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VIP-room Contractual System of Macau's Traditional Casino Industry

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JEL Classification: L13, L51, L83

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³ The Individual Visitors Scheme allows citizens from designated Chinese provinces to visit the Special Administrative Regions of Macau and Hong Kong without having to travel in a tour group or to get a special visa. See "Press Release of Macao Government Tourist Office, 2005 Press Conference", 2005-01-12, <http://www.macaotourism.gov.mo>

I. Introduction

Every casino in every gaming jurisdiction in the world has to deal with both substantial players (“VIP⁴ players”) and regular players (“mass market customers”), as does Macau. However, the approach that Macau has taken is significantly different from the rest of the world. These two categories of players are ushered into two different casino systems and so make Macau’s traditional casino industry a dual system –a VIP system and a “mass market” system. These two systems not only operate differently, but also are driven, impacted, and influenced by fundamentally different economic and other social or natural forces.

Therefore, to analyze or predict the evolution of Macau’s casino industry, the two systems should be viewed separately. For example, when the SARS epidemic affected Asia and created fears throughout the world in 2003, if one just simply raised the question of how much it was going to affect Macau’s casino market as a whole, the conclusion would have been vague and not meaningful. A better methodology would have been to separately analyze how much the mass market sector would be affected and how much the VIP sector would be affected. As a matter of fact, SARS in 2003 substantially depressed Macau’s mass market business but only very slightly influenced the VIP business. It might be impossible to provide a convincing explanation about why VIPs were apparently not deterred by SARS and mass market customers were, but the performance statistics indicate that was indeed the case.⁵

In another recent example, people speculated about how much Hong Kong’s newly built Disneyland that opened in 2005 would affect Macau’s casino market. Some said it was going to take some customers from Macau and some said it would increase the volume of visitation for Macau. In both cases, they were talking about just the mass market customers. Disneyland has virtually no appeal for Macau’s VIP customers because the great majority of VIPs are gambling-only players who have little regard for other tourist amenities. On the other hand, mass market customers are responsive to the

⁴ VIP stands for “Very Important Person.”

⁵ One explanation that was offered was the tacit approval by the Macau regulators of telephone betting. Thus, VIP players could have their representatives in the VIP rooms place the wagers that they monitored by telephone from distant locales.

general tourist and entertainment environment because most of them are relatively casual gamblers.

The operational style of the mass market system of Macau's traditional casino industry is quite similar to what one would find in Nevada casinos. The unique part in Macau has been the VIP system. Perhaps one or more elements of the VIP system can be found in other gaming markets, such as "dead chips,"⁶ customer representatives, commissions, etc., but one cannot find such a system as an organic whole in any other part of the world.

Macau's VIP-room contractual system was not designed at any one time. Rather, it began in the 1930s, and slowly evolved in the special cultural and geographic conditions affecting Macau and southern China, and matured by the mid-1980s. The system is organized around four actors: the casino, the VIP player, the VIP room contractor ("VIP promoter"), and the VIP customer representative (or "Junket operator.") Its construction involves three major elements: the VIP room, the VIP-room contract, and the dead chip.

Since the mid-1980s, Macau's casino industry has been dominated by the VIP sector; in terms of gross gaming revenues, VIP rooms captured about 70% of market share in 2004. However, in terms of profitability, about 70% is generated by the mass market sector, and the balance from VIP play. Moreover, the government taxes both the mass market and VIP sectors at the same tax rate (39% as of 2006.) When there was only a single monopoly operator in Macau—as was the case with STD from 1962 to 2004—the profit margin differences between the two sectors was not a major concern. However, with the new concessions and sub-concessions that resulted from the new gaming law passed in 2001, inter-casino competition has increasingly made the VIP structure—with its operating costs, revenue sharing arrangements, and tax obligations—a more critical economic issue.

Within the VIP-contractual system, marketing measures historically have not favored customers but rather customer recruiters, who are given incentives to recruit

⁶ "Dead Chips" are non-negotiable chips sold or lent to the VIP room contractor by the casino. They are then sold or lent to VIP room customers. Dead chips can be only used in play and cannot be redeemed for money. However, when the player wins, he is paid in "live chips," which can be redeemed for cash in the casino, or can be given to the contractor in exchange for more dead chips. This latter process is called "chip rolling."

customers to VIP rooms controlled by particular VIP contractors. Therefore, when inter-casino competition drives up VIP marketing costs, competing casinos involve themselves in a form of “cutthroat competition” where margins quickly get squeezed. Furthermore, most of the new entrants into the Macau market that have significant casino operations on other jurisdictions—the American gaming companies Las Vegas Sands, Wynn Resorts, and MGM and the Australian company PBL—must adhere to stricter standards than the concessionaires SJM and Galaxy with respect to probity issues and business practices of VIP promoters and Junket operators. Therefore there will be ongoing competitive pressures to modify or change the VIP system in ways that are more compatible with their business models and regulatory sensitivities. Indeed, after winning one of the original concessions, Wynn Resorts refused to break ground on its Macau casino until the legislation was changed that would allow the casino itself to grant credit, rather than being dependent on VIP promoters and junket operators for such services. An important consideration for this demand was the concern of being at the mercy of these independent contractors—many of whom might not be licensable by international regulatory standards—rather than agents employed directly by the casino for this important segment of the market.

Macau is a small and crowded city with limited land area (28 square kilometers) and other resources that make it difficult to develop a full complement of multi-dimensional tourist amenities to attract, contain and entertain enough mass market tourists for that to be the only significant market segment. Macau will need to do VIP business in some way. If competitive forces imply that the traditional VIP-room contractual system will have to change considerably from its present structure, or if foreign concession-holders cannot efficiently run the traditional VIP system because of regulatory or cultural challenges, then some other model will likely evolve; the new Macau will have to invent some other system to accommodate this market.

II. Terminology

As a unique casino operation system, the traditional VIP room contractual system has a complicated design. To understand how the system works, it is necessary to be

aware of those particular terminologies. There are three major elements that construct the VIP room contractual system: Dead Chips, VIP Rooms, and VIP Room Contracts.

Dead Chips

The dead chip—also called junket chip, nonnegotiable chip, or clay chip—is a kind of casino chip which is sold or lent by the casino to VIP promoters or Junket operators for betting purposes only. Dead chips are not cashable or refundable by customers, but are only usable in making wagers in the VIP room where they were purchased or borrowed. Since the dead chip is financially less flexible, logically its price should be cheaper than regular casino chips. In Macau, the dead chip's normal price is one unit of cash less 0.7% of the face value of the dead chip. The difference in valuation, 0.7%, known as “dead chip commission” (which is actually a commission paid on the purchase of dead chips at a rate of 0.7% of the face value of the chip), functions as a payment vehicle for the casino to reward the marketing efforts of VIP promoters and Junket operators.

Customers cannot purchase or borrow dead chips directly from VIP room casino cages. The casino only sells or lends dead chips to VIP promoters and junket operators. VIP promoters and junket operators can only buy or borrow dead chips from the VIP room's cage, and VIP customers can only buy or borrow dead chips from VIP promoters or junket operators. Dead chips are designed to guarantee the chips will actually be wagered on the gaming tables in that VIP room rather than going back to be cashed out at the cage without having been put into action.

VIP room

A VIP room is an individual room or set of rooms within a larger casino specifically designed and designated for VIP customers' usage only. Under the VIP-room contractual system, a VIP room has its own cage which functions as a financial vehicle between the casino and the VIP promoter. Its window is open to VIP promoters and junket operators only; VIP customers have nothing to do with this cage. All properties of the VIP room still belong to the casino; the dealers and the gaming managers are employees of the casino; and the gaming operations of a VIP room are run by the casino.

In effect, only the marketing efforts have been contracted out to the VIP promoter and their junket operators, who are subordinate to the VIP promoter.

Besides the VIP rooms, there are “mass gaming halls” in most of Macau’s historic casinos, where mass market customers play. They run in a manner similar to an ordinary Nevada-style casino.

VIP room contract

A VIP-room contract is a documented agreement between a casino company (such as STDM⁷) and a VIP promoter that outlines the rights and responsibilities of both parties. The documents are worded on room-by-room basis. There is no standard version of contract document in terms of items, terms and conditions, but general principles can be outlined from various contract documents.⁸

A more detailed alternative example between a casino and a VIP promoter might have conditions and follow the distribution of revenues as set out below.

1) **Minimum dead chip sales.** In a VIP room contract, the VIP promoter would guarantee a minimum amount of dead-chip sales during a certain period (usually a month). If the contractor had not accomplished the minimum amount of sales, he could be “fired” by the casino.⁹

2) **Over-sales reward.** If a VIP-promoter sells more dead chips than the promised minimum amount, the casino will reward the contractor for a portion of the over-sales. For example, the VIP promoter might receive an additional 0.15% of the amount of dead chips sold in excess of the minimum.

