Regulatory Mechanisms Applied to the Gaming Industry

When establishing a tax rate structure, it is important to consider the gaming regulatory environment in which the casinos or racinos operate. The regulatory environment dictates to some extent the revenue and profit potential of the individual casinos, and thus the tax burden that the casinos can reasonably tolerate. The two major regulatory variables that affect gaming revenue are:

1. Restrictions on Gaming
2. Level of Competition

Restrictions on Gaming

The regulatory environment often puts restrictions on gaming. For every restriction placed on a gaming operation there will be an adverse effect on the revenue potential of the operation. The most common examples include the following:

- Bet Limit – Sets a maximum amount for a single wager.
- Buy-in Limit – Sets the maximum that a gamer can obtain in chips or tokens over a specified period of time.
- Quantity Limit – Limits the quantity of a particular game type that a casino can offer.
- Limits on the Types of Games – Prohibits certain game types, such as Craps, Roulette or other traditional table games.

A bet limit, until recently featured in Colorado, in effect, constrains the amount waged by a gamer per trip. In addition, the bet limit eliminates the entire high-end table gamer segment, as these patrons would opt to travel to an alternative gaming jurisdiction.

A buy-in limit, relevant to Missouri, also restricts high-end play and generally slows down the pace of play due to the regulatory controls necessary to enforce the limit.

Several jurisdictions, including Illinois and West Virginia, impose a quantity limit on machines. This quantity limit often results in capacity issues during peak times as well as impacting the variety of slots on the casino floor. With a limited number of positions, gaming operators often scale back on promotions, as fewer patrons are needed to fill the casino.

Limits on the types of games are prevalent mainly in slots only environments that prohibit table games, often associated with racinos. Revenue potential is adversely impacted as studies have shown that gamers enjoy a variety of game types. A comprehensive survey conducted by The Innovation Group in conjunction with Yesawich, Pepperdine, Brown and Russell titled “The Portrait of the American Gambler”, found that 29% of gamers prefer table games. Nevada, at the other end of the spectrum, puts virtually no limits on games, even allowing sports / race book betting among other rare games.

Other restrictions which generally will adversely impact gaming revenue potential include the following:

- Limiting casino hours of operation;
- Restricting the access of local residents to the gaming floor;
- Limiting the level of credit a casino can provide a gaming patron; and
- Limiting the ability of gaming patrons to smoke via a smoking ban on the gaming floor.
- Limiting alcohol sales or giveaways.

Often, restrictions such as these are placed in legislation as a means of placating various anti-gaming factions. However, restrictive environments do not facilitate the generation of a competitive and sustainable industry in the long term. Cited benefits of any proposed restrictions should always be carefully considered and weighed against their negative impacts on the industry and ultimately government objectives associated with creating a healthy industry.

Level of Competition

The level of competition is often managed by the gaming laws of the state or the regulatory authority in charge of gaming. When more competitive situations are permitted, regulatory and oversight bureaucracy must be larger and processes more complex if they are to effectively monitor and control the industry.

The level of competition in a gaming market will also impact the revenue and profit potential of the individual casinos. A higher level of competition restricts gaming revenue potential on an individual licensee basis. Operating costs may also be driven up in more competitive environments due to competition for employees and customers amongst operators. The combined marginalization of revenue potential and incremental expense burden posed by this situation ultimately leads to inefficiency and, in extreme cases, distressed situations.

The two major approaches employed by regulatory authorities regarding competition are:

1. Free-market – Market forces determine the number of casinos. The level of competition is extremely high.

2. Managed Market – Regulatory authorities manage the level of competition either by law or by policy. The level of competition is typically much lower in comparison to the free-market states.

Public vs. Private Industry

While it is not common, some governments opt to maintain a direct involvement in the gaming industry through state ownership and even management of casino operations within their jurisdiction. A later section will examine the efficacy of such a model as compared to the more common private sector scenario.

Examples - U.S. Regulatory Environments

The following chart highlights the regulatory environment variables for the traditional casino style and racino jurisdictions in the US:

U.S. Regulatory Gaming Environment

	Restrictions on Gaming				Level of Competition	
	Bet Limit	Buy-in Limit	Quantity Limit	Limit on Game Types	Approach	# of Casinos
Casino Style:						
Colorado	**Yes**	No	No	**Yes**	Free-market	46
Iowa	No	No	No	No	Managed	10
Missouri	No	**Yes**	No	No	Managed	11
Mississippi	No	No	No	No	Free-market	29
New Jersey	No	No	No	No	Free-market	13
Illinois	No	No	**Yes**	No	Managed	9
Indiana	No	No	No	No	Managed	10
Louisiana	No	No	No	No	Managed	14
Nevada	No	No	No	No	Free-market	268
Racino Style:						
Iowa	No	No	No	No	Managed	3
West Virginia	No	No	Yes	Yes	Managed	4
Delaware	No	No	Yes	Yes	Managed	3
New Mexico	No	No	Yes	Yes	Managed	5
Pennsylvania	No	No	Yes	Yes	Managed	4
New York	No	No	Yes	Yes	Managed	8
Florida	No	No	Yes	Yes	Managed	4*

Source: The Innovation Group

* Number approved, not necessarily in operation

Reviewing The Market Outcomes of Policy Choices: A Case Study Approach

Through the presentation of selected jurisdictional experiences, this section will further explore the intent of the policy as it relates to actual outcomes in a variety of market contexts. The goal of this section is not to present an exhaustive list of outcomes, but rather to highlight and develop a set of themes we believe are relevant to the design of enabling policies (such that would enable Bermuda to achieve stated objectives). The themes examined are as follows:

- Effects of an Unreasonable and Unstable Tax Rate
- Successful Tax Rate Environments
- Tax Rate vs. Regulatory Environment (Managed vs. Free-Market)
- Effects on Tourism

