A WIN-WIN FOR PENNSYLVANIA:

Continued Public Management and Operation of the Pennsylvania Lottery

Prepared by:
AFSCME Council 13
January 8, 2013

EXECUTIVE SUMMARY

In November 2012, the Corbett Administration notified AFSCME that it was exploring a Private Management Agreement (PMA) for the Pennsylvania Lottery to "provide more reliable and predictable revenue to ensure the continued strength and viability of programs supporting older Pennsylvanians." The Administration committed that prior to executing a PMA, it would "verify that the private manager's annual profit commitments are significantly higher than the profit levels the Pennsylvania Lottery could achieve on its own, in order to justify the agreement and the incentive payments to the manager."[1]

Over the past six weeks AFSCME has reviewed thousands of pages of public documents as well as documents provided by the Commonwealth in response to a request for information and has concluded that the privatization of the Lottery will not meet the Administration's goals of providing "significantly higher" profit levels than the Pennsylvania Lottery could achieve on its own. The Commonwealth has failed to demonstrate that privatization of the Lottery will result in "improved delivery of services" and therefore, the work should not be contracted. Rather, the Commonwealth should adopt the thoughtful and reasonable alternative measures that AFSCME recommends in its full report. AFSCME believes that with the adoption of these alternatives, the Commonwealth can achieve the same desired goals without layoffs, downgrades, or the reassignment of bargaining unit work to private contracts.

This is a summary of AFSCME's research, findings, and written proposals for enhancing the services and funding delivered through public operation of the Pennsylvania Lottery. For full explanations and data, as well as all of AFSCME's written alternatives, please see the full report at www.afscme13.org.

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[1] Pennsylvania Lottery Private Management Agreement Summary of Terms and Conditions. Commonwealth of Pennsylvania, Office of the Governor

Element 1: The Fiscal Guarantee

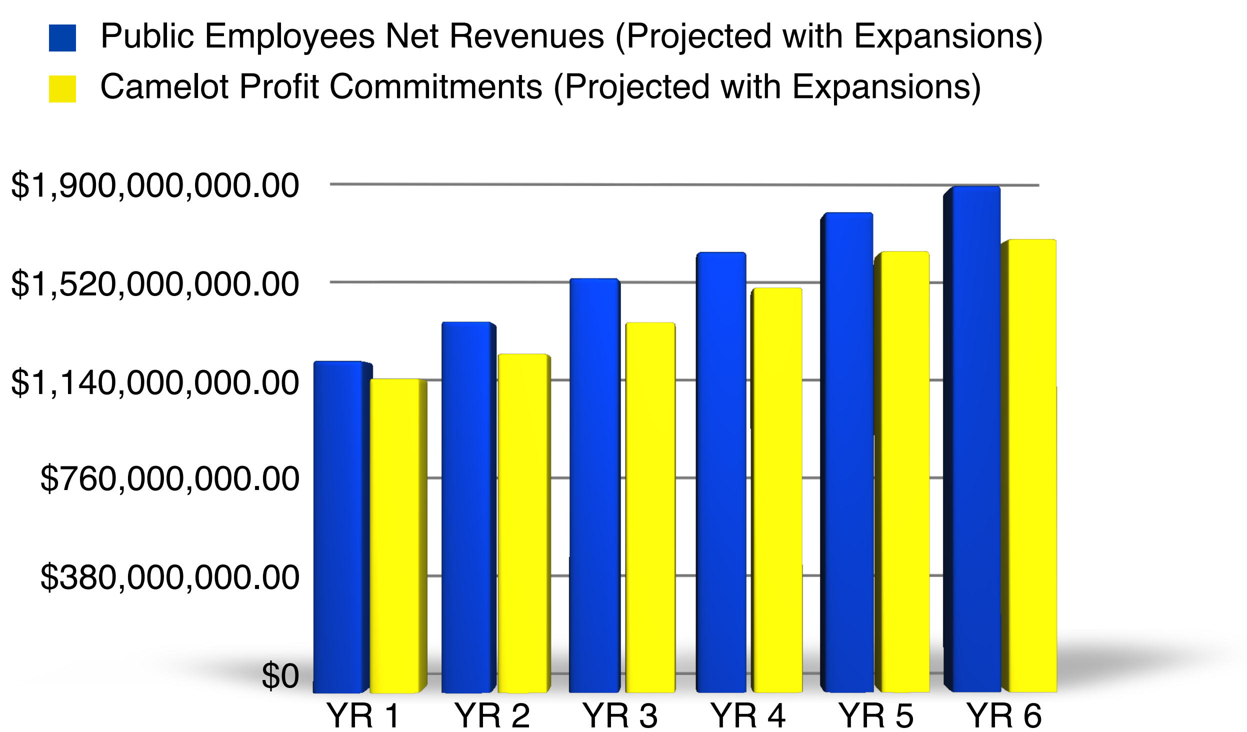
The Commonwealth claims a Private Management Agreement (PMA) will provide an Annual Profit Commitment (APC), backed by a cash collateral provided by the manager of $150 million and a $50 million Letter of Credit (LOC), which will result in more predictable funding.

