IN THE MATTER of the Gambling Act 2003

AND on appeal by **THE SOUTHERN TRUST**

BEFORE A DIVISION OF THE GAMBLING COMMISSION

Members: P Chin (Chief Gambling Commissioner)
G L Reeves
P J Stanley

Date of Decision: 19 February 2010

Date of Notification of Decision: 5 May 2010

DECISION
ON APPEAL BY THE SOUTHERN TRUST

Appeal

1. The Southern Trust (the "**Appellant**" or the "**Trust**") appealed, under section 61 of the Gambling Act 2003 (the "**Act**"), against a decision by the Secretary for Internal Affairs (the "**Secretary**") suspending its Class 4 operator's licence. The Secretary suspended the licence for five days under section 58(1)(b), which provides that the Secretary may cancel or suspend for up to 6 months a class 4 operator's licence if the Secretary is satisfied that the corporate society is failing, or has failed, to comply with any relevant requirement of the Act, licence conditions, game rules or minimum standards. The Secretary made his decision to suspend the Trust's licence following an audit of the Trust for the period 1 January 2007 to 31 December 2007. Specifically, the Secretary considered that:

(a) The Trust breached Limit C of Gazette Notice 5857, published 2 September 2004 ("**Gazette Notice**"), by incurring costs totalling $189,820 in excess of the maximum allowed under that Limit in refurbishing gambling areas in four venues (Ground 1).

(b) The Trust incurred unnecessary and unreasonable costs of approximately $100,000 as part of its project of refurbishing gambling areas at its venues in breach of the duty in section 52(1)(d) to maximise the net proceeds from class 4 gambling and minimise the operating costs of that gambling (Ground 2).

(c) The Trust incurred unnecessary and unreasonable costs of $40,000 by paying a brokerage company to arrange for a venue operator to sign venue agreements with the Trust in breach of the duty in section 52(1)(d) (Ground 3).

(d) The Trust failed to take immediate steps to disconnect all gaming machines at class 4 venues at which venue managers failed to bank all profits within the timeframe specified by the applicable regulations in breach of the duty in section 104(3)(b) (Ground 4).

The Trust's submissions

2. The Trust acknowledged that it breached Limit C of the Gazette Notice in undertaking venue upgrades of four venues. However it argued that the breaches did not justify suspension for the following reasons:

(a) They were inadvertent.

(b) They affected only four of the 107 venues at which the Trust operated at the time.

(c) The Trust had recovered the payments in relation to one venue and was in the process of recovering the payments in relation to a second (but acknowledged that it could not recover the payments from the other venue because those venues had since signed venue agreements with other societies).

(d) Suspension would punish 92 blameless venue operators.

3. In relation to the Secretary's claim that the expenditure on venue upgrades undertaken by the Trust at various venues was unnecessary and unreasonable, the Trust submitted that the upgrades were necessary owing to the poor condition of the gaming rooms in question and were reasonable for the following reasons:

(a) The Trust undertook the refurbishment programme only after assessing the effects of upgrades at two trial venues. In those cases, revenue had increased following the upgrades.

(b) The Trust consulted with venue operators, and ensured it accepted a competitive quote from the company contracted for the upgrade.

(c) The Trust was acting in accordance with its duty to maximise net proceeds, because the upgrades would attract more patrons and therefore more revenue.

(d) The upgrades would assist with harm minimisation because the upgraded venues would attract more affluent patrons and therefore reduce the Trust's reliance on less affluent gamblers.

(e) The enhancement and branding of venues would reduce the number of venues changing societies, thus reducing overhead costs in relation to the acquisition of new venues and the release of old venues.

(f) The expenditure was in accordance with the Secretary's guidelines about the Gazette Notice, which allowed for corporate societies to incur capital costs of development and enhancement upfront.

4. The Trust similarly argued that the brokerage fee was both necessary and reasonable. The Trust submitted that the Secretary changed his position regarding brokerage expenditure during the course of the appeal, moving from saying that the use of a broker was unnecessary and unreasonable because the Trust employed staff to perform the same function, to saying that the Trust had paid too much. The Trust submitted that the Secretary's change in position was in response to the Trust's explanation for the first concern (its staff were otherwise committed) and that, by changing his position when the basis for the original complaint was explained, instead of conceding the point, the Secretary demonstrated predetermination. The Trust submitted that the payments were reasonable and necessary because:

(a) at the time the broker was engaged the Trust was losing market share and needed to find new venues;

(b) the Trust could not use its staff who normally sourced new business as they were all fully committed on staff venue training in harm minimisation and other changes in legislation;

(c) the amount paid for the broker amounted to only 1.4% of the Trust's annual administration budget; and

(d) the Secretary had the power under section 116 of the Act to limit or forbid expenditure on brokers but had chosen not to do so.

5. On the matter of late banking, the Trust submitted that, contrary to the Secretary's conclusion, it did take immediate steps to disconnect gaming machines at venues where venue operators were late in banking their gaming machine proceeds. The Trust was not aware, at the relevant time, that it had the practical ability to turn off the gaming machines remotely. In the absence of such an ability, sending letters to the venue operators concerned, requiring them to turn off their machines, constituted an immediate step to disconnect all gaming machines at the venue under section 104(3)(a).

6. Finally, the Trust argued that the Secretary was treating it as a scapegoat. The Trust submitted that the Secretary acknowledged that the type of spending undertaken by the Trust was widespread in the industry, and that it was unfair for the Secretary to punish the Trust for doing what many other societies did.

The Secretary's submissions

7. In relation to the spending in breach of Limit C, the Secretary submitted it was not appropriate for the Trust to have undertaken refurbishment at the venues in question when those venues were already in receipt of the maximum allowable weekly venue payments. The venues and amounts at issue were:

(a) The Excelsior - $91,593.35;

(b) Mermaids - $26,204.12;

(c) Kope Turf Bar - $40,917.13; and

(d) Edinburgh Castle - $31,105.49.

8. The Secretary argued that, when the Trust said it was "recovering" the overspent amounts in relation to some of the venues, what it was in fact doing was reducing the payments it would otherwise have made to the venue operators. That is because the reason the limit was breached in the first place was that the Trust was already incurring the maximum $800 per week allowable per venue in the form of contractual contributions to venue operating costs in relation to those venues. The Secretary doubted the Trust's claim that it had "recovered" all of the sums spent in breach of the Limit in relation to one of the venues, pointing out that, even if the Trust had stopped all other venue payments to the venue and was recovering the expense at the maximum of $800 per week, the Trust would not have "recovered" the full amount at the time of submissions. Further, the Secretary was concerned that, in its efforts to recover the amounts spent in breach, and to allow for future capital expenditure without breaching the Limit, the Trust was instead breaching its venue agreements. The Secretary had three areas of concern:

(a) The costs schedules from the venue agreements for the venues in question submitted by the Trust as part of the appeal were not those attached to the venue agreements that the Secretary had approved under section 69.

(b) The over-expenditure was being recovered in breach of the approved venue agreements. That is, the Trust's method of "recovering" the expenditure from venue operators – reducing other venue payments – meant it was not making payments which were contractually due to the venue operator as set out in the venue agreement.

(c) Even under its revised policy, the Trust continued to incur expenses above the payment schedule. It did this by taking any difference between the actual hourly operating costs and the actual weekly operating costs and the allowable limit for those two types of costs (prescribed by Limits A and B in the Gazette Notice), adding those differences to any difference between actual costs and Limit C, and treating the combined total as available for the types of costs provided for by Limit C, ie development and enhancement costs.

9. The Secretary submitted that the Trust's development and enhancement programme not only involved breaches of Limit C in relation to the four venues, but, in relation to a further 10 venues (as well as the four venues that breached Limit C), involved incurring unreasonable and unnecessary costs, in breach of the Act. The Secretary estimated the expenditure to be $100,000. This was based on $78,612.52 of identified expenditure on particular items such as ceiling accents, carpet logos, feature walls and wall friezes, the costs of which were recorded in invoices attached to one of the affidavits provided in support of the Secretary's suspension. The Secretary considered that a conservative estimate of labour costs would bring the total expenditure to approximately $100,000. The Secretary later looked more closely at that figure and concluded that the installation and management costs alone for those upgrades came to $113,695.75 which, when added to the cost of the items installed, came to a total of $192,308.27.

10. The Secretary submitted that "'necessary' in conducting the gambling" referred to costs which enabled the gambling to be conducted in an appropriate manner. This might include replacing carpets or repainting walls in a gambling room if they were in a state of disrepair or enhancing lighting if a gambling room were poorly lit. Once it has been established that a cost is necessary, the Secretary submitted, the next question is whether the amount paid for the necessary upgrade is reasonable.