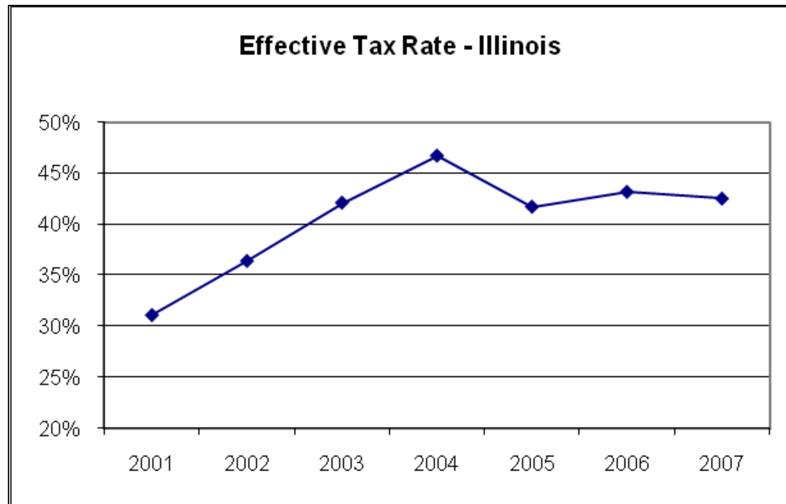
Effects of an Excessive and/or Unstable Tax Rate

Today's gamers have come to expect significant scope and quality, including numerous food & beverage and entertainment options. If the effective gaming tax rate is set at an equitable level in Bermuda, ultimately the gaming facilities will be more competitive at the international level and gaming revenues (especially those sourced from tourists), and hence gaming taxes, will be maximized.

The Innovation Group identified several examples where an unreasonable and unstable tax rate structure negatively affected the gaming industry in a particular jurisdiction. The negative consequences included reduced economic expansion, a decline in gaming revenue, and a reduction in the quality of the gaming product. The classic example relates to the tax rate environment in Illinois over the last several years. In addition, hard lessons were learned in Louisiana, New York, Florida, Maryland, and The United Kingdom.

Illinois

The Illinois legislature raised the gaming tax rates associated with the graduated tax schedule in June 2002 and again in June 2003. The 2002 change increased the effective tax rate in Illinois by about 7%, while the 2003 change further raised the effective rate by 8%. Adding to the already unstable tax environment, Governor Blagojevich began espousing a possible state takeover of the gaming industry. In June of 2005, the rates were rolled back to the June 2002 increase. The following graph highlights the effective tax rate volatility in Illinois over the last several years:



The net result of the unstable tax environment and the higher effective rate was an industry reaction, in an attempt to salvage profits, which curtailed economic expansion, decreased gaming revenue and negatively affected the quality of the gaming product for consumers.

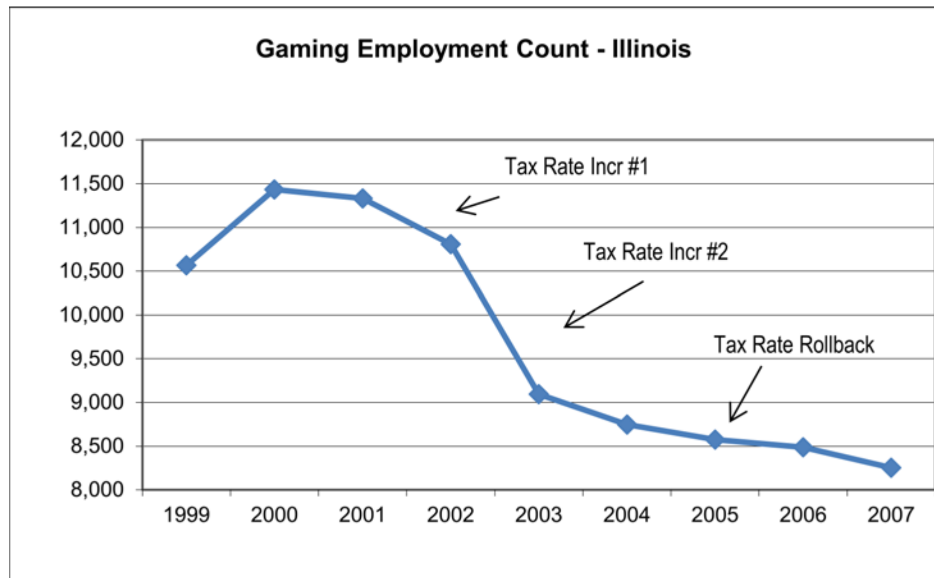
Impact on Economic Expansion

One of the best measures of economic expansion associated with a particular industry is employment. Direct employment in the gaming industry in Illinois peaked in 2000 at 11,434 employees, remaining steady at 11,333 through 2001. In 2002, the year of the first tax rate increase, employment declined 5% to 10,808 employees. The following year, in reaction to the second and the largest of the tax rate increases, employment dropped 16% to 9,094 employees. Employment continued to decline in 2004 as the full year effect of the June 2003 tax increase was realized. Employment stabilized somewhat following the tax rate rollback, which took effect in 2005, only to regain negative momentum in 2007. Since the peak in employment, 2,686 jobs were lost reflecting approximately $67 million in salaries. The following table and graph display the employment count data associated with the gaming industry in Illinois during the period of tax rate volatility:

Illinois Employment Summary

Year	Employees	% Change
1999	10,566	
2000	11,434	8.20%
2001	11,333	-0.90%
2002	10,808	-4.60%
2003	9,094	-15.90%
2004	8,748	-3.80%
2005	8,575	-2.00%
2006	8,486	-1.00%
2007	8,253	-2.70%

Source: Illinois Gaming Board



In addition to the decline in employment, there were other indications that economic expansion was curtailed. Various casino operators cited plans to delay or cancel casino expansion projects. MGM tabled plans to invest about $500 million in a new casino. Harrah's postponed a planned expansion at their Metropolis property. Argosy decided to scale back a previously announced barge expansion. The Casino Queen noted that their expansion would be in jeopardy if not for the tax rollback. Finally, one of

the Illinois Representatives that supported the tax rollback did so to induce investment, according to the St. Louis Post Dispatch. In summary, the tax rate increases in Illinois adversely affected economic expansion.