AFSCME Research and Assertions:

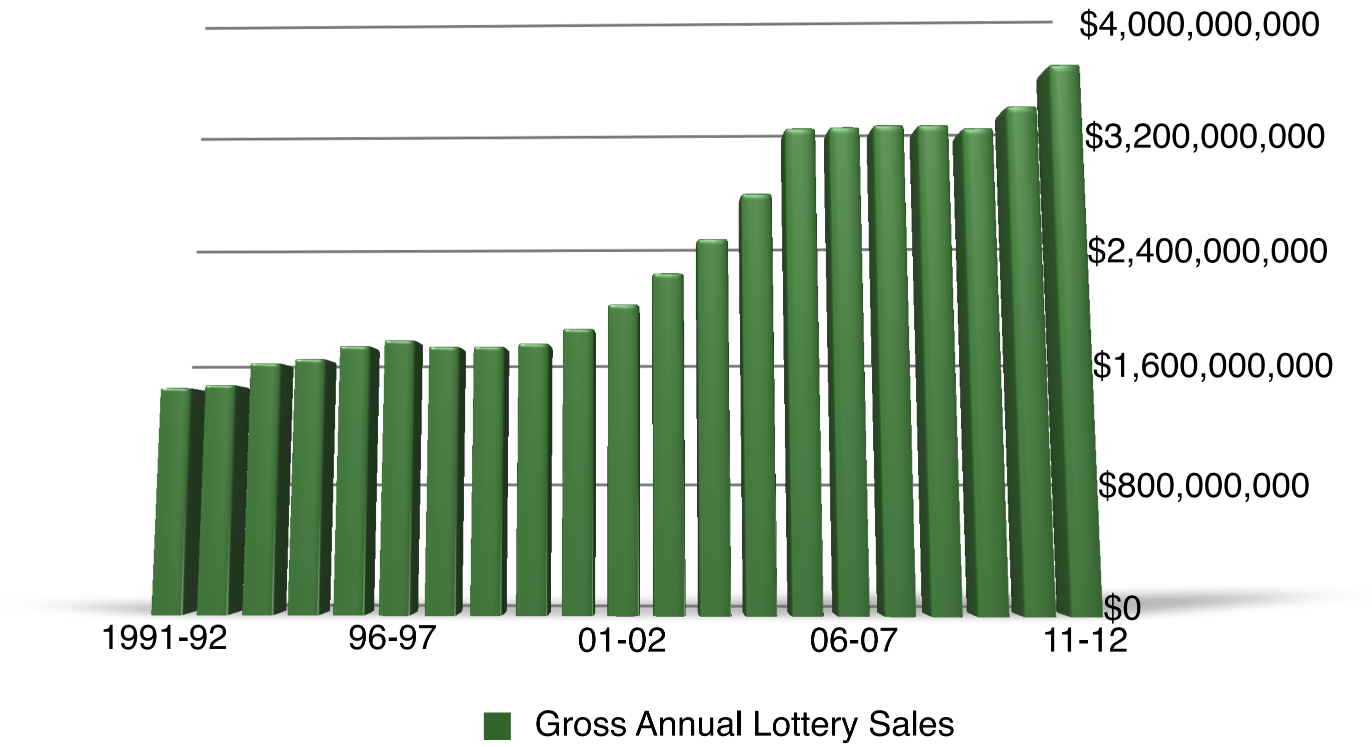
The Annual Profit Commitment (APC) is less than what AFSCME members could deliver under the same lottery offerings as outlined in the PMA.

