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October 17, 2022

California Gambling Control Commission
ATTN: Alex Hunter, Legislative and Regulatory Specialist
(CGCC-GCA-2021-07-R/C)
2399 Gateway Oaks Drive, Suite 220
Sacramento, CA 95833-4231
E-mail: *lawsandregs@cgcc.ca.gov*.

Dear Commissioners,

We are writing in response to the proposed amended language of § 12252.2. The proposed language sets the Annual Fee for a Non-Operational TPPPS License as $2,035.

This number seems excessively high as the Bureau of Gambling Control and Commission are not required to do much, if any, administration work for a non-operational license. The fee also does not appear to be proportional to the proposed fee for a TPPPS that is operating and requiring services but earning less than a three-year average less than $1.5 million. That fee is proposed as $4,069. Given that the operational company requires services from the Bureau, and the non-operational company does not, the non-operational fee does not appear to be proportionate.

The proposed fees are in addition to the license renewal fees paid by the non-operational TPPPS owners biennially. The amounts being collected for non-operational TPPPS licenses must be reasonable for the services rendered and not end up as amounting to an unapproved tax.

The State Auditor found in its May 2019 report that the amounts collected by the Bureau were excessive, not aligned with actual costs and that the licensees were subsidizing the bureau's inefficiencies. Given the excessive amount of money accumulated in the Gambling Control Fund, charging over $2,000 annually for a non-operating license appears the be headed in the wrong direction.

We are very concerned about the fees that are being imposed on both Card Room Owners and Third-Party Proposition Player companies this year. The fees have been raised astronomically for many of our clients while there is no corresponding increase in services or benefits being provided. While we realize that there has been some effort to realign the fees to solve the problem of an enormous excess of funds in the Gambling Control Fund, the current structure and amounts being collected are so excessive that it gives rise to the implication that the "fees" are really an impermissible tax being levied by a state agency.

A model based upon gross revenue is not a logical solution as there is no proportional relationship between income and the regulatory needs of each cardroom. For example, a cardroom with twenty tables may actually earn as much or more than a cardroom with fifty tables. The fifty table club has far more employees and regulatory needs, but under the gross revenue model, the smaller club is paying more and subsidizing the larger club.

We ask that the non-operational fee be explained, justified, and potentially amended to a lower cost prior to this regulation being adopted.

We also ask that before any further fees be enacted, the current structure be reviewed and aligned with the actual work provided. The fees should be a fair and reasonable reflection of efficient work provided, not just whatever someone chooses to bill or a percentage of what is earned by the companies paying the fees. The licensees paying exorbitant and excessive fees is not a solution to the excess in the Gambling Control Fund.

Very Truly Yours,

Jarhett P. Blonien

Jarhett P. Blonien

October 18, 2022

VIA EMAIL ONLY

California Gambling Control Commission
Attn: Legislative and Regulatory Review
2399 Gateway Oaks Drive, Suite 220
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E-mail: lawsandregs@cgcc.ca.gov

Re: Proposed Commission Fees Modernization Project II: CGCC-GCA-2021-07-R/C

To the California Gambling Control Commission:

Please accept the following comments on behalf of the California Gaming Association, whose membership includes both licensed cardrooms and third-party companies subject to the annual fee proposed in the above-referenced California Gambling Control Commission ("Commission") regulation. We object to the proposed regulation because:

(1) the annual fees intended to fund non-licensing activities will be impermissibly used to subsidize licensing costs, contradicting the findings by the State Auditor; and

(2) the proposed fee increase is an improper tax subject to Legislative approval because it exceeds the reasonable costs of regulating the industry, improperly allocates costs between cardrooms and third-party companies, and ultimately will result in a surplus to the Gambling Control Fund.

1. UNDER THE PROPOSED REGULATION, NON-LICENSING REGULATORY FEE REVENUE WILL BE USED TO UNLAWFULLY SUBSIDIZE LICENSING EXPENDITURES.

The vast majority of fees paid by cardrooms and third-party companies are licensing fees or non-licensing regulatory fees. State law requires license applicants to pay nonrefundable application fees for all license types and refundable background deposits (collectively referred to as "licensing fees") for most license types that are intended to cover the actual costs incurred in the investigation and processing of the application.[1] The "non-licensing fees" are the annual fees levied against

[1] Business and Professions Code § 19867(a).

cardrooms and third-party companies that enable the Bureau of Gambling Control ("Bureau") and Commission to carry out their duties and responsibilities under the Gambling Control Act.[2]

Historically, annual fees levied on cardrooms have been calculated based on the gross revenue and number of gaming tables the cardroom is authorized to operate, and fees levied on third party companies were based on their number of employees. However, a May 2019 Audit Report ordered by the California Legislature[3] found that the Bureau and Commission were consistently charging annual non-licensing fees that "far exceed" the agencies' actual costs to administer their oversight responsibilities, while simultaneously undercharging licensing fees.