Decline in Gaming Revenue

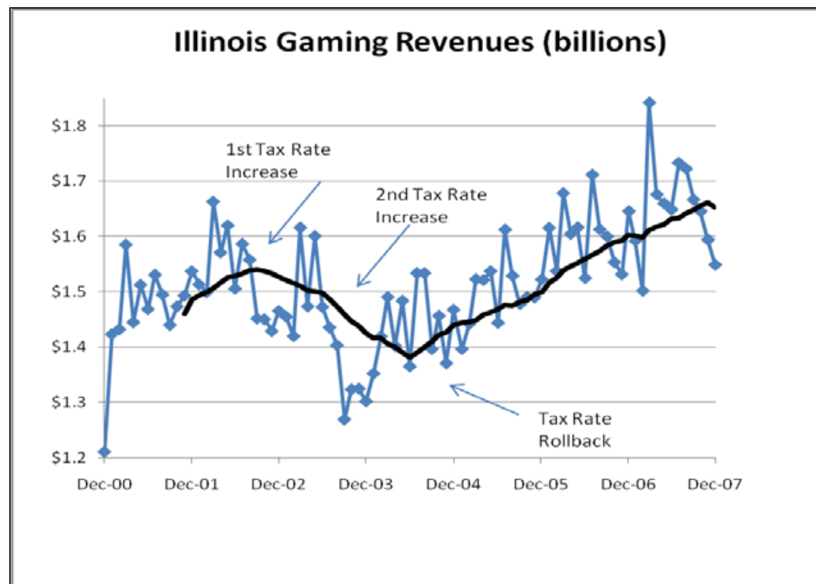
The most notable impact of the tax rate increases was the decline in Illinois gaming revenue. The decline in gaming revenue was mainly due to the reaction of the casino operators to implement policies to maintain profit margins. The casino operators reduced allocations for marketing and promotional items, mainly related to giveaways. Additional operating changes included reducing operating hours, charging admission fees and cutting back on customer service elements. The casino operators targeted remaining marketing efforts towards the high-end gaming segment. The strategy made sense especially considering the restriction on the number of slot machines associated with gaming in Illinois.

The casinos in Illinois posted gaming revenue in 2000 of $1.658 billion, a strong 22% increase over the prior year. The gaming revenue growth rate moderated somewhat in 2001 to 8%. Gaming revenue peaked at $1.832 billion in 2002, a modest 3% increase over the prior year as only the second half of the calendar year 2002 was impacted by the first rate increase. The second rate increase in June 2003 had the more profound impact, as gaming revenue fell 6.6%, the first year over year decline in gaming revenue since the inception of gaming in Illinois. Gaming revenue in 2004 was relatively flat at $1.718 billion. Following the rate rollback, gaming revenue increased 4.7% to $1.799 billion in 2005, then 6.9% to $1.924 billion in 2006, and again in 2007 to 1.983 billion (a gain of just over 3% over the previous year). The following chart shows annual gaming revenue for the Illinois casinos over the last several years:

Illinois Gaming Revenue

	Gaming Revenue ($ millions)	% Change
1999	1,363	
2000	1,658	21.60%
2001	1,784	7.60%
2002	1,832	2.70%
2003	1,710	-6.60%
2004	1,718	0.50%
2005	1,799	4.70%
2006	1,924	6.92%
2007	1,983	3.09%

Source: Illinois Gaming Board



Illinois gaming admissions were even more severely impacted by the tax rate increases as gaming

operators target marketing efforts towards the high-end gamer segment. In 2002, the casinos posted 18.2 million admissions statewide, roughly flat in comparison to the prior year. The 2003 admissions dropped sharply, decreasing 12% in response to the second tax rate increase. The poor admission results continued in 2004 falling to 15.3 million, an 8% decline in comparison to the prior year. The situation has reversed as gaming admissions were flat in 2005, and posted moderate growth in both 2006 and 2007. The following chart displays Illinois gaming admissions over the last six years:

Illinois Gaming Admissions

	Gaming Admissions	% Change
1999	21,992,000	
2000	19,015,000	-13.50%
2001	18,808,000	-1.10%
2002	18,822,000	0.10%
2003	16,598,000	-11.80%
2004	15,331,000	-7.60%
2005	15,323,166	-0.10%
2006	16,180,360	5.60%
2007	16,525,437	2.10%

Source: Illinois Gaming Board

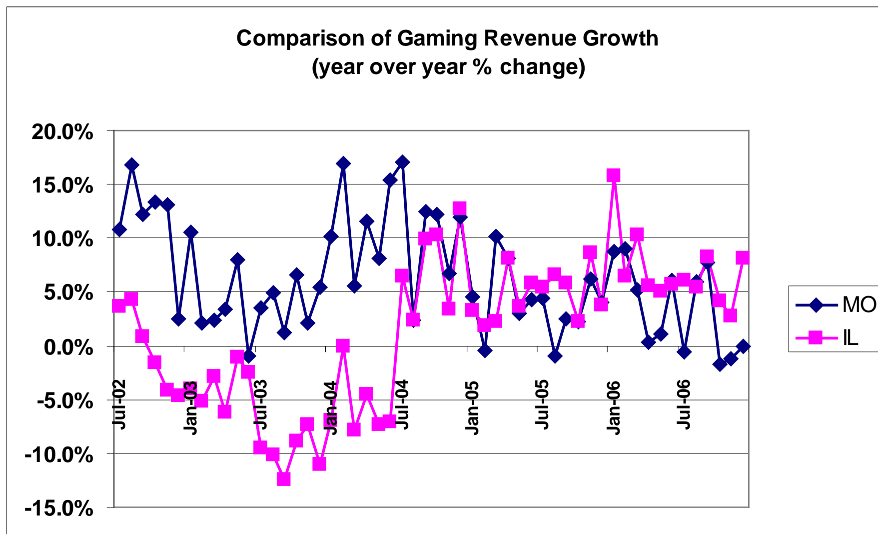
It is important to compare the Illinois statistics to neighboring states in order to rule out on overall industry decline. Prior to June 2002 the gaming revenue growth rates in Illinois and Missouri were similar. There was a clear divergence beginning in June of 2002, the date of the first Illinois rate increase. For fiscal year 2003 (July 2002 through June 2003) the spread between Missouri's gaming revenue growth rate and that of Illinois was nearly eleven percentage points. For fiscal year 2004, the disparity in growth rates was similar. Following the one-year anniversary of the second tax rate increase, growth rates between Missouri and Illinois were again comparable. The following chart and graph highlight the disparity in growth between Missouri and Illinois:

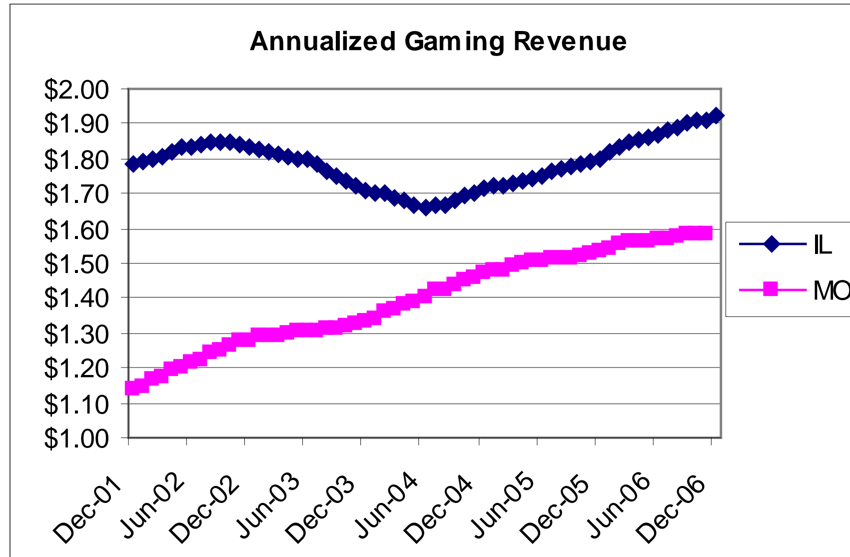
Gaming Revenue Growth Rate

	Illinois	Missouri	Spread
FY 2002	2.67%	12.42%	9.75%
FY 2003	-6.63%	4.07%	10.70%
FY 2004	1.03%	10.72%	9.69%
FY 2005	4.13%	4.00%	0.13%
FY 2006	6.93%	3.93%	2.99%
FY 2007	3.11%	-0.04%	3.15%

Source: Illinois Gaming Board; Missouri Gaming Commission

The following graph compares the monthly gaming revenue growth rates for Illinois and Missouri. Note that the gap appears immediately after the first rate increase and lasted for two years exactly. This supports our contention the decline in gaming revenue was the result of the tax increase and not typical market forces.





Decline in Quality of Gaming Product

An additional consequence of an unreasonable and unstable tax rate structure is the decline in the quality of the gaming product. As gaming margins tighten, the natural reaction of the gaming operators is to cut back on extraordinary customer service elements, such as free admission, longer hours of operation in the casino and restaurants, and free soda on the casino floor. In addition, the level of promotions, especially in the area of giveaways, will generally be curtailed. Finally, the lack of capital investment means the facilities age as annual capital infusions are reduced and no new games or amenities are forthcoming.

This was evident in Illinois following the second tax rate increase in June 2003. For instance, according to an August 1, 2003 article in the Chicago Sun-times, Harrah's Joliet sent letters to gaming customers citing an upcoming admissions charge. The article also noted that Harrah's discontinued its breakfast buffet and hotel room service and curtailed other food and beverage offerings. The Harrah's general manager noted that the changes were the result of the high tax environment. Hollywood Casino also announced its intention to charge for admission, parking, and soft drinks, all complimentary in the past. Finally, several casinos petitioned the Illinois Gaming Board to allow for shorter hours of operation.

New York and Florida

While we are not suggesting racinos in Bermuda, the cases of New York and Florida offer evidence as to how excessive taxation in a gaming jurisdiction that geographically competes with a low or no-tax jurisdiction can equate to reduced competitiveness in the high-tax jurisdiction.

New York

The State of New York had initially chosen a path which significantly limited the positive impact of gaming to the state by allowing operators to retain only approximately 20% of gaming revenue. This

revenue split created a problem for the operators in terms of justifying the capital investment needed to develop competitive facilities. The low level of revenues retained by operators under this arrangement also made it difficult to market the properties with promotions and giveaways and thus establish a customer base willing to make repeat visits. Without the ability to effectively communicate with customers and provide incentives to patrons, racinos in New York were unable to compete with the surrounding Native American casinos within the state and the gaming facilities in Pennsylvania.

In an attempt to reignite the positive impact of gaming, New York lawmakers went back to the drawing board to revamp the tax structure. Under the new structure, the racetracks would keep 32% of the first $50 million in VLT revenue, 29% on the next $100 million, and 26% on gaming revenue greater than $150 million. In addition, the legislation provides for a "marketing and promotional" payment to the racetrack for 8% on the first $100 million in VLT revenue and 5% on revenue greater than $100 million. It should be noted that out of the amount the tracks retain approximately a third goes to the horsemen.

This relief was not sufficient to ensure the financial health of some of the smaller tracks in upstate New York, which compete directly with Native American casinos that are either untaxed, or share revenue at a much lower rate. Some of these tracks have been on the verge of bankruptcy. This brought about the passage of the most recent bill (previously discussed) which became active in April of 2008. The bill increased racetrack commissions (in greater favor of troubled properties) and allowances for promotional activities so as to bolster the ailing operations and the health of the state's industry overall.

The saga in New York is illuminating and shows how long and difficult it can be to get the correct balance of taxes, capital investment, and revenue generation that are most likely to maximize benefits to the state.

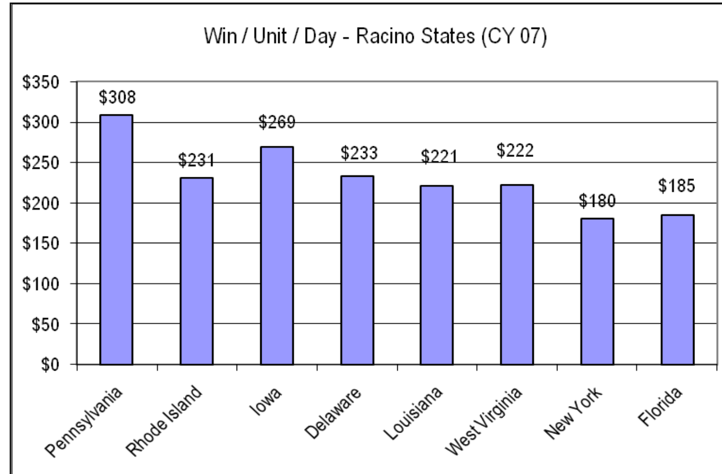
As noted previously VLT operations in New York were generating very low returns, as measured by win per unit per day[1], in comparison to other racino jurisdictions.