The Commonwealth has inaccurately claimed that Camelot, the sole bidder for the Pennsylvania Lottery, would provide more funding for senior programs over 20 years than public management because of its increased net revenue projections. Based on the details provided in the full written union alternatives, we project over the next six years a $799 million difference between the profit guarantees of the private manager *and the continued public management and operation* of the Pennsylvania Lottery. These estimates are conservative and are based on the expansions and improvements outlined in our union written alternatives.

Camelot APC vs. Projected Net Revenues w Expanded Gaming (Yrs 1 -5)



The Annual Profit Commitment is not more predictable than the historic performance of the Pennsylvania Lottery



AFSCME believes any reasonable person viewing the chart above would say that Lottery sales are predictable and that an annual sales commitment already exists. Total annual Lottery sales have not been below $2.4 billion since Powerball was added a decade ago (2002), and have not been below $3 billion since 2005-06 when the Millionaire Raffle became a core offering. These revenues held true despite the worst economic calamity since the Great Depression, the Global Recession (2007-09). This same recession caused a decline in lottery retailers between 2009-10 when businesses in the Commonwealth were folding at a record pace and revenue collections in all other areas of state government were down more significantly than the sales of the State Lottery.

The fiscal guarantee, $150 million cash collateral and $50 LOC, is a falsehood; the maximum the Lottery could ever draw in a single year is $95.9 million.

The "guarantee" does not exist as the Commonwealth has asserted because the Manager's Security and LOC have a maximum allowable withdrawal. The PMA stipulates that at no time may the cash withdrawal (or direct payment by Camelot to the Commonwealth) for failed APC's be greater than 5% of that year's "profits." While the total amount of the proposed fund is $200 million, there is no scenario of profit shortfalls where the Commonwealth could withdrawal the entire amount, even if the total profit miss was $200 million or more in a single year. Let's explore an example of Year 1 from the PMA:

Assuming the plan to privatize moves forward, and the bid is awarded to Camelot. Fast-forward to the end of Year 1 of their contract, June 2014, but things did not go as planned. Camelot did not deliver on its full Annual Profit Commitment of $1.13 billion. Despite strong sales revenues, cost overruns and slower than expected rollouts of gaming expansions led to a delivery of profits totaling $924.96 million. While this would be a strong performance for a state lottery (as strong as net revenues for the PA Lottery in 2009-10), it would be 18% under Camelot's guarantee for Year 1. The total amount of the shortfall of the profit commitment would be $203 million. However, due to the PMA and federal law, the most the Commonwealth could draw from Camelot or its security fund is **<u>$46.3 million</u>**. This is a **<u>$156.7 million shortfall</u>** that the State Lottery Fund and possibly General Fund would be on the hook to make up to fund senior programs, despite the $200 million Manager's Security.

In fact, the most money under any scenario the administration could expect from Camelot as a penalty for a failure to make its Year 1 Profit Commitment is $53.7 million, which is consistent with profits 4.77% lower than the commitment.[2] [3]

<u>Of all the scenarios we investigated, the maximum draw from the Manager's Security would be $95.9 million in Year 20 if Camelot delivered profits 4.77% lower than its guarantee. Therefore, this is the maximum guarantee available to the Commonwealth for its APC, not the $200 million it has so often asserted.</u>

This $95.9 million guarantee from Camelot to support missed projected sales is <u>half</u> of what exists today in the State Lottery Fund. This informal reserve has backed

[2] Appendix 2 - Full Report

[3] Assumes implementation of "27% Law" Outline in Commonwealth's PMA

lottery sales projections for 42 years, and it has never failed to be sufficient to back the needs of the Lottery Fund.

The Pennsylvania Lottery has more money in reserve now from previous operational surpluses to guarantee Lottery Profits than that which is actually available from Camelot. If we acted to formalize and strengthen the Lottery Reserve in the Lottery Fund, long-term guarantees would exist without privatization.

Minor changes to how the Fund Balance is managed, how the Commonwealth projects year to year sales, and projects annual funding commitments would result in more predictable funding than private management. The existence of a substantial and growing end of year State Lottery Fund balance in 2012, even after years of raiding the State Lottery Fund for programming monies, demonstrates the quick ability of the Pennsylvania Lottery Fund to replenish and create its own fiscal guarantee.

For full details on improving the State Lottery and the maintenance of a reserve, see the full report.