The State Auditor estimated that the combined non-licensing regulatory costs of the Bureau and Commission in fiscal year 2017-2018 were $6.9 million; however, non-licensing regulatory fees generated $18.9 million in revenue.[4] By contrast, the Gambling Control Fund received only $4.2 million in revenue from application fees and background deposits while the combined licensing expenditures of the Bureau and Commission totaled $9.9 million. This resulted in non-licensing funds being improperly used to subsidize licensing activities of the Commission and Bureau. 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.[5]

The Commission's proposed regulation to correct this potentially unlawful activity simply recategorizes tasks historically treated by the agencies and identified by the Auditor as licensing-related to instead be categorized as non-licensing. While it is possible that some activities identified as licensing might be better categorized as non-licensing, it is difficult to accept that mis-categorization was so extensive as to justify almost tripling non-licensing costs from $6.9 million in 2017-2018 to over $19 million in 2023.[6] This is especially true given the Audit Report notes that Bureau staff often misreported considerable amounts of time as nonbillable when performing billable background investigation activities.[7] Because these nonbillable tasks were paid from non-licensing regulatory fee revenue, once the Bureau began accounting for these tasks as billable hours against individual applicant deposits, non-licensing costs should have <u>decreased</u>, not increased.

The Gambling Control Act authorizes license application fees and deposits, in part, to determine the staffing needs of the Bureau as a reimbursable agency. Cost shifting as proposed in the Commission's draft regulation perpetuates the inefficiencies noted by the Auditor because the true costs of licensing remain obscured and unlawfully subsidized by non-licensing annual fee revenue.

2. <u>THE PROPOSED FEE REGULATION IMPOSES A TAX SUBJECT TO LEGISLATIVE APPROVAL.</u>

In *Am. Coatings Assn., Inc. v. State Air Res. Bd.* (2021) 62 Cal. App. 5th 1111, the court noted that in determining whether a regulatory fee is a tax for purposes of constitutional provision requiring passage by two-thirds majority of the legislature, courts evaluate: (1) whether the approved

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[2] Business and Professions Code § 19951(d)(e)
[3] California State Auditor Report 2018-132 ("Audit Report"): http://www.auditor.ca.gov/reports/2018-132/index.html
[4] Audit Report at page 34.
[5] Audit Report at page 35.
[6] Commission 2023 Annual Fee Invoice, Exhibit A.
[7] Audit Report at page 37.

fees would exceed the reasonable, estimated costs of administering the permit program; (2) whether the fee is used to generate excess revenue, that is, to generate more revenue than necessary to pay for the regulatory program; and (3) whether any class of fee payers is shouldering too large a portion of the associated regulatory costs. Cal. Const. art. 13A, § 3.

A. The Proposed Regulations Will Result in a Surplus to the Gambling Control Fund because the Fees Generated Exceed the Reasonable Costs of Regulating the Non-Application Activities of the Industry.

As noted above, the Audit Report found that the Bureau and Commission were charging non-licensing fees that far exceeded the agencies' actual costs to administer their oversight responsibilities. These actions resulted in an excessive surplus in the Gambling Control Fund and the Auditor's questions concerning the legality of the annual non-licensing fees.

When state regulatory fees exceed the reasonable cost of providing services necessary to regulate the activity for which the fee is charged, the fees are, in reality, taxes and violate Proposition 13 (Article XIII A of the California Constitution) unless passed by the voters or by a super majority of the Legislature. Neither has occurred.

As a result of the Gambling Control Fund's excessive surplus, the Auditor urged the Bureau and Commission to take steps to reduce the fund balance to not exceed one year of expenditures and change the manner by which non-licensing annual fees are calculated so that revenues do not exceed the non-licensing regulatory costs of the agencies.

