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Our File No. 33067.0002

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VIA EMAIL

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Re: **California Gaming Association Objections to Notice of Proposed Regulatory Action: Update to Annual Fees, CGCC-GCA-2023-03-R**

To the Office of Administrative Law ("OAL") Reference Attorney and the California Gambling Control Commission:

We write on behalf of the California Gaming Association ("CGA") to comment on the California Gambling Control Commission's ("Commission") Proposed Regulatory Action: Update to Annual Fees, CGCC-GCA-2023-03-R ("Proposed Action"). The Proposed Action would increase annual fee revenue for the 2025 annual fees, to be invoiced in October 2024.[1] CGA's membership includes both licensed cardrooms and Third-Party Providers of Proposition Players ("TPPPS") subject to these fees. CGA objects to the Proposed Action on these grounds:

[1] Initial Statement of Reasons: Update to Annual Fees, CGCC-GCA-2023-03-R, p. 1.

1. Under the APA, the rulemaking file is incomplete. As a consequence, the Proposed Action will not withstand judicial review.

2. The Commission's methodology to allocate costs[2] and to calculate annual fees is legally inadequate because (a) the annual fee collects more from the cardrooms and TPPPS than the Commission's reasonable costs for non-licensing regulatory activities; and (b) an annual fee charged to cardrooms and TPPPS based on annual gross revenue does not bear a fair or reasonable relationship to each entity's burdens on, or benefits received from, the Commission's regulatory activity.

3. The annual fee in the Proposed Action is unlawful for these reasons.

4. The Proposed Action fails to address a large, persistent surplus in the Gambling Control Fund.

1. The Rulemaking File Is Incomplete

Government Code[3] section 11347.3 requires the Commission to "maintain a file of each rulemaking that shall be deemed to be the record for that rulemaking proceeding." Section 11347.3, subdivision (b) lists documents that must be part of a rulemaking file, including "[a]ll data and other factual information," along with any "technical, theoretical, and empirical studies or reports … ."[4] All "data and factual information" is a broad category, embracing not only a consultant's final report, but the information and calculations underlying its findings, including certain emails between the Commission and consultants.[5]

[2] For purposes of this comment, the CGA intends the term "costs" to include all costs budgeted or incurred by the Commission and the Department of Justice's Bureau of Gambling Control to license and regulate cardrooms and TPPPS.

[3] Unspecified section references are to the Government Code.

[4] Gov. Code, § 11347.3, subd. (b) .

[5] *POET, LLC v. State Air Resources Board* (2013) 218 Cal.App.4th 681, 752.

Here, the rulemaking file does not contain the required documents. For example, the Initial Statement of Reasons states that the Proposed Action is based on the "most recent cost and fee analysis … utilizing the latest available data through fiscal year 2022–23."[6] The analysis and data are not included in the file, making it impossible to evaluate the reasonableness of the Commission's cost allocations and fee proposal. Instead, the available file contains just 29 pages of administrative forms to justify increasing a fee that generates nearly $20 million per year.

Further, the Initial Statement of Reasons for the Proposed Action states the "Commission has used the same calculation methods … as were utilized to determine the annual fee amounts in the current regulations."[7] As discussed in the CGA's comment letter on those current existing regulations ("existing regulations"), the rulemaking files for those regulations are incomplete.[8] We incorporate those earlier comments here. Therefore, the rulemaking file for the Proposed Action suffers from the same infirmities as the rulemaking files for the existing regulations.

The existing regulations were based on MGT Consulting's ("MGT") analysis of Commission data and calculation of the annual fees in MGT's "Department of Justice's Bureau of Gambling Control and the California Gambling Control Commission Fee Study Report of Findings" dated June 9, 2021 ("MGT Report"). To prepare the MGT Report, MGT met with staff to identify employees performing "fee-related services" and asked "subject matter experts … [to] estimate how much time those employees spent performing each particular fee service."[9] MGT also "provided guidance and templates to assist [staff] in developing their time estimates" which "were developed … within each fee area leveraging quantitative data analyses."[10] The rulemaking files for the

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[6] Initial Statement of Reasons: Update to Annual Fees, CGCC-GCA-2023-03-R, p. 1.

[7] *Ibid.*

[8] See, Rulemaking File for OAL Matter No. 2023-0306-03 (January 17, 2023 Letter from Michael G. Colantuono of Colantuono, Highsmith & Whatley, PC to the Commission regarding the California Gaming Association's Objections to Commission Fees Modernization Project III, pp. 3–4).

[9] MGT Report, p. 5

[10] *Ibid*.

existing regulations do not contain records of these meetings or the referenced templates, data, time estimates, or "quantitative data analyses."[11]

Additionally, the rulemaking files for the existing regulations do not contain MGT's underlying calculations or analyses. The MGT Report claims "[a] variety of methodologies were explored and tested but ultimately distribution of this cost was based on annual gross revenues. This methodology presented the fairest option for distribution."[12] The MGT Report provides no further explanation, analyses or calculations to justify this choice.[13] The file does not contain a record of the other methodologies considered. Nothing in the file justifies MGT's conclusion that an annual fee allocated among the cardrooms and TPPPS based on gross revenue is fairest, despite being the central conclusion of the MGT Report and the primary change to the fee structure. MGT fails to explain how the new methodology for allocating costs among the cardrooms and TPPPS based on gross revenue complies with Proposition 26 and case law limiting government regulatory fees to the cost of service.[14] Further, MGT's methodology change to now allocate costs based on gross revenue requires explanation and support because it is inconsistent with the fact that cardroom regulatory requirements increase based on number of tables, not gross revenue.[15] Gross revenue is a measure of ability to pay and therefore appropriate for taxes. It is not a measure of cost to regulate and is therefore improper as a basis to allocate regulatory fees like those in issue here.