Element 2: Funding for Older Pennsylvanians

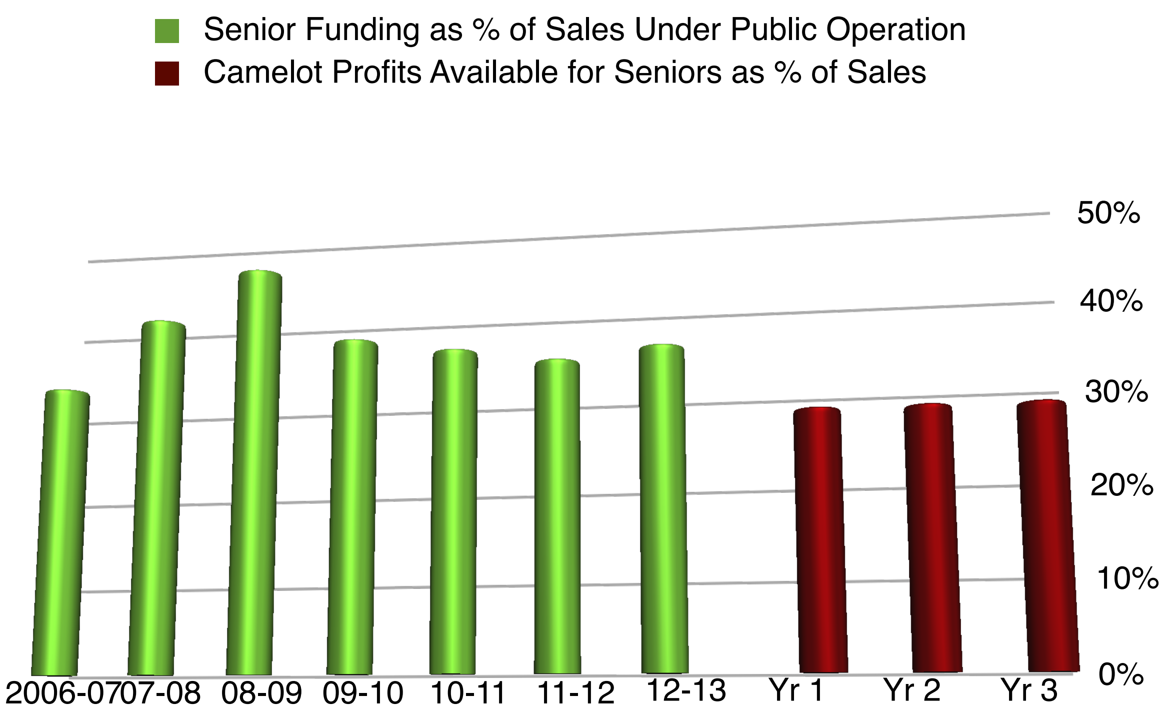
The Commonwealth asserts the PMA "provides assurances that senior programs receive all allocated funding without the Commonwealth's diversion of monies from other programs." The Commonwealth and the Governor have further claimed privatization would only proceed if it meant substantially "more money for Pennsylvania seniors." AFSCME's research demonstrates seniors would receive less money under privatization than continued public operation and management.

Camelot wants to begin its operation by cutting senior funding by 10%.

For the past ten years the Lottery has returned on average 35% of gross sales to fund senior programs. The private manager is guaranteeing a return of 27% of gross sales on an expanded Lottery, and supposedly $34.6 billion in profits over twenty years. However, to deliver on that amount, Camelot and the Commonwealth propose cutting the mandatory amount of profits available to fund programs for seniors by 10% right out of the gate.

Camelot's profit commitments for the first three years are lower than what is necessary to fund programs for seniors. This is because Camelot's projections are premised on a statutory cut in the percentage of sales that must go to benefit seniors from 30% to 27% - ten percent - and proposes it remain there for the next 20 years. This amounts to $1.244 billion in lost revenues to fund senior programs over 20 years.

If public employees have the opportunity to operate the Lottery under the same expansion, they would beat the private manager's guaranteed profits each year by at least 10% - 30%.



*FY 12-13 Estimated Based on IFO Sales Projection

Growth in programs and services funded by the Lottery (as well as their collective budgets) have increased in the last twenty years at a rate double the growth of Lottery net revenues.

While it is true that the senior citizen population is growing steadily and substantially, this does not automatically translate into exponential increases for the costs of the programs the Lottery funds for this population. There are numerous external factors and socioeconomic conditions that are changing the programming landscape for these expenditures. Take for example Medicare Part D and the Affordable Care Act (aka Obamacare), which are already estimated to save prescription drug programs more than $731.5 million that the Pennsylvania Lottery funds over the next ten years.[4]

Since FY 2002-03, the General Assembly and three governors have added $411.6 million in additional spending to the State Lottery Fund, a compound annual growth rate of 4.1%, while net revenues of the Lottery over the same period grew at a rate half that at 2.8%.

