UPDATE TO ANNUAL FEES

CGCC-GCA-2023-03-R

COMMENTS AND RESPONSES FOR PROPOSED REGULATIONS

I. 45-DAY WRITTEN COMMENTS

The Commission received the following written comments/objections/recommendations regarding the text of the proposed action during the 45-day written comment period that commenced December 29, 2023, and ended on February 12, 2024.

A. COMMENTS MADE ON THE PROPOSAL IN GENERAL.

These comments are made on the proposed action and are not directed at any specific regulatory section.

1. **Alan Titus, on behalf of Artichoke Joe's**: Mr. Titus expressed a concern that the proposed regulation would constitute a tax. Mr. Titus explained that because the fee is a percentage based on gross revenue it is a tax and that there is an insufficient nexus to the services provided.

   Mr. Titus additionally noted that in *California Building Industry Assn. v. State Water Resources Control Board* (2018) 4 Cal.5th 1032, 1046, (*California Building Industry Assn.)* the court found that a fee is different from a tax in that the fee "bears a reasonable relationship to the burdens created by the fee payers' activities or operations." Mr. Titus stated that where a fee consists of a percentage of gross revenue, the nexus between the fee and the services provided is too weak, and the fee is really a tax.

   Mr. Titus suggested that, in contrast to a fee based on revenue, a fee based on the number of tables bears a much stronger nexus to the burdens created by the fee payer's activities and is more consistent with other California Gambling Control Commission (Commission) regulations, such as the minimum internal control regulations.

   Recommended Response: This comment was considered but was not incorporated. The fees proposed in this rulemaking action do not constitute a tax just as the California Supreme Court held that the State Water Resources Control Board's fees were not a tax under the state Constitution in *California Building Industry Assn*, cited by Mr. Titus. Specifically, the Commission's proposed methodology is consistent with the requirements provided for in *American Coatings Assn. Inc. v. State Air Resources Board* (2021) 62 Cal.App.5th 1111 (*American Coatings*) which cites *California Building Industry Assn.*:

   1. The first factor from *American Coatings* is whether the approved fees would exceed the reasonable, estimated costs of administration. The calculation method described and implemented in the proposed action first calculates the Commission and

Department of Justice's (DOJ) regulatory needs based upon the legislative budget appropriations and then divides the amount proportionally amongst the entities based on their three-year average gross revenue. The fees are directly tied to functions performed and only those costs. They are not for deposit into other funds for different unrelated purposes. Because of this limitation, the total annual fee will not exceed the anticipated needs of the Commission and DOJ.

2. The second factor from *American Coatings* is whether the fee is used to generate excess revenue. The methodology used by the Commission to determine the fee is designed specifically to avoid collecting excess revenue. In fact, if the fees charged exceeded the costs of providing necessary services and were not tied to the reasonable regulatory expenditures of the Commission and DOJ, the Commission would be in violation of Business and Professions Code section 19951, subdivision (e). It is because of this requirement that the Commission has explicitly linked the annual fee amounts to the historical workload hours performed, and associated costs incurred, by the Commission and DOJ for each part of the industry – cardroom business licensees and third-party providers of proposition player services (TPPPS) business licensees, as appropriated by the legislature. It is also why this rulemaking process is now occurring to adjust the fees so that they continue to track with the costs and expenditures.

3. The third factor from *American Coatings* is whether "any class of fee payers is shouldering too large a portion of the associated regulatory costs." To that end, even though "regulatory fees are valid despite the absence of any perceived benefit to the fee payers" the Commission reassessed the fees for certain tasks so that they would be more accurately attributed. Specifically, the MGT Consulting Group (MGT) report considered the proper allocation of associated regulatory costs in both fixed application fees and in the annual fees for TPPPS and cardrooms. In their analysis, MGT determined that some fees must be increased, and some must be decreased to accomplish the goal of aligning the fees collected with the costs incurred. Additionally, in compliance with Business and Professions Code section 19840, the annual fee calculations determined by MGT reflected the requirement that the Commission "take into consideration the operational differences of large and small establishments" when adopting regulations. This necessarily includes the reasonable and implied assumption that smaller cardrooms are less able to bear regulatory burdens such as higher fees than larger cardrooms. Thus, the fact that larger gambling establishments with higher revenues have a higher allocation of annual fees is consistent with the legislative statutory direction.