⁷ SDTM is the common reference to the company *Sociedade de Turismo e Diversoes de Macau*, which had a monopoly license to operate casinos in Macau from 1962 to 2002. Their first competitor, Sands Macau (owned by the *Las Vegas Sands* corporation) opened in May 2004.

⁸ Often there are no documented contracts between VIP promoters and junket operators, whose cooperation and transactions are based on convention and oral agreements or, sometimes, simple bookkeeping. Furthermore, there was as of 2006 no regulatory requirement for the VIP contracts to be reviewed by regulatory authorities.

⁹ If a VIP promoter is unable to meet his minimum sales in a particular period, then other VIP promoters who have exceeded their targets may shift some of their sales to help them out. This is probably undertaken on an informal contractual basis to provide stability and “friendly competition” (and probably payments for such assistance) among VIP promoters.

3) **Dead chip commission rate.** A dead-chip commission rate must be stipulated within a VIP room contract. For most of the time when STDm served as the monopoly concessionaire in Macau, this rate held steady at 0.7%. However, since 2005, when the Sands Macau and then other casinos entered into the VIP Contract business, the rate has been pushed upwards. Note that this system implies the VIP Promoter receives payment based on actual dead chip sales (or theoretical win in the VIP Room) rather than on the actual outcomes—winnings and losses—of the games.

4) **Residual Revenue share.** To understand the concept “residual revenue”, one needs to know the casino revenue disposal sequence within the VIP room contractual system. Casino win is allocated in the following order:

- (1) About 39% of actual win goes as gaming tax to the Macau SAR Government;
- (2) dead chip commissions, as described above, are then paid to VIP promoters;
- (3) rewards for dead chip over-sales are paid to the VIP promoter;
- (4) a certain portion of residual revenue is allocated to the VIP promoter;
- (5) casino operational costs are covered;
- (6) the residual is retained as casino profit.

The term “residual revenue share” is in the fourth priority on this list. After the government extracts percentage tax from casino win, after VIP promoters are paid their dead chip commissions, and after the VIP promoter receives his over-sales reward, then the “residual” is shared between the casino and the VIP promoter. In one variation, the casino takes 70% and the contractor gets 30% of this residual.

5) **Deposit.** The VIP promoter must keep a certain amount of cash as a deposit with the casino, varying from several millions of Hong Kong dollars (or other currency equivalent) to hundreds of millions depending on the room condition, as a prerequisite to contract a VIP room. This is to protect the casino from possible credit risk. The deposit constitutes a ceiling of the dead-chip credit transactions

between the casino and the contractor – the casino never lends dead chips to VIP-promoters in an amount over that which they have deposited.¹⁰

III. Genesis of VIP Rooms in Macau

In the 17th century, Macau was separated from China and became a Portuguese colony with an independent economy. At the time, the land mass for Macau was only 10 square kilometers with a population of about 40,000. Macau was so small that it could not be self-sufficient, so it had to establish economic links to neighboring areas. Long before Hong Kong was founded, Macau under Portuguese rule served as a transfer station for China-Europe trade, and that became the primary economic base for the enclave. After 1842, Hong Kong was developed by the British and almost completely replaced Macau as an international trade port.¹¹

Macau had to find other strategies to survive. One such strategy was gambling.¹² The major gambling market then logically was Hong Kong, as well as Canton (Guandong) province of Mainland China. Furthermore, Macau's Portuguese government had legalized gambling in the 1840s, and Hong Kong's British government officially made gambling illegal in the 1870s. This provided a stable and reliable market for Macau's casino industry. At that time, the Hong Kong market seemed large and rich enough to sustain Macau. Thus, while Hong Kong captured Macau's role as a center for

¹⁰ After the SDTM monopoly ended with the opening of the Sands Macau in 2004, some variations emerged with Macau's VIP room system. One variation, the so-called "4025 room", was introduced first by SJM and then copied by some other casinos such as Wynn Macau (which opened September 2006.) This variant simplifies the contents of a VIP room contract and makes it considerably more straight-forward: the VIP room promoter takes a fixed percentage—say 40.25%—of actual casino win and the casino takes the balance—say 59.75%. The casino is responsible to pay the tax and all operational costs, whereas the VIP room promoter decides how and how much to share with his junket operators. With this variation, the dead chip system is no longer relevant for revenue generation for VIP promoters. Responsibility for credit and debt collection could lie with either the casino or the VIP room promoter.

¹¹ For a detailed discussion of this evolution, see William R. Eadington and Ricardo Siu, "Between Law and Custom — Examining the Interaction between Legislative Change and the Evolution of Macao's Casino Industry," *International Gambling Studies*, Volume 7 (2007), forthcoming.

¹² In the beginning, some of Macau's gambling operations were also involved in the "coolie" trade business – using casino credit to allure and trap gamblers and then sell them as indentured servants to European and American coolie recruiters. See Eadington and Siu (2007) *op. cit.*

international trade and became increasingly wealthy, Macau in effect became its “sin city” as a way to sustain its own economy.

Over the centuries, Macau has developed and enlarged itself by reclaiming land from the sea and allowing immigration from the Mainland. In the 1930s, following Japan’s invasion of China, Macau was flooded by Chinese refugees due to its political neutrality. Because of the population expansion, Macau needed a larger casino industry to sustain its larger society. Therefore it needed to import more gamblers.¹³ However, Macau was at that time by no means a tourist destination, so there was not much potential to expand the casino industry by attracting more tourist gamblers, or so-called mass market customers.

Responding to economic demand, a new technique for casino marketing was developed by some jobless or economically desperate men, which proved to be a very important invention for the development of Macau’s gaming industry. In the Chinese language, these individuals are called *Jin-Ke*, where “Jin” literally means “introducing” and “Ke” literally means “customers”. The *Jin-Ke* would go out to find gamblers from surrounding cities and invite them to Macau’s casinos.¹⁴ From then on, as Macau’s casino industry grew, the more *Jin-Ke* were needed to bring more gamblers to Macau.

When a *Jin-Ke* introduced a customer to a casino, he was paid by the casino, but the pay was not commercially priced. Apparently the first *Jin-Ke* were not paid based on the amount of money played by the customers they introduced nor by the number of customers introduced. However, this new “career” was a primitive institutional element that preceded today’s VIP-room contractual system.

The next significant evolution in this system occurred in the early 1970s when STDM held the monopoly concession for Macau’s casino industry, and the Casino Lisboa was opened. As the largest hotel-casino in the region, it created a “must-see effect” that attracted many more Hong Kong residents to cross the estuary by ferry to enjoy the Lisboa’s offerings. The ferry terminals on both sides of the Pearl River Delta

¹³ An economy does not benefit substantially if its casino industry is predominantly based on gambling by local residents. See William R. Eadington, “The Economics of Casino Gambling,” Journal of Economic Perspectives (1999), pp. 186-189.

¹⁴ Liu, P. L. (August 2002). *Aomen Bocaiye Zongheng* [An Overview of Macao’s Gaming Industry (in Chinese)]. Hong Kong, PRC: Joint Publishing (H.K.) Co., Ltd. Page 406.

became crowded and ferry seats were in short supply. The prevailing price for ferry tickets was substantially greater than face value, creating opportunities for ticket scalpers. This attracted gangsters who would gather at both terminals to scalp ferry tickets to willing passengers. These ticket dealers would buy tickets from the ferry ticketing counter at face value and then sell them to passengers at inflated market prices. Obviously, this was not good either for the ferry company or the casino, both of which were owned and operated by STDMM.

The resolution for this problem was suggested by the leadership of STDMM, who called a meeting with the ticket dealers and offered them an alternative. If the ticket dealers would cease their ticket scalping activities and leave the ferry terminals alone, STDMM would allow them to make money in the casinos, which would ultimately be much more profitable than ticket dealing. The ticket dealers took the deal, left the ferry terminals and went into the casinos. In the meantime, the so-called “dead chip” system had already been invented so, what the former ticket dealers were invited to do within the casinos was dead chip dealing.¹⁵

The following example illustrates how a dead chip dealer would make money in transactions within a casino:

The dead chip dealer goes to a particular casino cage that is specifically for transactions for dead chip dealers and buys dead chips at face value. The amount of dead chips purchased by the dealer would be kept track of, and he would later receive a commission of, say, 0.7% of total dead chip purchases.¹⁶ This 0.7% is referred to as the “rate of dead chip commission.” With the dead chips in his pocket, the dealer would wander around the casino to look for and accost significant (VIP) players. Many times, the baccarat tables would be the best places to find such a target. The chip dealer would locate his target customer and “make friends” with him by helping and serving him. In return for the “friendship”, the customer would agree to buy dead chips from the chip dealer at a one-to-one rate instead of buying regular chips at the casino cage. This would

¹⁵ Ibid., p. 407

¹⁶ This represents a commission of 0.7% of the face value of the chip. In the earliest days of dead chip programs, the rate for dead chip commissions was not that high. It gradually increased as the dead chip dealers’ working radius became larger and costs to the dead chip dealers increased. The 0.7% commission rate was the rate when Macau’s VIP-room formal contractual system was established.

not make any difference for the customer because dead chips and regular chips function the same on baccarat tables.