Without further explanation and access to the documents, data, estimates, and analyses missing from the rulemaking files for the existing regulations, the CGA cannot fully evaluate the Proposed Action for reasonableness and compliance with the law.

The lack of information in the rulemaking files for the Proposed Action and the existing regulations should concern the Commission. A court may invalidate a

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[11] See, Rulemaking Files for OAL Matter Nos. 2022-1021-06, 2023-0306-03.

[12] MGT Report, p. 19.

[13] *Id*. at p. 21.

[14] Cal. Const., art. XIII A, § 3, subd. (d) (Proposition 26); *California Building Industry Association v. State Water Resources Control Board* (2018) 4 Cal.5th 1032, 1046.

[15] See, Cal. Code Regs., tit. 4, §§ 12380–12396.

regulation due to a "substantial failure to comply" with the APA.[16] Omission of required documents from the rulemaking file is such a "substantial failure."[17] Finally, in any judicial action, review is limited to the record before the Commission, subject to narrow exceptions.[18] If the record cannot justify the Commission's fees, a court will invalidate them.[19]

2. The Methodology Used by the Commission to Allocate Costs and Calculate the Annual Fee Is Flawed

Proposition 26 requires the Commission to demonstrate from the record that annual fee revenue "is no more than necessary to cover the **reasonable costs** of the governmental activity, and that the manner in which those costs are allocated to a payor bear a **fair or reasonable** relationship to the payor's burdens on, or benefits received from, the governmental activity."[20] Defects in the Commission's fee-setting methodology mean that the Commission cannot do so.

a. The Reasonable Costs Requirement

The Commission has two primary revenue sources: licensing fees and annual fees. Licensing fees are application and investigation fees paid by licensees seeking to work or own gaming businesses.[21] Cardroom and TPPPS owners also pay annual fees to fund the Commission's non-licensing regulatory activities.[22] The May 2019 State Auditor Report ("Audit Report") found the Commission consistently charged cardrooms and TPPPS annual fees that "far exceed" the Commission's actual costs for

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[16] Gov. Code, § 11350, subd. (a).

[17] *POET, supra,* 218 Cal.App.4th at p. 755;

[18] Gov. Code, § 11350, subd. (d); *Western States Petroleum Assn. v. Superior Court* (1995) 9 Cal.4th 559, 578.

[19] *American Coatings Assn., Inc. v. State Air Resources Bd.* (2021) 62 Cal.App.5th 1111, 1128–1129.

[20] Cal. Const., art. XIII A, § 3, subd. (d).

[21] May 2019 State Auditor Report, p. 31.

[22] *Ibid*.

non-licensing regulatory activities, while simultaneously undercharging licensing fees.[23] Such a fee cross-subsidy is illegal under Proposition 26.

The Proposed Action, like the existing regulations, continues this practice by setting annual fees for cardrooms and TPPPS that exceed the Commission's total costs for non-licensing activities. Therefore, the fees in the Proposed Action violate the California Constitution.[24]

The MGT Report found the Commission's non-licensing costs are twice as high as the Audit Report identified.[25] The existing regulations set annual fees based on the MGT Report costs of $14 million, meaning that the existing regulations set annual fees for cardrooms and TPPPS that collected twice as much revenue as necessary to recover the reasonable costs of the Commission's non-licensing regulatory activity.[26]

The Proposed Action maintains these errors and projects to increase the Commission's annual fee revenue further.[27] The collection of annual fee revenue in excess of the Commission's costs for non-licensing regulatory activities violates Proposition 26's "reasonable costs" requirement.[28]

Further, the existing regulations impose fees that incorporate methodological flaws in MGT's allocation of Commission costs between licensing and non-licensing activities funded from annual fee revenue. If a cost could not be directly attributed to an individual license application, then MGT assigned the cost to the annual fee, even if it is a licensing activity cost.[29] For example, costs for managing the Licensing Section itself

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[23] Audit Report, pp. 33–35, Figures 7 & 8.

[24] Cal. Const., art. XIII A, § 3, subd. (d).

[25] Audit Report, p. 34 [6.9 million]; MGT Report, p. 19 [approximately $14 million].

[26] MGT Report, p. 21.

[27] Notice of Proposed Regulatory Action: Update to Annual Fees, CGCC-GCA-2023-03-R, p. 6.

[28] Cal. Const., art. XIII A, § 3, subd. (d).

[29] MGT Report, pp. 17–18.

were assigned to the annual fee.[30] In other instances, MGT shifted 100% of costs shared between licensing and non-licensing activities to the annual fee.[31] The MGT Report provides no explanation for allocating licensing costs to the annual fee other than to say they are not specific to an applicant.[32] The Proposed Action continues this practice.[33] Allocating overhead and other indirect costs is, of course, a routine aspect of fee setting and not an occasion to ask some other class of fee payors to bear the burden.