Win per unit per day for New York in CY 2007 was about $180, just $3 more than the previous year and well below the 2007 simple average for other racinos of about $238. One of the arguments regarding New York, which is supported by the Innovation Group, is that because of the high tax rates operators have not invested heavily in their facilities or customer development. As a result, many of these facilities do not offer competitive products compared to other regional choices like casinos in Connecticut or Atlantic City.

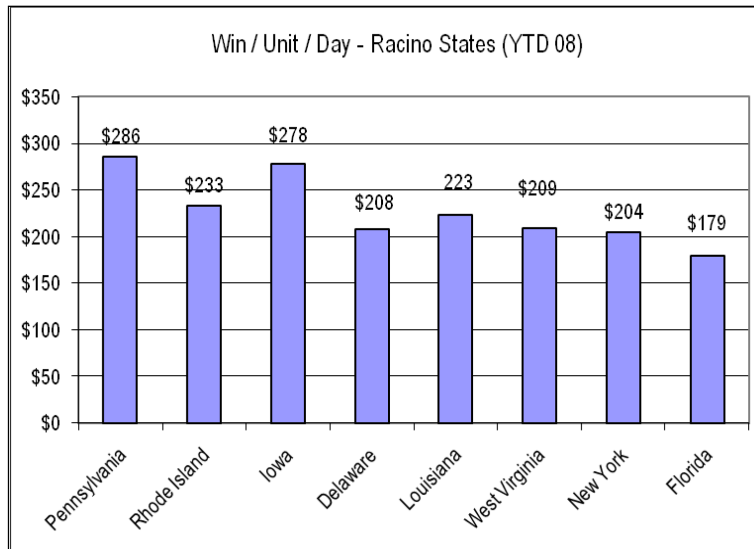
Revisions to the effective tax rate coincided with statewide performance increases on a per unit basis for the most recent statistics available for 2008, YTD win per unit measuring $204, immediate effects

[1] ***Win per unit per day*** is an important industry metric used to gauge the relative performance of gaming machines. The calculation is made as follows: Gaming revenue held by the casino after all winnings are paid out (often referred to as Gross Gaming Revenue) is first divided by the average number of gaming machines over the analysis period and then by the number of operating days in the analysis period. The metric reflects the average amount of gross gaming revenue generated by each machine for each day it operates; and. thus illustrates the comparative revenue generating efficiency of the unique sets of machines being analyzed.

likely created by increased marketing budgets as opposed to immediate capital expenditure. It should be noted that win per unit since the distribution adjustments took hold this past April was $212. The following graphs display win per unit per day for the major racino jurisdictions for CY 2007 and YTD 2008:



Sources: State Gaming Commissions



Sources: State Gaming Commissions

Notes: Win per unit based on data reported through Oct 31, 2008 for Iowa, New York, Delaware, and Florida; September 30, 2008 for Pennsylvania, Louisiana, and West Virginia; and August 31, 2008 for Rhode Island

Florida

Florida provides another example of how a high tax rate can reduce the competitive effectiveness of a gaming operation. In Florida, the state tax rate is 50% (which includes a 3% distribution to local government), with the tracks negotiating a share for purses from the remaining 50%, estimated at 7.5%. At first glance, win per position performance has been lower than would be expected for this market, as seen in the table below.

Florida Racinos 2008

Property	Win Per Position
Pompano (ISLE)	$220
Mardi Gras	$158
Gulfstream (MECA)	$140

Source: State of Florida

The cause of this poor performance in Broward lies with competition from the nearby Seminole Indian's Hard Rock Casino in Hollywood, Florida. The Seminoles pay no taxes and as a result have been able to not only develop an attractive facility, but also have been able to out-compete the racinos through promotions and marketing efforts that the racinos, because of their tax burden, are unable to match. The racinos have no significant advantages in terms of proximity to the gamer population that would potentially offset the Seminoles' advantages.

Louisiana

Louisiana provides an example of a situation where the requirement of an up-front fee combined with high gaming taxes contributed to a severe negative impact on the industry. The land-based casino in New Orleans was required to pay a minimum of $100 million in state taxes annually, and riverboats an effective tax rate of about 21.2% on gaming revenues. Local taxes for riverboats elevate the effective rate by an additional 5%, approximately. In 1995 two new riverboat casinos opened in New Orleans. They both closed within nine weeks. The City of New Orleans was left to fight with other creditors over collecting $3 million in taxes and fees.

In 1995, the temporary land-based casino had netted only about one-third of its projected revenue. The closing of the land-based casino led to the layoff of roughly 1,000 city workers and a 5% cut in the city budget. Both of these failures were directly related to high tax rates. The land-based casino eventually reopened at a new location with the help of reorganization under bankruptcy protection that led to an agreement to drop the minimum annual tax payment from $100 to $50 million. Nonetheless, the casino

has downsized significantly and consequently has not generated the additional capital investment originally anticipated or the projected level of tax revenue. By the time the casino reopened, competition from the Mississippi Gulf Coast and riverboat casinos elsewhere in New Orleans and around the state had transformed the competitive environment to one of high intensity. Difficulties created by this level of competition are compounded by the lack of profitability, which in turn reduced the ability to budget sufficient marketing expenditures, leading to reduced revenue potential. It is only recently with the removal of certain restrictions on the addition of a hotel and restaurants associated with the casino that the property has turned the corner in terms of profitability.

The Louisiana riverboats lagged other markets in terms of profitability. The Innovation Group believes that the tax rate is too high in relation to the competitive and regulatory environment. Louisiana is known for strict controls on slots, which often delay the latest and greatest machines from getting to the casino floor.

Maryland and the United Kingdom

Experiences in the U.S. state of Maryland and in the United Kingdom provide insights into the typical outcome of policies which produce excessive taxation, a restrictive regulatory environment, an unstable tax or regulatory environment, or some combination thereof. Both jurisdictions are in the midst of introducing or expanding gaming within their borders. Their experiences are particularly useful in demonstrating the impact of policy on the ability of a jurisdiction to attract the desired level of capital investment in its gaming industry.

