

France opens competition in online games ushering in new markets, market players and value chains

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In mid-2010, France will open market competition to online gambling and casinos. The market is opening as European law evolves and reacts to the growing number of illegal Internet sites. The ensuing new legal scope targets quality-based competition versus price-oriented competition, especially to contain addictive behaviours, and more specifically, money laundering. Concomitantly, the game market is creating new value chains, including media and telecommunications groups. In the short term, the historic players (Française des Jeux, the government owns a 72% and appoints directors and PMU, an economic group comprising the 51 associations which organize horse races) are key players in the new landscape, with the long term horizon pointing to major changes.

Although the online games market is an exceptional sector, the market is opening to competition in a very classical way.

By the summer of 2010, French legislation will have defined the guidelines to open competition for online games and betting. This is not the end of «just another» public monopoly. As underlined in the bill, «*betting and games are neither an everyday business, nor everyday service*», falling under the aegis of «*public law and order, public security and health protection*»¹.

Legislative kickoff dates back to 2003, when the CJCE (Court of Justice of the European Communities) believed that Italy had violated the principle of free circulation of services by prohibiting online bookmaking (the Gambelli decision). In 2006, the European Commissioner of the Internal Market and Services warned France (as well as Austria and Italy) that the sports betting market should be opened. Negotiation and finetuning will have taken four years (defining the scope of games involved, tax laws,

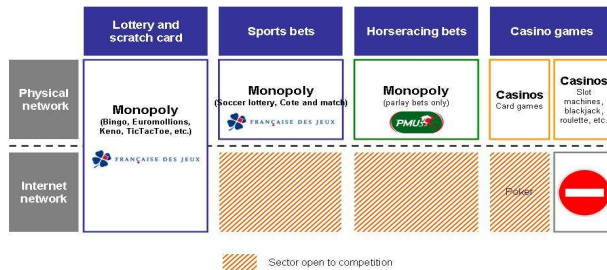
etc..) to adopt a law accounting for the following specificities:

- The market is only partially opening to competition, covering online horse-race betting, sports bets and poker. The law does not cover offline bets and games, lotteries or scratch cards (which remain under the aegis of the Française de Jeux), and casino-based games other than poker (namely slot machines).
- New entry players will receive a license, renewable for a five-year period, from the ARJEL (Regulatory Authority on Online Games, a recently created instance to this end). A licensed player of a European Union country will not automatically be accredited in France (French nationals playing on a non-French accredited site will be deemed as engaging in illegal play). In the same token, a French casino license holder, is not automatically accredited for online gaming.
- The payout rate, or players' gains are limited to 80% - 85%. Illegal sites currently post rates topping 90% (as do slot machines in casinos), while legally accredited sites (FdJ and PMU who have the monopoly) offer payout rates between 50% and 75%.
- Taxes will be about 2% for poker, 8.5% for sports bets, 15.5 % for horse-racing bets, with the amount of the bet serving as the basis for tax versus the payout.

¹ Bill, p.3.

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Figure 1: Scope of gambling and betting games open to competition



Source: TERA Consultants

«Technology» is more likely the force pushing the opening, rather than «the European pressure ».

Recently created instances, such as ARJEL and HADOPI, could pursue the same objective: setting up coherent regulatory instances to police traditional lines of business upset by the Internet and other electronic communication networks (namely the mobile phone).

In France, the forces prying these markets open are linked to the Internet rather than European injunctions. Proof lies in the number of Google's online gambling links. Excluding the FdJ and PMU sites, most sites are illegal (try playing from a French IP address). The online player is on the threshold of scrub comprising myriads of sites offering various quality levels and guarantees (namely those based in or outside the EU), to which the player is more often than not oblivious. By definition, revenues for an online game are difficult to estimate, but the FdJ underlines a 3 G€ figure representing an illegal online bet from a French-based site FdJ².