11. The Secretary did not have evidence regarding the state of the gambling rooms in question, although he was prepared to acknowledge that, on the basis of some photos provided by the Trust, at least some of the gaming rooms at the venues in question were in a state of disrepair. He therefore left out of his estimate of the cost of upgrades any costs relating to items – such as lights and carpets – that might legitimately have required upgrades. The Secretary submitted that most of the costs included in his estimate related to branding the venues with a Southern Trust theme. In his view, such branding costs were not reasonable or necessary. All items he referred to in his estimate of $100,000 (later revised to $192,308.27) were items, such as neon ceiling accents and feature walls, that in his view could never be necessary. Therefore the question of reasonableness did not arise.

12. In relation to the brokerage fees, the Secretary maintained that the amount was unreasonable, as was the use of a broker per se, given that the Trust already employed staff whose roles included sourcing new venues. The Secretary expressed scepticism about the proffered reason for the Trust to use a broker (that its staff were otherwise engaged on harm minimisation training), and suggested that it had more to do with the fact that the broker was a close acquaintance of the new owner of two venues, who was looking to sign new venue agreements. The Secretary submitted that, if the staff were in fact otherwise engaged in harm minimisation training, the Trust should have waited until they were available. He further submitted that the amount paid to the broker was excessive, as was the fact that the Trust paid the broker "per venue" given that both venues were owned by the same operator and therefore the number of venues did not expand the scope of the broker's role.

13. Finally, in relation to late banking, the Secretary accepted that the Trust was not aware of the remote disconnection facility at the relevant time. Nevertheless, he maintained that the Trust's actions were insufficient to satisfy section 104. The Secretary submitted that, in the 92 instances of late banking during the audit period, the Trust only sent letters on the Monday immediately following the fifth working day in 42 cases. Further, the Secretary submitted that the fact that many of the letters were sent to the same recidivist venue managers should have prompted the Trust to realise that the letters were ineffective. The Trust should have taken further action such as monitoring EMS reports for gaming activity to check that the machines had in fact been disabled, and manually disconnecting the machines in extreme cases. The Secretary submitted that it was incumbent upon the Trust to be more proactive in relation to recidivist offenders.

Analysis

The issues and legislative background

14. Aside from some points of finer detail, particularly around late banking, the essential facts are, broadly, not contentious. The Commission proceeds on the basis of the following having occurred in 2007:

(a) The Trust spent over $192,308.27 (including project management, installation and development costs but not including all items that were installed as part of the refurbishment) upgrading 14 of the 107 venues with which it had venue agreements.

(b) More specifically the Trust spent the amounts recorded in paragraph 7 above, totalling $189,820.09, on upgrading four venues when it was already paying each venue the maximum amount permitted under Limit C.

(c) The Trust paid $40,000 as two $20,000 payments to a broker for signing up two new venue agreements under common ownership.

(d) There were approximately 92 instances of late banking during the audit period, for which the Trust's primary response was to write letters to venue managers requiring immediate disconnection of gaming machines.

15. The Secretary identified four grounds for suspension, involving often overlapping obligations under the Act or secondary legislation as follows:

Conduct by appellant	Breaches
Breach of Limit C	Failure to comply with limit issued by Secretary under section 116; failure to maximise net proceeds and minimise costs under section 52(1)(d).
Expenditure on DEM costs	Failure to maximise net proceeds and minimise costs under section 52(1)(d); incurring costs that are not actual, reasonable or necessary.
Expenditure on broker's fees	Failure to maximise net proceeds and minimise costs under section 52(1)(d); incurring costs that are not actual, reasonable or necessary
Failure to disconnect machines	Breach of section 104(3) requirement to take immediate steps to disconnect gaming machines in cases of late banking.

The parties each took the stated grounds for suspension given by the Secretary following the Department's audit, as a structural basis for their submissions, and concentrated their arguments on narrowly-focused disagreement about whether the Trust's actions amount to breaches of specific and isolated obligations and, if so, what the appropriate penalty should be.

16. The first three grounds are not only linked by a common alleged breach (namely of section 52(1)(d), the obligation to maximise net process and minimise costs); they are linked factually because they involve expenditure driven by competition between societies to gain and retain class 4 venues. The expenditure on venues and the payment of brokerage fees to sign venues raises the issue of the extent to which gaming proceeds may be used to fund such competition between societies, rather than for distribution to the community. The concerns of the Trust over the loss of venues and their gambling turnover to other societies (which it describes as "market share") as the motivation for the challenged expenditure are well set out in its evidence.

17. In order to put the overlapping arguments in context and to provide a proper analytical framework to evaluate them, the Commission starts by considering the overall statutory scheme in relation to class 4 gambling and the use of gambling revenue.

Class 4 gambling is not a commercial activity but is conducted by not-for-profit societies so as to distribute the proceeds for charitable or community purposes.

18. Class 4 societies' interrelated duties to distribute their net proceeds only for authorised purposes and to maximise those net proceeds are fundamental to their existence. Section 30 defines class 4 gambling as gambling, the net proceeds of which "are applied to or distributed for authorised purposes" and for which "no commission is paid to, or received by, a person for conducting the gambling". Section 4 defines "net proceeds" and "authorised purposes" as follows:

> **net proceeds**, in relation to gambling, means the turnover of the gambling plus interest or other investment return on that turnover plus proceeds from the sale of fittings, chattels, and gambling equipment purchased from that turnover or investment return less—
>
> (a) the actual, reasonable, and necessary costs (including prizes), levies, and taxes incurred in conducting the gambling; and
>
> (b) the actual, reasonable, and necessary costs incurred in complying with whichever of the following apply to the gambling:
>
> (i) this Act or any other relevant Act:
>
> (ii) an operator's licence:
>
> (iii) a venue licence
>
> **authorised purpose** means,—
>
> (a) for class 1 gambling, class 2 gambling, and class 3 gambling, any of the following purposes:
>
> (i) a charitable purpose:
>
> (ii) a non-commercial purpose that is beneficial to the whole or a section of the community:
>
> (iii) promoting, controlling, and conducting race meetings under the Racing Act 2003, including the payment of stakes:
>
> (iv) an electioneering purpose:
>
> (b) for class 4 gambling, any of the purposes specified in paragraph (a)(i) to (iii)

19. Section 31 provides that class 4 gambling may only be undertaken by a corporate society that holds a class 4 operator's licence for that gambling and a class 4 venue licence for the venue where that gambling takes place. Section 4 defines a corporate society as:

corporate society means a society that is—

(a) incorporated under the Incorporated Societies Act 1908; or

(b) incorporated as a board under the Charitable Trusts Act 1957; or

(c) a company incorporated under the Companies Act 1993 that—

(i) does not have the capacity or power to make a profit; and

(ii) is incorporated and conducted solely for authorised purposes; or

(d) a working men's club registered under the Friendly Societies and Credit Unions Act 1982

20. The Trust is a charitable trust under the Charitable Trusts Act 1957.

21. A corporate society's application for a class 4 operator's licence must, pursuant to section 50(2), include, among other things:

(a) details of the authorised purposes to or for which net proceeds from the class 4 gambling will be applied or distributed; and

(b) information about the financial viability of the proposed gambling operation and the means proposed to maximise the net proceeds from the class 4 gambling to be applied to or distributed for authorised purposes; and

(c) in the case of an applicant that operates mainly to distribute net proceeds from the class 4 gambling to the community, details of the methods, systems and policies for consideration of applications and distribution of net proceeds.

22. The Secretary must refuse to grant a licence (section 52), or must refuse to renew a licence (under section 56), if the Secretary is not satisfied on each of the grounds listed in that section. The Secretary may also suspend or cancel a class 4 operator's licence if he is satisfied that any of the grounds in section 52 are no longer met and, in deciding whether to suspend or cancel a class 4 operator's licence, he must take the matters in section 52 into account. The grounds, which therefore constitute in effect a series of obligations, include:

(a) The applicant's purpose in conducting the class 4 gambling is to raise money for authorised purposes; and

(b) The applicant will maximise the net proceeds from the class 4 gambling and minimise the operating costs of that gambling; and

(c) The net proceeds from the class 4 gambling will be applied to or distributed for authorised purposes.

23. The following statutory provisions also reflect the importance of the requirement to distribute net proceeds only for authorised purposes:

(a) The holder of a class 4 operator's licence must obtain the Secretary's approval before it changes its governing document in a way that may have the effect of altering its objects such that it is no longer capable of applying or distributing net proceeds from the class 4 gambling to or for authorised purposes (section 55(1)).

(b) Suspension, cancellation or refusal to renew a licence does not affect a corporate society's obligation to apply or distribute the net proceeds from the gambling to or for authorised purposes (section 60(1)(a).

(c) Corporate societies that exist mainly to distribute net proceeds to the community must review their methods of distribution at least annually (section 109); and must comply with detailed publication requirements regarding distribution, in respect of which failure to do so is a summary offence (section 110).

(d) Failure to apply or distribute net proceeds only to or for authorised purposes is a summary offence: (section 106). Conviction results in automatic cancellation of all class 4 operator and venue licences held by the society with no right of appeal.