The existing regulations and the Proposed Action impose fees calculated using the Commission's projected costs which each presumes to be justified. In adopting this presumption, the existing regulations and the Proposed Action fail to address many of the Audit Report's concerns. For example, the Audit Report noted that, on average, Commission staff spent 27 hours on each work license application, at an average total cost of $2,000 per applicant, despite a maximum license fee of $250.[34] The MGT Report simply institutionalized the practice, and the Proposed Action maintains the practice. The costs used to calculate the annual fee for the Proposed Action are inflated by the inclusion of licensing costs, causing the annual fee to recover more than the "reasonable costs" of the Commission's non-licensing regulatory activity.[35]

Finally, the Proposed Action continues calculating the annual fee based on flat percentages of certain fee payors' gross revenue. Flat fees based on fluctuating variables

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[30] *Ibid*.

[31] See, Rulemaking File for OAL Matter No. 2023-0306-03 [Initial Statement of Reasons, Commission Fees Modernization Project III, CGCC-GCA-2022-03-C, pp. 10–11].

[32] MGT Report, p. 17.

[33] Initial Statement of Reasons: Update to Annual Fees, CGCC-GCA-2023-03-R, pp. 5, 9 [Cost Pool 2 allocates all licensing costs not particular to an applicant as recovered through the annual fee, not licensing fees].

[34] Audit Report, pp. 33, 65.

[35] *Id*. at p. 33 [noting that the Commission's $9.9 million in licensing expenses exceeded licensing fee revenue by $5.7 million and that these excess costs were recovered from cardroom and TPPPS owners through the annual fee].

such as gross revenue do not reflect the reasonable costs of a regulatory activity.[36] The annual fees collected as flat percentages will rise or fall due to economic and other conditions that are unrelated to the Commission's non-licensing regulatory costs. Such a fee "cannot be said" to coincide with the Commission's costs.[37]

Accordingly, the fees proposed by the Proposed Action violate Proposition 26 because the Commission's annual fee charged to cardrooms and TPPPS collects more than the reasonable costs of the Commission's non-licensing activities.[38] The annual fee is therefore "a vehicle for generating revenue" for the Commission's discretionary use and is unlawful unless approved as a tax.[39]

b. The Fair or Reasonable Apportionment Requirement

The Proposed Action does not set annual fees for cardrooms and TPPPS in a manner that bears a fair or reasonable relationship to their respective burdens on, or benefits received from, the Commission's non-licensing regulatory activities.[40] The fair or reasonable requirement requires that the Commission apportion the fees among the fee payors in a manner that the annual fee paid by each entity bears a fair and reasonable relationship to the fee payor's burdens on or benefits from the Commission's regulatory activity.[41] Historically, the Commission levied annual fees on cardrooms based on number of authorized gaming tables, and Commission regulations levied fees on TPPPS based on their numbers of employees. The Commission abandoned this approach in 2023.

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[36] See, *Howard Jarvis Taxpayers Ass'n v. City of Roseville* (2002) 97 Cal.App.4th 637, 648–649 ("*Roseville*") ["On its face, this fee does not represent costs. It is a flat fee."]; *Howard Jarvis Taxpayers Assn. v. City of Fresno* (2005) 127 Cal.App.4th 914, 928 ("*Fresno*").

[37] *Roseville, supra,* 97 Cal.App.4th at p. 648.

[38] Cal. Const., art. XIII A, § 3, subd. (d).

[39] *Jacks v. City of Santa Barbara* (2017) 3 Cal.5th 248, 261.

[40] Cal. Const., art. XIII A, § 3, subd. (d).

[41] *City of San Buenaventura v. United Water Conservation District* (2017) 3 Cal.5th 1131, 1210 ("*San Buenaventura*").

With the adoption of the existing regulations in 2023, active TPPPS and cardrooms earning three-year average gross revenues of less than $1.5 million are charged a fixed annual fee ($4,069 for third party providers, $10,473 for cardrooms.)[42] Those earning three-year average gross revenues greater than $1.5 million are charged a flat percentage of their average gross revenue (1.54% for third party providers, 1.29% for cardrooms).[43] Without explanation, the Proposed Action decreases the percentage of average gross revenue for the annual fee charge for TPPPS to 1.48% and increases it for cardrooms to 1.33%.[44]

FEES BASED ON GROSS REVENUES ARE NOT JUSTIFIED. While gross revenue may be a measure of ability to pay, it is not a measure of the Commission's costs for non-licensing regulatory activities. Therefore, it is not a constitutional method for apportioning the Commission's annual fee costs to the fee payors.[45] Indeed, economies of scale suggest larger operators have lower costs of regulation as a percentage of gross revenues than smaller ones. Yet, the existing regulations set the annual fee for similarly situated cardrooms and TPPPS at varying levels based only on their revenue generation. Notably, the MGT Report did not support this approach, and nowhere suggests that annual fees based on a percentage of gross revenues somehow correlates to the Commission's costs of regulatory activity.[46]

To meet the fair or reasonable requirement, all cardrooms and TPPPS must be charged their actual cost of service. The Commission cannot properly apportion the annual fee revenue requirement to the cardrooms and TPPPS by charging an annual fee based on annual gross revenue because the Commission failed to identify a sufficient nexus between an entity's annual gross revenues and the Commission's annual costs to regulate the entity. [47]

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[42] See, Cal. Code Regs., tit. 4, §§ 12d52.2, 12368.

