# Review of AFSCME's Lottery Counterproposal

January 14, 2013

## Counterproposal Overview

**AFSCME's Lottery counterproposal has received careful review from the commonwealth in accordance with the Article 43 process.**

- AFSCME's counterproposal differs from Camelot's binding-bid in a number of important respects:

1. Financial Security: Camelot's proposal is backed by at least $200 million in collateral while AFSCME proposes a significant increase in the lottery reserve fund through possibly withholding dollars from senior programs.

2. Aspirational Targets vs. Annual Profit Commitments (APCs): AFSCME's 5-year profit target is not a guarantee but rather is an uncertain projection for the lottery. The Private Management Agreement offers aggressive but realistic APCs with upside potential and downside protection over a 20 year period.

3. Quantitative Analysis: AFSCME's counterproposal lacks quantitative analysis to support the profit claims and instead lists 33 business strategies with minimal research and calls for the creation of a business plan to execute their goals. Camelot has already provided the commonwealth with a detailed, 200+ page business plan complete with financial analysis, in-depth marketing strategy, and thorough third-party research.

4. Business Strategy: A number of the business strategies proposed by AFSCME are not in line with best practice as evidenced by other top performing lotteries. Camelot's bid represents the cumulative knowledge of global best practices for lottery operation and management.

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# Comparison of Camelot and AFSCME Proposals

| Metric | Camelot's Binding-Bid (received 11/16/12) | AFSCME Counterproposal (received 1/8/13) |
|---|---|---|
| **Financial Security** | – $150 million cash plus $50 million Letter of Credit (LOC) renewable annually<br>– Such amount of the LOC shall be maintained during the Term (and any Disentanglement Services Period) and increased annually based on the Consumer Price Index | – No financial security upfront<br>– Proposal to create a $500 million reserve over time (instead of spending that money on senior programs) |
| **Operations** | – Service-Level Agreements (SLAs) ensure highest standard for performance; if private manager fails to meet required SLAs, this will result in financial penalties for the manager<br>– For example, if the average transaction time for a single on-line Lottery wager transaction exceeds 4 seconds during each sales day, the commonwealth can assess as liquidated damages for degraded performance $5,000 per day<br>– Annual Business Plan, subject to commonwealth pre-approval<br>– 200+ page comprehensive strategy | – No performance standards discussed<br>– Admission that no formal business plan exists today<br>– Claim to surpass 15,000 retailers by 2023, which is viewed as highly improbable based on past experience<br>– Refer to the Lottery's current rollout approach of a loyalty program as "not acceptable" |
| **Social Responsibility** | – Camelot is internationally recognized for selling lottery tickets in a socially-responsibly way<br>– 2012 World Lottery Association award winner | – No detailed discussion of social responsibility<br>– Some mention of younger demographics and age verification on internet |

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# Camelot’s Financial Security for Senior Programs

**AFSCME mischaracterized the Camelot binding-bid in a number of respects, especially on the issue of financial security.**

- AFSCME states numerous times that the maximum guarantee available to the commonwealth is less than $200 million. ***This is incorrect***. Camelot’s APCs are backed by a $200 million financial guarantee across multiple years with a 5% cap in any one year.
- This $200 million in collateral is <u>new money</u> to back profit commitments that does not exist today.

| Funding Protection | Lottery PMA |
|---|---|
| $150 million in Upfront Cash Collateral | If a private manager fails to meet annual profit commitments, the commonwealth will draw shortfall payments down from the $150 million cash collateral provided by the manager to secure its performance. |
| $50 million Letter of Credit (LOC) | In addition to the $150 million cash collateral, Camelot is providing a $50 million LOC that <u>must be replenished annually and grows with inflation.</u> |
| $200 million+ Funding Protection (with replenishable LOC) | Thus, Camelot is offering over $200 million in protection for senior program funding that is not available today. |

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# AFSCME's Counterproposal Lacks Operational Details

