

# Guide: Licence condition prescribing minimum return to authorised purpose

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## Purpose

This guide applies to clubs and the few non-club class 4 operators that mainly apply funds to their own authorised purpose. These operators are not subject to regulation 10 of the Gambling (Class 4 Net Proceeds) Regulations 2004, which specifies a minimum return to authorised purpose for class 4 societies that mainly or wholly distribute net proceeds to the community.

This guide provides a framework for:

- considering whether to add a licence condition to a class 4 operator's licence that prescribes a minimum return to authorised purpose; and
- considering an application to renew a class 4 operator's licence where the applicant has failed to meet the minimum return to authorised purpose specified in a licence condition.

As a responsive regulator, we want to help societies to become compliant. Using these guidelines provides an opportunity to work collaboratively and consistently with clubs and "own purpose societies" to achieve the Act's core objective for the licensing of class 4 gambling, which is to raise funds for authorised purposes.

## Introduction

Class 4 societies that mainly apply net proceeds to their own authorised purposes are usually required to apply or distribute a minimum amount of their gross proceeds (GST exclusive) to authorised purposes. This is achieved by the addition of a condition to their class 4 operators' licences, imposed in accordance with the power provided to the Secretary for Internal Affairs in section 53 of the Gambling Act 2003 (the Act).

**Specifying this requirement reflects the basic premise of the Act that gambling is prohibited and illegal unless it is authorised under the Act and complies with the Act, relevant rules, licence conditions and minimum standards. A requirement of section 52 regarding grounds for granting a class 4 operators licence is that the applicants purpose in conducting class 4 gambling is to raise money for authorised purposes.**

There are two types of societies that mainly apply net proceeds to their own authorised purposes, clubs and "own purpose" societies. In both cases they raise funds mainly for their own purposes rather than mainly distribute funds to others.

These class 4 societies are not subject to regulation 10 of the Net Proceeds Regulations, which only apply to societies that mainly or wholly distribute their funds. This is because when the regulations were first developed in 2004, it was identified that the community return requirements for class 4 societies that apply funds to their own purposes should be flexible enough to allow accumulation of funding for long term major projects (like, say, an extension to the club premises). The flexibility required for these societies could not be achieved by regulation. Therefore the decision was made that they should be subject to licence conditions specified by the Secretary.

The power to add conditions to a licence is discretionary, and can be tailor made to reflect the special circumstances of each society.

The standard wording for the licence condition is as follows:

- (1) The minimum amount of net proceeds that a licence holder must apply and/or distribute for authorised purpose(s) is the proportion equivalent to 37.12% of its GST exclusive gross proceeds for each of its financial years, unless the Secretary has approved the accumulation of funds in accordance with licence condition 4 of these Class 4 Operator's Licence Conditions.
- (2) For the purposes of this condition, "gross proceeds", in relation to class 4 gambling has the same meaning as defined in regulation 3 of the Gambling (Class 4 Net Proceeds) Regulations 2004.

At the beginning of a licence period, the Secretary has to decide whether to impose the condition on a club or an "own purpose society". Sometimes at the end of a licence period, the Secretary has to decide whether to renew the class 4 operator's licence of a club or an "own purpose society" that has not met the condition. A framework for ensuring that these decisions are consistent and reasonable is required.

# Adding a licence condition specifying a minimum return to authorised purpose

## Basis for the power to add licence conditions

Section 53(2) provides an ability for the Secretary to add conditions to a class 4 operator's licence. Section 53(2)(c) of the Act states that the conditions that the Secretary may add to a class 4 operator's licence include "conditions concerning the management, application, and distribution of funds derived from gambling and from the investment of those funds".

The ability to add a condition to a class 4 licence specifying a minimum level of return to authorised purpose was confirmed by the Gambling Commission in its *Brunner* decision:

The Commission did not consider the minimum proceeds conditions to be *ultra vires* simply because they had a similar effect on clubs that mainly apply net proceeds as regulations 10 and 11 of the regulations have on societies that mainly distribute net proceeds. The conditions are separately authorised under the Act and supplement rather than conflict with the regulations. The decision not to impose by regulation but leave it to individual licence conditions is consistent with an intention to allow flexibility of application. Accordingly the Secretary is not precluded by 2004 Cabinet policy from exercising the discretion conferred on him under the Act in relation to such licence conditions.<sup>1</sup>

## Power to add licence conditions is discretionary

As is made clear by the Act, adding licence conditions is a discretionary power. The Secretary has the ability to add the condition to a class 4 licence with a view to facilitating the achievement of the Act's purpose<sup>2</sup>, but each case has to be assessed on its merits. This is the main difference to regulation 10, which is a minimum return requirement that applies universally to all societies that mainly distribute funds to authorised purpose.