[43] See, Cal. Code Regs., tit. 4, §§ 12380–12396.

[44] Initial Statement of Reasons: Update to Annual Fees, CGCC-GCA-2023-03-R, pp. 4–5, 8–9.

[45] *San Buenaventura, supra*, 3 Cal.5th at p. 1210.

[46] MGT Report, p. 21.

[47] *California Building, supra,* 4 Cal.5th at p. 1046.

It appears from statements made in public hearings that the Commission changed the methodology for calculating the annual fee from a per-table charge to a charge based on gross revenue to subsidize annual fee costs for non-operational and smaller cardrooms and TPPPS.[48] In the Final Statement of Reasons for the existing regulations, the Commission acknowledged that the annual fee based on gross revenue is intended "to protect smaller cardroom business licensees from paying an amount that, while smaller than that of a more profitable cardroom business licensee, is of a much higher percentage, and therefore much more impactful and burdensome."[49] If the Commission wishes to subsidize smaller operators, it must use discretionary revenues to do so – it may not overcharge larger operators to fund the subsidy.

Unfortunately, the Proposed Action continues to base the annual fee on gross revenue and continues to subsidize annual fee costs for non-operational and smaller cardrooms and TPPPS at the expense of other fee payors.[50] The Proposed Action acknowledges this cross-subsidy in rejecting the alternative of per-table annual fees because it would result in "increases to non-operational and smaller cardrooms and TPPPS [which] could have significantly jeopardized whether the entities could maintain a license/business."[51] The acknowledged cross-subsidy causes the annual fee structure to violate Proposition 26's fair or reasonable apportionment requirement because the annual fees paid by high-earning cardrooms and TPPPS do not bear fair or reasonable relationship to their burdens on, or benefits received from, the Commission's non-licensing regulatory activity. Non-operational and low-earning cardrooms and TPPPS pay less than their fair share and high-earning entities pay more.

THE INCREASE IN THE PERCENTAGE CHARGED TO CARDROOMS IS NOT JUSTIFIED. The existing regulations imposed a flat rate of 1.29% of gross revenue on cardrooms, set to recover the Commission's predicted 2023 costs, based on the three-year average revenue of those cardrooms which generate more than $1.5 million in annual gross

[48] June 27, 2023 Commission Hearing.

[49] See, Rulemaking File for OAL Matter No. 2023-0306-03 [Final Statement of Reasons, Commission Fees Modernization Project III, CGCC-GCA-2022-03-C, p. 19].

[50] Initial Statement of Reasons: Update to Annual Fees, CGCC-GCA-2023-03-R, pp. 4–5, 8–9.

[51] *Id*. at p. 14.

revenue. The three-year average included revenue from 2020, 2021, and 2022. In 2020, most cardrooms suffered about a 50% loss of revenue due to COVID restrictions on assemblies. The cardrooms suffered smaller losses in 2021 and 2022. For the 2025 annual fee, 2020 will drop out of the three-year average, and the average revenue will increase dramatically, which will cause the annual fee owed to also increase without any increase in the Commission's costs. For example, one CGA member estimates its annual fee for 2025 will increase over 20% simply because 2023 (and not 2020) will be included in the 2025 fee calculation. This is likely true for all cardrooms whose annual fee is calculated as a percentage of gross revenue.

Yet, the Proposed Action inexplicably proposes to increase annual fee revenue from cardrooms by $399,524 by increasing the percentage of gross revenues paid by cardrooms.[52] The rulemaking file lacks any explanation or data justifying the increase. Further, the file includes no accounting for the fact that the drop off of 2020 from the three-year average will dramatically increase annual fee revenue for 2025 without an accompanying increase in Commission costs. The Commission's failure to account for this dramatic increase in fees renders the annual fees imposed on cardrooms under the Proposed Action unfair, unreasonable, and unlawful.

3. The Proposed Action Is Unlawful for These Reasons

The defects identified above are fatal to the Proposed Action. Statute requires that fees "be limited to the reasonable regulatory expenditures … to administer this chapter."[53] "Whenever by the express or implied terms of any statute a state agency has authority to adopt regulations to implement, interpret, make specific or otherwise carry out the provisions of the statute, no regulation adopted is valid or effective unless consistent and not in conflict with the statute … ."[54]

Similarly, a regulatory fee is valid only if it meets the Constitution's requirements that it be limited to "reasonable costs" and "its allocation among fee-

[52] Notice of Proposed Regulatory Action: Update to Annual Fees, CGCC-GCA-2023-03-R, p. 6.

[53] Bus. & Prof. Code, § 19951; Cal. Const., art. XIII A, § 3, subd. (d).