For example, assume a customer has a gambling budget of one million Hong Kong dollars and has bought that amount of dead chips from the chip dealer. Then the dealer receives HK\$1 million from the customer and will later receive a HK\$7,000 commission for purchasing the chips, clearing a profit (before expenses) of HK\$7,000.

One should keep in mind that it is not easy to find such substantial gamblers who are willing to be befriended. For most dead chip dealers, catching a gambler like the customer in the example once every month or two would be unusual. So if the chip dealer can only make HK\$7,000 from each substantial gambler befriended, it would not be a very profitable business. However, as a matter of practice, the dead chip dealer may make much more than that.

One should note that gamblers can bet on a table with either dead chips or regular chips, but when they win, they are always paid in regular chips. Most gamblers do not stop betting when they have “washed out” their dead chips (i.e. converted them all to regular chips via winnings). Instead, they would usually continue betting with their just-won regular chips.

When the customer decides to do so, this provides an opportunity for the dead chip dealer to make much more money. While the customer gambles at a baccarat table, the dead chip dealer would typically stand by him. When the customer had lost all of his dead chips and was about to use his just-won regular chips to keep betting, the dead chip customer would propose: “Friend, don’t do that. I have dead chips here for you. Exchange your regular chips for my dead chips. It does not make any difference to you, but it makes some difference to me.”¹⁷ As the win-and-lose patterns would continue, the dead chip dealer “rolls the dead chips” and as a result would make more money. When the customer has eventually lost all of his original buy-in to the casino, the dead chip

¹⁷ Many players are aware of the VIP room contractual system and understand the value they are creating for the Junket operator. In such cases, they will negotiate some “kick-back” from the dead chip dealer’s commissions to continue the (mutually advantageous) chip rolling at the baccarat tables.

dealer has become another winner from the game – a considerable portion of the customer’s original stake has worked its way into the dead chip dealer’s pocket.

The actual amount of money the dead chip dealer would have made would depend on how often the dead chips were “rolled,” which in turn would depend on how many win-and-lose rounds occurred in the game. If the customer who originally bought the dead chips from the dealer was very unlucky and lost all his dead chips without winning any regular chips, then the money the dead chip dealer made from the customer would be just 0.7% of the original buy-in. On the other hand, if the customer won a lot of money in the beginning and kept betting with the just-won money (rolled into dead chips) and gradually lost it back, then the customer might generate, say, five or ten times as much as the original commission for the dead chip dealer before he finished his round of gambling.¹⁸ In general, with a 0.7% commission on dead chip sales, the chip dealer will earn approximately 0.35% of the aggregate amount of all wagers made with dead chips.

In summary, for the game of baccarat, the house advantage (defined as the long run ratio of win to handle) is about 1.3%. With a dead chip system, the average dead chip will have an expected longevity of slightly less than 2.0 betting rounds.¹⁹ Thus a customer who began with HK\$1 million and played until it was lost but always purchased dead chips from a broker would, on average, generate a handle of HK\$75 million, implying dead chip transactions of about HK\$37.5 million, and commissions to the

¹⁸ Limited insight on the relationship between initial buy-in and the amount of rolling dead chips to be resold can be gained by examining baccarat data from Nevada casinos to establish a relationship between buy-in and total amounts of money wagered. For the 12 months ended October 31, 2006, Nevada’s baccarat tables generated total win of \$755.1 million with a hold percentage of 10.75%, where hold percentage is the ratio of win to “drop,” and “drop” is the amount of cash or cash equivalents that go into the drop box at the table (or alternatively, the amount of chips purchased at the baccarat table.) On average, baccarat is about a 1.3% house advantage game, suggesting that the ratio of “handle” (total amount wagered) to win is approximately 75 to 1. Therefore, we can conclude that in Nevada, the handle for that 12 month period was approximately \$58.1 billion, the drop was approximately \$7.0 billion, and the ratio of handle to drop was approximately 8.27. If only dead chips are used by the customer for bet making, the expected handle generated by \$1 of dead chip before it is lost is slightly less than \$2. Assuming a Macau VIP player buys in to a baccarat game at the same rate as a Nevada baccarat player, then a player loss of \$1 million would represent a handle of \$75 million and original chip purchases of \$10.75 million. If all regular chips were rolled into dead chips, this would imply total dead chip sales of \$37.5 million (approximately half of handle), and a subsequent commission to the chip dealer of \$262,500, or a rate of about 26% of total player losses. This rate is approximately equal to the ratio of (the rate of commission)/(two times the house advantage), where the denominator in this ratio is the house advantage at baccarat times the expected handle generated per dead chip.

¹⁹ Note that this implies the casino should win about 2.5% of total dead chip sales in gross gaming revenues. However, this win rate should not be confused with House Advantage, whose denominator is Handle, not dead chip sales.

broker of about HK\$260,000, approximately 26% of the theoretical win for the casino. Therefore, the amount of money that a dead chip dealer can make is not only dependent on what level of customers he can find and recruit, but more importantly, how the game actually goes on and how successful he is in “rolling chips” during play.

In its earlier years, the dead chip dealing business was basically an inside-the-casino business. However, as more and more entrepreneurs became dead chip dealers, the competition for “friend-making” became more intense and success at it became harder to achieve. As a result, chip dealers would travel to other cities and countries to “make friends” to recruit them for the casinos. This phenomenon significantly changed the nature of the dead chip dealing business and created some new issues for the Macau casino industry.

First, the evolving *Jin-Ke* were voluntarily and unconsciously functioning as casino marketing agents, which would ultimately change the nature of the relationship between the casinos and the dead chip dealers. In the early years, the casino just tolerated these dealers in return for their agreeing to stop scalping ferry tickets. Under the evolved relationship, the casinos increasingly benefited by new business brought by dead chip dealers serving as customer recruiters.

Secondly, the costs and risks associated with “friend making” increased as a result of the more extensive recruiting efforts that were required. The dead chip dealers needed to pay transportation, lodging, and other expenses for their potential customers before they could actually make profits through dead chip sales and chip rolling. Also, an institutionalized mechanism needed to be established that would recognize and protect the relationships between the recruiters and their recruited customers, in order to protect them from possible “scooping” by other dead chip dealers.

Finally, once the dead chip dealers realized that they could go abroad to recruit customers, the dead chip dealing market expanded substantially. As a result, the number of dead chip dealers also expanded enormously, from a few dozen in the beginning to perhaps thousands. The monopoly concessionaire STDM was having more and more difficulty in dealing with so many independent entrepreneurs, and therefore sought other alternatives. In summary, the dead chip dealers evolved from *Jin-Ke* to dead chip dealers into “VIP promoters” as the market expanded.

Beginning in the 1980s, Mainland China began its market oriented economic reforms. In terms of disposing state-owned or collective-owned enterprises and cultivated lands, the reform operation looked simple: retain the socialist nature of the economy by keeping public ownership, but create a market economy by privatizing management. This was called the “contractual system.”

Interestingly, the contractual system in Mainland China was not very effective within China in the years soon after the reform. However, it served as an inspiration for Macau and especially its gaming industry. The management of STDM exploited the idea of “contract” and designed and developed its special “VIP-room contractual system.” This served to institutionalize the dead chip dealers into VIP-customer representatives or VIP promoters and built up a more efficient VIP marketing system that also helped to manage the thousands of dead chip dealers. In this manner, STDM found a strategy to develop its gaming market even though it did not have a domestic market to draw from in a location that did not have many of the attributes of a traditional tourist destination.