The Gambling Commission has identified some general guiding principles for adding licence conditions under the Act. It has noted that the conditions need to be fair and reasonable in the circumstances. Making this assessment means taking into account the following factors:

- whether the condition is the result of a process of reason rather than a whim or arbitrariness;
- whether the condition is proportionate. This involves weighing the benefits gained from imposing the condition, compared to the costs and the detrimental effects incurred; and
- whether the condition is fair to both the individual faced with the condition and the community.<sup>3</sup>

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<sup>1</sup> *The Brunner Rugby League Club* GC08/11, pp 14-15

<sup>2</sup> See section 3.

<sup>3</sup> *The Lion Foundation* GC16/06, p 9

Examples of the application of these principles to particular fact situations can be found in the Commission’s decisions on licence conditions that set access restrictions to class 4 venues.<sup>4</sup> In each case it is clear that imposing such conditions needs to be considered on a case by case basis, and will depend upon the specific circumstances involved.

With respect to a licence condition specifying a minimum return to authorised purpose, to date the Department has adopted a standard approach specifying a minimum return for all clubs and “own purpose societies”, and then taking a flexible, case-by-case approach to cases of non-compliance.

This approach reflects the fact that the Act makes it clear that the primary purpose in granting a licence in the first place is to raise money for an authorised purpose.<sup>5</sup> As explained by the Gambling Commission in its *Brunner* decision, the objective of specifying the licence condition is to provide “a check that the community benefit justifies the class 4 gambling permitted by the licence ...”<sup>6</sup>.

The rest of this document provides guidance to responding to cases of non-compliance.

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<sup>4</sup> For example, see: *The Lion Foundation*; *The Southern Trust* GC22/06; *The Southern Trust – The Riversdale Hotel* GC05/15.

<sup>5</sup> See section 52(1) of the Act, which states that the Secretary must refuse to grant a class 4 operator’s licence unless the Secretary is satisfied that (b) the applicant’s purpose in conducting class 4 gambling is to raise money for an authorised purpose, and (c) the applicant’s proposed gambling operation is financially viable.

<sup>6</sup> *Brunner*, p 13

# Responding to clubs not meeting the licence condition

## Framework for decision-making

This part of the paper provides a decision-making framework for situations where a club or “own purpose society” that mainly applies funds for its own authorised purposes submits an application to renew its class 4 operator’s licence, and has not met the minimum rate of return as set out in the conditions of its licence and/or is forecasting a return below the minimum rate in the next licensing period.

The framework focuses on the following key factors, namely:

- as a first step, establishing whether not meeting the licence condition is the result of one-off circumstances;
- establishing that the applicant’s purpose in conducting the gambling is to raise money for authorised purposes despite not meeting the licence condition; and
- confirming that the applicant is maximising its return to authorised purposes and minimising its costs.

Additional points to consider that specifically relate to clubs are provided.

A diagram summarising the process is provided at page 13.

## Is not meeting the licence condition a one-off?

### Initial (or one-off) breach of licence condition

Where it is the first time the society has not complied with the licence condition, it is unlikely to constitute sufficient grounds to refuse to renew the licence. Where the financial forecasts show a realistic return above the required rate of return in the next financial year and the society can provide a sufficient explanation for the breach, this would further strengthen the case for issuing the licence subject to the Secretary’s satisfaction with the other grounds.

Also, as a responsive regulator, we want to help societies to become compliant. Situations like this provide an opportunity to work with the society concerned to establish whether it is possible to achieve a better performance in returning funds to the community.

### Leniency for one-off costs

Similarly, the Secretary should exercise a degree of leniency towards the licence condition in years where additional one-off compliance costs have been imposed or arisen unexpectedly (e.g. through a natural disaster or similar event).

A flexible approach should take into account the impact of one-off costs on the financial performance of a society. However, a circumstance that would preclude applying leniency to one-off compliance costs is where the one-off cost is signalled well in advance of the implementation date allowing for societies to plan for it.

## **Second and/or subsequent non-compliance**

A second actual or forecasted instance of non-compliance with the licence condition will require further consideration of the renewal application, in accordance with the guidelines contained in this document.

Continued non-compliance with the conditions of a licence can be a sufficient ground for refusing to renew a licence.

Also, the past compliance history of the society concerned can be used to assess whether there will be future compliance. The past financial performance of the society can be used to assess the reasonableness of the financial forecasts submitted in the renewal application. This will be particularly relevant where a society that consistently fails to meet the minimum return required by the licence condition submits financial forecasts indicating it will meet the minimum return requirement.