What the Commonwealth of Pennsylvania, its privatization team, and the lone bidder Camelot failed to take into account is that although the state statute mandates a minimum amount of money that must come from Lottery ticket sales to fund senior programs, the state has never spent the minimum amount allowable on Lottery's supported programs for seniors. In fact, the trend has been to raid the State Lottery fund in search of remote relevance back to the benefit of older Pennsylvanians to fund spending priorities.

The anticipated program costs graphed below are based on the February 2012 Legislative Budget and Finance Committee Report on "Pennsylvania Lottery Funding of Programs and Services for Older Pennsylvanians" and the 2012-13 Adopted Budgeted Allocations of the State Lottery Fund. It assumes the same programs currently funded by the Lottery will continue, that Medical Long Term Care funding levels continue at current levels, and all other program costs estimates stated by the LB & FC Report are valid.[5]

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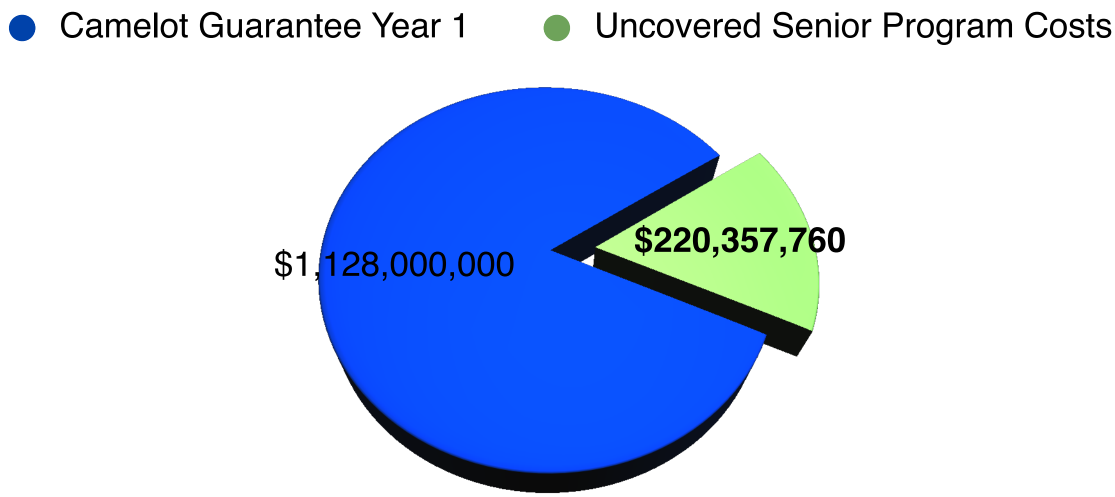
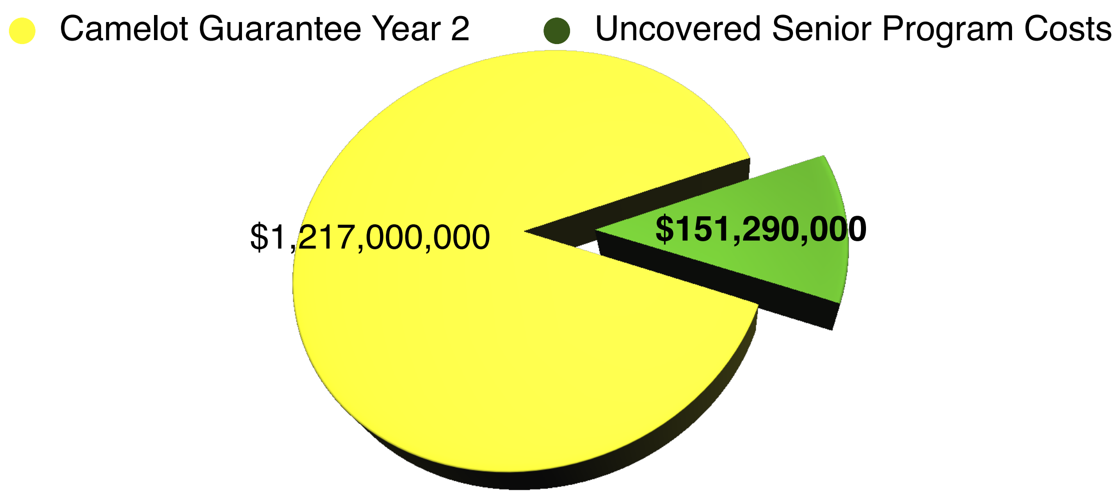
[4] Pennsylvania General Assembly. (Feb 2012). *Pennsylvania Lottery Funding of Programs and Services for Older Pennsylvanians.* Harrisburg, PA: Legislative Budget & Finance Committee. Retrieved from http://lbfc.legis.state.pa.us/reports/2012/62.PDF.