These examples offer a cautionary tale to governments considering gaming legalization: Ignoring the basic economic needs of industry stakeholders increases the probability that benefits to the state (in whatever form they are being sought) could as best remain marginal, and may go completely unrealized.

Maryland

In November 2007, Maryland Government officials passed House Bill 4 (HB4), allowing a referendum on the legalization of Video Lottery Terminals (VLTs) with the primary purpose for providing funds for public education. The question of legalization, which had been turned down in the past, came at time when all other surrounding states had permitted gambling in some form within state limits, making a compelling case for Maryland to do the same. Citing the financial benefits associated with its approval, the bill was passed by a large percentage of residents in November 2008. The amendment permits the issuance of five video lottery licenses and the operation of 15,000 slot video lottery terminals in predetermined locations. The following is a list of the locations, the number of terminals allowed and other specified stipulations.

An initial license fee of $3,000,000 for every 500 video lottery terminals is required and must be paid at the time of the application. In addition, bidders must exhibit a $25,000,000 direct investment by the applicant for construction and related costs for each 500 video lottery terminals included in the bid. There is also an annual fee of $42 per video lottery terminal. The Maryland tax rate is set at a very high 67% of gaming revenue.

The Maryland Education Trust Fund -Video Lottery Terminals, or Senate Bill 3, details the licensing scheme and regulatory structure for the video lottery terminal operators, manufacturers, and other parties directly connected to video lottery terminals. It also covers how Maryland will spend the proceeds from the operations of video lottery terminals. Some major provisions that the bill declares include, but are not limited to, the following:

- Not more than one VLT operation is permitted in a single county or Baltimore City.
- Individual or business entities may not own more than one VLT facility.
- Licensee must begin operation of VLT facility within 18 months of license being issued.
- VLTs can only be owned or leased by the State.
- All proceeds from operation of VLT's will be electronically transferred daily to the Maryland State Lottery Fund.
- Operating hours are set from 8:00 a.m. to 2:00 a.m.
- Facilities are responsible for all of their own marketing, advertising, and promotions.
- Facilities may not provide free food or alcoholic beverages.

The above conditions will impact revenue potential and scope of each gaming facility, both positively and negatively.

As a result of the high tax rate of 67% and the license fee requirement, coupled with other restrictions, and despite the regulated limit on licenses, only six total applications were received (on February 2nd 2009) for the five potential licenses. These applications represented bids for less than half the potential gaming positions envisaged by the state. The results of the process were so disappointing that state officials are now considering rebidding and revisiting the conditions.

Thus, the primary goal of the process of legalizing casinos, i.e. government revenue generation and revitalization of the horse racing industry, is unlikely to be realized.

United Kingdom

Casino operations in the U.K. are presently limited to just 20 machines a piece which operate under both strict bet and payout restrictions. A new regulatory regime was introduced in 2005 with the intent of supporting growth in the casino segment through the addition of 17 casinos. While restrictions would remain rather stiff, the new law is substantially more lax in areas of casino size and payout limit, which would enable the new facilities to compete more substantially as an entertainment experience. A specific number of licenses would be issued in the following formats:

One regional casino – What began as a proposal for multiple regional "super" casinos became legislated as the addition of just one regional casino to the marketplace following strong opposition to the proliferation of Vegas-style gaming by a number of U.K. anti-gaming forces. Defined as having a customer area of at least 5,000 square meters (50,000 sq ft) and up to 1,250 gaming machines with unlimited jackpots, the remaining regional facility was earmarked for the city of Manchester.

Eight large casinos - A minimum customer area of 1,500 square meters and up to 150 gaming machines with a maximum £4,000 jackpot.

Eight small casinos - A minimum customer area of 750 square meters, and up to 80 machines. Unlike the others, they cannot offer bingo.

Shortly after taking over as Prime Minister in June 2007, Gordon Brown announced that the entire super-casino issue was under review – adding to the number of blows suffered by the casino sector during the course of 2007. As well as the UK-wide smoking ban introduced on July 1, in his final Budget as Chancellor, in March Brown raised the upper threshold on casino gaming tax to 50 percent (effectively a 36% hike in the overall tax burden).

The result of these moves strongly contrasted with the intent of the 2005 law. Thus, the growth anticipated as a result of legislative change has been undermined by the government's recent approach to taxation.

Revenues at existing facilities have been adversely affected by the smoking ban which went into effect in 2007, as well as the increase in casino gaming duty introduced in the 2007 Budget. Doubts continue to surround when the so-called 'super-casino' authorized under the 2005 Act will be introduced, or whether it will even be introduced at all. The country's largest operators have expressed their growing dissatisfaction with the UK's approach to casino regulation and taxation.

For example, Malaysia-based Genting (the UK's largest gaming operator) recently reported a 90 percent drop in profits from its UK casino operations, which operate under the Stanley's brand. Peter Brooks, executive deputy chairman of the group was quoted as saying: "It is ironic that the government allowed us all to believe they were going to encourage the gaming industry to be a launch pad for regeneration, when in fact they introduced new levels of tax that are making a major contribution to the serious pressures the industry now faces."

Rank Group, the second largest group operating in the country has also seen its shares battered over the last year as a ban on smoking and forced removal of lucrative slot machines has provoked a steep decline in business, and the gaming tax hike has hurt its casino profitability.

Finally, UK gaming operator Ladbrokes confirmed that it had scrapped plans to re-enter the British casino market. Formerly a major player in the sector, Ladbrokes' interest in the UK's land-based casino industry was reinvigorated by the 2005 Gambling Act. Ladbrokes announced that it has decided not to bid for any of the sixteen new UK casino licenses expected to be introduced under the 2005 Act. The move, that Ladbrokes is calling a 'commercial decision', has generally been interpreted as a result of the unstable nature of the government's attitude towards casino gaming in the country.

A Ladbrokes spokesman said "We have conducted a review of our casino strategy and have decided to withdraw from the process due to the length of time it would take to generate sufficient return on the capital spend required."

Successful Gaming Environments

A number of jurisdictions have found a balance between the gaming tax rate and casino profitability. Jurisdictions with successful tax and regulatory environments include Nevada, Mississippi, Missouri, and the Bahamas.