Revenue performance of VIP rooms, along with total gross gaming revenues and the market share captured by VIP room play, (measured in Macau patacas, or MOP)²⁰ are reflected in Table 1, below:

TABLE 1
VIP ROOM PERFORMANCE, 2000-2005

YEAR	VIP ROOM GAMING REVENUES (MOP millions)	GROSS GAMING REVENUES (MOP millions)	VIP ROOM SHARE OF TOTAL GAMING REVENUES
2000	10,790	15,878	68%
2001	12,755	18,109	70%
2002	15,864	21,546	73%
2003	21,532	27,849	77%
2004	28,916	40,187	72%
2005	28,023	44,725	62%
2006	32,668	54,996	59%

²⁰ The exchange rate of MOP as of the end of 2006 is \$1 = MOP8.0061

IV. The Main Actors

A VIP-room contractual system is organized around four actors: the casino, VIP-promoters, Junket operators, and VIP players.

The Casino

Macau had only one company with casino operations, STDM (succeeded by its wholly owned subsidiary SJM in 2002), from 1962 until May 2004, when the Sands Macau casino opened. The VIP-room contractual system had been invented and run solely by STDM for about 20 years until June 2004 when Waldo Casino— owned by the Hong Kong based company Galaxy—opened and started doing VIP business under this system. STDM was the inventor, designer, organizer and operator of the VIP-room contractual system. Because this system runs without explicit codification in law, STDM played a dominant role in establishing rules, managing, and otherwise “lubricating” the system.

VIP promoters

The VIP promoter plays a pivotal role within the VIP-room contractual system between the casino and junket operators. He is the fabricator, organizer and maintainer of the interpersonal web of junket operators. He also serves as a lender to junket operators and occasionally to customers. Contracting a VIP-room requires a highly skilled person with good person-to-person traits who is capable of dealing with very complicated and sometimes even dangerous personal affairs. The VIP promoter is also the one who bears major risk in terms of credit transactions within the VIP-room contractual system. VIP promoters can either be natural persons or legal persons.

Junket Operators

A junket operator is typically a self-employed person who earns dead-chip commissions by “selling” his customers to a VIP promoter. Junket operators evolved from being dead chip dealers that dealt primarily with customers already in the casino, to individuals who recruit customers at their own cost and risk. As such, junket operators

are not only dead chip dealers but also marketing agents for VIP promoters and for the casino.

Following is a typical process for a junket operator to work with customers in the following manner:

1) Targeting.

A VIP-room is a contractor-centered team. However, in some cases, a junket operator will also have a team of his own. For example, a junket operator might open a travel agency in a major city and hire or collaborate with local representatives to work for them. In the 1980s and 1990s—when the major market of Macau’s casino industry was Hong Kong—most junket operators worked on an individual basis. One individual would typically go back and forth between Hong Kong and Macau and would do all the recruiting work himself. Now that Macau’s major gaming market has shifted from Hong Kong to Mainland China, such processes have become more complex. The distance, the cultural differences and even language obstacles—some VIP promoters whose native language is Cantonese do not speak Mandarin—have led some junket operators to organize their own teams. A new term that has been suggested for assistants to junket operators is *Bo-Jao*, which literally means “porter”.

One junket operator would typically focus on a particular geographic area to scan for people who are rich enough and so inclined to be VIP customers. When a junket operator or his men find such a target, the next step would be to contact him and establish a “friendship” or relationship.

2) Friend making.

Usually, gambler recruiters would not tell target customers their real intention in the beginning unless the target himself actively brings it up. Usually the recruiter would tell the targeted individual that he is running a travel agency based on Macau. If the friend making process is successful, a friend-accompanied free trip to Macau will be proposed.

3) Ushering.

On the way to Macau, the companion (junket operator or assistant) pays all expenses including transportation and accommodation. When arriving in Macau, a casino visit will be proposed. If agreed, a visit to the VIP room at the casino will be proposed.

If agreed upon, the successfully recruited customer will be escorted into the VIP room that is affiliated with the recruiter.

4) Free dead chip loan.

This step is when the customer is first informed of the VIP room policy: his gambling budget has to be some minimum, such as HK\$500,000 in order to be eligible to play in the VIP room. This is also the time to test whether the targeting strategy has worked. If it turns out that the customer is unwilling to continue—the customer is either not that rich or is not willing to borrow that much money—then all efforts undertaken and costs expended by the junket operator will have to be absorbed as losses. On the other hand, if the customer agrees to the terms, a free (no interest) dead chip loan of, say, one million Hong Kong dollars will be offered.²¹ The junket operator gets the dead chips by borrowing or purchasing them from his “boss,” the VIP promoter. At this point, the junket operator has made his first commission money (against the dead chip loan) of approximately HK\$7,000. Whether this commission will actually be realized by the junket operator will depend on whether the debt will ultimately be successfully repaid out of winnings or collected.

5) Dead chip dealing.

The customer is next ushered to a baccarat table and starts his venture. It is also the time for the representative to make additional commissions through chip rolling. In this context, he has returned to the role that his predecessors followed – a dead chip dealer. For the junket operator business, this step is essential, which is why the Macau society still refers to them by the old title “dead chip dealers” (*Da-Ma-Zai*). For purposes of this analysis, the name “junket operator” is used in order to distinguish the old-time dealers who made money only for themselves, and the current dealers who benefit not only themselves, but also the casino and the VIP promoters.

At this point, the successful recruiter stands by his “friend” with some dead chips ready in his pocket waiting for the player to wash out his current stock of dead chips, willing to cash out the regular chips the player has won. The two “friends” both are eager on the game but with different goals. The gambler just wants to win, but the junket

²¹ Not all players are naïve to the underlying realities of the VIP room, as is suggested by the player in this example. Many players are fully aware of the terms and conditions under which they are invited to play, and therefore there is not an element of “seduction” or “deceit” as implied in the illustration.

operator hopes more for extended rounds of winning and losing. The same process described in Section III (above) repeats itself. If the player happens to win, the junket operator would expect to be generously tipped, and the debt would be paid off right away. If the player loses, the junket operator would still make some dead chip commission from the player's losing process. As is the reality in casino games, losers are more common than winners, so most cases would have to go to the last step – debt collection.

6) Debt collection.

Consider the case where the venture ends with the customer having lost the entire amount extended to him in credit by the junket operator. The player should pay it back to the junket operator, but he may not be willing or able to do so.

How then are such debts collected? Interestingly enough, within Macau's VIP room system, gambling debts are neither legal nor illegal. Macau's junket operators typically do not use threats or violence to collect debts to the extent that loan sharks elsewhere might. They also do not go to court to seek legal enforcement of the debt even though the newly passed gambling credit law says they are allowed to do so.²² The way many gambling debts are collected is based on cultural considerations, in which "friendship", "conscience", "family," "prestige," or "honor" play important roles. Many cases eventually are resolved based on these cultural elements.

In comparison to stereotypical *loan shark* practices or the legal avenues used by casinos in other jurisdictions, the Macau VIP room debt collection system has one advantage: a junket operator purportedly knows ahead of time his customer's financial background when initially targeting and recruiting him. When the junket operator lends the target customer dead chips, he has a reasonable idea of where the credit ceiling is. Furthermore, when collecting debt, the junket operator is reasonably certain that his customer is able to pay it. When this description is an accurate of the underlying reality, it is not difficult to understand how this debt collection system would work without having to turn to threats of violence or intimidation on one hand or legal recourse on the other. However, it is likely that when the system as described above does not result in debt payment settlements, other extra-legal means of debt collection may indeed come into play. The extent to which extra-legal means of debt collection (i.e. threats,

²² Administrative Regulation 6 (2002), and Law 5 (2004)

intimidation, violence, induced crime such as embezzlements, etc.) occurs is an obvious concern for regulators, especially those from outside Macau that oversee companies which are concession or sub-concession holders in Macau.

VIP customers

In Macau, the term *VIP Customer* has a specific meaning, and is not equivalent to the American expression *High Roller*. A VIP customer must meet such two conditions: first, he must have a significant gambling budget of, say, HK\$500,000 per trip; second, he must be recruited, ushered and financed by a junket operator into a VIP room to play.