Current regulatory problems are not in line with public targets (especially in terms of controlling addictions). Technological evolutions are already pushing problems to the fore. Applied to online games this phenomenon epitomizes the classical technological transition. Anchored in fundamental and irreversible evolutions, new technologies seek to reduce costs and vary the game offer (namely by having players interact more with one another in poker games), more households now have the technology to play (computers, mobile phones, ...), and users are more proficient in using their mobile phones.

² www.francaisedesjeux.com/generated/media/PRESSE/presse_pdf_157.pdf.

³ Although illegal, up to 2 million Germans play online games; www.igamingfrance.com/2-millions-de-joueurs-en-allemaigne-malgre-linterdiction/4033

Given this context, the regulatory monopoly status is not a pass/safety net for tomorrow, since the ensuing rent creates an economic area for new competitors (the payout rate for the FdJ and the PMU is low compared to the scrub sites).

One of the legal objectives is to instill quality-based competition rather than price-based competition.

Since it will be impossible to entirely prohibit illegal sites³, the law pushes licensed players to use quality-based criteria as marketing rationale. This orientation stems from legal obligations (transparency, containing fraud and money laundering, reducing excessive gaming, etc.). But just as fundamentally licensees will not be as competitive on a price-basis compared to the illegal sites which are exempt from paying all types of taxes, or (most often) have no external pressure (as they are hosted in European zones which have low tax rates). Generally speaking, legal sites offer a payout rate which is at minimum less than 10% and based solely on price, legal sites would lose this war.

The strategy, therefore, lies in building a brand to make players confident: sponsoring deals with sports' companies or with specific media could be key to implement this strategy.

Enhanced quality was perceived even before the law passed. In October 2008, the Nantes University Medical School inaugurated the first center of addiction for betting and games, partnering with the FdJ and PMU. Why didn't the incumbents take this type of action earlier? Today, in light of the new market competition, their action appears as a means to further anchor the public's perception of the FdJ and the PMU as responsible players.

This dimension is key since French authorities believe that online players will pay a 10% premium (linked to the more modest payout of licensed French players) for State certification, respect of specifications requested by licensees and the efforts sites make to provide quality services.

The French are not compulsive players, there is room for growth.

As a game-playing nation, France is averagely intense: households dedicate 0.9% of their budgets, which is below the EU average, and lags behind countries like Finland (1.9%) or Spain (2%) and even the United Kingdom (1.2%)⁴. Although there is no average national figure, the French do not seem to be compulsive players (in line with the Germans at 0.8%).

The current situation stems from sustained long term growth. In the beginning of the 1980's, game playing rose an average 3% a year, exceeding average household growth (2%) (INSEE). Growth is linked to two key innovations. One, the creation of a National Lottery in 1976, and ensuing offshoots, including the Euro Million. Two, as of 1988, the progressive authorization of slot machines in casinos. Further, both the FdJ and the PMU have innovated: the FdJ launched new types of scratch cards or sports lotteries, while the PMU has diversified types of wagers.

In 2008, wagers totaled 37 billion euros (50% for casinos and 25% for FdJ and PMU), bringing in 8.2 billion euros in gross revenues (2.5 billion euros for casinos, 3.5 billion euros for the FdJ and 2.5 billion euros for the PMU). A number of factors, however, show that the industry is losing wind, with no growth relays in sight. Since 2003, wager growth has grown less than spending on leisure, and according to INSEE is even stagnating under 10% (and has not been impacted by the economic crisis).

Until now France's traditional offline game offer has met players' expectations, but the under-30 set will be more tempted by an online version, via a computer or mobile phone. It is also probable that the frontier between video games and gambling will become fuzzier.

So, redefining the rules for online gaming also means anticipating tomorrow's gameplay. Today's Internet offer may not suffice demand, and new Internet-based services may lead to higher household outlays, especially since the French market shows room for growth, and market competition will not lead to mere cannibalization (for either online or offline game offers).

Looking forward to the medium term, the incumbents have the required assets to keep the ball in the market's new

segments. Indeed, market competition will not impact the offline core businesses of the FdJ or PMU, since the current sociological structure of their client base is mainly offline. More, since this client base is neither attracted by the Internet nor by mail-order, they are not likely to turn to online games when competition opens. Finally, popular games like lottery drawings are not included in the proposed law, so new market players will not be able to offer lottery games⁵.