   In addition, the court in *American Coatings* held that the "question of proportionality is not measured on an individual basis. Rather, it is measured collectively, considering all rate payors" and that it "need not be finely calibrated to the precise benefit each individual fee payor might derive." (*American Coatings* citing *California Farm Bureau Fed'n v. State Water Res. Control Bd*. (2011) 51 Cal. 4th 421, 438) The court stated that "a fee is valid if there is a reasonable basis in the record for the allocation." Further, "the record need only demonstrate a reasonable relationship, not

an exact relationship." Despite having concerns about the process used to set the fees, the court in *American Coatings* held that "the resulting fees are reasonably related to the burdens imposed by the affected manufacturers and are not illegal taxes." This careful balance is no different than in *American Coatings* where the court found there was no equal protection or due process violation in exempting air pollution sources that emitted less than 250 tons while charging those emitting more on a per-ton rate.

As explained in this response, and in the Initial Statement of Reasons, the fees proposed to be assessed by the Commission are reasonably related to the "burdens" imposed by cardrooms, especially when taking into account their different sizes as required by Business and Professions Code section 19840 and are not a tax.

2. **Alan Titus, on behalf of Artichoke Joe's, and Meghan A. Wharton, on behalf of the California Gaming Association**: Mr. Titus and Ms. Wharton expressed a concern that the proposed action does not set fees in a manner that provides a fair or reasonable relationship to their respective burdens on, or benefits received from, the Commission's non-licensing regulatory activities.

   Ms. Wharton also noted that gross revenue is not a measure of any ability to pay a fee, nor is it a measure of the Commission's regulatory costs. Ms. Wharton notes that gross revenue does not reflect reasonable costs of a regulatory activity since they will rise or fall due to economic and other conditions and are unrelated to the Commission's regulatory costs. Ms. Wharton argued that based on economies of scale, larger operators should have a lower cost of regulation than smaller operators, and yet the proposed annual fee is opposite, charging more to larger operators. Ms. Wharton suggested that all entities should be charged their actual cost of service and the Commission failed to identify such a nexus to an entity's annual gross revenue.

   Mr. Titus expressed a concern that by providing a flat dollar amount for cardrooms with average annual gross revenue under $1.5 million, the proposed action violates principles of equal protection. Mr. Titus noted that there is a significant increase in the amount owed by a cardroom for just exceeding the threshold by $1; a 60% increase or approximately $7,500. Mr. Titus opined that a universally accepted foundational principal of taxation, and by extension fees, is horizontal equity and that the proposed action violates this principle.

   Mr. Titus expressed concern that in order for a fee to pass constitutional muster, it cannot be arbitrary and must be rationally related to a legitimate state purpose. Mr. Titus additionally expressed concern because the proposed action fails the standard of horizontal equity, it is arbitrary. Mr. Titus suggested that the fee should be structured so that greater fees are borne by those who require greater services and the fees should increase in a fair proportion to those services.

   Finally, the commentors observed 2020 was impacted by COVID. Mr. Titus noted that these years included the shutdown of all cardrooms and that as gross revenues increase, the annual fees collected will likewise increase, and this will result in an overfunding of

the Gambling Control Fund in violation of Business and Professions Code section 19951, subdivision (e). Mr. Titus suggested that should the calculations continue to utilize gross revenues, the calculations be halted until 2023 gross revenues can be collected and replace 2020 in the three year calculation. Ms. Wharton noted that the proposed action proposes to increase the amounts charged to cardrooms but lacks the explanation or data to justify that increase and does not include any accounting for the anticipated drop of the 2020 year fiscal information. Together, these will result in a dramatic increase in fees, which is unfair, unreasonable, and unlawful.