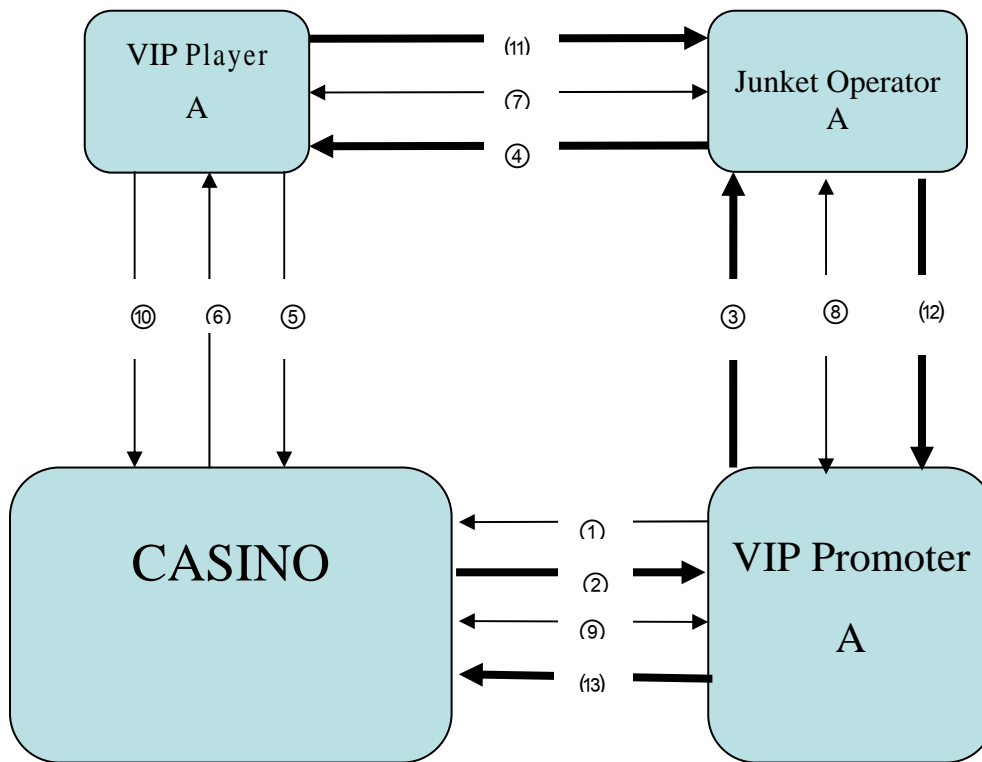
Before 2002, VIP customers came mainly from Hong Kong. By 2006, over 80 percent of VIP customers were coming from Mainland China. With the entrance of the new concessionaires (Sands Macau, Wynn Macau) into the mass market business as well as the VIP room business, it became more difficult to preserve the traditional pricing and revenue sharing structures among the major VIP room actors. As a result, the casinos dealing in the VIP room business in the mid-2000s shifted their attention to Mainland China to look for new customers and new junket operators. These competitive changes have significantly impacted Macau's VIP-room system as well as their operations. Cost and risk factors were much higher when dealing with Mainland customers relative to Hong Kong residents. Higher costs and risks, and subsequent lower profits, drove some junket operators out of the business. Some VIP promoters therefore were unable to find enough junket operators to supply customers. This consequently drove some VIP promoters to give up their contracts.

V. Operations

Based on the terminology introduced above, this section describes how the system runs, i.e. what kinds of transactions the four actors make over the three elements. Chart 1 describes thirteen transactions typically occurring among the four groups of people within the VIP-room contractual system. The thicker lines represent credit transactions. By understanding this chart, one can get a clearer perspective about how the system works and the roles that every group plays. The mark "A" under each group except

CASINO implies there are numerous individuals within each group; however, they are dealing with only one casino.

CHART 1
TRANSACTION FLOW OF VIP-ROOM CONTRACTUAL SYSTEM



Transaction 1: The VIP promoter puts a deposit into the casino's account. This is the precondition for the entire system to continue. It ensures that the casino will bear no credit risk, and provides a pool from which the VIP promoter can draw.

Transaction 2: The casino provides dead chips to the VIP promoter.

Transaction 3: The VIP promoter lends dead chips to the Junket operator.

Transaction 4: The Junket operator lends dead chips, just borrowed from the VIP promoter, to his customer, the VIP player.

Transaction 5: Using the borrowed dead chips, the VIP player starts gambling with the casino.

Transaction 6: The VIP player accumulates regular chips while “washing” his dead chips (playing with the dead chips until they are lost) through transaction 5.

Transaction 7: The junket operator starts dead chip dealing (i.e. “chip rolling”.) In order to stop the player from using the just-won regular chips in his wagers, the junket operator—standing by the player—keeps exchanging the player’s regular chips with dead chips he has on hand at a one-for-one price. The double arrow indicates the exchange of regular chips going to the junket operator for dead chips going to the player.

Transaction 8: The junket operator sells the regular chips that he just “bought” from his customer through transaction 7 to the VIP promoter and receives the equivalent amount in dead chips plus commission.

Transaction 9: The VIP promoter sells the regular chips that he just “bought” from his junket operator through transaction 8 to the casino for the equivalent amount of dead chips plus commission.

Transaction 10: Using the dead chips that he just “bought” from his junket operator in transaction 7, the player continues to bet until he once again exhausts all of his dead chips. The cycle continues until the player decides to quit, or when the player has lost all of his playing chips.

Transaction 11: The junket operator starts to collect debt from the customer—which had been created by transaction 4—regardless of whether the customer has won or lost.

Transaction 12: The junket operator pays his debt—which was created by transaction 3—to the VIP promoter.

Transaction 13: The VIP promoter repays the original chip draw—which was created by transaction 2—to the casino.

These thirteen transactions provide a general description of the design of the system. In practice, there will be variations. For example, when a player wins and leaves the VIP room with his winnings, he would typically pay off his debt right away and give a large tip to his junket operator. Also, as noted earlier, when the contractual relation calls for it, the casino will pay an over-sale bonus to the VIP promoter, the casino and the contractor will divide residual revenue, or other contractual elements will come into play.

VI. Economics

Since the establishment of the VIP-room contractual system in the mid-1980s, it has played a major role in the growth of Macau's casino industry. A significant amount of total gaming revenues—averaging about 70% since 2000—is generated by VIP rooms. (See Table 1.) Chart 2 depicts an input-output flow of Macau's casino revenues, demonstrating the role of the VIP room sector in Macau.

The percentages stated in Chart 2 are approximate. Two figures whose values significantly affect the viability of the system are the percentage of gross casino revenue coming from VIP rooms, and the costs accruing to VIP promoters, junket operators, and their agents. According to performance figures reported by SJM in 2005, its gross gaming revenue from casinos was 34.4 billion MOP (US\$4.3 billion) and its VIP marketing costs were 13.9 billion MOP (US\$1.74 billion), accounting for 40.4% of its gross casino revenue. Moreover, this percentage compares marketing costs incurred only within the VIP room sector whereas gross gaming revenues also include the revenue from the mass market sector. If one were able to isolate the ratio of VIP marketing cost to VIP sector revenue, then the percentage would likely be much higher. For example, if 75% of SJM's 2005 gaming revenues were from VIP rooms and 95% of their marketing costs were from VIP rooms, then the ratio of VIP marketing cost to VIP sector revenue would be well over 50%.

Thus, in terms of casino win and government taxes paid, the VIP room sector has played the dominant role in Macau's casino industry in recent years. However, in terms of casino profit, compared to the mass market sector, it is not nearly as significant a contributor, because more than 50% of VIP room casino revenues are taken up by payments to VIP promoters and their representatives. But the mass market segment—as of 2006, at least—does not have these costs.

Table 2 includes statistical data of the three casino companies that were operating in Macau in 2004 and 2005. The Sands Macau was the only one that was concentrating predominantly on the mass market business in that period, whereas the numerous casinos of SJM as well as the Galaxy Waldo Casino were primarily VIP operations with only

limited mass market casino play. The stronger profit rates of Sands Macau in comparison to SJM, as well as the negative or negligibly profitable status of the Galaxy Waldo Casino, is a reflection of the challenges presented with the high marketing costs and increasing competition for VIP room play.

Table 2
Performance of Macau's Three Casino Companies, 2004-2005²³
(MOP millions)

	Gross Casino Revenue 2004	Gross Casino Revenue 2005	Profit 2004	Profit 2005	Profit as % of Revenue 2004	Profit as % of Revenue 2005
SJM	35,240	34,409	4,044	5,560	11.50%	16.10%
Sands	3,112	7,706	952	2,372	29.33%	29.60%
Galaxy	3,088	3,988	-99	6.2	-3.21%	0.15%

It should also be noted from Table 2 that SJM's gross casino revenue decreased 2.3% from 2004 to 2005, but its profits increased 37.5% in the same period. This implies that SJM was making more money by (probably) doing more mass market business and reducing its dependence on the VIP room sector.