## AFSCME's operational proposals lack sufficient detail and supporting facts for thorough evaluation.

| | |
|---|---|
| **Keno** | • The keno expansion offers no specifics on execution best practices or strategies to ensure responsible play. |
| **Loyalty** | • Suggestions for strengthening the loyalty program are not fully explained, although AFSCME does criticize the "slow rollout approach" under current Lottery management. |
| **Internet** | • Proposal to prohibit the sale of terminal-based games - such as The Daily Number, Powerball, and MegaMillions – via the internet.<br>• Proposal to only permit internet purchases via token cards.<br>• Such restrictions are contrary to the world's most successful interactive lotteries and have been problematic in other jurisdictions.<br>• Camelot has specifically outlined in its proposal, based on its global management experience, how to independently and responsibly grow both retail and internet sales (i.e., no cannibalization). |
| **Retailers** | • The dramatic proposed expansion of the retailer network (to 15,000 by 2023) is highly improbable based on past experience and not justified on a return on investment (ROI) basis. |

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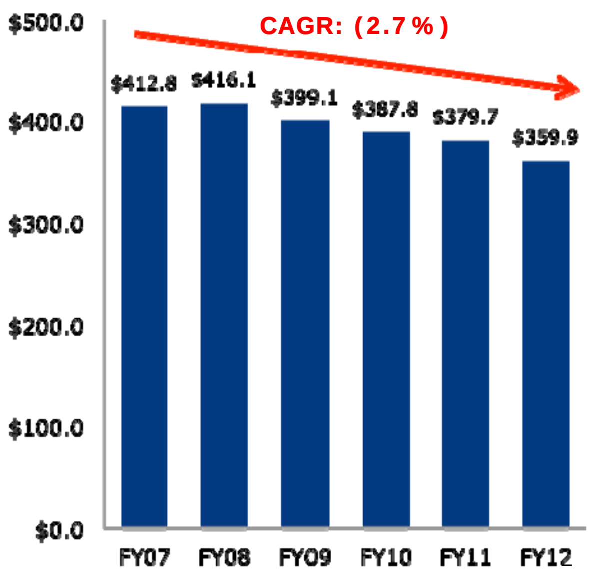
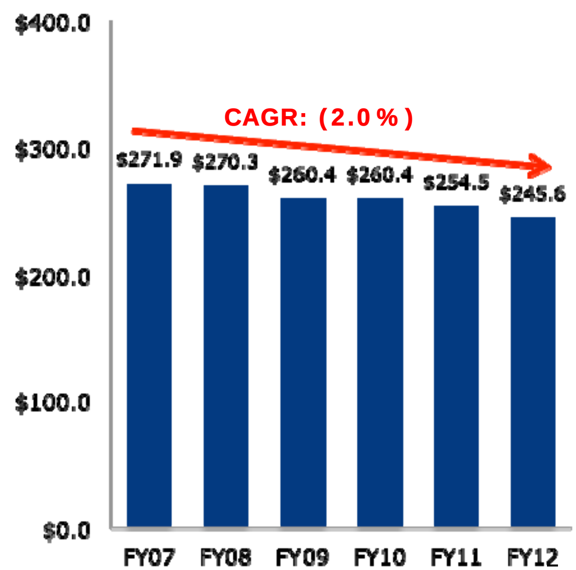
## AFSCME Reinforced Terminal-Based Game Concerns

**AFSCME did not offer a plan to reinvigorate declining terminal-based games, which are the Lottery's highest margin product.**

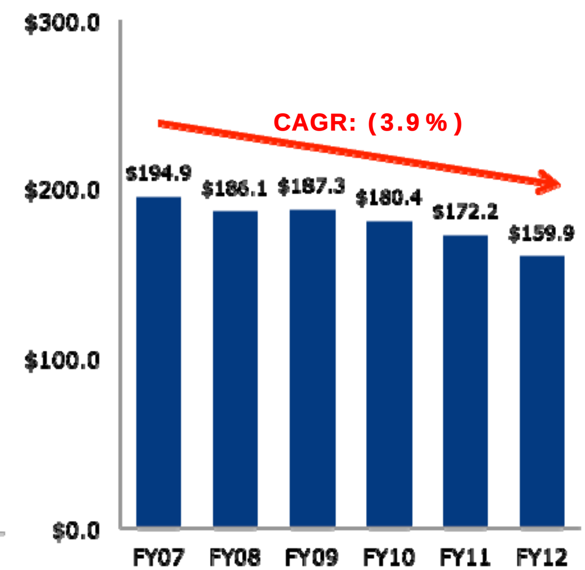
The Daily Number




Big 4




Cash 5




($ in millions)