[54] Gov. Code, § 11342.2.

payors be fair or reasonable."[55] Here, the flawed methodology employed in the existing regulations makes the Proposed Action unrelated to the costs of the Commission's non-licensing activities. Further, the annual fee is not fairly and reasonably apportioned among the cardrooms and TPPPS. Therefore, the annual fee in the Proposed Action is unlawful under Proposition 26 and other law.

4. The Proposed Action Fails to Address the Surplus in the Gambling Control Fund

Finally, like the existing regulations, the Proposed Action makes no attempt address the large and persistent surplus in the Gambling Control Fund built up pre-COVID and only partially spent down in the COVID years.[56] Despite that surplus, the Proposed Action increases fee revenue, without any plan to spend down reserves or even justify maintaining them.[57] Therefore, the Commission's annual fees will again generate excess revenue and constitute a tax.[58]

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The California Gaming Association respectfully requests that the Commission not adopt the Proposed Action and instead direct staff to prepare proposed fees that reflect the reasonable cost of the non-licensing regulatory activities of the Bureau and Commission.

Sincerely,

Meghan A. Wharton

MAW:tsw

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[55] Cal. Const., art. XIII A, § 3, subd. (d); *California Building, supra,* 4 Cal.5th at p. 1046.

[56] Audit Report, p. 36, Figure 9.

[57] Notice of Proposed Regulatory Action, CGCC-GCA-2023-03-R, p. 6.

[58] See, *American Coatings Assn., Inc. v. State Air Resources Bd.* (2021) 62 Cal.App.5th 1111, 1125 ["What a fee cannot do is exceed the reasonable cost of regulation with the generated surplus used for general revenue collection. An excessive fee that is used to generate revenue becomes a tax."].

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February 12, 2024

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Re: Update to Annual Fee
CGCC-CGA-2023-03-R

Dear Mr. Rosenstein:

I write on behalf of Artichoke Joe's with comments on the proposed regulations referenced above. The proposed amendment to Regulation 12368.2 to increase the annual cardroom fees raises a number of statutory and Constitutional concerns.

Section 19951 of the Gambling Control Act, authorizes the Commission to set licensing and non-licensing annual fees, but subdivision (e) limits annual fees to the "reasonable regulatory expenditures" of the Commission and the Department to administer the Act. This limit is mandated by the state Constitution, which treats any charge that exceeds reasonable regulatory costs as a tax. (Cal.Const. Arti. XIII A, Sec. 3(b).) The proposed regulation would violate these limits in the following respects:

- The proposed "fee" would be calculated as a percentage of gross gaming revenue. While the charge might be intended to cover costs, it is not directly tied to costs and has an insufficient nexus to the services provided, and therefore legally constitutes a tax, not a fee.

- Fees would not be proportionate to services provided and would violate principles of equal protection.

- There is insufficient evidence to determine that the fees to be generated comply with the limitation in Section 19951.

- Calculation of the fee rate was based on outdated data regarding average annual gross revenues, and as a result the fee rate will result in total fees in excess of expenditures by about 20%, in violation of statutory and Constitutional limitations.

- The Gambling Control Fund is overfunded by at least $45 million from excessive fees collected in the past, but the new rates fail to use those funds, instead seeking to collect fees equal to the expected annual expenditures. This too violates the statutory and constitutional limits.

- The proposed regulations would not include a provision to reduce future excessive accumulations in the Gambling Control Fund as necessitated to comply with Section 19951(e).

These issues are discussed in detail below.

I. IMPOSITION OF A PERCENTAGE CHARGE BASED ON GROSS REVENUE WOULD CONSTITUTE A TAX, NOT A FEE, BECAUSE THERE IS AN INSUFFICIENT NEXUS TO THE SERVICES PROVIDED

The proposed regulation would impose annual fees calculated as a percentage of gross gaming revenue of the licensee. The charge is 1.33% of the cardroom's average gross gaming revenue over a three-year period. This looks like a tax and works like a tax, and because there is insufficient nexus between the fee and the costs incurred by the state agency, legally this would be a tax.

In order to constitute a fee as distinguished from a tax, the charge must "bear[] a reasonable relationship to the burdens created by the fee payers' activities or operations." *California Building Industry Assn. v. State Water Resources Control Board* (2018) 4 Cal.5th 1032, 1046. Where a fee consists of a percentage of gross revenue, it does not satisfy that requirement. The fee is not based on actual costs of regulation or on some element closely related to the costs of regulation. Thus in *Howard Jarvis Taxpayers Ass'n v. City of Roseville* (2002) 97 Cal.App.4th 637, 648–649, the court ruled that a *percentage fee* imposed by a city on utility companies was illegal because it was not based on costs incurred by the city. The court wrote, "Roseville sets the in-lieu fee at a flat 4 percent of each of the three

utilities' annual budgets. On its face, this fee does not represent costs." The court explained that the amount of the fee was not dependent on costs incurred by the city and could increase for a reason unrelated to the costs incurred by the city. The court concluded, "It cannot be said that this flat fee on budgets coincides with these costs." Similarly here, the annual fee on its face is not based on costs incurred and could increase for a reason unrelated to costs incurred by the gaming agencies. Therefore, legally it would constitute a tax.

We are unaware of any precedent allowing state fees to be based on revenue. Revenue is a common basis for taxes, not for fees, and the proposed fee would be virtually indistinguishable from a tax.