For Macau in total, casino gross gaming revenues grew by 11.3% between 2004 and 2005, but this was composed of a 48.2% growth in mass market gaming revenues and a 3.1% decrease in VIP room revenues. This inter-sectoral shift was a reflection of the former monopolist (SJM) and the other casino companies (Galaxy and Las Vegas Sands, as well as Landmark and Emperor²⁴) responding to the relative profitability of the two sectors, as well as players choosing to pursue mass market opportunities rather than getting involved with the VIP room system. This occurred because of more attractive terms offered by casino companies in the form of traditional "complementaries" which are more representative of Las Vegas casino operations than had previously been seen in

²³ Data are collected from the casino firms' annual reports promulgated by the web page of Macau government, <http://www.imprensa.macao.gov.mo/cn/>

²⁴ Landmark and Emperor are both private companies that were operating casinos in Macau in 2006 under the SJM license, with undisclosed contractual relationships with SJM. Such casino firms are independent legal enterprises who are "renting" a casino license from a concessionaire. The typical license renting condition is a "4025 room," as described in footnote 9, above.

Macau, as well as more attractive facilities. As competition increases with new casino openings in Macau in 2006 and beyond, one can expect to see greater marketing efforts to attract the mass market segment.

Prior to 2000, the casinos of Macau suffered from an obvious absence of capital investment and showed other physical and operational characteristics that reflected the fact that there had been a monopoly concession over gambling in place for the past four decades. The flagship casino hotel, the Lisboa, was built in the early 1970s, and in comparison to casinos elsewhere in the world, the amount and extent of maintenance and reinvestment in the subsequent decades was quite limited. Other casinos operated by the concessionaire STDM ranged in appearance from squalid to unexceptional, and Macau's entire casino industry left the impression of being uninterested in developing any mass market business beyond that which was already coming through the door. Some practices in the main casino rooms, such as dealers taking "tea money"²⁵ and the general attitude of staff toward customers also reflected the lack of a customer-oriented culture. There was a near-absence of slot machines in the STDM casinos and those that were present were dated and came from a limited number of manufacturers.²⁶ The miniscule market share for slot machines in Macau was at least partly related to the concessionaire's lack of interest in providing gaming machines of any quality for their customers. Finally, Macau's casinos in the late 1990s suffered from a visible presence of loan sharks and prostitutes, and the casino industry was plagued with internecine battles among triads fighting for control of the lucrative VIP rooms.²⁷

In summary, Macau's casino operations generated strong margins from mass market gaming rooms because of a substantial demand for that segment of the business in spite of a lack of sales and marketing effort, whereas the VIP room contracts had much lower margins due to significant revenue sharing between the casino and the VIP

²⁵ Tea money is the term used to describe a form of mandatory tipping imposed by dealers. A small portion of a winning wager would be taken by the dealer and put into their tip pool without the consent of the player. Protests by players against this practice would not be met with satisfaction.

²⁶ A casual inspection by slot machines in the Casino Lisboa by one of the authors in 2001 indicated that the slot machines that were in operation came from either IGT or Sigma, and were vintage 1990 to 1993.

²⁷ See, for example, Diane Brady, "Mayhem in Macau: The joint is jumpin' at the Hotel Lisboa." *Wall Street Journal*, May 29, 1998, p. 1.

promoters and their agents. This profit margin discrepancy between the mass market and VIP room sectors had always existed since the VIP room contractual system was established, but with the emergence of competition in Macau, there occurred an apparent adjustment from VIP rooms towards the mass market sector not only with the new entrants but also with SJM. The question remains, why did this not occur sooner?

The concept of equilibrium is neither about total nor average but marginal. One could argue that, during the monopoly period, the inter-sector equilibrium was in place, insofar as the marginal profit of additional VIP sector investment would be similar to the marginal profit of comparable investments in the mass market sector. Thus, in comparison to mass market play, the much higher win per table figures for VIP room play were offset by various costs, including revenue sharing with VIP room contractors, resulting in lower profit margins accruing to the monopolist, leading to a balance between these two sectors.

In 2004, however, two events occurred that disturbed this equilibrium. SJM's gaming monopoly in Macau ended in May with the opening of the Sands Macau, and the so called "free individual travelers scheme" (FITS) was launched by Chinese central government.²⁸ These two factors created considerable dynamic for change to Macau's traditional VIP system as well as demand for mass market play. First, the entry of competing companies into the Macau market provided—arguably for the first time—some buyer power on the part of players to better negotiate the terms that would define their conditions for play. For mass market players, this implied that for the first time, they could "shop" more than one casino company for amenities, such as ambience and attractiveness of the casino, friendliness and agreeability of the dealer staff, complementaries offered by the casino, and better prices and terms on the games. As more and more new casinos are opened by the six concessionaires and sub-concessionaires²⁹ from 2006 onward, the extent of effort to capture market share among

²⁸ The Free Individual Travelers Scheme considerably relaxed visa restrictions on a city-by-city and province-by-province basis for Mainland Chinese citizens who wished to visit Hong Kong and/or Macau. The subsequent dramatic increase in Macau visitation by Mainland Chinese is directly attributable to this relaxation.

²⁹ The new gaming law had permitted three casino concessions, which were awarded to SJM, Wynn Resorts, and a joint venture between Las Vegas Sands and Galaxy. A subsequent split between Las Vegas Sands and Galaxy persuaded the Macau SAR government to issue an additional sub-concession to the Las Vegas Sands. They later allowed the other two concessionaires to sell off one sub-concession each. SJM

the mass market customer base will likely become a dominant characteristic of the Macau gaming industry with methods and strategies not unlike Las Vegas.

In 2006, Macau's gross casino revenue reached 55.0 billion MOP (\$6.9 billion), reflecting year over year growth of 23.0%. The mass market sector grew in that period by 33.7%, whereas the VIP sector grew by 16.6%. (Gaming machine revenues grew 64.4% in 2006, to capture a 3.6% market share, up from 2.7% in 2005.) The mass market segment is being driven by the combination of improved mass market gaming facilities and non-gaming attractions in Macau's new casinos, and continuing expansion of the Free Individual Travelers Scheme (FITS). As of 2006, one can argue that it is FITS which is driving Macau's mass market business and therefore the continuing rapid growth of the over-all gaming sector. However, the benefits from FITS for the concessionaires will be tempered by increased inter-casino competition, which will reduce profit margins from mass market play, as well as affect the profitability and viability of VIP room play as well.

A strong case can be made that the primary purpose behind the liberalization of gaming laws in Macau was to attract Foreign Direct Investment (FDI) and to stimulate the development of Macau's economy through its casino industry. It is highly likely that Macau's post-1999 Special Administrative Region (SAR) government was inspired by the success of Las Vegas and other casino centers throughout the world. In this respect, the outcome—driven significantly by the newly competitive environment in Macau—has been extremely favorable. As noted above, the absence of any substantial capital investment in Macau's casino industry over the previous three decades is also a commentary on the inherent complacency and lack of dynamic that can occur with monopoly.

However, the implications for the existing and historic structure of Macau's traditional VIP room subculture may not be quite so positive. As noted earlier, a typical VIP-room contract includes five major components: minimum dead ship sales, rate of dead chip commission, dead chip over-sales reward, residual revenue share, and required

sold theirs for about \$300 million in 2005 to a partnership between MGM Mirage and Pansy Ho (daughter of Stanley Ho, the primary individual behind SJM), and Wynn Resorts sold its sub-concession in 2006 for about \$900 million to a partnership between the Australian company PBL and Melco, a Macau based company controlled by Lawrence Ho, son of Stanley Ho.

amount of deposit. Under monopoly, these five components were probably viewed as management tools of the concessionaire for extracting economic rents (profit) from VIP room operations. However, with the emergence of new competition, they have increasingly become strategic tools among operators for attracting VIP customers by way of VIP promoters. Each of these components can be maneuvered to capture VIP business by creating incentives for VIP promoters to choose one casino operator over another.

Competition typically has as the benefit of improving price and other terms of offering received by customers. However, it also has the effect of reducing the buyer power of casinos relative to VIP promoters. Furthermore, more desirable (i.e. licensable) VIP promoters might acquire considerably greater seller power.³⁰ This creates an environment where the capture of economic rents shifts away from casinos and increasingly to (at least a sub-set of) VIP promoters.

In order for Macau casinos to capture or retain VIP business under a competitive environment, higher dead chip commission rates could be offered to attract more desirable VIP promoters; the required amounts of deposit for VIP room promoters could be reduced; the VIP promoters' share of residual revenue could be increased; the minimum dead chip sales could be reduced; and/or the over-sales rewards could be enhanced. Thus, clear beneficiaries of gaming liberalization are not only the players but also those intermediaries who can take advantage of both competition and their relative attractiveness as agents.