The last provision illustrates the degree of importance, in the operation of a class 4 society, of the statutory requirement to distribute all net proceeds, as defined, only for authorised purposes.

24. The statutory scheme is clear: holders of class 4 operator's licences must return all net proceeds to the community, and they must maximise those net proceeds. The definition of net proceeds is fundamental and ultimately controlling of society activity. Net proceeds are defined as all of a society's gambling revenue less only the actual, reasonable and necessary costs which a society incurs "in conducting the gambling" and complying with statutory requirements and licence conditions. Any cost incurred that is not actual, reasonable and necessary in conducting the gambling, or in compliance, is not excluded from the definition of net proceeds and is therefore subject to the section 106 distribution requirement. Although section 106 does not say "all" net proceeds, its requirement that net proceeds (defined as "all turnover" less specified items) be

distributed "only" to authorised purposes has the effect of requiring all net proceeds to be distributed for authorised purposes.

25. Further, regulations passed pursuant to section 114, prescribing minimum amounts and time periods for distribution expressly require the distribution of all net proceeds. Regulation 11 of the Gambling (Class 4 Net Proceeds) Regulations 2004 provides:

> **11 Timing requirements for distribution of proceeds for authorised purposes**
>
> (1) A licence holder must distribute for authorised purposes,—
>
> (a) during each of its financial years at least every quarter, all or nearly all of the net proceeds from the class 4 gambling during the financial year, and
>
> (b) within 3 months after the end of each of its financial years, any remainder of the net proceeds from the class 4 gambling during the financial year.

The requirement that "all or nearly all of the net proceeds" be distributed each quarter, together with the requirement attaching to any remainder (thus accounting for any not distributed immediately as "nearly all" of net proceeds) obliges class 4 societies to distribute *all* of their net proceeds.

The incurring of costs is subject to close control and legal constraint and not generally merely a matter of discretion

26. There is no express authorisation for class 4 operators to incur costs in relation to venues (or indeed other operating costs). Rather, the ability to incur such costs is implicit in the definition of net proceeds and in the power conferred on the Secretary to limit such costs. Any such limits do not constitute an authorisation to spend those amounts without regard to other restrictions on expenditure, as the Trust seems to have thought.

27. Contrary to the Trust's submissions, the definition of net proceeds, when combined with section 106 and section 52(1)(e), has the effect that societies may only incur costs that are actual, reasonable and necessary in conducting the gambling or in legal compliance. Costs that are not actual, reasonable and necessary to the conduct of the gambling and legal compliance are not excluded from the definition of net proceeds and are therefore subject to the statutory requirement of distribution only for authorised purposes. The incurring of any other costs is, therefore, not permitted because anything beyond what is actual, reasonable and necessary for conducting the gambling and legal compliance is subject to the requirement of distribution for authorised purposes. It follows that only actual, reasonable and necessary costs for the specified purposes may be incurred. An

effective prohibition on incurring costs beyond what is actual, reasonable and necessary for conducting the gambling and legal compliance is consistent with the duty to minimise operating costs (and maximise net proceeds).

28. The duties in section 52(1)(d) to maximise net proceeds and minimise operating costs are coherent and internally consistent, albeit not necessarily entirely co-extensive. This is an issue raised in the submissions. The Trust complained that the Secretary's submissions on the point (that an implication of the duty in section 52(1)(d) is to ensure that increases in net proceeds do not come with a "price tag of unnecessary expenses") amounted to treating the phrase "maximise net proceeds" as redundant, or otherwise involved substituting the conjunction "by" for "and". The Trust, for its part, argued that its expenditure led to increased turnover, and that it was required to increase turnover under section 52(1)(d).

29. In the Commission's view, both arguments tended to adopt extreme positions. A class 4 society is subject to two express duties, to maximise net returns and to minimise costs, which are not in conflict and of apparently equal weight. It is not necessary to construe the obligations by giving primacy to the latter (as the Secretary urged). As costs must bear some relationship to the size of the gambling operation, the Commission doubts that it prohibits the incurring of costs which would be expected to increase materially the net proceeds. If interpreted in that extreme way, compliance would require reducing, or even closing down, the gambling activity. However, that conclusion does not mean that costs may be increased so long as there is some hope or expectation of additional gross revenue (as the Trust argues). The overall sense conveyed is a requirement of conservatism in spending and the need to protect funds intended to benefit the community from speculation and waste.

30. The Act provides for the Secretary to impose further limits on costs across the sector as a whole (section 116) and in relation to individual class 4 societies via class 4 venue agreements (section 69). These limits are in addition to the general requirement to minimise costs and to incur only reasonable and necessary costs. The Act does not confer on the Secretary the power to set limits that would have the effect of contravening other obligations in the Act; therefore any limits set by the Secretary can only either confine or further limit costs that a class 4 society could otherwise incur under the Act.

31. Under section 116, the Secretary may, by notice in the *Gazette*, set limits on, or exclude, the costs that class 4 societies may incur. The costs that he may exclude or limit include costs associated with the class 4 venue, costs associated with repairing and maintaining gambling equipment; and costs of operating the society. The limits may be expressed as a specific amount, as a percentage or as an amount for each gaming

machine. Relevantly to this appeal, the Secretary has imposed, by Gazette Notice, limits in relation to venue costs pursuant to section 116 and excluded all types of costs other than the categories in relation to which he has set limits.

32. On the issue of competitive spending to secure venue agreements, it is also worth remembering that, in addition to the reference to "no commission" in the definition of class 4 gambling (section 30) the Act expressly prohibits (section 115) the payment of commissions to venues (or indeed to anyone). Commission is defined as a payment that is based directly or indirectly on a percentage of gambling turnover. Prior to passage of the Act, the Government Administration Committee considered submissions by industry members that commissions would be easier to manage, reduce growth in sites and encourage better site operator performance and a higher return to the community. The Committee rejected the proposal, stating in its report:

> We do not consider that class 4 venue operators should be paid a commission, as it may conflict with the duty of a society to do all it can to maximise the return to the community from class 4 gambling.

33. Further control over costs arises from class 4 venue agreements. Holders of class 4 operator's licences also usually require venue licences in order to be able to conduct class 4 gambling. A corporate society that intends to operate gambling anywhere other than at a non-commercial class 4 venue that it owns or leases and uses mainly for club members must include in its application for a venue licence a venue agreement: section 67. A class 4 venue agreement is defined by section 4 as an agreement or agreements between the holder of, or applicant for, a class 4 operator's licence or a class 4 venue licence and the venue operator that sets out their respective rights and responsibilities. The form and content of the venue agreement must be approved by the Secretary and must include, amongst other specified details, an itemised list of costs associated with the operation of class 4 gambling at the venue: section 69.

Summary of legislative policy

34. If one considers the legislation in the manner set out above, the following conclusions may be drawn:

(a) Class 4 societies are not commercial ventures but exist to hold licences and conduct gambling in either society venues or, under venue agreements in the premises of others, for the purpose of raising money for community purposes.

(b) They are required to be modest in their expenditure in order to maximise the net proceeds which they must distribute to the community. Expenditure by

societies must be closely controlled and monitored because the costs which they incur are at the expense of the community which receives the remainder.

(c) The legislative requirements include speedy distribution of net proceeds, meaning that societies cannot accumulate funds and create financial reserves (a matter on which the Commission ruled in decision GC19/09) and, it follows, withhold funds from community distribution in order to provide advances to venue operators.

(d) There is nothing in the Act, or elsewhere, which authorises expenditure by societies (which involves depriving the community of funds) on competing with one another to secure venues and the gaming receipts therefrom. This is a form of expenditure which may seem reasonable to the society (which wishes to have as much money as it can earn to distribute) but is less reasonable when seen from the perspective of the community as a whole. It does not matter to the community as a whole which incorporated society receives the receipts from which venue when all such proceeds must be distributed for authorised purposes. From the community perspective, reducing the total funds for distribution to the community by funding competition between individual societies for venues is not reasonable. In addition, legislative concern about the prospect of venue operators extracting benefits from gaming proceeds at the expense of the community needs to be borne in mind.

(e) Expenditure is permitted only if it is an actual, reasonable and necessary cost incurred in "conducting the gambling" or complying with related legal obligations and, if it is a venue cost, if provided for in a venue agreement and within the limits created by the Regulation. Spending on venues outside the statutory restrictions for competitive purposes is unlawful.

35. The conclusions drawn from the statutory analysis above are supported by commentary around the Responsible Gambling Bill when the Act was introduced:

(a) The proceeds from class 4 gambling are from their inception community funds.

(i) The Government Administration Committee stated in its commentary to the Bill that "the money going through non-casino gaming machines is public money" and that, following a society's cessation, 20 working days was "ample time for the distribution of community funds".

(ii) The General Policy Statement at the beginning of the Bill emphasised that the underlying theme of the Bill was that "gambling is usually prohibited unless it is run to raise money for community purposes".