Fees should be based on the number of tables operated by the cardroom, as they were from 1998 through 2022. Regulation targets the games, all of which are played as gaming tables. For example, the minimum internal control regulations (Reg. 12380) base regulatory requirements on the number of tables operated at the club. A fee based on the number of tables bears a nexus to the burdens created by the fee payer's activities, whereas a fee based on revenue does not.

II. SECTION 12368.2 WOULD NOT APPLY FEES PROPORTIONATE TO SERVICES PROVIDED AND SO WOULD VIOLATE PRINCIPLES OF EQUAL PROTECTION

The proposed regulation would charge those cardrooms with average annual gross revenue under $1.5 million a flat dollar amount but charge cardrooms with average annual gross revenue of $1.5 million or more a flat percentage of their average gross revenue. The flat dollar amount for the former would be $12,468; the flat percentage fee rate for the latter would be 1.33%. As a result, a club with average gross revenue of $1,499,999 would owe a fee of $12,468, but a club with average gross revenue of just $1 more, $1,500,000, would owe a fee of $19,950. The latter, with extra revenue of just $1, would owe $7,482 more in fees, 60% more. These fee rates do not comport with principles of equal protection.

One of the foundational principles of taxation, and by extension of imposition of fees, is that of horizontal equity, that people similarly situated should be similarly taxed or charged similar fees. It has been said this principle is "an intuitive concept" and "universally" accepted. The fee structure in section 12368.2 violates

that principle. One dollar difference in gross revenue results in a widely divergent charge in fees.

For a fee to pass constitutional muster, it must be rationally related to a legitimate state purpose. It must not be arbitrary. Where a tax regime, or here a fee regime, fails to have horizontal equity, as this one does, it fails that test. Fees need to be based on a reasonable calculation of the cost of services, but where there is no horizontal equity, they fail that test, and the classifications are considered arbitrary. See *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287, 296 (1988); *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881-83 (1985). Here, the regulation does not just impose graduated rates, but different types of rates. Those with less than $1.5 million gross revenue are charged a flat rate but those with more are charged a percentage rate. Further, the dividing line of $1.5 million is arbitrary. These classifications do not satisfy the requirement that the fee structure be reasonable and have a rational basis, and thus they fail to comply with requirements of equal protection.

Here, the fee should be structured so greater fees are borne by those who require greater services and the fees should increase in fair proportion to the greater services. Greater fees can be imposed on one cardroom over another only if the fees are tied reasonably in proportion to greater demands on the state's services.

III. THERE IS INSUFFICIENT EVIDENCE IN THE MATERIALS CIRCULATED TO DETERMINE THAT THE FEES TO BE GENERATED COMPLY WITH THE LIMITATION IN SECTION 19951

The Administrative Procedure Act requires that the Commission provide the public sufficient information to show that the regulation would comply with section 19951(e). Government Code §11350(b)(1) requires that the necessity for a proposed regulation be "supported by substantial evidence." Similarly, section 11246.3 states, "The proposed adoption, amendment, or repeal of a regulation shall be based on adequate information concerning the need for, and consequences of, proposed government action." Government Code §11346.2(b)(1) requires the Commission to include in the Initial Statement of Reasons "the rationale for the determination by the agency that [the regulation] is reasonably necessary to carry out the purposed and for which it is proposed."

Two pieces of information are needed. First, the total regulatory costs to administer the Gambling Control Act is needed. The Commission has provided a spreadsheet, but the source for these numbers is unknown, and the Commission needs to provide some official source document so that the numbers can be verified. Further, information should be provided to support the allocation of costs to different pools.

This information is especially needed because of discrepancies in the recent reports that presaged these new fees. In 2019, the State Auditor issued a report on the fees and found that the nonlicensing regulatory costs were $6.9 million for the 2017-18 fiscal year. *State Auditor*, p. 34. In response, the Commission hired a consultant, MGT Consulting, and in 2021, MGT issued a Report and asserted that the nonlicensing regulatory costs for the 2019-20 year were $14,186,313, over twice as much as the State Auditor had found for the 2017-18 fiscal year. The Commission now claims that the non-licensing regulatory costs are $21,877,967. These discrepancies have never been adequately explained, even though the result has been increases in annual cardroom fees of 250-300% over just a few years.

Second, information is needed to show what revenue will be generated from the fees and that it does not violate the legal limitations. If, as proposed, the fee is to be based on average three-year gross revenue, the Commission needs to disclose the cardroom gross revenues for the three years to be used and the calculation of the fee rates. Commission staff has confirmed that they used the most recent revenue number they have, which was for 2020, 2021, and 2022. However, they did not provide the actual numbers for each year, and the years used create a mismatch as will be discussed next.[1]

IV. BECAUSE OF A MISMATCH IN REVENUES USED TO CALCULATE FEE RATES AND REVENUES ON WHICH ACTUAL FEES WILL BE CALCULATED, THE FEE RATE WILL GENERATE MUCH MORE REVENUE THAN ALLOWED UNDER SECTION 19951

The proposed fee rates were calculated based on revenues from 2020, 2021, and 2022, but when fees for 2025 are invoiced by October 1 this year, the

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[1] We do not advocate release of gross revenue figures of each cardroom. Such information is highly confidential. Part of the problem of basing fees on gross revenue is that the fees paid reveal cardroom gross revenue and become highly confidential.

new rates will not be applied to revenues obtained in those years but to revenues obtained in 2021, 2022, and 2023. Revenues from 2020 will fall out of the calculation and be replaced with revenues from 2023. This is significant because 2020 revenues were dramatically impacted by Covid, and were only about 50% of normal. Revenues in 2023 were normal, and so about twice as much as in 2020.