Another key advantage for the incumbents is that their offers have been online for a number of years (reaping high-level wagers, totalling 5% of all bets placed with the FdJ and PMU). Both market players already have the required economic assets to develop an online offer which meets the legal scope in the new market competition. The PMU's ambition is to move outside of its current field to sports bets (especially in light of the World Soccer Cup), while the FdJ is seeking to move into poker (via a partnership with the Barrière casino group).

The situation is trickier for casinos, since the industry is already highly competitive and casinos can not provide the online offers that the FdJ and PMU provide. More, online poker is biting into the cake that casinos were eyeing to offset the erosion of their slot machines.

In addition to the market opening to competition, the shake-up is redefining the breadth of the value chain.

While the first part of this brief focused on the retail market, the law has spawned an industrial reorganization. Technically speaking, analyzing the value chain underlines the differences between the physical network as a monopoly profiting the physical distribution network and the virtual network which includes:

- Developers of landline and mobile handsets involved in the design and production of TV sets, set top boxes, mobile phones, TV over IP and game consoles.
- Telecommunication operators, as they are a prerequisite to transfer content and games to a terminal.
- Game platforms as they aggregate access to services and handle the player's financial accounts for the games available on the online platform.

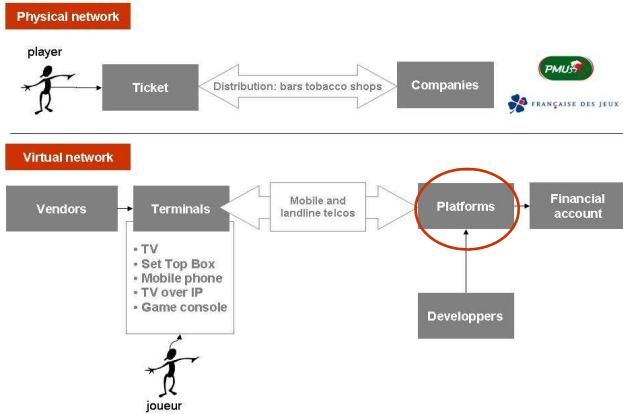
⁴ Besson D. (2005), In 25 years, the French have doubled the level of their wagers, Insee Première, n° 1016, Mai.

⁵ Cf Annual reports of the FdJ and PMU.

- The platform's service offer enhances as software developers further the interface.

Bwin opposite the Portuguese national lottery, Santa Casa (the decision upheld the national lottery's decision), confirms that heterogeneity will continue to reign as the European Union reorganizes the game industry.

Figure 2: Value chain of physical and virtual networks



Source: TERA Consultants

This reorganization also brings to light possible partnerships, between telecommunications operators and the media in the gaming arena. For both parties the appeal is strong. First, because of the wagers. Second, because game content drives traffic over networks and thus brings audiences (the number of shows dedicated to poker is proof enough).

It is key to underline the platform's strategic position, since it does not appear in the value chain of a physical game, yet it is the crux of the online game. Bet aggregators and client accounts are key players, as they link to various online poker sites, pushing the concentric rings farther out, and bring in bets and potential payouts (thereby underpinning network externalities).

Aggregators are dividing up the pie: some are focusing on the wholesale business (Playtech, Ogame), while others do both retail and wholesale business (888). These aggregators are the game's backbone and are well-positioned to reap the market's most likely royal flush: poker⁶.

Conclusion ... one step further

The CJCE's September 2009 decision, pitting the Portuguese soccer league and online game company

Given this backdrop, the reorganization of the French market as it opens to competition is the accomplishment of complex arbitrage...and will likely be difficult to implement. Organizing fair competition among market players with different interests and business scopes will be pivotal.

Another bone of contention will be how to allocate costs for the same concern, given that part of its business is run as a monopoly and another part is run as a competitive business. More, the legal climate is unstable.

⁶ MECN (2009), The French Gambling Market.

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