[5] Appendix 4 - Full Report

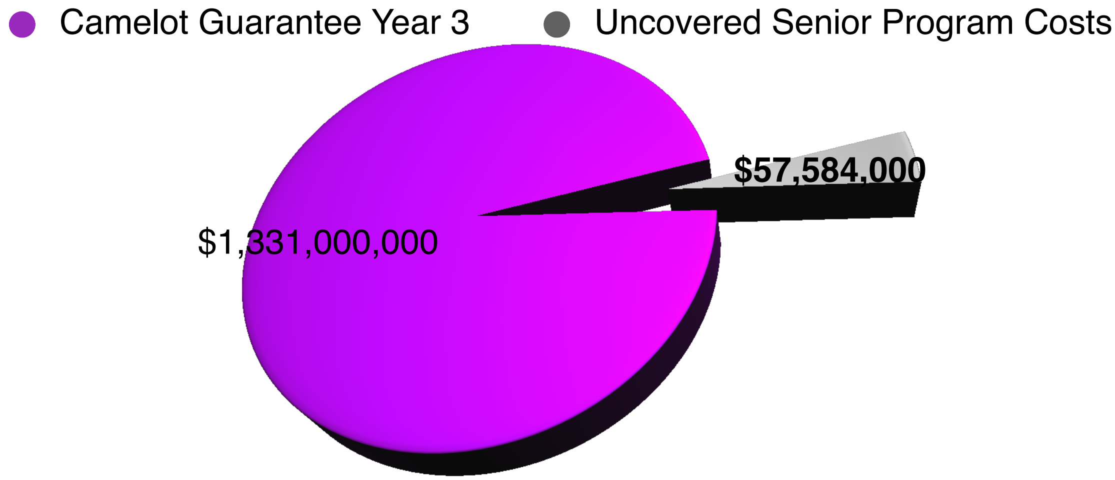
Camelot's Annual Profit Commitments Insufficient (Year 1)



Camelot's Annual Profit Commitments Insufficient (Year 2)



Camelot's Annual Profit Commitments Insufficient (Year 3)



If Camelot makes it Annual Profit Commitment in Year 1, it will still be **$220.4 million** short of what is likely to be allocated by the General Assembly this year from the State Lottery Fund for programs benefiting older Pennsylvanians. Even assuming a $165 million transfer from the Gaming Fund to pay for a portion of property tax rebates and $6 million in interest and miscellaneous revenues, the State Lottery Fund would still be operating under a deficit, therefore drawing approximately $50 million from reserves. AFSCME recognizes that investment income from the Lottery Fund and Gaming Fund transfers will be available to help make up the difference between Camelot's APC and the likely State Lottery Fund Allocations in Years 2 and 3 of the PMA, and those revenues will be enough to overcome the shortfall. However, how can this scenario reasonably be viewed as an improvement over the status quo since the Manager's Security cannot be used to overcome the full difference?

The 29.9% of net revenues our members delivered in 2011-12 is more than the 27% Camelot plans to guarantee, and because there is no profit-taking through public operation, AFSCME members will always be able to produce more net revenue than this lone bidder. It's not about politics; it's about arithmetic. When all the numbers are crunched, at the end of the day, Camelot's numbers come up short.

AFSCME Council 13 believes if given the chance to implement Keno, subscription services, robust loyalty programs and on-line games with the PA Lottery's current employees, the net revenues realized to fund senior programs would be more than what Camelot is offering every year for the next 20.