Recommended Response: This comment was considered but was not incorporated. The Commission incorporates its response to the prior comment. Charging smaller entities with a different calculation is consistent with the requirements of the Gambling Control Act. Business and Professions Code section 19840, requires the Commission "take into consideration the operational differences of large and small establishments." In fact, the Commission's regulations are filled with many examples of differing requirements for entities based on their size. It is the Commission's view that dividing the annual fee proportionally amongst all entities, including those with a three-year average gross revenue under $1.5 million would be inconsistent with the requirements of Business and Professions Code section 19840. The $1.5 million threshold was chosen as a reasonable boundary between cardrooms of larger and smaller size. This fee threshold is fundamentally similar to the fee charged in *California Farm Bureau Fed'n v. State Water Res. Control Bd.* (2011) 51 Cal. 4th 421, 434 which set a minimum annual fee as the greater of $100, or $.03 for each acre-foot of water and purportedly charged fees to only 40 percent of those affected. Or in *California Bldg. Indus. Ass'n v. State Water Res. Control Bd*. (2018) 4 Cal. 5th 1032, 1051 where the court noted that one stormwater fee which was allegedly greater than the costs to the stormwater area was only one part of eight program areas, which the court found was collectively obtaining revenue not greater than those reasonably necessary to administer the entire permit program. Or in *American Coatings* where polluters emitting less than 250 tons were exempted from the per ton charge.

Additionally, while it is possible that the allocation percentages set by the proposed action might result in excessive collections in the future should revenue significantly increase across the industry, including for instance the 2020 and 2021 years that were affected by COVID, this is true of any *fee structure set in regulation* as the costs can change over time. The calculation here takes the past three years of a specific cardrooms revenue to determine what as a base line percentage of total gaming revenue each cardroom would pay. While the 2020 and to a lesser extent the 2021 years may affect the fees as they fall off the three-year average, it is also possible a cardroom might close down again for an extended period of time or may have a break in the operation of certain games which substantially undercuts their revenue. This reduction though will not be captured in this methodology.

Regardless, the Commission has committed to annually examining the annual fee amounts and making regulatory adjustments as necessary to confine the fees invoiced to the costs incurred as much as reasonably possible. That practice is exemplified by this

rulemaking process where the fees are being calibrated and will occur again in subsequent years. Should an increase in revenue occur in a manner that cannot be effectively corrected through the rulemaking process by adjusting the fee amounts annually, the Commission will consider offsets for previous years over collections or other methods necessary to ensure only the proper amount is collected. This practice is consistent with the requirement to make a report detailing the fees biennially to the legislature under Business and Professions Code section 19951(f)(2).

Additionally, Ms. Wharton's contention that entities should be charged only for their individual cost of service is inconsistent with the goals of the Act and holdings in caselaw. Moreover, the cases cited are not on point as they refer to fees on property related services rather than on statewide licensing programs. (*Howard Jarvis Taxpayers Ass'n v. City of Roseville* (2002) 97 Cal. App. 4th 637, 647[the fee…shall not exceed the funds required to provide the *property-related* service]; *See City of San Buenaventura v. United Water Conservation Dist.* (2017) 3 Cal. 5th 1191, 1205) Second, her argument is contradicted by numerous court cases cited in response to the first comment finding that regulatory fees "need not be finely calibrated to the precise benefit each individual fee payor might derive." (*California Farm Bureau Federation v. State Water Resources Control Bd.* (2011) 51 Cal.4th 421, 438; *California Building Industry Association v. State Water Resources Control Board* (2018) 4 Cal.5th 1032, 1052 ["regulatory fee…does not require a precise cost-fee ratio."]). Ms. Wharton's position also misinterprets the purpose of the annual fees, which are not a cost for service exchange between regulators and the industry, but rather, are intended to protect the health and safety of the public by sufficiently enabling the Department and Commission to fully carry out their duties as required by the Act.

Lastly, while larger cardrooms may be able to operate more efficiently and benefit from economies of scale in generating revenue, it is those same cardrooms that compose a larger percentage of the gambling in California on a dollar basis. Additionally, large cardrooms and TPPPS have more employees to be licensed, likely generate more public complaints with more patrons, make more requests for approval to the Commission, have more complex ownership structures, essentially more everything workwise for both the Commission and DOJ.

3. **Alan Titus, on behalf of Artichoke Joe's, and Meghan A. Wharton, on behalf of the California Gaming Association**: Mr. Titus and Ms. Wharton expressed a concern that there is insufficient evidence in the rulemaking file to determine that the fees comply with statute. Mr. Titus expressed a concern that there are compliance concerns involving the limitation in Business and Professions Code section 19951, subdivision (e), which provides:

> (e) The amount of fees collected pursuant to this section shall be limited to the reasonable regulatory expenditures of the department and the commission to administer this chapter.