Government entities have flexibility in assessing regulatory fees, both in the calculation of the fee and in its application to individual rate payors. *Farm Bureau Fed. v. State Water Resources Control Bd.*, 51 Cal.4th 421, 438 (2011) (citations and internal quotation marks omitted) However, the fees must be tied to the actual cost of the governmental activity they support. "[P]ermissible fees must be related to the overall cost of the governmental regulation. They need not be finely calibrated to the precise benefit each individual fee payor might derive. 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 general revenue becomes a tax." *Id. See also Jacks v. City of Santa Barbara*, 3 Cal.5th 248, 261 (2017) ("If a state . . . governmental agency were allowed to impose charges in excess of the special benefit received by the payor or the cost associated with the payor's activities, the imposition of fees would become a vehicle for generating revenue independent of the purpose of the fees. Therefore, to the extent charges exceed the rationale underlying the charges, they are taxes.").

As previously discussed, the Commission's underlying method for determining the annual fee for non-licensing regulatory activities is flawed because it includes both licensing and non-licensing regulatory costs. This error has resulted in an estimated annual fee under the proposed regulation of over $19 million [8] for 2023 – an amount that exceeds the $18.9 million in non-licensing fee revenues from 2017-2018 that the Auditor found grossly exceeded the actual costs of regulating such activities ($6.9 million) and resulted in the excessive surplus to the Gambling Control Fund.[9]

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[8] Commission 2023 Annual Fee Invoice, Exhibit A.
[9] Audit Report at page 34.

We appreciate the effort that has gone into creating an annual fee calculation that addresses the issues raised in the Audit Report. However, the Auditor's recommendation was to reduce the amount of non-licensing fees charged to licensees because the revenues from this fee structure ($18.9 million) in no way approximated the actual costs of regulation ($6.9 million). The proposed regulations do not reduce these fees and instead employ a byzantine methodology to rationalize charging almost the exact same amount, $19 million.

B. THE PROPOSED COST POOLS ARBITRARILY ALLOCATE THE COSTS OF NON-LICENSING REGULATORY ACTIVITIES BETWEEN CARDROOMS AND THIRD-PARTY COMPANIES.

The Commission's methodology for determining the allocation of non-licensing costs between cardrooms and third-party companies is arbitrary and not based on the differences associated with regulating the licensees.

For example, Cost Pool 3 represents 48% of the total non-licensing fee. Under the proposed regulation, it would be allocated 76% to cardrooms and 24% to third-party companies simply because cardroom entity licensees, which include both non-operational cardrooms and those with less than 10 tables, outnumber third-party licensees. There is no rationale for using the number of licenses to allocate the largest cost pool, particularly given the fact that Cost Pool 3, by definition, is for non-licensing related costs.

Similarly, Cost Pool 4 represents all non-application costs generated by matters requiring Commission action that relate to third-party companies and cardrooms and allocates 61% of these costs to third-party companies. The designation of Cost Pool 4 as 'non-application costs' demonstrates the flaw in the proposed regulation's methodology given the vast majority of matters requiring Commission action relate to application determinations. Moreover, the allocation between the entity types is based only on the number of third-party related items that appear on Commission agendas compared to cardroom items, without regard to the relative time requirements of those items which can vary greatly depending on the complexities involved.

The improper allocation of non-licensing costs combined with the absence of additional services to justify the dramatic increase in the Bureau and Commission's expenditures leads us to believe that the fee calculation as proposed is an unlawful tax that bears no correlation to the reasonable costs of regulating the industry and only serves to maintain or increase the surplus in the Gambling Control Fund.

For these reasons, the California Gaming Association respectfully requests that the Commission not act on the proposed regulations and instead direct staff to draft language that reflects the actual non-licensing regulatory activities of the Bureau and Commission.

Sincerely,

Joe Patterson
Executive Director

manatt

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October 19, 2022

Client-Matter: 62491-030

VIA E-MAIL: LAWSANDREGS@CGCC.CA.GO

California Gambling Control Commission
Attn: Legislative and Regulatory Review (RE: CGCC-GCA-2021-07-R/C)
2399 Gateway Oaks Drive, Suite 220
Sacramento, California 95833

Re: Comments on Commission Fees Modernization Project from Park West Casinos, Inc., Certified Network M, LLC and Network Management Group, Inc

Pursuant to the Notice Of Availability Of Modified Text Of Proposed Regulations dated October 4, 2022 ("Notice"), we submit these comments in the above-referenced matter on behalf of Park West Casinos, Inc., Certified Network M, LLC and Network Management Group, Inc.