(b) Stringent controls are required to prevent class 4 gambling operators from incurring excessive site expenses and thus diverting community funds to venue operators:

(i) The General Policy Statement provided that one of the measures for improving the distribution of gambling funds was to set "tighter controls on site expenses".

(ii) The Government Administration Committee reported in its commentary to the Bill that the majority of the Committee was not persuaded by arguments of some submitters that, rather than the Secretary being able to prescribe operators' costs, the Bill should place only a general duty on operators to incur such costs as are fair and reasonable in the circumstances. Instead, the Committee relied on advice by the Department:

> The Department advises that its experience to date suggests that, if expenses are left to gaming machine societies to determine, the costs of the society and its sites - especially site rental for the 18 machine sites – can 'blow out' to the detriment of funds for the community In the absence of firm controls, societies can find it very difficult to avoid paying high site-based charges if they wish to retain or obtain a high-turnover site.

36. Longstanding concerns about competition for class 4 venues resulting in inflated expenses, and the need for regulatory controls, have received judicial recognition. In *Pub Charity v the Attorney-General* CA103/4, 8 November 2004, the Court of Appeal considered an appeal by a class 4 society against a decision of the High Court dismissing an application for judicial review. In its judgment, the Court set out a revealing discussion of the class 4 gambling environment prior to the enactment of the Gambling Act 2003 and the actions taken by the Secretary in order to curb "competitive" spending. The discussion provides a useful overview of the historical issues and insight into how present statutory and regulatory controls on class 4 expenditure in relation to venues developed. The background is set out at paragraphs 3 to 10 of its judgment:

> [3] In November 1987, the Minister of Internal Affairs (the Minister) decided to implement a licensing regime for gaming machines under s 8 of the Gaming and Lotteries Act 1977 (the Act). The licensing regime was introduced as a temporary measure pending review of the Act, and was a response to the introduction of gaming machines by entrepreneurs on an unlicensed basis. The purpose of the licensing regime was to provide an element of consumer protection and to ensure that money raised through the use of gaming

machines was channelled back into the community. Licences are issued only to non-profit societies that operate gaming machines to raise money for a purpose authorised by the Act. Those purposes may be charitable, philanthropic, cultural, party political, or otherwise beneficial to the community

[4] Despite several reviews of gaming and two draft Bills, it was not until 2003 that new legislation was enacted in the form of the Gambling Act 2003. Provisions of that statute governing the operation of gaming machines did not take effect until 1 July 2004, so this case is concerned only with the Act.

[5] There is provision in s 8 of the Act for regulations, but no regulations were made governing the operation of gaming machines. The Department of Internal Affairs (the Department), officers of which issue licences under delegation from the Minister, has filled the vacuum to some extent by promulgating standard licence conditions relating to matters such as purchasing of machines, banking of profits, payment of expenses, record keeping and distribution of profits. Licences also include conditions specific to a given society such as its statement of authorised purposes and its schedules of gaming machines, equipment and approved sites.

[6] A prominent feature of the licensing regime has been the Department's attempts to ensure that gaming machines can be operated only for the object of raising money for purposes authorised by the Act. It has done so partly by controlling expenses that may be claimed by a society or paid to the operator of a given site and requiring detailed financial reporting. Until 1996, the Department capped expenses at a fixed rate that was intended to cover space used and electricity consumed by the machines. In 1997, the Department allowed societies to claim expenses on an actual and reasonable basis, and accepted a wider range of expenses. Societies were largely left to determine for themselves whether expenses were actual and reasonable.

[7] Site payments made by societies to site operators under the 1997 regime had two components. They were "site rental", being payment for the right to place the machine on the site, and the costs of labour to administer the machines. Site rental payments were intended to reflect the value to the society of a particular site.

[8] Pub Charity was the first non-profit society to receive a gaming machine licence, and it has around 3,000 gaming machines at approximately 335 approved sites. Beginning some time before 1997, however, competing societies were established. This created an opportunity for site operators to move their custom between societies, which in turn led to an increase in site payments being paid to some operators. In one case, more than $800 per machine per week (pmpw) was being paid. This behaviour led to a 1997 complaint from Pub Charity in which its Chief Executive, Mr Bray, complained that high turnover sites were being poached by societies "less scrupulous" than Pub Charity. By inflating expenses in this way, operators reduced the profit available for authorised purposes.

[9] These developments led the Department to review its practice of allowing societies to determine whether expenses were actual and reasonable. In 2000, the Department undertook a survey of licensees. The results of that survey showed that expenses paid did not exceed $150 pmpw at 70% of sites. For the remaining 30%, sums of $250 or more were being paid. The survey results were shared with the industry. The Department subsequently learned that societies were under pressure to match $250 pmpw to remain competitive. The survey return showed that up to $250 pmpw was being paid for two of the sites that were the subject of the High Court proceeding. Pub Charity relied on this to support a claim that it had a legitimate expectation that payments could continue at that level.

[10] The Department's response was to implement a regime under which standard licence conditions were amended, effective 1 October 2001. Licences had provided that not less than 33% of gaming profit must be returned to the community. The new conditions emphasised that all available funds must be returned to the community, not just the 33% minimum. Expenses of up to $150

> pmpw were authorised, but payments in excess of that required a dispensation. Applications for dispensation were to be supported by evidence verifying the expenses claimed.

37. The Court's discussion demonstrates the evolution of the Secretary's approach to controlling expenditure on venues as a response to excessive spending by class 4 societies competing for venues. Although the Secretary's methods of control in the period being considered by the Court were largely via licence conditions, the Court's description illustrates the class 4 environment against which the Act was drafted and it is significant that many of the licensing techniques then used by the Secretary, for example, setting industry wide controls on costs and minimum requirements for returns of net proceeds, were later provided for in the Act (for example by section 116 and the Gambling (Class 4 Net Proceeds) Regulations 2004).

38. The importance of the foregoing discussion should not be underestimated. There are clear dangers in societies forgetting their true function and acting as if they are commercial gambling operators. The requirement to distribute all net proceeds for authorised purposes, and to maximise net proceeds and minimise costs, are fundamental obligations of purpose, not to be approached as if they were a tax on commercial activity, strictly and minimally construed and applied. The legislation creates a cumulative series of constraints on expenditure, starting with section 106, section 52(1)(e) and section 52(1)(d) and the definitions of net proceeds and authorised purpose, continuing through the supervision of venue agreements and their costs schedules by the Secretary and ultimately subject to regulatory limits set under section 116. The latter are not exceptions to the former, creating an entitlement to incur expenditure which is not actual, reasonable or necessary for conducting the gambling or legal compliance, or in excess of what is provided in approved venue agreements.

Has the Trust breached its duty to minimise costs and incur only reasonable and necessary costs? Grounds 2 and 3

39. The starting point for determining whether there has been a breach of a statutory requirement which might justify suspension is whether the Trust has failed to maximise net proceeds, to minimise costs and to only incur costs which are reasonable and necessary for conducting the gambling and legal compliance. These are a set of connected and overlapping obligations which are best considered together. The evidence about expenditure on development and enhancement of venues, branding and brokerage should first be considered in respect of these fundamental obligations.

40. The Commission has already discussed the duty to minimise costs as a separate and additional (but not inconsistent) duty to maximise net proceeds, specifically and as part of the overall legislative analysis. The legislation has a strong focus on cost

containment as a significant matter of principle and policy. The language of the Act and secondary legislation does not indicate that societies have a licence to speculate and to use and risk community funds in an endeavour to secure gambling receipts for themselves rather than other societies.

41. This construction is supported and emphasised by the use of the word "necessary", a strong word which has been held by the courts to set a high standard, in excess of what might be merely desirable, convenient, or reasonable. The Court of Appeal has held in *Environmental Defence Society v Mangonui County Council* [1989] 13 NZTPA 197, 203 per Cooke P, that "... 'necessary' is a fairly strong word falling between expedient or desirable on the one hand and essential on the other". In the Commission's view, "necessary" carries a similar meaning in the context of class 4 gambling expenditure.

42. The Court of Appeal's analysis of the words "actual, reasonable and necessary" in *Pub Charity v Attorney-General* (at paragraph 36 above) is also instructive. In that case, the Court was required to consider the phrase "actual reasonable and necessary" in the standard licence condition then applied to all licences by the Secretary, condition 56(1), which provided:

> The society shall apply gaming machine funds only to expenses that are actual, reasonable and necessary to the society's gaming machine operations.

Although the phrase was then used in a licence condition, it now appears in the 2003 Act in a similar context, namely limitation of a class 4 society's operating costs. It should be noted that the 2003 Act effectively narrows the permitted range of expenditure compared to the licence condition, the phrase "to the society's gambling operation" being potentially wider then "the conduct of the gambling" and legal compliance. The Court of Appeal considered that the Department was entitled to limit the "actual, reasonable and necessary" expenses referred to in condition 56 of the licence to costs which were *caused* by the gaming operation. This meant that the Department was justified in excluding costs which would be incurred by the site operator whether or not the gaming operation were present and costs that were common to the activities undertaken on the site including the gaming operation. Such costs included rates and rents. Further, the Court considered that payments for such costs, that is, payments to venue operators for costs common to the entire venue or rates and rent contravened the statutory prohibition on paying remuneration to venue operators, because then (assuming the venue operator was already reimbursed for the costs incurred as a result of having the gambling operation at the venue) the venue operator would be paying less for his outgoings than he would otherwise, which by definition would increase the venue operator's profit.