Additionally, Mr. Titus opined that the proposed action fails to provide all required information required by Government Code sections 11346.3[1], 11350, subdivision (b)(1), and 1136.2, subdivision (b)(1). Mr. Titus additionally opined that in order to be in compliance with these requirements, the Commission must provide two additional pieces of information:

1. Total regulatory costs to administer the Gambling Control Act. Mr. Titus notes that the Commission did provide a spreadsheet but did not provide the source for the numbers and that the Commission must provide "some official source document so that the numbers can be verified" and that this additional information should support the allocation of costs to the different pools.
2. The Commission needs to disclose the cardroom gross revenues for the three years to be used in the calculation of the fee rates, which are 2020, 2021, and 2022.

Mr. Titus suggested that since cardroom gross revenues are confidential and therefore cannot be shared, the Commission's calculations should not include them and should instead utilize gaming tables as was done in 1998 through 2022.

Ms. Wharton expressed concern that the Commission's rulemaking file is incomplete. Ms. Wharton noted that the analysis and data are not included in the file, making it impossible to evaluate the reasonableness of the Commission's allocations and proposed fee amount. Ms. Wharton further notes that the rulemaking file references MGT's report but fails to include any records of meetings, templates, data, time estimates, and quantitative data analyses referenced by MGT.

Recommended Response: This comment was considered but was not incorporated. The Commission incorporates its response to the prior comment. In addition to the ISOR and NOPA, the rulemaking file includes the STD. 399 which documents the costs, cost increases, etc. attached to this rulemaking process. It also provides three pertinent attachments which include:

1. Cost Pools, Summaries, and Cost Calculations for Proposed Regulations
2. Cost Pool Breakdown (used for both the Proposed Regulations and the Alternative Considered)
3. Cost Pools, Summaries, and Cost Calculations for Alternative Considered

These documents collectively both show the Commission and DOJ's costs broken down by positions, hours, and costs per hour with included overhead and administrative costs. The three documents process these numbers through the six cost pools discussed in the ISOR and NOPA. The first document reflects the proposed regulations and how the

[1] Mr. Titus' comment references Business and Professions Code section 11246.3; however, there is no such section. Based on the quoted text provided by Mr. Titus ("The proposed adoption, amendment, or repeal of a regulation shall be based on adequate information concerning the need for, and consequences of, proposed government[al] action"), the Commission has identified the comment as referring to Section 11346.3(b)(1) and has summarized and responded to the comment as such.

allocation of all the DOJ and Commission's costs are spread across the six cost pools and by entities between Cardroom and TPPPS. This document clearly ties the fees that are required by the Commission to be paid by the Cardroom and TPPPS, which is ultimately collapsed into a percentage charged on each entity's revenue based upon the total gross gaming revenue of each sector. Unlike the City of Roseville's 4% flat fee on the three utilities budgets which were a flat fee in *Howard Jarvis Taxpayers Ass'n v. City of Roseville* (2002) 97 Cal. App. 4th 637, 649 cited by Mr. Titus, the percentages here are directly calculated to meet to the legislatively approved budgets of the Commission and DOJ to regulate the industry as a whole.

The second document further clarifies how these cost pools themselves are broken down as allocated to the positions with associated overhead and administration at the Commission and DOJ. It identifies the relevant positions along with the number of hours each position incurs in each cost pool as well as the rate attributed to that employee on an hourly basis. This is broken down by hours rather than position as some employees perform work in multiple different cost pools. In addition, there are certain unique and specific materials and supplies that are directly tied to specific cost pools along with set offs. These positions, hours, and rates are categorized and totaled to equal the budgeted amount referenced in the first document.

The third document is substantially like the first document but for a change in methodology which is like what Mr. Titus has suggested where annual fees are based upon the number of tables, as opposed to gross revenue. This alternative was discussed in the ISOR and it was specifically explained why the fees based on tables while maintaining the cost pools would not work. Under this regime the TPPPS would also revert to the prior formula based on their employees. This system would have ultimately increased fees on cardrooms and TPPPS and would have also shifted more of the costs to small businesses and non-operational licensees. Ultimately these criteria were not justified and inconsistent with the Act. Lastly, basing fees on tables or employees creates calculation issues and is disadvantageous to the public. For instance, having more tables at a cardroom creates more participatory opportunities for a patron, while basing fees on the number of tables disincentives a cardroom from operating those tables. The same sort of disincentive occurs with basing fees on employees as these employees can be hired and fired simply to avoid higher fees. This disincentives business from hiring members of the public and is again disadvantageous to the public.