Today, with net revenues over $1 billion annually, net revenues are 175% higher than 20 years ago.Three exceptional points exist with regard to historic net revenues. As a percentage of gross sales:

- Net revenues (profits) have **<u>consistently remained above 29.5%</u>**[6]
- Net revenues (profits) over the past 20 years have **averaged 36%**.[7]
- On information and belief, at no point in the last 20 years has the General Assembly budgeted senior program support <u>below</u> 30% of gross sales. **The 20 year average is 38%.**[8]

Element 3: Lottery Expansion and Long-Term Growth

The Commonwealth has set up automatic expansion of the Lottery once its contract is signed with Camelot Global Services PA LLC.

The privatization would lead to the loss or reassignment of work for 258 Commonwealth employees, 174 of whom are represented by AFSCME, over the course of a six month transition of operations from the Commonwealth to the private manager.

AFSCME would support legal expansion of Lottery offerings as a means of securing more net revenues to support funding needs for older Pennsylvanians, but the games must be responsibly marketed and not come at a price to retailers or workers.

The PMA appears to achieve most of the "guaranteed gains" in profits through the expansion of Lottery's portfolio, not via the expertise of Camelot. Our research clearly shows that the Lottery could be legally expanded in the same areas and public employees could achieve the same or greater gross sales and net revenues than the sales and profits the private manager claims. Therefore, privatization is wholly unnecessary to achieve the same ends.

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[6] Appendix 1 - Full Report

[7] Ibid

[8] Ibid

AFSCME members working at the Pennsylvania Lottery could implement Keno immediately, and over five years, faster and to more locations than the private manager.

It is not for AFSCME Council 13 to determine if unilateral expansion of gaming in the manner described in the PMA is legal. We have filed appropriate legal challenges in Commonwealth Court because we believe expansion must be authorized by the legislature, however that does not mean AFSCME Council 13 is opposed to expansions of games. In fact, whether authorized through executive or legislative action, Lottery gaming expansion can be accomplished without the assignment of management of the Pennsylvania Lottery to Camelot or any other private manager. This is evidenced by past successful expansions of the Lottery gaming portfolio (Powerball, Mega Millions, Millionaire Raffle), completed successfully with the assistance of some outside contractors but always fully owned and operated by the Commonwealth of Pennsylvania.

AFSCME asserts that Internet games should have key safe guards to verify the age of the player and ensure commissions to existing brick and mortar retailers.

Internet gaming, or online gaming, as contemplated by the PMA presents a complex set of challenges for retailers, the Pennsylvania Lottery, and our potential player audience. It is also unresolved to what extent Internet lottery gaming would be legal under existing state and federal laws, and what authority if any the Lottery has to authorize such an expansion without legislative approval. Whatever system is designed, it must comport with federal law, state law, and provide a secure environment for the transmission of valuable and sensitive information.

In our full report, AFSCME Council 13 proposes a solution that will ensure that on-line gaming serves as a benefit to our brick and mortar retailers, not a hinderance to their commissions. Our solution will also ensure that age verification takes place for all online participation in the Pennsylvania Lottery, and that our program can lead the way with innovation and reaching a much younger player demographic with game offerings that are more beneficial to the net revenues of the Pennsylvania Lottery annually than the instant wins these audiences trend toward playing today.

Operational improvements would lead to stronger customer relations, retailer relations, and net revenue performance over the long-term without privatization. There is no need to furlough, layoff, or terminate a single employee in order to achieve the desired improvements.

With these expansions outlined above, it will be important to continue to build on the number and types of authorized Pennsylvania Lottery retailers. Today there are more than 9,200 in Pennsylvania, and AFSCME believes the Pennsylvania Lottery will be able to surpass 15,000 retailers by FY 2023-24.

Union Alternatives to a Private Management Agreement

Visit www.afscme13.org to see the full report with a detailed list of union alternatives to achieve the Commonwealth's desire to have "more reliable projections for annual sales revenues," as well as reliable mechanisms for "guaranteeing" a minimum level of funding to support the senior programs Lottery funds, expand both sales and net revenue opportunities, and enhance the Lottery playing experience.

Commonwealth Fails to Demonstrate Improved Delivery of Service

Based on our analysis, the Commonwealth has failed to meet its burden of proof of providing improved delivery of service through assigning Master Agreement and Master Memorandum work outside of the contract. We offer these written alternatives as clearly sufficient means to achieve the service improvements the Commonwealth seeks without a single layoff, furlough or downgrade.

AFSCME Council 13 looks forward to being a partner with the Commonwealth of Pennsylvania in further modernizing, expanding, and improving the services of the Pennsylvania Lottery to move even closer to becoming the Number One publicly managed, operated and owned Lottery in the nation.