



Bulletin

- Water
- Energy
- Retailing
- Transport
- Financial services
- Healthcare
- Telecoms
- Media
- Post
- Competition policy
- Policy analysis and design
- Regulation
- Strategy
- Contract design and evaluation
- Dispute support services
- Market design and auctions

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Lucky numbers

DOES THE NATIONAL LOTTERY NEED MORE COMPETITION?

In July 2003, the Government announced plans to allow more companies to participate in the National Lottery. Competition can be a powerful mechanism for delivering lower prices, higher quality and innovation. In this case, however, it is far from clear that more competition would benefit the good causes that the lottery is intended to support. This bulletin, which summarises a recent Frontier Economics report completed for Camelot, explains why.

The National Lottery was launched in 1994 with the principal aim of raising money for good causes, including the arts, sport, charities, heritage, millennium projects, health, education and the environment. It has since raised over £14bn for these purposes. Duty on lottery sales also represents a significant source of tax revenue for the Treasury.

In July 2003, the Government announced that it had decided a radical new approach to licensing the National Lottery was needed¹. The current "single licence" model, whereby the National Lottery is run by a single operator, would be replaced by a "multiple licence" →

model, whereby the National Lottery Commission (NLC) might offer one or more operating licences to run different parts of the lottery.

One option considered was to separate operation of the lottery infrastructure from the sale of lottery products. This was rejected on the basis that lotteries are best when run as integrated businesses. Instead, the Government proposed that different operators should be allowed to offer different lottery products. For example, one licence might be awarded for Lotto games and another for scratch cards. There might also be separate licences for an international lottery draw, and for online games promoted via the internet, mobile phones and digital TV. It was envisaged that there would be common branding of all lottery products.

COMPETITIVE ADVANTAGES

The Government has made it plain that the promotion of effective competition is one of its key policy goals. Competition is recognised to be a powerful mechanism for delivering consumer benefits, in terms of lower prices, higher quality and innovation².

With regard to the National Lottery, the Government's particular concern was that there should be effective competition for the next licence, which runs from 2009. It was worried that firms might be deterred from bidding, either by the strength of Camelot's position as the incumbent operator or by the difficulty of operating the entire lottery. The second factor might be particularly important if Camelot itself decided not to bid. Since firms seeking a licence would have to compete in terms of the size of the contribution they believed they could make to good causes, a lack of competition might, the Government fear, lead to a loss of revenue for charitable purposes.

The Government also appeared to believe that allowing more companies to participate in the lottery would stimulate innovation and revenues. It saw the multiple licence model as a way of adding competition "within the market" (between lottery operators, for customers) to competition "for the market" (between bidders for licences to run the lottery itself). Indeed, some advocates saw the multiple licence model as a way of increasing competition at both levels. If the NLC designed the tendering process to make it difficult for a single firm to win all the licences (or reserved some for new entrants), it might, so these advocates argued, not merely increase competition within the market, but encourage more firms to bid for licences in the first place.

GOOD FOR WHOM?

The problem with this approach is that the conventional consumer-based rationale for promoting competition is not directly applicable to the National Lottery. The primary purpose of lottery policy is to raise funds for good causes, rather than to maximise the benefits (lower prices, higher payouts) enjoyed by the consumers who play the lottery. The Government wants the lottery to be highly "profitable", because it is only from those profits that it can extract funds for good causes. Competition should therefore be seen as an objective only in so far as it protects or enhances these funds.

To understand the implications of competition, we need to answer three questions.

- What effect would increased competition "within the market" have on the amount of money raised for good causes?
- What effect would increased competition "for the market" have on the amount of money raised for good causes?
- Are there other ways in which the funds raised for good causes could be increased?

What effect would increased competition "within the market" have on the amount of money raised for good causes?

The funds available to good causes depend upon the size of the economic value of the lottery (the value of sales net of Lottery Duty, less costs), as well as how it is split between

Lucky numbers

good causes and the profits earned by lottery operators. It is far from clear that this economic value would be increased by allowing a number of operators to run different parts of the lottery. It might be more likely to result in a decrease. A single operator has both the incentive and the ability to develop the lottery more efficiently than multiple operators. With multiple competing operators there are significant risks that:

- the loss of economies of scale and scope results in higher total operating costs;
- free-riding by some operators results in under-investment in the lottery brand and infrastructure;
- product launches are undermined by a lack of co-ordination between licensees; and
- licensees focus on increasing their market share rather than expanding the market.