In 2020, cardrooms were closed by state mandate from March 15 to June 15, then from July 15 to about September 1 when they were allowed to open outdoors, and then from December 15 through the end of the year. In addition, from November 30 to December 15, cardrooms were shut between 10 p.m. and 5 a.m. Thus, even cardrooms which operated outdoors were closed about 45% of the year. Covid and needed protocols further constricted revenues. This significantly reduced gross revenue for all the cardrooms, which at best was only about 50% of normal.

Therefore, we know that when fees are calculated later this year, the revenue for one of the three years will approximately double, and the average gross revenue numbers will significantly increase over last year's average. Below, I show the calculation of three-year average gross revenue for 2024, using the 2020 revenue at 50% of normal, and the calculation for 2025, using 2023 instead of 2020. In this calculation, *"2x"* represents a normal year:

	2020	2021	2022	2023	Avg
3 yr avg for 2024	x	2x	2x	n/a	5x
3 yr avg for 2025	n/a	2x	2x	2x	6x

From this, we can see that the three-year average revenue will increase from 5x to 6x, a 20% increase. We know today that results will be similar to this and that fees generated later this year will be about 20% higher than projections based on the outdated 2020 numbers. Because fee rates were set based on the 3-year average for 2024, instead of the 3-year average for 2025, they will result in large overfunding of the Gambling Control Fund, in violation of section 19951(e).

Cardrooms are required to file a report with 2023 gross revenue numbers by April 29, 2024. The Commission should wait to amend the fee rates until those are filed and staff can calculate new fees based on the revenue numbers that will actually be used in the fee calculation for 2025. Of course, this whole problem could be avoided by basing fees on number of tables operated, not on revenue.

V. BECAUSE THE GAMBLING CONTROL FUND ALREADY HOLDS SUCH A LARGE SURPLUS, THE ANNUAL "FEES" BEING ESTABLISHED BY THE REGULATION ARE UNNECESSARY TO COVER ANNUAL EXPENSES AND WOULD CONSTITUTE AN ILLEGAL TAX

The purpose of charging fees is to defer current expenses, not to raise revenue. When fees are excessive and are used for other purposes or banked, legally they constitute taxes. *American Coatings Assn., Inc. v. State Air Resources Bd.* (2021) 62 Cal.App.5th 1111, 1125.

The Gambling Control Act provides that fees collected be held in the Gambling Control Fund. (§19950(b)). The GCF currently has a surplus balance of over $45 million (currently on loan to the General Fund). Given that the amount of nonlicensing regulatory expenses for 2024 is $21,877,967 and the amount of licensing expenses is only about $5 million, this surplus represents enough to fund the agencies for over a year and a half. The proposed regulation makes no provision for use of any of those existing funds but seeks to recover the full amount of future expenses to be incurred during the year, thus maintaining this illegal fund.

Not only does this violate section 19951, but it also violates Constitutional law. As the Supreme Court has ruled, "... the state may not charge an amount exceeding the costs it incurs because, if it were so allowed, 'the imposition of fees would become a vehicle for generating revenue independent of the purpose of the fees.' [cite omitted]." *Calif. Bldg. Industry Assn. v. State Water Resources Control Board* (2018) 4 Cal.5th 1032, 1046.

The existence of an excessive surplus in the Gambling Control Fund was first raised in July 2018, by then Assemblyman Rob Bonta, Assistant Majority Leader, when he requested that the Joint Legislative Committee approve an audit of the Bureau of Gambling Control and the California Gambling Control Commission. Then Assemblyman Bonta wrote in relevant part:

> The GCF surplus balance has grown every year since inception. It stood at $56,501,000 in 2018 and was projected to be $59,000,000 in 2019. The GF has been growing at approximately $2 to $3 million annually over its ongong expenditures. The GCF fees collected far exceed the Legislature's intent that there be sufficiant funds to allow the agencies to regulate gambling establishments. (Bus. & Prof. Code

> §19951(g)). ¶ An audit should examine whether the current level of revenue collection is approprite, necessary, and reasonably tailored to the stated purpose and if there is a rational basis for the fees being charged.

Assemblyman Bonta also asked that the audit address certain specific issues, one of which was to "Identify the magnitude of any surplus balance in the GCF and ***determine*** *its appropriateness and* ***whether fees paid by licensees should be reduced or refunded.***"

On August 9, 2018, the Joint Legislative Audit Committee voted unanimously to approve the audit request. The State Auditor conducted the audit, and in May 2019, released her Report. The Report addressed the issues regarding the propriety of fees in a twelve page section entitled "The Bureau and Commission Have Charged Fees That Do Not Align With Regulatory Costs, Resulting in an Excessive Surplus and Fairness Concerns." The State Auditor found a number of problems with the fees being charged, including that the annual fees (called nonlicensing regulatory fees) paid by the cardrooms and third party companies far exceed the costs of related oversight. The Audit Report reads (at p. 34) :

> ...the Gambling Fund's balance has continued to increase because nonlicensing regulatory fees have generated far more revenue each year than the bureau and the commission have spent on the related regulatory activities.... For example, we estimated that the bureau and commission had combined nonlicensing regulatory costs of $6.9 million in fiscal year 2017-18; however, the nonlicensing regulatory fees generated $18.9 million in revenue that year–resulting in a surplus of $12 million in fee revenue.