As is often the case with markets that become increasingly competitive, economic rents (excess profits) shrink even though total revenues, tax receipts, market efficiency, consumer surplus, and various other aggregate measures increase. VIP sector competition drives marketing costs higher and reduces overall margins. Shifting relative power of casinos and VIP promoters redistributes excess profits that are still earned. Interestingly the Macau SAR government actually increased the percentage tax rate on gaming—as part of the gaming liberalization Act—from 36% to 39 % of gross gaming revenues, and the rates applied equally to both VIP room gaming revenues and mass market gaming revenues. Because of the lower profit margins associated with the VIP

³⁰ VIP promoters are more desirable if they are able to bring in greater volume of VIP room play, and (especially for the American and Australian concessionaires) if they are licensable or otherwise acceptable in other gaming jurisdictions.

sector, at least in the early (2004-2006) period following liberalization, those casinos that were mainly doing VIP business performed well below those primarily catering to the VIP sector.³¹

The link between lower VIP room margins for Macau's casinos and higher tax rates may put increasing pressure on the government of Macau to lower percentage gaming tax rates overall, or at least for VIP room gaming revenues. Besides the reductions in profit margins brought about by greater competition, the fact that four (and perhaps five) of the six concessionaires or sub-concessionaires have (or might have) significant premium player gaming operations in other jurisdictions with significantly lower percentage gaming taxes will encourage them to redirect premium play to their other properties if possible, in order to retain a higher volume of after-tax win.³² The high tax rate in Macau also creates an environment where VIP promoters and even operators may be encouraged to evade taxes by contracting with players at terms different than those officially reported in the casinos.³³

For the primary VIP room contract described above, the following illustration uses 2005 data to provide a simple analysis for following revenue distributions among the various entities. The following 2006 data are the basis for the statistical analysis:

VIP sector gross gaming revenues: 32,668 million MOP

The ratio of Casino win to dead chip sales is 2.8%

Macau has about 80 VIP rooms

The comprehensive gaming tax rate is about 40%

On average, a VIP room's minimum dead chip sales are about 500 million MOP per month.

³¹ This could be seen in the comparative performance of the Las Vegas Sands (running the mass market Sands Macau) and Galaxy (running the VIP room Waldo) in 2005 and 2006. Las Vegas Sands generated margins of XX%, whereas Galaxy's profit margins were X%. Source:

³² For example, Singapore (Las Vegas Sands, Genting) passed its Gaming Act in 2005 with a 15% tax rate, accompanied by an even lower 5% rate on "premium play." (It should be noted that in early 2007, Genting offered to sell a portion of its Singapore casino to SJM in return of a casino in Macau under the SJM license. See "Government quizzes Genting over its tie-up with Stanley Ho," Straits Times, January 25, 2007, p. 1.) The effective tax rate in Victoria, Australia (Crown) for Gross Gaming Revenues in VIP rooms is 10%, and in Las Vegas (Wynn, Las Vegas Sands, MGM), the tax rate is 6.75%.

³³ For example, it is asserted that some VIP promoters contract to bring customers to a Macau casino, where the outcome of their play will be recorded in Hong Kong dollars or Macau patacas. However, when winnings or losses are settled up between customer and promoter outside of Macau, the settlement might be made in U.S., Australian, or Singapore dollars. In Macau, this tactic is called "on-table-under-table."

Then:

Total dead chip sales = 32,668 MOP million / 2.8% = 1,116,714 MOP million

Dead chip commissions = 1,116,714 MOP million * 0.7% = 8,167 MOP million

This assumes dead chip commissions are paid at the traditional rate of 0.7%.

Reward for dead chip over-sales = $(1,116,714 - 500 * 80 * 12) * 0.15\% = 955$ MOP million

This assumes the reward for dead chip sales over the minimum guarantee are rewarded at 0.15% from the casino to the VIP promoters.

Taxes = 32,668 MOP million * 40% = 13,067 MOP million

Remaining revenues are then divided between the VIP promoter and the casino at a 30/70 split, so:

- For the VIP promoter, total revenues would be

$(8,167 + 955 + (32,668 - 8,167 - 955 - 13,067) * 30\%) = 12,266$ MOP million.

From this amount, the promoters must support the costs of junket operator networks, marketing costs for players, uncollectible debt, and various other costs of doing business. Since this has been a relatively competitive market for Macau for some time, it might be expected that costs of doing business among VIP promoters have pushed profit margins toward “normal profit” levels.

- The casino total revenues after taxes and revenue shares with promoters would be

$(32,668 - 8,167 - 955 - 13,067) * 70\% = 7,335$ MOP million

However, this is not yet casino profit. Operational costs for VIP rooms (labor, supplies, maintenance, accounting, depreciation, etc.) are the obligation of the casino.

Thus, profit margins for the casino from the VIP business are significantly below the gaming revenues earned, and a high proportion are absorbed into either taxes or payments to VIP promoters who in turn incur marketing costs in delivering and servicing customers to the casinos.

Under the “4025 room” variation with a 60%/40% revenue split between the casino and VIP promoter, the example would work as follows:

VIP sector gross gaming revenues: 32,668 million MOP

Revenue share to VIP promoters: $40\% * 32,668 = 13,067$ million MOP

Revenue share to casinos: $60\% * 32,668 = 19,600$ million MOP

Taxes = 32,668 MOP million*40% = 13,067 MOP million

After tax revenues for casino = (19,600 – 13,067) = 6,533 MOP million

From this amount, the casino must pay for labor, maintenance, accounting, depreciation, and any other expenses related to the VIP rooms. (Note the similarity of outcomes between the traditional revenue sharing scheme and the split under the “4025 room” arrangement.)

If increased competition among Macau’s casinos leads to contractual terms more favorable for VIP promoters relative to casinos, then the profit margins enjoyed by casinos from their VIP room operations will be pushed further downward. Furthermore, to the extent that VIP promoters operate in competitive environments, a high proportion of their revenues will be taken up in costs of generating customers and/or in an increase in the number of VIP promoters in the market. Finally, reductions in tax rates will not permit permanently higher returns on invested capital, as long as competition continues to be the norm in Macau. However, such reductions might prevent a flight of premium play to competing jurisdictions with lower tax rates that have casinos associated with Macau’s concessionaires and sub-concessionaires.

V. Additional Observations

As increasing affluence in China and other parts of Asia, along with the Free Independent Travelers Scheme (FITS) and improved regional air travel send more and more mass market and VIP customers to Macau, the ability of the newly competitive Macau market to take full advantage of both segments may be affected by other considerations. In particular, there will be constraints from the limited available land in Macau, from the relatively small Macau labor force that is presently eligible to work within the casinos, from limits on infrastructure and housing for needed labor, and from ongoing competition both within Macau and from the South-east Asian region. The fact that the supply of casino facilities in Macau is scheduled to grow dramatically between 2006 and 2011 suggests there will be very interesting and challenging times ahead for gaming operators as well as Macau SAR government planners. To better predict the

future of Macau's casino industry, it is useful to look at its geographic and cultural characteristics.

1. Why was the VIP-room contractual system born in Macau?

Macau is a small and confined peninsula, with fewer than 500,000 residents on its 28 square kilometer territory. However, it has almost all the governmental branches that an independent country would have, including two military bases and three Central Government office buildings. (In 2005, Macau was listed as a city of "world cultural heritage" by the United Nations, which inserts many constructional restrictions on construction in Macau in order to protect its cultural relics and view spots.³⁴) Macau is already a crowded city, but as new casino hotel resorts open, it will need to import a large amount of foreign labor and arrange for housing and infrastructure either in Macau or in neighboring Guangdong Province in Mainland China to accommodate them. Furthermore, if Macau's casino industry becomes increasingly dependent upon mass market customers, then it will need additional land for non-gaming tourism facilities to attract, contain and entertain the tourists. Will this be feasible?³⁵

Macau's traditional VIP-room structure is consistent with its geographic constraints. VIP customers are not especially interested in non-gaming tourism amenities, such as Disney Hong Kong or Universal Studios Singapore, but are rather very gaming-centric in their preferences. Furthermore, they generate considerable expected win per visitor for the casinos, and thus put less strain on the labor, land, and infrastructure needs than do mass market customers. In short, because VIP customers are high rollers whereas most mass market customers are comparatively low rollers, the VIP sector places considerably lower demands on resources per player and per unit of revenue generated than do mass market customers.

If geographic conditions explain the necessity, then cultural conditions explain why Macau has built up such an unusual and arguably eccentric special casino system.

³⁴ In 2007, several Macau civic organizations protested an already-begun construction project of a new office building of the Central Government that would have blocked the view of East Oceanview Hill. As a result, the Central Government was forced to lower the height of the building.

³⁵ For several years following the hand-over in 1999, Macau leaders lobbied the SAR Government to obtain or "lease" neighboring Hengqin island, which is almost three times larger than Macau's territory, from Mainland China. However, these efforts were unsuccessful.