## **Key factors to consider when there is ongoing non-compliance with the licence condition**

The following factors should be considered in cases where the society has not met the licence condition a second or subsequent time.

### **Society must be raising money for authorised purpose**

Section 52 of the Act requires the Secretary to be satisfied that the applicant's purpose in conducting class 4 gambling is to raise money for authorised purposes. Meeting a licence condition specifying a minimum return is likely to satisfy the Secretary; however, where this is not met, further evidence must be considered.

When the licence condition has not been met, the society must provide evidence that satisfies the Secretary that the primary purpose of the society's operation continues to be the raising of funds for authorised purposes. This will be a question of fact. The onus will be on the society to demonstrate that it is minimising the costs arising from its gaming machine operation and applying the maximum amount of funds possible from the machines to authorised purposes.

Generally this will involve looking at the totality of the class 4 operation and what the funds generated by it are being used for. This will involve an assessment of whether the society is minimising its costs in relation to the class 4 operation through an examination of the financial information submitted with the renewal application.

Where the class 4 society is incurring costs that are not actual, reasonable and necessary to its gambling operation, then it is likely that the Secretary will not be satisfied. This is grounds for refusing to renew the licence application, although it would be prudent to work through any costs issues with the society prior to proposing to refuse to renew.

It will also require an assessment of the type of costs being incurred, particularly in relation to payments related to the gaming machine operation. If a large proportion of the proceeds are devoted to paying machine-related costs (including servicing costs and relevant fees and duties), then the primary purpose is not raising funds for an authorised purpose.



Similarly, in the case of a club, providing gaming machines as part of an “entertainment mix” for club members cannot be the primary purpose of a class 4 gaming machine operation. At the most, this should be ancillary and subordinate to the requirement to generate funds for authorised purposes.

### **Some points to consider about clubs**

In assessing how to respond to non-compliance with a licence condition setting a minimum return to authorised purpose, there are a few points relating to clubs that could be considered in appropriate circumstances.

Clubs can and do play an important role in their communities, both directly through their membership and indirectly through activities they undertake in their communities. In smaller urban centres, the club premises may be the only community facility available.

While club gaming machine operations may not be large enough to benefit from economies of scale, they can benefit from lower cost structures (e.g. no third party venue costs to reimburse and often no grant-related costs) and some costs being considered applications to authorised purpose.

Clubs can often be small organisations run by volunteers. As a result, there can be frequent turnover of people running the class 4 operation, with associated variances in performance in meeting obligations under the Act. As such, an education and persuasion approach may be more appropriate rather than other stronger regulatory tools, especially if the club personnel concerned are willing and able to improve their performance.

### **Other points to consider where society performance is an issue**

Other factors that may be worth considering when a society has not been performing satisfactorily include:

- Has the society been realistic in its forecasts of its financial performance?
- Has the society had other incidents of non-compliance with requirements of the Act?
- What plans does the society have to turn around its performance? Does the society have a recovery plan in place?
- How engaged are the people (or key persons) involved in the society’s governance?
- Could the society reduce its machine numbers to reduce its costs? (If the society is a club and operates not more than seven machines in total, the Gambling (Fees) Regulations 2015 allow for lower licensing fees to be charged.)
- If the society is a club, what is the state of its membership? Is it declining or growing?
- If the society is a club, has it considered seeking the Minister’s approval to merge with another club?

The “Provincial RSA” case study overleaf illustrates the application of some of these points and the points relating to clubs above.

### **Case Study: A Provincial RSA**

In **2014**, the RSA did not apply to renew its class 4 licence and the licence expired. Later in 2014 a new licence was issued after an application was received.

In **2015**, the club submitted an application to renew its class 4 gaming licences. Financial viability concerns were noted with low generation and application of proceeds at 14 per cent. (The club's current licence condition was set at 37.12 per cent). However, there were some one-off factors present. It was evident that the loss of the licence, resulting in a ten week period with no machines, had been detrimental to the club. The club had not only lost gambling revenue and had higher than usual audit fees; it had also suffered a reduction in membership. The club had also made the decision to reduce its gaming machines from 12 to 10.

The Department granted the renewal application after visiting the club to discuss its situation and its plans for improving its financial position.

In **2016**, the club again applied to renew its licence. There were still financial viability concerns, with the generation and application of proceeds at 17.5 per cent and a forecast return of 24.5 per cent.

In order to get an accurate picture of the club's finances and test its forecasts, the Department requested draft financial statements from the club and reviewed EMS data. The Department then met with the club to discuss its concerns. The entire committee consisting of approximately 12 members attended the meeting, which demonstrated a willingness to work with the Department to improve. It was noted that many of the committee members were volunteers.