1. Introduction and Summary.

The Notice states:

> Comments relative to the proposed text should be limited to only the most recent modifications. *Double italicized underline* and ~~*double italicized strikethrough*~~ in the enclosed modified text denotes those modifications. Comments not related to the most recent modified text will not be given consideration

Notwithstanding this admonition, the comments below are focused on what is now ***missing*** from the various versions of regulations released pursuant to the Commission Fees Modernization Project. In short, the Commission has apparently put aside the concerns first identified by the California State Auditor, which advised that "the bureau and commission should reset their regulatory fees to reflect their actual costs."[1] The Commission's first version of the regulations at least made an attempt to adopt a methodology to ensure that fees would reflect the Commission's and Bureau's costs; the Commission then withdrew those provisions, leaving annual fees in place that have no basis in fact and leaving licensees with no ability to reconcile fees to the Commission's and Bureau's costs.

[1] Bureau of Gambling Control and California Gambling Control Commission: Their Licensing Processes Are Inefficient and Foster Unequal Treatment of Applicants (May 2019) (California State Auditor) ("Audit Report"), p.42.

Instead, the new regulations have imposed annual fees that are based on a percentage of the cardroom or TPPPS revenue, rather than on the Commission's and Bureau's actual cost to provide services to the licensee. With the advent of this new approach, annual fees have increased significantly, which will only exacerbate the issues first identified by the State Auditor – fees that are higher than the Commission's and Bureau's costs, and a burgeoning surplus. The Commission's first set of draft regulations attempted to address this potential problem by providing for an annual reconciliation process. The Commission deleted this process for both cardrooms and for TPPPS, without providing an opportunity for public comment, and has not reinstated it here or in any other proceeding.

Without an annual reconciliation process, and without a comparison to the Commission's actual costs, an annual fee based on a percentage of revenue has all the appearances of a tax, rather than a fee, and clearly violates Proposition 26. The Commission can choose to ignore these comments at its peril. We recommend that the Commission instead revisit the calculation of the annual fee, remove the basis for the annual fee as a percentage of revenue, and institute an annual reconciliation that bases the annual fee to each licensee to reflect the Commission's and Bureau's actual cost to provide services.

2. Background.

A. Audit Report Recommended Alignment of Fees with Costs and Recognized the Potential Violations of Prop 26.

The State Auditor was very clear on how the Commission's fee structure should be established:

> The bureau and the commission have established regulatory fees that do not align with the actual costs that they incur when performing oversight activities. These fees—which applicants and gaming business owners pay—***raise questions about the legality and fairness of the current fee structure.*** In part because some of the fees are higher than necessary, the balance in the Gambling Fund has doubled over the past five years, and it is projected to increase to $97 million by June 2020. If the balance reaches this amount, it will represent a surplus of more than five times the combined annual operating expenditures of the bureau and commission. This excessive surplus has enabled the bureau to engage in inconsistent billing and time-management practices.[2]

The State Auditor then noted that if fees are not related to actual costs, the supposed fee is actually an unlawful tax:

[2] *Id.*, p. 2 (emphasis added).

> 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***. . . . Given the lack of alignment that we found between fee revenue and the costs of regulation, we believe that a thorough review of the current fees is urgently needed.[3]

B. The MGT Report Used Faulty Pandemic-Era Data for Its Projections and Cited No Evidence to Support the Conclusion that Annual Fees Should Be Based on Revenues Rather Than Actual Cost of Service.

MGT Consulting prepared a report for the Commission entitled, "Department of Justice's Bureau of Gambling Control and the California Gambling Control Commission Fee Study Report of Findings" ("MGT Report"). MGT found that "The current third-party annual fee assessment results in an overpayment of annual fees."[4] MGT then made two initial faulty assumptions in its analysis. First, it used three-year averages for cardroom and TPPPS revenue reports. These three-year averages obviously include periods of time when cardrooms were shut down due to the emergency orders issued by Governor Newsom during the pandemic. Future revenue will undoubtedly be higher, assuming there are no future emergency orders. With fees based on deflated revenues, future fees would be much higher than necessary to cover the Commission's and Bureau's costs of providing service, even if that methodology were close to accurate.

Second, MGT made the false assumption that basing the annual fee on the revenue a club or TPPPS produces would reflect the Bureau's and Commission's cost of providing services to that licensee.[5] As a rough example of the fallacy of this approach, MGT did not compare two cardrooms that have a near-identical number of tables, near-identical number of employees, and significant differences in revenues. These revenue differences could be due to factors such as differences in location, management, or the type of clientele. It is almost impossible to imagine that the services provided by the Commission and the Bureau to two near-identical cardrooms would vary significantly based solely on differences in revenue. MGT did not cite any evidence to support its belief that near-identical cardrooms should be taxed at different levels based solely on revenues. Instead, MGT stated, without any evidence, that "[t]his methodology presented the fairest option for distribution."[6]

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[3] *Id.*, p. 35. The State Auditor also noted that, "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," which was estimated to "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." *Id.*

[4] MGT Report, p. 9.