43. The Court of Appeal's interpretation of actual, reasonable and necessary operating costs is also relevant in that it provides a legal foundation for the Secretary's current guidelines to the Gazette Notice. The guidelines exclude payment of any venue costs for maintenance or enhancement of items that affect the entire venue, not just the gambling area, for example air-conditioning. Further, the Court's approving inclusion in its judgment of the Secretary's explanation of what was an "actual, reasonable and necessary" cost in the Secretary's guidelines at the time, makes clear that the Secretary's current approach to "actual, reasonable and necessary", is soundly based. The Court noted at paragraph 55:

> The Department also issued guidelines, which although not part of the licence clarified the Department's policy with respect to expenses The guidelines provide that "actual" expenses are based on actual, rather than projected, expenses and are able to be substantiated. "Reasonable" expenses take into account the size of the operation and normal market values for the goods or services provided. "Necessary" means necessary to the gaming operations. The society must exercise good business practice and due care to ensure that expenses are clearly related to the society's function of raising funds for authorised purposes.

This may be compared with the following paragraph under the heading "Overview of Gambling Act requirements" on page 2 of the Secretary's "Guidelines on Venue Costs under the Gambling Act 2003", which provides:

> The costs of operating gaming machines (including venue payments) must be "actual, reasonable and necessary" (section 4 definition of "net proceeds").
>
> ***Actual:*** The society and venue operator must be able to show that the costs were actually incurred. For example, labour costs must be based on the actual pay scales in use at the venue, and the hours worked.
>
> ***Reasonable:*** The costs must be in proportion to the size of the operation, and should take into account normal market values or prices for the goods and services provided.
>
> ***Necessary:*** The costs must be necessary to the gambling operation. The society must exercise due care to ensure that expenses are clearly related to and are actually necessary for the society's function of raising funds for authorised purposes.

Unfortunately the Secretary's guidelines failed to draw attention to the change in wording between the former standard condition and the new definition of "net proceeds" commented on in paragraph 42.

44. Because of the well-established distinction between what is necessary and what is merely expedient or reasonable, in the Commission's view "necessary" defines whether a cost may be incurred at all, and "reasonable" defines its quantum. Costs which make up what may be deducted from turnover to constitute net proceeds are (actual, reasonable and necessary) costs "incurred in conducting the gambling" and in complying with legislation and licence conditions, nothing more.

45. The submissions and evidence disclose very different approaches to assessment of what costs may be incurred. In the Commission's view, having regard to the overall context, the Secretary's approach is preferable and adopting an even stricter standard might be warranted on the statutory language. However, it accepts that the assessment is not a bright line and some flexibility at the margins of an assessment that involves a degree of subjectivity and judgment is inevitable.

46. The Commission's first task is to consider whether the expenditure disclosed by the evidence is within the statutory obligations or constitutes a breach of them. The state of the evidence is such that the Commission is not placed in a position to make this assessment item by item. That is because the expenditure was apparently incurred without the Trust undertaking an item by item necessity analysis which the Commission can reappraise. This should not be seen as a matter of advantage for the Trust; in order to discharge its obligations, such an appraisal was required. As there is insufficient evidence of the Trust having undertaken a reasoned and detailed consideration of what work was necessary, the Commission can only make its assessment of necessity in the round. If it considers that there has been a breach in the round, it makes the best assessment that it can of the extent of the breach for the purposes of assessing penalty. Such an assessment itself will involve a degree of approximation so far as the amount of cost in breach and resulting loss is concerned.

47. The Commission considers that much of the expenditure at issue is in breach of the Trust's obligations. A significant proportion of the expenditure was not necessary for conducting the gambling, did not maximise net proceeds and minimise costs and ultimately amounted to using net proceeds for other than authorised purposes. The Commission makes the following comments:

(a) There is no indication that the Trust's decision to incur the development and enhancement expenditure involved consideration of whether it was **necessary for the conduct of the gambling** at the venue or whether the expenditure might constitute a failure to minimise costs. The evidence indicates that a central consideration for the Trust was the perceived threat that the venue operator might choose to enter into a venue agreement with a different society on the expiry of the current venue agreement with the Trust. The development and enhancement costs incurred contain a mixture of benefit to the venue operator (substantial capital improvements to the venue being paid for by the Trust) and incentive to stay (by incorporating branding and related elements in the work done).

(b) While the Trust says that it considered whether the expenditure would tend to increase gambling revenue and refers to testing which established that gambling revenue did increase at venues on which expenditure had been made, the evidence is limited to a contention that there would be some increase in revenue, not that the increase would comfortably exceed the expenditure thus increasing net proceeds.

(c) The indication is that the primary consideration in incurring the expenditure was competition between societies for venues. From the Trust's point of view, a failure to compete in a bidding war for favours to venue operators would lead to the latter signing with other societies. From a community point of view that would simply result in another society distributing those proceeds for authorised purposes but, from the Trust's point of view, such a move would seriously disadvantage the Trust. From the Trust's perspective, the use of community funds to win the favour of venue operators and secure them for the Trust was justified as a matter of the Trust's survival. The Commission has previously (decision GC19/09) dealt with the problem of a society treating its own survival as a first priority and ahead of its obligations to the community. The priority accorded to competition for venues echoes the concerns of the Department (which were taken on board by the Government Administration Select Committee) that, unless the expenses of societies were strictly controlled, they would be unable to resist the pressure to secure the favour of the operators of desirable venues by spending excessively and competitively at those venues in conflict with their primary duties to the community.

(d) Although, in the cases of two of the four venues, the expenditure may have been recovered (or treated as recoverable by the mechanism of withholding payments due under the relevant venue agreements) that seems to have been an attempt at mitigation as it is clear that the expenditure was not characterised as a loan or otherwise recoverable at the time it was incurred. The Trust produced no loan agreements or acknowledgments of debt. That the expenditure was not originally characterised as a loan is clear from the fact that the Trust accepts that it cannot recover any of it from the venue operators who did not re-sign. Those latter funds accordingly represent a total loss of community funds as a result of an unsuccessful attempt to secure those future revenues for the Trust rather than another society.

(e) From a commercial point of view, some of the expenditure was rational only because, from the Trust's point of view, it was the community's money which it was risking, not its own, and the Trust did not see itself being held to account

by the community. It is difficult to see a commercial operator risking its profits by incurring substantial expenditure on another party's premises without having secured a documented loan and/or contract extension but merely in the hope that the expenditure would result in a new contract and that it would produce a sufficient increase in revenue to more than offset the cost.

(f) It is clearly possible that improvements and enhancements, in excess of mere maintenance, are conceivably necessary in order to conduct class 4 gambling at a venue if the state of the venue were such that the need for remedial work compromised the conduct of class 4 gambling. It would therefore not be true to say that development and enhancement expenditure on venues could never be necessary nor consistent with minimisation of costs. However, the contrary is not the case either: just because such expenditure may sometimes be necessary and reasonable, it does not mean that it generally is. In the Commission's view, such expenditure by a society is likely to be rare indeed.

(g) If a society elects to incur development and enhancement expenditure directly, it is expected to be able to make a convincing case for the necessity and reasonableness of each item of expenditure, including the decision for the society rather than the venue owner to incur the cost in each case. As a general principle, using net proceeds which should be promptly distributed for authorised purposes to fund improvements to the property of others will not be easy to justify or reconcile with the statutory obligations of societies to the community.

48. It is convenient to consider the expenditure on brokerage fees in terms of the same obligations. The brokerage fees are not venue expenses which are subject to the Gazette Notice discussed below. Expenditure on venue agreements is a cost of operating the society rather than a direct venue expense.

49. The incurring of expenditure on venue agreements is no less subject to the requirement of being actual, reasonable and necessary for the conduct of the gambling and complying with the legislative and licensing requirements. It is necessary for class 4 societies to employ or contract staff to supervise the gambling operations and to ensure that the society and its contracted venues meet their legal obligations. No doubt the liaison work which is required contributes to the relationship between the society and the venue operators and enhances the likelihood of retaining venues once the contract expires, but such expenditure is entirely justified by the operational requirements of conducting the gambling and legal compliance and does not rest on competitive aspirations by the society.

50. It is not clear to the Commission that payment of brokerage conceptually falls within the type of expenditure permitted by the Act, although the Commission would acknowledge that there is an element of degree involved. Negotiating and documenting venue agreements is a necessary part of the conduct of gambling and compliance with legal obligations, but there is a difference both of kind and degree between that and what amounts to a success fee for securing a signature on a contract. Certain costs relating to entry into contracts are necessary if a society is to conduct gambling at a venue and meet its legal obligations but expenditure incurred by a society in simply endeavouring to get venues signed to another society to sign to it instead do not meet the same test.