The club agreed that a reduction in the number of gaming machines would be beneficial to the club. By reducing its machines to seven, the club could pay lower licensing fees. The reduction in machines would also minimise costs for items such as maintenance and repairs.

Other factors that were brought to the Department's attention included:

- the club had been a popular community entity for many years for returned service men and their families in the district; and
- a new chef had been hired to redevelop the menu and the club had almost 40 bookings leading up to Christmas. The club expected the bookings to increase revenue and membership.

The licence was renewed on the basis that the club's financial position was expected to gradually improve and on the basis that the poor performance had arisen from the failure to correctly renew their licences in 2014.

## Further considerations on authorised purpose performance

If the key factors have been considered and the Secretary is satisfied that the club or own purpose society is minimising its costs and is conducting the gambling to raise money for authorised purposes, then a final factor to consider is the society's authorised purpose performance. The following framework may be useful for shaping our responses to varying levels of authorised purpose performance that do not meet the minimum specified by a licence condition.

### Percentage return performance framework

For a club or an own purpose society to run a financially viable operation, the costs structure of its gambling operation must be sufficient to create a sustainable gambling operation. This means it must be able to meet its fixed and variable costs, as well as enable the operation to replace equipment on a reasonable on-going basis, and be able to generate and apply a sufficient return to the community.

As a general guide:

- those clubs or own purpose societies that are returning between 30 per cent and 37.12 per cent should continue to be renewed with support and encouragement to increase their returns to the licence condition minimum;
- those returning between 25 per cent and 30 per cent should be considered marginal operations that require closer attention. This is likely to take the form of encouraging the society to develop a recovery plan for attaining higher levels of authorised purpose performance. (The content of the plan will depend upon the particular circumstances of the society concerned, but could range from relatively low-level change like changes in society personnel to deeper governance and structural changes like shedding gaming machines or, in the case of clubs, considering a merger with another club<sup>7</sup>); and
- those returning less than 25 per cent should be considered unviable operations and as a general rule, dependant on the assessment of the specific circumstances, their class 4 operator's licence should not be renewed. (As an example of the specific circumstance that may arise, see the "points about clubs" and "other points" on page 9.)

It can be seen that the inference that the renewal application should be refused increases as the return to authorised purpose decreases. However, an upwards trend towards the minimum return should be considered favourably in terms of the renewal application.

The approach outlined above reflects the fact that, based on historical financial information provided by clubs as part of licence renewal applications, it appears that a club must be able to return a 25 per cent minimum return in order to allow a sufficient buffer in the event revenue is lower and variable costs are higher than projected.

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<sup>7</sup> See sections 95 and 96 of the Act.

Finally, the focus of this guide has been on authorised purpose performance. There will of course be other relevant factors that need be considered as part of the licence renewal process that may be influential in the decision-making process. For example, has the society concerned been meeting all its “continuing obligations” as set out in section 53A, which include ensuring that, at all times, the risks of problem gambling are minimised.

### **Case Study: A South Auckland Bowling Club**

*(The following case study illustrates the use of the “Percentage return performance framework” over two licensing periods. In 2015, the club was performing just within the 25-30 per cent range. The Department worked with the club to try to improve its performance. In 2016, the club’s position had deteriorated further and was performing below 25 per cent. Its outlook was poor and there was little prospect of retrieving the situation. The Department requested the club to surrender its licence.)*

In **2015**, the club submitted an application to renew its class 4 licence. The Department had a number of concerns with the club’s performance.

More funds had been applied to the club’s authorised purpose than had actually been generated by its class 4 gambling operation. The Department also advised the club that it was marginal in terms of its ability to generate sufficient proceeds from its operation to justify the granting of a class 4 licence. The club was only returning 26 per cent of its gross proceeds to authorised purposes and a similar performance was forecast for the following year. The club’s accounting practices did not conform to accepted standards.

The Department met the club to discuss its concerns and to provide assistance. This included providing the club with a set of mock accounts and advice on appropriate accounting methods.