A subsection with the heading "The Gambling Fund's Balance is Excessive and Expected to Increase" discusses this in more detail and on p. 35 reads:

> One effect of the lack of alignment between the current fee structure and the costs of oversight is an excessive–and still growing–surplus in the Gambling Fund. Over the last five fiscal years, the balance in the Gambling Fund has doubled. ...[T]he ending balance for fiscal year 2013–14 was $30 million. By the end of fiscal year 2017-18, the balance was $61 million, more than three times the bureau's and commission's combined total annual expenditures of $18 million.

> During this five-year period, the two entities' expenditures averaged only 66 percent of the Gambling Fund's revenue. Additionally, the January 2019 Governor's proposed budget includes the State's General Fund's repayment in fiscal year 2019–20 of $29 million it received in loans from the Gambling Fund in 2008 and 2011. As a result, the proposed budget projects that the fund balance will increase to more than $97 million by June 2020–a surplus of more than five times the bureau's and commission's projected annual expenditures.

The State Auditor then cautioned that the overfunding of the Gambling Control Fund raised an issue whether the regulatory fees were in legal effect taxes, writing (p. 35):

> *When an agency uses regulatory fees to subsidize different activities because the fee structure for those activities is inadequate, the regulatory fees may be serving as taxes rather than regulatory fees–which is unlawful.*

Therefore, the State Auditor warned (p. 35):

> *The bureau and the commission need to take steps to reduce this fund balance to a more reasonable level.*

The State Auditor Report also discussed what would be considered an appropriate reserve, and noted that the Government Finance Officers Association recommends that entities maintain fund balances of at least two months of their operating revenue or expenditures, which for the Gambling Fund would be about $3 million. Allowing that this may be insufficient, the State Auditor wrote that "the fund balance should not exceed one year's worth of expenditures." (State Audit, p. 36.)

Since issuance of the Report, no action has been taken to reduce the surplus. As a result of Covid and lack of fee collection, the balance was reducted, but in the 2020-21 fiscal year, the General Fund borrowed another $85 million from the Gambling Control Fund, of which $45,000,000 remains outstanding. The fund balance is projected to be $51 million as of June 30, 2024. This is well in excess of one-year's expenditures of the two agencies, and every dollar in fees to be collected under the new regulation will be more than necessary to cover

"reasonable regulatory expenditures." Thus the fee is illegal under section 19951 and under the Constitution.

VI. BECAUSE THE PROPOSED REGULATIONS DO NOT INCLUDE A PROVISION TO REDUCE FUTURE EXCESSIVE ACCUMULATIONS IN THE GAMBLING CONTROL FUND, THE FEE RATES FAIL TO COMPLY WITH SECTION 19951

The proposed regulation includes no cure to draw down the surplus in the GCF or to prevent a further build up in the GCF if, as expected, excessive fees continue to be collected.

The first version of these regulations, approved on an emergency basis by the OAL on August 1, 2022, provided for a credit in future years if fees charged proved too high. Section 12368.1 provided:

> "For future years each cost pool will need to account for any prior year adjustments through a carry forward. A carry forward as used in this section will account for and reconcile any over and under costs allocated in prior years for each cost pool."

That language was not enacted in the final regulation.

This type of provision has been employed by other agencies in regulations which recoup all their costs in fees. See *Calif. Bldg. Industry Assn. v. State Water Resources Control Board* (2018), 4 Cal.5th 1032, 1045 [Water Code §13260(f)(1)) authorized the Water Board, if it determined "that the revenue collected during the preceding year was greater than, or less than, the revenue levels set forth in the Budget Act" to "further adjust the annual fees to compensate for the over and under collection of revenue."] and *California Farm Bureau Federation v. State Water Resources Control Board* (2011) 51 Cal.4th 421 [Water Code §1525 required that the total budgeted cost of the Division's operations be recovered from the fees and required the SWRCB to review and revise its fees each year. If the revenue collected during the preceding year was either greater or less than the revenue levels set forth in the Budget Act, the SWRCB was authorized to adjust the annual fees to compensate for the disparity.]

This type of reconciliation protects against overcharges of fees and is required by section 19951(e) in order to prevent further illegal accumulations.

* * *

In conclusion, the regulation violates section 19951(e) and the state Constitution in a number of respects. As a result, it is not consistent with the statute in violation of Government Code §11349.1(a)(4), not necessary to effectuate the purpose of the statute in violation of §11349.1(a)(1), and not authorized by the statute in violation of §11349.1 (a)(2). For all these reasons, the regulation is not proper and should not be adopted as drafted. We appreciate your consideration of these comments.

Sincerely,

Alan Titus