51. In the circumstances, the Commission does not consider that it is necessary, in disposing of this appeal, to reach a final view on whether the incurring of brokerage costs *per se* is unlawful. For the reasons set out above, it has serious doubts that it is but, in this case, it finds that the amount of expenditure was, in any event, excessive having regard to what was involved. Even if a brokerage fee for obtaining an executed venue agreement were necessary "in conducting the gambling" or complying with the legislation or licence, the amount paid in this case ($40,000 for the execution of two contracts by one person) was not reasonable when considered as expenditure of funds which would otherwise have been distributed for authorised purposes.

Did the Trust breach the Limit C constraints? Ground 1

52. Apart from the more generally expressed obligations to incur only reasonable and necessary expenses for conducting the gambling and to minimise costs, the Act provided (section 116) for the Secretary to set absolute limits on venue expenses and the Secretary did so in the relevant Gazette Notice which prohibits any expenditure on venues other than within one only of three categories with a specific limit on each category and an overall limit expressed as a percentage of revenue.

53. The relevant Gazette Notice 5857, is titled "Limits and Exclusions on Class 4 Venue Costs Notice 2 September 2004". The Secretary published the Gazette Notice pursuant to section 116, which provides:

> **116 Secretary may limit or exclude costs of corporate society**
>
> (1) The Secretary may, by notice in the *Gazette*, set limits on, or exclude, the costs that may be incurred by a corporate society that conducts class 4 gambling.
>
> (2) The costs that may be limited or excluded by the Secretary include the following:
>
> (a) costs associated with the class 4 venue, including salary or wages paid to a key person or another person for work

associated with class 4 gambling at the venue, whether or not they are costs identified in the class 4 venue agreement:

(b) costs associated with repairing and maintaining gambling equipment:

(c) costs of operating the corporate society, including fees, salary, expenses, or other payments to a key person or another person involved in operating the corporate society.

(3) A notice under subsection (1) may apply—

(a) to specified licence holders or classes of licence holder; or

(b) in respect of specified venues or classes of venue; or

(c) in respect of specified gambling equipment or classes of gambling equipment; or

(d) in respect of specified games or classes of games.

(4) A limit may be expressed in any way that the Secretary considers appropriate, including the following:

(a) as a specific amount:

(b) as a percentage:

(c) as an amount for each gaming machine.

(5) A contract or other arrangement or obligation entered into by a corporate society, whether before or after the passage of this Act, that does not comply with limits set under subsection (1) is an illegal contract for the purposes of the Illegal Contracts Act 1970.

(6) A notice by the Secretary under subsection (1)—

(a) is a regulation for the purposes of the Regulations (Disallowance) Act 1989; but

(b) is not a regulation for the purposes of the Acts and Regulations Publication Act 1989.

54. The Gazette Notice sets limits on three types of costs that a corporate society may incur: hourly operating costs, weekly operating costs and venue operating costs. The relevant limit, Limit C, relates to venue operating costs. It provides that a corporate society, when incurring costs associated with class 4 venues, must not incur venue operating costs of more than $800 per venue per week. Limits A and B are limits on hourly operating costs and weekly operating costs respectively. A fourth limit, Limit D, limits the overall amount of costs associated with a class 4 venue that a corporate society may incur across all its venues to 16% of the turnover from all class 4 gambling conducted by that corporate society in any 12-month period, less prizes paid in that period.[1]

[1] On 17 July 2008 (after the period within which the audit took place) a new gazette notice was issued clarifying that the gaming machine profits referred to in Limit D were exclusive of GST. The change does not affect the issues on appeal. Although the appellant's and Secretary's submissions discuss Limit D, the Secretary expressly

55. The Gazette Notice defines venue operating costs as:

(a) labour costs for the performance of tasks required for the weekly provision of a venue;

(b) security costs;

(c) developments and/or enhancements and/or maintenance of the venue; and

(d) fees, for managing the provision of services (a) to (c), not exceeding 25% of the sum of (a) to (c).

56. The Gazette Notice does not specify how such costs may be incurred. In a Guideline published in December 2004 ("**Guideline**"), however, the Secretary stated that, although venue operators should pay for the majority of DEM costs, societies may pay directly for DEM costs under Limit C. As most DEM costs would be incurred in excess of $800 per week, and it would be impractical to pay for such costs in instalments of $800 per week, the Secretary accepted in the Guideline that societies may incur a lump sum and apportion the sum across a number of weeks to keep within the $800 limit. Most societies will have other venue operating costs in addition to any DEM costs that they incur, therefore the amount of DEM they may apportion each week will be the difference between the other venue operating costs and the $800 cap subject to the requirement to minimise costs or incur only actual, reasonable and necessary costs. The payments must be structured over the period remaining on the venue agreement or within the time frames specified for that asset in the IRD "depreciation schedules" (Guideline, page 8).

57. The Guideline also states that costs incurred under each of Limits A, B and C should be itemised in the list of costs attached to venue agreements required under section 69. Section 69 provides in relevant part:

> **69 Form and content of class 4 venue agreement**
>
> The form and content of a class 4 venue agreement must be approved by the Secretary and must include–
>
> ...
>
> (b) an itemised list of costs associated with the operation of class 4 gambling at a venue

58. As the Commission indicated above, these controls are additional to and, cumulative upon, the more general statutory obligations and prohibitions. The Trust's submissions adopt a different approach and indicate that the limits have been interpreted and applied by the Trust as if they were an authorisation to spend any amount up to those limits

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does not rely on it as a ground for appeal, stating that rather than litigating it before the Commission he has commenced a review of the matter.

without regard to other statutory obligations. The Trust's approach can be seen from its submission that the Gazette Notice "permits" DEM costs, which were previously prohibited and in the following illustrative passages from its submissions:

> 37. ... it is further submitted that the decision of whether or not to upgrade a venue is, under current law, essentially a business decision. It is a decision which is proper for the relevant Class 4 Venue Operator to take and it should not be subject to second guessing by the Department unless there is some clear reason to do so.
>
> ...
>
> 93. It is submitted that the Department appears to be endeavouring to make unlawful expenditure that was specifically made lawful by the introduction of the entire category of developments and/or enhancements and/or maintenance as a venue operating cost in the Gazette Notice of 02 September 2004.
>
> 94. TST's evidence is that prior to the introduction of that part of the Gazette Notice it was unlawful for Class 4 Licence holders to incur any costs in respect of developments and/or enhancements of a gaming room.
>
> 95. There is nothing in the definitions contained in the category which restricts developments and/or enhancements to that bare minimum. Indeed such a suggested definition is clearly incompatible with the actual words used.
>
> 96. It follows that Class 4 Licence holders are entitled to pay to enhance or develop venues.

And at paragraph 112 of its submissions in reply:

> ...all of these criticisms are new. All major Class 4 Licence holders upgrade and brand venues and have done so since it became lawful.

59. The Commission regards that approach as unsound. It is inconsistent with the statutory context, especially having regard to the power conferred on the Secretary, which is limited to the imposition of further and tighter restrictions with no express or implied power to reduce the primary statutory obligations.

60. To be fair, the Trust's view may be, at least in part, derived from guidelines and other communications issued by the Department along with or after the publication of the Gazette Notice, although the Commission observes that the Trust has been highly selective in its references to such publications to support its practices, ignoring other comments which clearly do not support them:

(a) The Secretary issued an explanatory letter at the time of the Gazette Notice. The letter made plain that the Notice prohibited societies from incurring directly the cost of capital developments at a venue. Such costs had to be incurred by the venue operator with the society having the ability to make subsequent reimbursement on a weekly basis within the specified limit.

(b) The Department subsequently released guidelines (October 2004) to similar effect. It emphasised that the amounts were maximums, that societies must be able to justify any particular payment with reference to the obligation to make only actual, reasonable and necessary payment and minimise costs and that it was not expected that all venues would receive payments up to the limits, with most being far lower than the maximum limits. The capital costs must be incurred initially by the venue owner on the basis that the society can reimburse by way of weekly payments within the specified limits, although such reimbursement is limited to those expenses "specific to the gambling area and required for the gambling operation", and exclude costs to improve the whole venue.

(c) Following consultation with the sector, the Department issued an amended Guideline (December 2004). This repeated the warnings about all expenditure having to meet the actual, reasonable and necessary standard and the obligation to minimise costs and the expectation that most venues would not receive payments as high as the limits. Without amending the Gazette Notice, the new Guideline indicated that societies could now pay directly for the capital costs of qualifying developments of and enhancement to the gambling space. Societies accordingly had an option to reimburse such expenditure incurred by the venue operator as before or to incur it directly and deduct it from sums which would otherwise be paid to the venue. If that latter option were taken, the payments had to be structured over the period remaining on the term of the venue agreement. In addition, the Guideline indicated that venue operators were expected to fund most DEM costs themselves (ie direct society expenditure was the exception, not the rule) with this being especially important in respect of items which were not easily transferred from venue to venue (such as structural changes, carpet, paint and wallpaper).