Nevada

Nevada is the second largest gaming jurisdiction in the world (trailing only Macau), with roughly $35.4 billion in capital investment, generating $12 billion and $1 billion in annual gaming revenue and gaming taxes and fees, respectively. The gaming industry in Nevada employs over 202,200 people and serves as the economic engine for most Nevada cities. As discussed at length, one of the key factors for the success of the industry is the low effective tax rate of 8.5%, as a lower tax rates encourage greater capital investment. In addition, the unrestricted gaming environment also helps to maximize revenue and profit potential and thus contributes to more capital investment. Yet despite the lowest effective gaming tax rate in relation to the comparable group, the Nevada casinos display one of the lowest EBITDA profit margins of around 20%. This is due to the intense level of competition in the market. As of June 2005, over 268 casino operations are competing for business in Nevada. In addition, Nevada competes with other local gaming markets. It is generally accepted that the tax regime in Nevada has resulted in achievement of the goals upon which it was based namely the development of gaming facilities capable of attracting gamers from across the globe.

Mississippi

Mississippi is in many ways similar to Nevada, with a relatively low effective tax rate and high capital investment. The Chief Executive Officer of Pinnacle Entertainment, a casino owner in Mississippi, noted that the Las Vegas-style gaming in Mississippi is a function of the low gaming taxes. The Mississippi casinos employ roughly 28,800 people. The gaming industry in Mississippi generates roughly $2.8 billion in annual gaming revenue, resulting in about $345 million in taxes and fees. Again, despite Mississippi's low effective tax rate of about 12%, profit margins are not unreasonably high at approximately 27%. Again, this is due to a high level of competition. Mississippi has 29 casinos with nearly 1.5 million square feet of gaming space and 38,800 slot machines (prior to Hurricane Katrina). Mississippi also competes with casinos in Louisiana, particularly New Orleans, and Baton Rouge. Thanks to the profit margins, gaming companies continue to invest money in Mississippi. Gaming operators are anxious to rebuild the Gulf Coast following the destruction caused by Hurricane Katrina. The reasonable effective tax rate still makes Mississippi a good place to do business.

Missouri

Missouri's gaming tax strategy also works well, featuring a higher tax rate, relative to Nevada and Mississippi, in conjunction with a control on competition. Although Missouri's effective tax rate is higher than Nevada and Mississippi at 27.4%, the casinos still exhibit a reasonable EBITDA profit margin of about 27.1%. This is due to the limitations on competition associated with the policy of the regulatory agency, as discussed earlier. Yet capital investment in Missouri was reported at $1.8 billion, a decent amount for a state with only 11 casinos. The industry employs roughly 11,100 people, an average of

about 1,000 per casino. Missouri generally exhibits large casinos in the major markets with ample amenities including numerous high-end hotels. The profit margins encourage the existing casinos to reinvest in their projects. The Missouri Gaming Commission reported that since the inception of gaming in 1994, Missouri casinos have reinvested approximately 60% of operating cash flow (EBITDA) back into their operations.

Bahamas

The low effective tax rate of 6.9% has encouraged substantial capital investment, as witnessed not only in the development of Atlantis (just under $2 billion) but also the several other mega-resort casino vying for a position on the island (an investment consortium which included Harrah's was interested in the market for a possible $2.6 billion investment until that deal fell through for political reasons). In addition, the unrestricted gaming environment helps to maximize revenue and profit potential and thus contributes to the continuing flow of investors interested in the market. The country's 4 facilities generate $225 million in annual gaming revenue from tourists alone, as locals are not permitted to participate in the activity. The Bahama's largest casino resort displays reasonable EBITDA profit margins of around 30% per annum. This is due to both the managed jurisdictional environment-- which to date has prevented further investment in a large-scale gaming product-- as well as limited regional competition historically. The competitive situation is quickly changing as more Caribbean countries are liberalizing gaming laws as part of an attempt to lure more high-end tourists to their shores. This may have the "in-demand" Bahamas rethink their historical pattern of denying additional large scale development being sought there by so many able investors. Nonetheless the demand itself is a tribute to the successful balance of tax structure, regulatory structure, and industry profitability.

Specific to the goals of Bermuda, however, the experiences of the Bahamas can also offer cautionary guidance. While the jurisdiction has been wildly successful in attracting formidable investments, smaller facilities have not materialized. Generally a low tax environment would enable smaller investments just as it attracts larger ones. However, the Bahamas graduated tax scheme is the inverse of that seen in most jurisdictions that do not use the flat tax-- it imposes higher rates on smaller operators (equivalent to 3.5 times the effective annual rate for the largest operators), essentially precluding development of these smaller facilities. A typical graduated tax scheme, for which there are numerous examples in the U.S., would tax smaller operators at lower rates and larger operators at higher ones. This would allow smaller properties to compete.

For Bermuda, the development of smaller properties is important. If the licenses can be tied to hotel properties, this could potentially bolster development of new hotel supply (new rooms) and subsequently induce incremental international tourist visitation via hotel marketing efforts and the overall improvement of the tourism product. This goes a step beyond the Singapore model of implicitly emphasizing mega gaming projects in their policy approach.

Tax Rate vs. Regulatory Environment (Managed vs. Unmanaged)

Capital investment will not vary across markets strictly according to the tax regime, but can also vary based on a combination of the tax and regulatory environment. Jurisdictions throughout the Latin American and Caribbean regions yield insights into the interplay of these two policy levers as they impact overall capital investment, and ultimately the level of utility the industry represents to the state.

In Jamaica and Peru we see how nominal tax rates and a lax-market regulatory environment lead to a disjointed, local's oriented industry. In Panama, we see that despite a low tax rate, the lax regulatory policy enabled an environment that, in the long run, undermined the ability of the government to create an industry which fostered its goals of tourism development. In Chile, we see how extreme and pro-active levels of market management combined with a competitive RFP process enabled the country to reap economic development, tax revenue, and tourism enhancement goals despite a somewhat higher tax rate and strict development (investment) requirements.