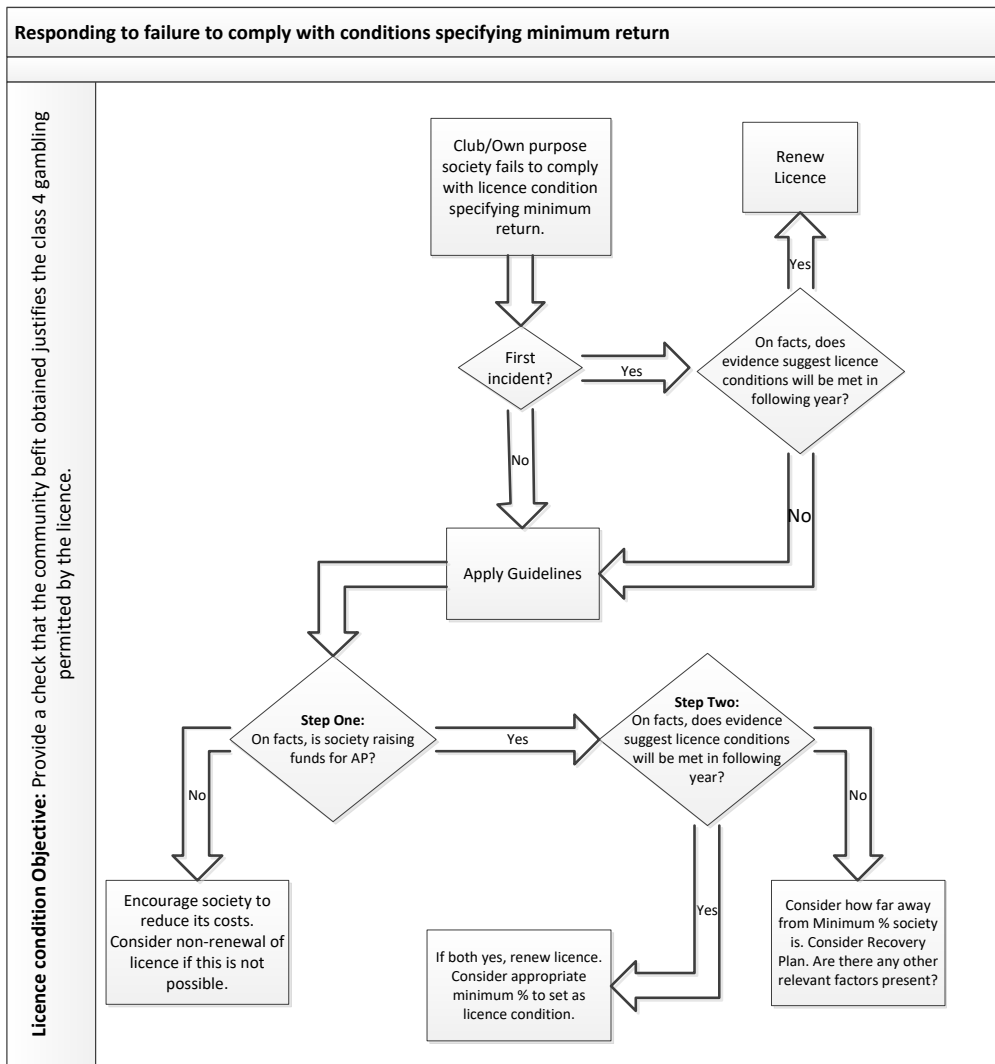
The licence was renewed on the basis that a significant improvement in the club’s financial position was expected in the following year.

In **2016**, the club again applied for its licence to be renewed.

There were multiple concerns with the application. The club had not addressed any of the issues raised during the 2015 licence renewal, and its financial position had deteriorated further. The club was still applying more funding to its authorised purpose than it was actually generating from its gambling operation, and its actual level of return to authorised purposes was only 15 per cent.

There were no clear changes that could be made to enable the club to turn around its operation. The club was only operating six gaming machines which meant that it was already paying the lower licensing fee. A further reduction in machines would not help either. Club membership had grown slightly from 96 to 108 persons, but this was not considered significant.

The Department suggested that the club should voluntarily surrender its class 4 licence. The club agreed.



## Additional information

The following documents provide additional information:

- Gambling Act 2003 – sections 3, 4 (definitions of “apply” and “distribute”), 30, 50 – 53A, 56
- *Gambling Act 2003: Consultation on Possible Regulations* (Department of Internal Affairs, Wellington, 2003) at 8.2
- *Gambling Act – Gaming Machine Accountability Regulations*, Cabinet Social Development Committee paper SDC (04) 112
- *Gambling Act – Gaming Machine Accountability Regulations*, Cabinet Social Development Committee Minute SDC Min (04) 18/6
- *The Lion Foundation* (Kilbirnie Tavern) GC03/07
- *Kiwi Community Trust* GC19/09
- *The Brunner Rugby League Club* GC08/11
- *Policy Briefing: Paper 3 – Options for raising the rate of return to authorised purposes*, Internal Affairs Briefing, 12 October 2012
- *New regulations to reform the Class 4 gambling framework*, Cabinet Economic Growth and Infrastructure Committee paper, April 2014