61. Adopting the alternative path of the society funding capital costs and being reimbursed by deduction over time confers a cash flow or interest benefit on venue operators at the expense of the community, even if confined to the remaining period of the venue agreement and the principal sum is thus recoverable. Funds which would otherwise be distributed to the community are effectively advanced on an interest-free basis to the venue operator. To the extent that such payments exceed what is deductible over the remainder of the term of the venue agreement, they are an entire transfer of value to the venue operator at the expense of the community.

62. It is common ground that the expenditure which is the subject of the appeal was in breach of Limit C. The Trust concedes this and explains that it was inadvertent, the

result of a failure to have regard to the limit and the remaining term of the venue agreements when the expenditure was incurred. This inadvertence was in addition to the apparent lack of regard for the necessity and cost minimisation obligations and the approved venue agreement cost schedules.

63. In addition to offering the explanation of mistake or inadvertence, the Trust also argues that assessment of the extent of its breach is affected by later recovery, actually received or projected. While recovery is relevant to assessment of the harmful consequences of a breach and thereby will affect penalty, recovery of expenditure in excess of the Notice limits does not mean that the expenditure was not incurred and the limit therefore breached. It is clear that the Trust has breached the limits set under section 116 and that any subsequent recovery is relevant to penalty but does not remove or excuse the breach.

Has the Trust breached section 104(3)? Ground 4

64. The Commission regards the allegations of breach of section 104(3) as a subsidiary issue. In the scheme of things, even if made out, its effect on the Commission's view of penalty would be negligible.

65. The issue is not so much what occurred (as that does not seem to be the subject of much dispute) but rather whether the Trust's conduct constitutes a breach of section 104(3). Section 104(3) provides as follows:

> **104 Gaming machine profits must be banked**
>
> ...
>
> (3) If a venue manager contravenes this section, the holder of the class 4 operator's licence—
>
> (a) must take immediate steps to disconnect all gaming machines at the class 4 venue and advise the Secretary of the disconnection; and
>
> (b) must not reconnect the gaming machines at the venue until the gaming machine profits have been banked.

66. The Secretary has accepted that the Trust did not know it was able to disable machines remotely. The Trust took immediate steps in relation to the majority of instances of late banking, and in the majority of those cases the action was fairly effective (insofar as the proceeds were banked within a day). Although there is some force in the Secretary's point that some of the venue operators clearly did not regard the letters as a serious matter, the Trust is also correct to say that it is not an enforcing authority. The Secretary's response to a request for further information as to what further action the Trust could have taken was revealing: beyond further phone calls and letters, and

manually turning off machines in extreme instances, there was not much more the Trust could have done.

67. In the Commission's view, the Secretary has failed to establish a case of breach, certainly not of a breach which would justify suspension. In the light of developments in electronic disconnection, little in the way of useful guidance would be gained from the Commission attempting to spell out obligations for the future. The Commission is struck by the fact that a course of conduct which was commended in a previous audit report has been subsequently advanced as a statutory breach. The Commission does not find a breach of section 104(3).

Penalty

68. While the Commission has rejected Ground 4, it has concluded that the other grounds for suspension (unnecessary expenditure, expenditure in breach of Limit C and failure to minimise costs) are established. Because of the overlapping nature of the obligation and breaches, it is appropriate to consider penalty in the round.

69. The Trust requested, in its submissions, the opportunity to make further submissions on penalty in the event that the Commission found any breach to be made out. The Commission declines that request for the following reasons:

(a) The breach of Limit C was essentially conceded and the submissions thereon were essentially directed to penalty.

(b) In fact, on any analysis, the Trust not only had ample opportunity to address penalty, it took up that opportunity and much of its submission, both original and in reply, addressed penalty and mitigation.

(c) The Commission's usual practice of hearing submissions on all matters at once is well-established and notified. The Commission gave no indication to the parties that it intended to depart from that practice.

(d) No reason to do so exists. The Trust has been accorded an ample opportunity to be heard on penalty and has, in fact, made full submissions on that aspect.

Mitigation by recovery

70. While subsequent recovery does not excuse or eliminate a breach of Limit C (or, for that matter, of the obligations relating to minimising costs and incurring only actual, reasonable and necessary costs of conducting the gambling or complying with legal obligations), any recovery of excessive spending is obviously potentially mitigating as it reduces the negative consequences to the community of the breach.

71. The evidence indicates that there has been some recovery of the excessive expenditure so that it does not represent a total loss to the community. The Trust concedes that the venues which did not renew their venue agreement with the Trust have managed to retain a benefit, at the expense of the community. The Trust claims it received $8,500 from the sale of development and enhancement assets to the new society operating at the Edinburgh, and $9,478.00 on the sale of such assets to the new class 4 society signed with Mermaids. In addition the Trust recovered $3,946.59 from Mermaids before it changed hands. The remainder ($22,586.76 in respect of the Edinburgh Castle and $12,779.53 in respect of Mermaids) is unrecovered and unrecoverable. In the case of the venues that re-signed, the Trust claims that it has recovered, or is in the process of recovering, the payments in breach of Limit C. While any such recovery is fortuitous, as the expenditure was incurred by the Trust without any lawful right to recover it, the benefits should be reflected in a lesser penalty.

72. The quality of the Trust's evidence on this point is not impressive as it amounts to little more than assertion, unsupported by any contemporary or corroborating documentation. In the Commission's view, the fact and extent of any recovery is a matter which it was incumbent on the Trust to establish as it is a matter of mitigation. The evidence that the Trust has recovered, or is recovering, the excessive expenditure on capital costs by unilateral deduction of amounts payable under venue agreements is not supported by confirmation from the venue operators that they have accepted such deductions and have acknowledged a liability to repay by deduction after the event. The evidence does not exclude the possibility that venue operators may dispute the deduction and later seek the withheld payments to which they are *prima facie* entitled under the venue agreements

73. The Commission notes that the Secretary does not appear to have considered stipulating, under section 59(4)(d), matters which the Trust might have dealt with in order to obtain an effective reduction in the period of suspension. Possibly the explanation lies in the sequence of the pre-suspension events, which included a draft audit report and a final audit report together with a proposal to suspend the Trust's class 4 operator's licence for five days, in response to each of which the Trust made submissions before the Secretary decided to suspend the licence. In the final audit report, under the heading "Requirement for remedial action" the Secretary required the Trust to recover from the venue operators the amount of $181,843 plus GST that was spent on upgrades and enhancements at four venues and to provide evidence of this; and to recover from venue operators amounts spent on upgrades where margin was available under Limit C, where those amounts cannot be repaid over the remaining term of the venue agreement and to provide evidence of the recovery. The Trust outlined the

steps taken to recover amounts spent in breach of Limit C in its response to the final audit and proposal to suspend. The Secretary stated in his decision to suspend that he had carefully considered the Trust's submissions, but still considered a suspension of five days was appropriate in the circumstances. He did not specifically refer to the steps the Trust was taking to recover the money.

74. In the usual course of events, steps to mitigate the effects of a breach on the community would be an obvious candidate for the use of section 59(4)(d), with the reduction in the suspension being linked to the amount recovered. In such an event, proof of actual recovery would not have been in issue as the Trust would have made sure that it established the basis for an earlier end to the suspension period. In this case, while it is a matter of mitigation, the Commission can ask itself what it might have stipulated and for what sort of reduction.

75. For the purposes of the present appeal, the Commission is willing to proceed on the basis that recovery has, or will be, achieved as the Trust says. In the light of the preceding comments, similar concessions in the future should not be expected and supporting documentation and acknowledgments are expected in any subsequent appeal. The Commission accordingly proceeds on the basis that the expenditure on Excelsior and Kope Turf Bar has been, or will be, recovered by deduction from payments otherwise due to the venue operators. It follows that any attempt to reverse the effect of those recoveries in the future will not be permitted expenditure.

76. Before concluding its remarks on mitigation by recovery, the Commission should address its concerns about the mitigation remedy which the Trust has adopted. The recovery of over-payments by deduction seems to involve significant amendment of the approved venue agreements in an area of key focus and supervision, namely the payment of expenses to venue operators. The recovery solution is therefore not only not clearly established (the evidence being silent on whether Excelsior has agreed to the deductions at all and the evidence that Kope Turf Bar has agreed being uncorroborated), it constitutes a breach of the obligation to obtain the Secretary's approval for venue agreement payment schedules and variations thereto.