Jamaica and Peru

While both of these markets are undergoing change in terms of tax policy, regulation, and overall goals for their gaming industries, Jamaica and Peru have similar histories which has led them to where they are today. Though occurring for different reasons in each market, a history of loose legislation and lax regulatory enforcement effectively created a low tax, or no-tax environment, with few if any licensing requirements. These extreme examples of the free-market approach over time enabled the proliferation of approximately 1,000 small operations in each market. In 2006 (prior to new regulations) Peru's 8 casinos and 930 game rooms (89% unregistered) housed 56,000 slots (an average of just 59 per facility); the Jamaican gaming environment consisted of approximately 1,200 operators with less than 20 machines, and around 14 gaming lounges that were licensed to have between 20 and 150 VLTs. Historically, tax collections amount to but a small fraction of what they should have been given the revenue generated—that is when they were collected at all.

The collection of small and disjointed facilities which has evolved in both markets fails to act as a lure for tourists. Such facilities do not contribute to tourism product as they cannot effectively market themselves to domestic, let alone international demand and, they are not attractive enough to be leveraged as a destination marketing tool. Witness how in both markets these small facilities have been estimated to garner hundreds of millions of dollars in gross gaming revenues, primarily from locals.

For their part, both markets are focusing on change, Peru is focusing on policy shifts that increase regulation, monitoring, and taxation of its existing facilities while Jamaica is more intent on drawing mega-developments oriented to tourists. However, it is their historical policy approach combined with implicit tax effects which has them both back-tracking in search of more beneficial implementation structures for the gaming industry within their borders.

Panama

Panamanian casinos and slot halls are governed by Decree Law No. 2, which in 1998 privatized the then state-run industry by setting out detailed laws and regulations for the country's new private operators. Casinos in Panama are permitted in any hotel of 300 rooms or more providing they are situated beyond

a certain distance from schools and hospitals. The low entry barrier was intended to accelerate the development of the nation's then burgeoning and now booming tourism sector. The market's performance has realized double-digit growth every year since 2002. However, contrary to the initial intent of the 1998 legislation, it is increasingly Panamanians, rather than international tourists, that are driving the sector's robust growth.

Panama's 14 full scale casinos collectively house 3,477 slots and 212 gaming tables. In addition, another 3,451 slot machines are divided amongst the country's 27 slot halls. Slot halls, which average 127 gaming positions per facility to the average of 355 typically housed in a full scale casino, are generally smaller facilities which in addition to lacking table games do not offer amenities, services, or overall attraction of a full scale casino.

Panamanian gaming performance is provided in terms of slots and tables and is not property-specific, thus no official information is available regarding the performance of full scale casinos versus slot halls. Based on past Innovation Group engagements in the market, of the $246 million of Panamanian gaming revenues reported driven by the full scale casinos and the slot halls in 2008, we would estimate that slots and tables located in full scale casinos generate approximately 73%, or $180 million, of the total.

Potential for tourism oriented investment was marginalized in the case of Panama despite the low 10.5% levy on its casinos. The capital investment decision was governed more by the very competitive environment which quickly developed in major population centers through the rapid proliferation of full scale casinos and slot halls. With some exceptions, the level of competition created an environment too risky to attract the level of capital necessary to target international tourists as the primary demand segment. The table below offers a profile of full scale casino operations in Panama.

Full Scale Casinos

Facility		Slots	Tables	Positions
Veneto Hotel and Casino	Panama City	511	42	805
Casino Majestic	Panama City	489	36	741
Royal Casino	Panama City	300	27	489
Hotel El Panama & Fiesta Casino	Panama City	561	20	701
Riande Contiental Hotel & Crown Casino	Panama City	150	20	290
Gran Hotel Soloy & Fiesta Casino	Panama City	313	11	390
Riande Granada Hotel & Crown Casino	Panama City	40	5	75
Sheraton Panama Hotel & Crown Casino	Panama City	200	4	228
Fiesta Casino @ Hotel Washington	Colon	195	11	272
Fiesta Casino	David	280	12	364
Fiesta Casino Decameron Hotel	Fallaron	93	7	142
Hotel Guayacanes	Chitré	150	6	192
Casino Mallorca	Colon	75	4	103
Casino Mirage	David	120	7	169
		3,477	**212**	**4,961**

Source: Property websites; Casino City; Gamingfloor.com; The Innovation Group

Chile

Prior to 2005, gaming in Chile consisted of approximately 3,500 slots and 165 tables which operated in seven lightly taxed and loosely regulated facilities. A task force orchestrated by the national lottery in 2004 further estimated some 10,000 clandestine slots scattered throughout the country, half of which could be found operating in the capital region. The government of Chile sought the economic benefits of more gaming in 2005 legislation aimed at removing clandestine operations and enabling tightly controlled expansion of the industry under a competitive bid process that would allow for maximum transparency.

Through this, the Office of the Superintendent of Casinos ("SCJ") was created and given the tools and authority to govern, regulate, and enforce the letter and intent of the law. Since that time the SCJ has been granted the authority to license a maximum of 27 casinos: 7 of which pre-date the 2005 decree; and 17 which resulted from it, and 3 others which were subsequently added. Licenses were distributed in an elaborate and highly competitive bid process whereby the SCJ based their decision on criteria such as the likely impact of the proposal on tourism in the region in question, as well as the quality of the casino project itself. The process was designed to provide maximum transparency in all its facets and to strictly control the level of competition in each market region. The SCJ estimates that these 17 new casinos will generate approximately $267.4 million in total in the first year of operations, yielding $44.8 million in tax revenues. Tax streams generated for the country by the first 17 new facilities are anticipated to total $204 million by the fifth year of operations.

With an effective tax rate of 30.2%, Chile's tax burden is not a low one. Yet the country managed to effectively entice over $800 million dollars of tourist-oriented capital investment to Chilean municipalities that in many cases was unlikely to occur. The facilities will range in size from 200 to 800 machines and have up to 60 tables, and will all be coupled with a variety of ancillary developments (hotels, evens centers, IMAX theaters, restaurant and retail complexes, etc.) positioned to attract both domestic and international tourists. This goes to the point of the importance of stability for investors. Chile's implementation was so strictly planned and controlled that potential investors were not deterred by the high tax rate, because in effect the government was guaranteeing a large amount of certainty in regards to the competitive situation and taxation. Thus by reducing the element of uncertainty and risk, government was able to create conditions which allowed its goals to be achieved even with a higher tax rate.