goals of economic efficiency and progress will be undermined in the future with the proposed conduct as compared to the future without the proposed conduct.