**In FY07, The Daily Number, Big 4 and Cash 5 cumulatively generated $880mm in sales. In FY12, these three games generated $765mm (a decline of $114mm)**

Source: Lottery Annual Reports

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# AFSCME Mischaracterized the Treatment of Employees

**AFSCME's analysis of potential layoffs under the PMA is entirely inaccurate. Camelot plans to grow the number of employees.**

- The AFSCME analysis describes potential layoffs, furloughs and downgrades. This is misleading. Camelot believes retention of the existing lottery team and investment in further headcount are essential to delivery of its business plan and has gone on record to this effect.

- Camelot does not seek growth through attrition but rather expects to increase the number of employees and will rely on an expanded sales force to achieve success.

- The AFSCME counterproposal calls for maintaining the existing Lottery workforce but does not explicitly call for expanding Lottery employment.

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## Addendum: Fact Check

No. 1: "The total amount of the proposed fund is $200 million" (p4).

- The $50 million Letter of Credit (LOC), which grows with CPI, is an annual – not a one time – obligation.

No. 2: "The privatization would lead to the loss or reassignment of work for 258 employees…over the course of a six month transition" (p10).

- Camelot has expressed an interest in hiring all existing Lottery employees and expects to increase the number of employees in the state.
- The transition period is twelve, not six, months.

No. 3: "If it is predictability in budgeting the commonwealth seeks, it should examine the sale projection process it uses…" (p15).

- The Lottery, which is comprised of AFSCME employees, developed the sales projection process. It is curious to criticize the sales process for which AFSCME is currently involved and responsible.

No. 4: "Camelot's projections are premised on a statutory cut in the percentage of sales that must go to benefit seniors from 30% to 27%... This amounts to $1.244 billion in lost revenues to fund senior programs…" (p4).

- This is fundamentally false. The commonwealth asked for bids under both current law and sustained 27% relief for the precise reason in case there is a change of law. Camelot's bid under a 27% scenario offers the commonwealth $810 million more of funding to senior programs than current law.

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## Addendum: Fact Check

No. 5: "The profit-taking of a private manager…would further stress the fiscal health of the State Lottery Fund" (p27).

- This statement is false since Camelot will only earn incentive compensation if it exceeds the APCs, which have been found to be $3.0-$4.5 billion higher than Lottery Budget projections over twenty years. The APCs represent a floor for profits to the commonwealth as Camelot must exceed these commitments to make any money, and the commonwealth and Camelot share in any upside.

No. 6: "If the General Assembly fails to lower the statutory minimum payment to senior programs from 30% to 27%, it will constitute an adverse action" (p29).

- This is simply not true. The commonwealth asked for APCs both under current law and a 27% scenario. Only if there is a legislative measure to require a 30% return prior to June 30, 2015 (or more than a 30% return after July 1, 2015) will it constitute an adverse action under the PMA.

No. 7: "Pennsylvania Lottery sales on a yearly basis are predictable" (p30).

- Even if sales were deemed to be predictable, such fact is irrelevant since what matters for senior programs is how much profit the Lottery generates. The fact that the Lottery experienced negative profit growth in eight of the last twenty years indicates volatility. Also, over the past twenty years, there were two instances in which Lottery's profit declined in 3 consecutive years.

No. 8: The public to private comparison is an "apples-to-screwdrivers" comparison (p41).

- The report fails to consider that the Office of Budget has conducted a comprehensive "apples-to-apples" analysis which accounts for the Lottery also pursuing new value drivers such as keno and internet sales.

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