77. The Secretary makes this point in relation to both the "recovery" of DEM costs in excess of Limit C and the Trust's current accounting policy. The Secretary submitted that the costs schedules at Tab 33 of the Trust's bundle, are, for three of the four venues, not the schedules attached to the venue agreement submitted to the Secretary for approval. This is contrary to section 69, which requires such approval. The Secretary also submits that the Trust's current accounting policy disregards both section 69 (the

requirement for the Secretary to approve venue agreements) and Limit C. The Trust's current accounting practice involves adding:

(a) the difference between the Limit C allowance ($800 per week) and the amount claimed by the venue operator under the venue costs schedule;

(b) to the difference between the total amount claimed by the operator under Limit A, B and C and the amount actually paid on those claims; and

(c) then deducting from that total the balance of unrecovered DEM expenses incurred by the Trust directly.

78. The Secretary's contention that the practice involves a disregard for section 69 of the Act implies that he has not approved any venue agreement with costs schedules based on this practice. The Secretary also submitted that by adding (a) and (b), the Trust ignores the Limit A and B elements of (b) and treats them both as generally available. The Trust counters that this is acceptable; that, by reducing payments to which the venue operator would otherwise be entitled, the Trust is doing no differently than if the venue operator presented it with a cheque for the outstanding amount. In response to a request to both parties by the Commission for further information, Mr Wilson for the Trust said at paragraph 91 of his third affidavit:

> TST is entitled to allocate funds in this manner because there is nothing that says that it is not entitled to do so. Instead I believe that this practice is entirely consistent with both the letter and spirit of the Gazette Notice and the Act.
>
> As I understand it the issue is not the incurring of costs but the recovery or otherwise of DEM cost.

79. In the circumstances, the Commission considers the benefits of recovery to be so significant that it does not treat these matters as an additional breach of obligation potentially relevant to suspension but it is appropriate to make some observations about what has been put forward on behalf of the Trust:

(a) It is correct that the Gazette Notice does not prohibit recovery measures, but the Notice and other provisions cited above prohibit the incurring of the expenditure to be recovered in the first place. This includes using net proceeds for the purposes of making advances to venue operators (the mitigation strategy used).

(b) The Trust's accounting policy is based on a flawed interpretation of the statutory scheme. It has purported to convert maximum restrictions on certain types of spending to spending entitlements without regard to numerous other restrictive provisions.

(c) The Trust's policy and the recovery programme show a disturbing lack of concern about the terms of formal venue agreements which require prior approval under the Act. The venue agreements are themselves another means by which societies are constrained from transferring community funds to the benefit of venue operators. Again the Trust seems to have treated the imposition of the Gazette Notice, not as an additional constraint, but as an entitling substitute for all other constraints and obligations to which it is subject.

80. With the benefit of hindsight, the decision by the Secretary to permit the direct incurring of development and enhancement expenditure on venues was regrettable. It has made the monitoring and control of society costs difficult. It is also clear from the evidence that it has led to widespread abuse of the concession as, under competitive pressure, societies have chosen to make something intended to be exceptional a matter of standard practice and, if the practice of the Trust is typical, implemented it with highly selective regard to the terms of the Guideline. Little thought seems to have been given to the effect of such expenditure on approved venue agreements or on the legal obligations on societies to distribute net proceeds with dispatch.

81. The Commission has concluded, having regard to the size of the community loss, that a suspension is appropriate. The Commission has considered the following factors in mitigation:

(a) The Trust does not appear to have acted with clear guilty knowledge, although there is a strong flavour of selective attention. On the contrary, it thought, albeit wrongly, that by complying with its minimum return requirements and mostly staying within the Gazette Limits, it was meeting all necessary obligations. The Trust seems to have genuinely thought that it was entitled to spend what it liked within the Gazette Limits, once it had accounted for minimum returns, as part of its "commercial" discretion.

(b) The Trust has recovered the largest two of the payments that were in breach of Limit C, albeit that the recovery has been entirely fortuitous.

(c) The Trust's behaviour was to some extent condoned by the Department's own conflicting advice on the payment of venue operating costs and confusing statements about commercial competition. Rather than relying on and enforcing the primary obligation to minimise costs and incur only reasonable and necessary costs, the Department seems to have tacitly accepted that community funds could be used for competitive purposes so long as it did not get out of hand. Such an approach was bound to lead to confusion and

pushing unclear boundaries and, in the Commission's view, was wrong in principle.

(d) The Trust has not acted in an exceptional way. It is clear from the evidence that many other class 4 operators have undertaken similar venue upgrades. As the Trust appears to be the first class 4 society to have been audited for a period in which venue upgrades have been undertaken, or at least the first to appeal a decision of the Secretary on the matter, the Commission does not know how its spending compares to that of other venues.

(e) The effect of a suspension will affect all 92 venues of the Trust, not simply those on which excessive expenditure was made.

82. The Commission approaches the question of penalty on the basis that the Trust's breaches are not exceptional in kind or degree; it is merely the first society to come before the Commission as a result of a series of audits. The Commission is conscious that the penalty imposed in this case will be something of a benchmark for the suspension of the licences of other societies. For good reason, there has long been concern about societies' ability to resist pressure from venue operators to benefit operators at the expense of the community. The legislative provisions were intended to provide a basis for societies to resist that pressure but their effectiveness is ultimately dependant on effective enforcement and concerted effort to deprive those in breach of the benefits of their breach.

83. In fixing a penalty in this case, the Commission records its expectation that the Secretary will be diligent in his investigation of similar conduct by other societies and that those who have breached will suffer proportional consequences. This is not simply a matter of justice between societies; in addition, legislation designed to remove the temptation to deprive the community of net proceeds by conferring benefits on venue operators will only work if enforcement is uniform and rigorous. The evidence suggests that those societies who have complied with their obligations are likely to have suffered significant loss of revenue to societies who have been prepared to push beyond the boundaries. Consistency of enforcement is now required to do justice and to ensure that, in the future, societies are no longer forced to choose between legal compliance and financial advantage.

84. There is little to guide the Commission on an appropriate penalty in its previous decisions. In the Whitehouse Tavern Trust appeal ("**WTT**") (decision GC34/06), the Secretary suspended the WTT's operator's licence for incurring costs that were not reasonable and necessary (including sending a venue manager to a conference and

paying the venue manager's wages) and making distributions that were not for authorised purposes, including $1,000 to a mayoral campaign and $25,000 to a residents' association to appeal an Environment Court decision. The payments were far smaller, and the WTT made far fewer payments of unnecessary costs, than in the present case. On appeal, the Commission reduced the suspension from seven to four days, but it is important to note that special reasons existed for the reduction. The Commission recorded its serious concerns about the Secretary's handling of the matter. The Secretary had informed the WTT that he would withdraw the suspension entirely if the WTT repaid a specified amount (comprising only a small proportion of the challenged expenditure). The WTT made the required payment in full but the Secretary did not withdraw the suspension, instead reducing it from 30 to seven days. While the Commission did not consider that such a penalty would ordinarily be inappropriate or that the Secretary's broken promise should result in no penalty at all, it took into account that a further reduction was appropriate to reflect its disapproval of what had occurred. No similar considerations exist here.

85. It is not clear to the Commission, whether and to what extent, the Secretary has taken into account the extent of the recovery after the audit report. In submissions to the Commission, the Secretary expressed scepticism about the recovery claims, so they are unlikely to have carried much weight in his suspension decision. The recoveries were of the two largest amounts of DEM expenditure, totalling over $130,000 (although there has been no recovery of the other payments in excess of Limit C (approximately $60,000), of the other unidentified expenditure on other venues or the brokerage fee ($40,000)). In the Commission's view, whether expressed as a section 59(4)(d) matter to be dealt with or a matter of mitigation, a recovery of that magnitude should have made a material impact on the penalty.

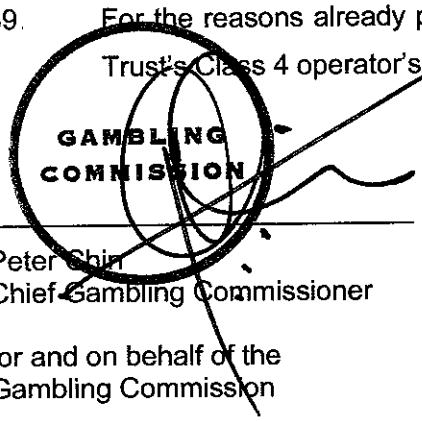
86. The Commission considers that, without a substantial recovery, a suspension of at least seven days would have been appropriate, reducing by a couple of days in the event of a substantial recovery.

87. Having considered matters in the round, the Commission upholds the suspension of five days imposed. The appeal is dismissed.

88. As the appeal has had the effect of suspending the Secretary's order, it is necessary for the Commission to stipulate the commencement of the suspension which it has upheld on appeal. The days of suspension need not be taken consecutively but must all be taken within one calendar month of the decision.

Decision

89. For the reasons already provided, the Division dismisses the appeal and suspends the Trust's Class 4 operator's licence for five days.



Peter Chin
Chief Gambling Commissioner

for and on behalf of the
Gambling Commission

5 May 2010