4. **Alan Titus, on behalf of Artichoke Joe's, and Meghan A. Wharton, on behalf of the California Gaming Association**: Mr. Titus and Ms. Wharton expressed concern that the fees proposed are not necessary because the Gambling Control Fund has a surplus that could cover any and all immediate expenditures of the Commission or DOJ. Mr. Titus provided specific references, including monies borrowed by the Legislature in support of the General Fund. Ms. Wharton notes that without any plan to spend down the reserves or justify maintaining them, the proposed action is excessive and therefore constitutes a tax.

   Recommended Response: This comment was considered but was not incorporated. The commentors are correct that there has been a historical surplus of collected fees which

ironically based upon Mr. Titus protestations above, were based upon table amounts. However, the industry has filed a class action lawsuit (*Lucky Chances, Inc. et. al. v. California Gambling Control Commission and Bureau of Gambling Control*, Sacramento Superior Court Case No. 34-2020-80003510-CU-WM-GDS) on behalf of all cardrooms and third-party providers of proposition player services (TPPPS business licensees) who have over paid licensing or annual fees, including entities and natural persons that are no longer operating or employed. The class action lawsuit seeks restitution and disgorgement to the plaintiffs of any fees that are determined by the court to have been overpaid to the Commission or DOJ. Using the same funds at issue in the lawsuit in the manner suggested in the comment, would essentially provide two offsets; one on the current year annual fees following any determination in the lawsuit. Additionally, not all fee payers originally over charged are those currently being required to pay annual fees, and providing the benefits solely to current payers would be inappropriate.

5. **Alan Titus, on behalf of Artichoke Joe's**: Mr. Titus expressed concern that the current version of the annual fee does not include reconciliation language allowing for crediting to be applied to future annual fees if fees charged proved too high. Mr. Titus noted that in the original rulemaking action an early version included such a provision but that it was later removed during the rulemaking process. Mr. Titus commented that by removing the reconciliation language and the language outlining the methodology for determining the annual fee originally adopted in the initial emergency file, the new fixed fee is no longer reasonable as required by Business and Professions Code section 19951, subdivision (e). Mr. Titus suggested that the inclusion of reconciliation language could help prevent further accumulations of fees in excess of the Commission's and DOJ's regulatory costs.

   Recommended Response: The commenter notes a concern that the proposed action is inconsistent with the requirements of Business and Professions Code section 19951, subdivision (e); however, the Commission maintains that the proposal is consistent with the requirements of Business and Professions Code section 19951, subdivision (e).

   While it is true that the proposed regulations originally adopted by the Commission during the initial emergency file included reconciliation language for previous years, this language was not intended to provide an offset for an existing fund balance but was intended for adjustments to this new annual fee determination method. The existing fund balance is the subject of a class action lawsuit and the Commission incorporates its response to the prior comment.

   Further, the originally adopted language, while approved as an emergency filing, was unfortunately later determined by the OAL to lack the specificity necessary for a fee to exist in regulations. Therefore, at OAL's direction, instead of adopting a fee determination methodology, the Commission performed the fee determination and adopted the 2023 fee amounts into regulation. As was previously stated in the Finding of Emergency for the first readoption of this filing, OAL Matter Number 2022-0922-01EE, the amounts billed for the 2023 annual fee did not change. With this shift in regulation philosophy (changing from adopting the methodology to adopting the actual annual fee amount), the Commission moved the methodology to the Finding of Emergency.

Finally, nothing in this year's analysis included any need for a previous year's offset, and so one was not included in this proposed rulemaking action's calculations. However, the Commission is committed to the continued consideration of such a process should the amounts collected warrant such an inclusion as was indicated in prior comments.