To address these problems, and attempt to reconcile the competing interests of different operators, the NLC would have to become a much more interventionist regulator, making commercial judgements on operational and strategic issues. This increased level of regulatory intervention would be costly in itself. In addition, it might stifle product innovation, particularly if operators sought to use the regulatory process to inhibit rivals.

What effect would increased competition "for the market" have on the amount of money raised for good causes?

Since the total economic value of the lottery would probably be lower with multiple operators, the multiple licence model would only generate more money for good causes if the share of economic value obtained by good causes was increased substantially. That would be the case only if the multiple licence model led to a significant increase in competition "for the market", in the form of stronger bidding for licences.

It is questionable whether bidding competition would be stronger in the multiple licence model. For a start, it is far from clear that there would be a lack of competition for a single licence in 2009. The second lottery licence contains a number of provisions that are designed to minimise any incumbency advantage that might otherwise be enjoyed by Camelot (for example in relation to the ownership of infrastructure and intellectual property). Moreover, it does not appear that Camelot has any significant brand advantage, exclusive contracts or relationships, or any proprietary technological knowledge that would inhibit competition. A further important factor is that the lottery will be more mature and hence easier to value in 2009 than at previous bidding rounds.

Shifting to a multiple licence model would increase bidding costs and complexity, as well as increasing market and regulatory risk. Taken together, these considerations might well deter some bidders, thus decreasing rather than increasing bidding competition.

Some advocates of the multiple licence model suggest that offering "bite-sized" licences would attract single licence bidders who were unable to operate the entire lottery. However, even this argument needs to be challenged. Potential single licence bidders might be reluctant to enter the bidding against large competitors, who might be able to take advantage of the synergies between licences to bid more competitively for all (or most) of them. Of course, the NLC could seek to encourage single licence bids by reserving licences for new entrants, but this would risk imposing an inefficient outcome, to the detriment of the development of the lottery and at a cost to the good causes.

Could the amount of money raised for good causes be increased in other ways?

It may be possible to increase the amount of money raised for good causes by modifying the single licence model to encourage bidding competition. For example, consideration should be given to the impact of:

- giving the lottery operator greater freedom to select different suppliers during the course of the licence; or
- underwriting bidding costs to encourage new entry.

Another way of potentially increasing competition for licences would be to permit gambling and gaming firms to operate the lottery through a subsidiary. The problem with this option is the risk that it might affect the National Lottery brand. To maintain a level playing field Camelot would also have to be permitted to diversify beyond the National Lottery. A reserve price based on the incumbent's historic performance could also be incorporated to protect against the risk of weak competition.

MORE COOKS, LESS BROTH

This analysis leads us to three conclusions.

- Multiple licence holders competing "within the market" might raise less money for good causes.
- The multiple licence model would only increase funds for good causes if competition "for the market" were increased significantly, but it is far from clear that moving from a single to a multiple licence model would have this effect.
- Competition "for the market" can be increased within the single licence model.

Taken together, these points suggest that offering multiple licences would be a complex and risky option with no clear benefits to good causes. Competition within the market might seriously reduce the economic value of the lottery. And it is highly questionable whether the multiple licence model would increase competition for the market. This analysis leaves no convincing argument for preferring the multiple licence model.

TREAD CAREFULLY...

Before deciding to offer multiple licences and risking a reduction in the amount of money available to good causes, the Government would be well-advised to:

- re-assess whether there is a serious danger of inadequate competition in the single licence model;
- assess the options for increasing competition within the single licence model; and
- assess whether the money available for good causes could be increased by giving the operator a stronger incentive to increase lottery sales.

If the Government still decides to switch to a multiple licence model this time, it must take steps to mitigate the risks to good causes. This would require:

- ensuring that a single firm can win all licences – so that the efficient single operator outcome is still possible;
- designing licences so that competition within the market is limited; and
- ensuring that the NLC is properly resourced and prepared to cope with the much greater demands it will be required to meet.

In general, the Government's emphasis on competition has given a powerful rigour to its economic policy and regulatory stance. But competition is not an end in itself. Without examining its consequences, the Government risks serious damage to other policy objectives. In this case, it is in danger of undermining the revenue for good causes, which the National Lottery was set up to raise.

SOURCE	<ol style="list-style-type: none"> 1. Department for Culture, Media and Sport, <i>National Lottery Licensing and Regulation - Decision Document (July 2003)</i>. 2. See, for example, <i>the OFT guidelines (February 2002)</i>.
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