[5] *Id.*, p. 21.

[6] Id., p. 19.

MGT proposed a flat fee based on a range of revenues,[7] with an annual reconciliation.[8] MGT did not recommend annual fees that are based on a percentage of revenue.

C. The Commission Made the MGT Recommendations Worse by Imposing Annual fees Based on a Percentage of Revenue, by Removing Any Perception of Fees Based on Cost of Services, and by Removing an Annual Reconciliation.

The Bureau took MGT's flawed proposal and made it worse—and by doing so, virtually ensured that the annual fee will be enjoined as a violation of Prop. 26. First, the Commission has based the annual fee for cardrooms and for TPPPS's solely on a percentage of annual revenue.[9] The Commission did not present any evidence to support this fee methodology, and the Commission's percentage-based fees will almost surely exceed the fees recommended by MGT, which were themselves based on faulty or nonexistent methodology.

The Commission also considered, and then withdrew, regulations that would have established an (albeit flawed) methodology for calculating the annual fee.[10] Those same regulations would have provided for an annual reconciliation—again, flawed as it would not have been based on the Commission's and Bureau's actual costs to provide services to cardrooms and TPPPS's, but at least providing an opportunity for licensees to address those calculations.[11]

Incredibly, the Commission decided instead to drive an annual fee calculation into familiar territory—underground. Instead of providing for an annual fee calculation in the regulations, the Commission stated that "the calculation method . . . has been moved from the regulation text to this [stet] supporting documentation of the rulemaking file as further discussed in Section 12252.2 below."[12] Oddly, there is no "further discussion" in Section 12252.2.

D. An Annual Fee Based Solely on a Percentage of Revenues Violates Proposition 26.

Under Prop. 26, the government must produce evidence showing the estimated costs of the regulatory activity, and the basis for determining the manner in which the costs are apportioned, so that charges allocated to a payer bear a fair or reasonable relationship to the

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[7] *Id.*, p. 32.
[8] *Id.,* p. p. 25.
[9] 14 California Code of Regulations ("CCR") § 12252 2 (TPPPS); § 12368.2 (cardrooms).
[10] Final Statement of Reasons (undated), p.2 (available at http://www.cgcc.ca.gov/documents/enabling/2022/Fees_Mod_II_2nd_FSOR_REVISED_2022_0929.pdf)
[11] *Id.*
[12] *Id.*

payer's burdens on or benefits from the regulatory activity"[13] The Commission has not done this –there is no evidence in the record to support an annual fee based on revenues, or that those annual fees bear a fair or reasonable relationship to a licensee's benefits from the regulatory activity.

In determining whether a regulatory fee is a tax for purposes of Prop. 26, courts evaluate (1) whether the approved fees would exceed the reasonable, estimated costs of administering the program; (2) whether the fee is used to generate excess revenue, that is, to generate more revenue than necessary to pay for the regulatory program; and (3) whether any class of fee payers is shouldering too large a portion of the associated regulatory costs.[14] Here, the new fees seem destined to exceed the Bureau's and Commission's reasonable, estimated costs of administering the licensing program; the fees will therefore generate excess revenue; and, because the fees are based on revenues rather than services, one or more classes of fee payers are shouldering too large a portion of the associated regulatory costs.

3. Conclusion.

In short, the Commission has decided to impose an annual fee on licensees that has no basis in fact and that is based solely on revenues rather than the Commission's and Bureau's cost of services—at a higher level than the current fee structure, which as noted by the State Auditor, already exceeds the costs of the Commission's and Bureau's services. If the Commission intends to perform any sort of annual reconciliation, it apparently intends to perform that in secret, with no accountability to cardrooms or TPPPS's.

We urge the Commission to reconsider this flawed approach. The Commission should calculate the annual fee based on the Commission's and Bureau's actual costs of services, and institute an annual reconciliation through regulations to ensure that the fees charged accurately reflect those costs.

Sincerely,

Randall W. Keen
Manatt, Phelps & Phillips, LLP

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[13] *Am. Coatings Assn., Inc. v. State Air Res. Bd.*, 62 Cal. App. 5th 1111, 1124, 277 Cal. Rptr. 3d 284, (2021).
[14] *Id.* at 1125-1126.