6. **Meghan A. Wharton, on behalf of the California Gaming Association**: Ms. Wharton expressed a concern that the proposed action does not meet the statutory requirement to cover reasonable costs of governmental activity. Ms. Wharton expressed concern that the proposed action continues to set annual fees for cardroom and TPPPS in excess of the Commission's total costs for non-licensing activities. Ms. Wharton commented that the over charge of annual fees is based, in part, on MGT's identification that the Commission's non-licensing costs were twice as high as those California Bureau of State Audits (State Auditor) audit report 2018-0132 (State Auditor's report). Ms. Wharton expressed concern that the proposed regulations will result in non-licensing regulatory fee revenue being used to subsidize licensing expenditures, providing an example of licensing supervisory costs being applied to the annual fee and not to the direct fees related to the processing of an application.

   Recommended Response: This comment was considered but was not incorporated. The State Auditor recommended that the Commission undergo a cost and fee analysis and reset regulatory fees to reflect those costs rather than recommending that the estimates used by the State Auditor in its report be the controlling numbers. The State Auditor did not identify how it reached its estimates or what job functions and tasks were considered "non-licensing" and is not willing to share that information with the Commission as the State Auditor's confidentiality is protected by state law. The Commission has no insight into those numbers including how they were derived or justified and suggests any reliance thereon is misplaced at best.

   However, the main takeaway from the State Auditor's report is that the Commission followed the State Auditor's recommendation in contracting with MGT for a full cost and fee analysis. Based on the most recent fiscal analysis conducted by the Commission, the annual fees expected to be collected will not significantly exceed the funding requirements of the Commission and DOJ, and as stated, should that unexpectedly occur, the Commission will consider the adoption of future annual fee determinations to offset with the goal of only collecting what is needed. Additionally, the Commission and DOJ continues to examine its workload tracking and allocation to various fees and cost pools; however, it must be understood that a single person performs various tasks, many of which are attributable to different funding sources and are identified as such.

7. **Meghan A. Wharton, on behalf of the California Gaming Association**: Ms. Wharton expressed concern that the proposed regulations will result in non-licensing regulatory fee revenue being used to subsidize licensing expenditures.

Recommended Response: This comment was considered but was not incorporated. The Commission and DOJ collect three different types of fees related to the controlled gambling industry, each of which has a purpose that does not overlap with the others:

1. Fixed Application Fees
2. Application Deposits
3. Annual Fees

Fixed Application Fees represent those costs that occur with every application, and include such tasks as data entry of the application and other tasks necessary to process the application. These costs also include specific work performed by the Commission's staff for each application once received from the DOJ. These costs are provided for in Title 4, California Code of Regulations (CCR), Section 12090. This proposed action does not amend any of the Fixed Application Fees.

Application Deposits are for costs incurred by the DOJ while conducting background investigations and other tasks specifically linked to the unique nature of an application for licensure. While referenced in the Commission's regulations, these background deposits are controlled by the DOJ and can be found in Title 11, CCR, Section 2037, with a few provided by the Commission in Title 4, CCR, Section 12090. This proposed action does not amend any of these Application Deposits.

Annual Fees represent the amount paid annually by cardroom business licensees and TPPPS business licensees. These funds are paid into a special fund, the Gambling Control Fund, and are designed to cover the additional costs that are not otherwise covered by a Fixed Application Fee or Application Deposit incurred by the Commission and DOJ in their oversight of the controlled gambling industry. This proposed action seeks to amend the annual fees for cardroom business licensees but does not include an amendment to the annual fees for TPPPS business licensees.

As part of the State Auditor report, released May 16, 2019, the State Auditor identified that the DOJ was misidentifying work functions and how they relate to the three types of fees collected, and therefore, as part of the MGT study, the specific tasks of the Commission and DOJ were examined and allocated to the correct fee type. As such, the Commission significantly adjusted (mostly by reducing) the Fixed Application Fees (OAL Matter Number 2022-0721-10C, effective September 1, 2022).

With the Fixed Application Fees properly adjusted to reflect the work necessary, and the ability of the DOJ to adjust their collection of Application Deposits already present in Title 11, CCR, Section 2037, the remaining work functions conducted by the Commission and DOJ are attributable to the Annual Fees. Costs were divided into six cost pools, as described in the associated Initial Statement of Reasons, the NOPA, and as reflected in the more detailed attachments to STD 399 discussed above.