Ethnically and culturally, the people of Macau are Chinese no matter what kind of political status they hold. Chinese culture has three important elements that have been important in contributing to the VIP system.

First, Chinese like doing business based on personal relationships rather than on the prevailing legal system. (This phenomenon can even be found in Chinese American communities.) Ethnic Chinese may live within the same legal environment as other non-Chinese citizens but behave differently due to cultural differences. For example, in Macau, a VIP promoter could have several dozen employees working for him with no employment contract, no staff cards, and no official payroll. The VIP promoter establishes his network and informal contractual relationships based purely on personal acquaintance and business needs.

Second, Chinese place significant importance on their prestige or “face” when interacting with others. This can function a self-restraining limit on their own behavior. For example, at present China is trying to copy many things from the Western world, economically, sociologically, culturally, and even, to some extent, politically. The official slogan in China is “modernization” or “connecting to the international track.” But in many respects, Chinese will not emulate Americans or other Westerners. For example, popular culture audience participation media shows such as *American Idol*, *Jerry Springer*, or *The Bachelor* would not likely be successful in China because there would not be enough guests willing to go on national TV and sacrifice their prestige or “face” in order to entertain others or to make them laugh. In a similar vein, when a gambler has borrowed money from a junket operator or VIP promoter and refuses to pay it back, then the junket operator or promoter can threaten to reveal him to his social circle and cause him to lose face. In Chinese culture, this is a substantial threat that works in most cases.

Third, related to the two cultural elements mentioned above, Chinese place high demands on confidentiality. When they gamble, they do not want others to know who they are, and they are reluctant to leave any written record about what they have done. In this manner, the traditional VIP-room contractual system provides just such an anonymous environment. When a VIP player borrows dead chips from his representative, he gets the money without having to fill out any application forms and providing personal information, as would be the case when borrowing money in a Western casino.

These three cultural factors are not only important in explaining why the VIP system was invented in Macau, but they also provide insights into how other systems, transplanted from other jurisdictions and other cultures, may or may not work in a Chinese environment. If companies or regulators want to change the style of business in Macau's casino industry, they need to address the geographic and cultural conditions first. Since these conditions are not easily changeable, one can conclude that Macau's casino industry will have to retain some variant of the traditional VIP business as it will prove difficult for (some) casinos to survive only on the mass market custom.

2. Can Outsiders participate in the VIP business in Macau?

This question can be divided into two sub-questions: First, can foreign (non-Chinese) casinos effectively participate in the VIP business following Macau's traditional ways? Second, can foreign casinos develop their own VIP business in Macau using techniques developed elsewhere, such as Nevada or Australia?

Because the VIP-room contractual system is run primarily through a personal acquaintance network, in order to develop VIP business in a Macau manner, foreign casinos would have to construct similar personal networks. But there is an important personnel principle that presently operates within Macau's VIP system: the VIP promoters hire their junket operators from the same cities and provinces from where their customers emanate. This principle suggests, for example, that Hong Kong junket operators would be ineffective in dealing with Mainland China customers. In a similar vein, VIP promoters would have to come from the same region as the junket operators.

Thus, the system by itself cannot organize the personal acquaintance network and make the system work. It has to rely on a personal network built around a core of customers from a specific region.

Therefore, as Mainland Chinese customers have taken the place of Hong Kong gamblers and have become the dominant market in the past few years, this has signaled a personnel switch throughout the VIP system as the positions of VIP promoters and junket operators have increasingly been filled by Mainlanders. This personnel switch has brought some substantial changes within Macau's VIP system. For example, when a

Mainland VIP promoter, say from Guangzhou City, has contracted a VIP room, he would usually bring his own customer base from among his acquaintances in his home city. After he has exhausted the financial capacity and willingness to play among his customer base by running the room for a period of, say, a year, he would then “sell” or “subcontract” his VIP room to another man from another Mainland city, without necessarily letting the casino know. The new VIP promoter would keep running the VIP room using his home city resources until they were exhausted, and then he would once again hand the room over to another promoter without necessarily letting the casino know.

As a result, in Macau’s traditional VIP system, many of the names on the contract documents may not be the names of the real promoters and operators. Furthermore, the casino may not really care as long as the system continues to make money, and as long as the regulator does not complain about the lack of documentation.

This kind of practice makes it more complicated and difficult for foreign casinos to practice cultural adaptation. It is hard to believe foreigners could accept this kind of situation, either from an internal audit context, or with the knowledge that such practices may be unacceptable to their regulators in other jurisdictions. Furthermore, it may be virtually impossible for Westerners to organize effective personal networks on their own in this manner inside Mainland China.

If outsiders cannot do VIP business in a Macau way, can they do it in another “transplanted” way?

There is another cultural conflict that may come into play. Though Macau’s traditional VIP system runs on a system of personal acquaintances, the typical means of conducting VIP business in Las Vegas or Australia is based on law and regulation. The main problem in adapting such systems in Macau is that a high proportion of Chinese gamblers have substantial demands for personal confidentiality and anonymity in the casino. Most Chinese premium players would not accept divulging the information demanded in the paperwork now required (by regulators) in Nevada-style casinos; they would not want to leave an audit trail of their gambling patterns. Most of the time, this sensitivity regarding confidentiality is not rational but rather cultural. The challenge is that Chinese gamblers will resist paperwork, yet without paperwork the foreign casinos will be constrained in doing business in a manner satisfactory to their regulators.

3. Can Macau's casinos go to a specialization?

If foreign casino operators cannot conduct their VIP business either by traditional Macau standards or by the techniques that they presently follow in their home jurisdictions, would it be possible for foreign operators in Macau's casino industry to develop a hybrid approach to the VIP business that is legal and acceptable from a regulatory perspective and yet still culturally compatible to a substantial proportion of VIP customers? Alternatively, if that cannot be accomplished, will Macau's casinos evolve into a segmentation where some casinos cater only or predominantly to VIP business, leaving foreign operations to mainly conduct mass market business?

With respect to an emerging hybrid—where casino companies would adhere to broad legal and socially responsible principles demanded by “international standards of gaming regulation,” while at the same time establishing culturally acceptable relationships with VIP customers and their representatives—this will depend largely on the actions and attitudes of regulators in Macau and abroad. From Macau's perspective, there is an understanding of the realities of the VIP business as it has been historically and as it is evolving. An informal goal of Macau's regulators would be to achieve a level of acceptance within the global regulatory community that would be seen as meeting or exceeding international regulatory standards. However, they would want to achieve this without jeopardizing the revenue flows that come from Macau's VIP rooms.

The success of Macau regulation would likely depend on the extent of competence it can demonstrate in meeting the primary concerns of other jurisdictions and other regulatory bodies. Among such major concerns would be to assure that the Macau casino industry operates within its own laws and regulations and avoids serious scandal; that criminal organizations or practices do not become embedded or endemic in the Macau casino industry; that foreign companies with Macau gaming operations are not implicated in serious scandals that could affect their reputations in their home jurisdictions; and that Macau gaming regulation is consistent with broad international objectives for transcendent issues such as money laundering and possible links to international organized crime cartels and to terrorism.

Generally speaking, casino industries in many countries have striven for legitimacy and domestic acceptance over the years, and lawmakers and regulators have had serious concerns with events or circumstances that push the industry's reputation in other directions. Given the rather sordid recent history of Macau prior to 1999, many foreign jurisdictions probably remain skeptical of Macau's ability to be fully successful in this regard. However, the apparent economic and regulatory success of gaming in Macau through 2006 suggests a favorable outcome. If the regulatory structure of Macau is ultimately deemed acceptable by international reputation, then other jurisdictions will be less likely to impose their own standards and values in evaluating Macau casinos that are abiding by Macau regulation and law, and will be more willing to grant credibility to Macau's regulatory practices.

On the other hand, if such a hybrid does not emerge, then the Macau casino business will likely evolve into two camps: those casinos that have no real reason to adhere to international standards of regulatory practice, and those who must adhere. In the first camp would be casino companies licensed only in Macau; in 2007, that would include SJM and Galaxy. The second camp would include those companies that must answer to regulators elsewhere; in 2007, that includes Wynn, MGM, Las Vegas Sands, and PBL. If such a bifurcation does emerge, then the most interesting trade-off in the intermediate and long term would be: Could the foreign casino companies enhance the gaming and non-gaming offerings to such an extent that the primary VIP customer base in Macau would become, over time, more "Western," and therefore willing to sacrifice their preferences for personal networks, anonymity and confidentiality for the pleasures that Las Vegas and Australian operators have become so professional in offering? Clearly, the foreign companies, as reflected in the capital investments they have committed into the Macau market as of 2007 believe that a favorable outcome of one type or the other will indeed emerge.

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