

Testimony of Peter Tartline, Executive Deputy Secretary – Governor's Budget Office
Senate Finance Committee: Lottery Private Management Agreement
Monday, January 14, 2013

Good Morning. I would like to thank Chairmen Brubaker and Blake and Members of the Committee for the opportunity to testify at the Senate Finance Committee's special hearing on the Pennsylvania Lottery's Private Management Agreement ("PMA"). The Governor appreciates the committee calling this hearing now so that we can have an honest, meaningful discussion about the merits of the PMA with Camelot.

This testimony will provide greater clarity on the procurement process; will answer questions the committee, the legislature or the general public may have regarding this procurement process and the parties involved; and the outcomes we will achieve through this private management agreement. For the avoidance of doubt, the PMA does not contemplate video poker, video poker like games nor video lottery terminals ("VLTs").

This procurement was borne from a simple, yet significant, fact. Pennsylvania needed a way to provide stable, appreciable revenue to fund programs for older Pennsylvanians. The framework of the process was designed to maximize the annual profit commitment of the bidders. It included a multi-phased approach that kept bidders and stakeholders engaged and informed throughout the process. The process was utilized to create competitive tension in order to achieve the greatest possible return for older Pennsylvanians. Most importantly, the process has resulted in ensuring more money for programs for older Pennsylvanians.

We recognized that we needed experts to assist us in the process. That's why we engaged Greenhill as our financial adviser and DLA Piper as our legal adviser. Greenhill was selected via a competitive procurement issued by the Department of General Services in July 2011. DLA Piper was selected through sole source, in part due to the firm's legal experience in representing the State of Illinois on the first US Lottery PMA transaction.

We knew that the procurement process must follow the procurement code, maintain the integrity of bids submitted and create competitive tension amongst potential bidders that would bring about the best results for the Commonwealth. Throughout this process, I maintain that those criteria were met, and we have an opportunity before us that represents the outcomes that we had sought.

I would like to present a timetable of this procurement process. In early 2012, the idea of a PMA for the Pennsylvania Lottery was recommended by the Governor's Advisory Council on Privatization and Innovation in a public meeting. We began to develop a strategy to embark upon this project. With the assistance of the Department of General Services and our legal and financial advisors, we constructed and released a Request for Qualifications on April 2, 2012. It was publically discussed at a hearing held before the House Aging and Older Adult Services Committee on April 3, 2012. AFSCME, the union representing many of the Lottery employees, was also informed of the Commonwealth's intentions prior to the release of the Request for Qualifications.

The responses to the RFQs were received and reviewed in May and June of 2012. We evaluated the responses based upon financial capability, social responsibility and technical capability of the organizations that were interested in pursuing this project. In late June 2012, we qualified three bidders to continue in a Multi-Step Sealed Bidding process. We also provided the General Assembly with an update of our progress at this key milestone. Again, Lottery employees and AFSCME continued to be apprised of developments as we progressed.

Throughout the summer and into early November, we worked with our qualified bidders to develop the structure and content of what would ultimately become the PMA. We commenced our due diligence. We conducted initial probity investigations to determine each bidder's character, financial ability, fitness and suitability to continue. We shared our lottery information with all the bidders via non-disclosure agreements. We offered drafts of a potential agreement and received frank, honest feedback from those bidders. In short, this was a collaborative effort with potential partners that produced contractual criteria, profit shortfall protections, business plans and, ultimately, a set of documents that would protect and benefit the Commonwealth.

It was through this back and forth that potential bidders removed themselves from the process. Specifically, in August 2012, one qualified bidder withdrew from due diligence because it chose to explore other Lottery opportunities it believed to be more commercially attractive. In early November 2012, a second qualified bidder withdrew citing a "one-sided" PMA, inconsistent accounting methods used by the Lottery, and a desire by the commonwealth for the winning bidder to pay transaction costs.

From the Commonwealth's perspective, ensuring the protections for the lottery and the programs it funds was a point that we would not yield. The fact that two bidders removed themselves from consideration was not of the Commonwealth's doing, but rather a business decision on their part, and not uncommon in large public private partnerships.

It should also be noted that the fact that they removed themselves from contention was not shared with any other bidder in order for us to maintain competitive tension and protect the integrity of this process. Each qualified bidder signed confidentiality and non-disclosure agreements to protect the process.

In mid-November the Commonwealth issued a request for priced bids. Since the terms and conditions of the potential PMA had already been worked out through the preceding process, a purely objective evaluation of the Annual Profit Commitments could be made.

And an objective evaluation it was. Specifically, the bidder had to complete a table, indicating its Annual Profit Commitments for Contract Years one through 20, both under current law and under a scenario that provided for the continuation of a 27% statutorily mandated rate of return. For the purposes of bid evaluation only, we developed a calculation called the APC Transaction Value, which represented the net present value of the total of the average Annual Profit Commitments with respect to Contract Years one through 10.

It should also be noted that in order to submit a priced bid, bidders were required to post \$50 million in cash as bid security to be held in escrow that the commonwealth could collect if the bidder withdrew its offer.

In accordance with procurement laws, DGS posted a bid tabulation on November 20, 2012, which contained the APC Transaction Value for the submission of our final bidder, Camelot Global Services PA, LLC. The bid was deemed responsive and offers \$34 billion in Annual Profit Commitments over twenty years. The bid assures at least 9.1 percent annual growth in profits over the first five years of the agreement. Over the next 10 years, it assures 5.8 percent annual growth in profits (6.1 percent if the 27% statutorily mandate rate of return is continued).

I should also point out that Article 43 of the AFSCME master agreement has played an integral part in this procurement. This component of the master agreement requires, when there is a contract being considered for the performance of bargaining unit work, that the Commonwealth entertain alternatives from the union that would accomplish the objective of the contract. Following the development of the final draft of the Private Management Agreement, the Commonwealth notified AFSCME on November 9, 2012 of the development and provided the opportunity, as afforded by Article 43, to provide a competitive response to the private bidder. AFSCME's Lottery counterproposal was received on January 8¹. On January 9, the Commonwealth met with AFSCME to discuss its Lottery counterproposal and asked questions.

After careful review, the Commonwealth has decided to reject the counterproposal and proceed to issue a Notice of Award to Camelot.

The Notice of Award is not a political ploy, "a midnight raid" or a "slap in the face" as some have suggested. Rather it is a necessary step that closes the formal procurement process and is a statement of our intent to move forward in this process. Now that we are out of that phase, we are able to discuss with specificity the details this committee, other interested lawmakers and the general public seek.

For the purpose of deciding to issue a Notice of Award to Camelot, we had to compare their Annual Profit Commitments to our own budget projections and historical performance, accounting for both the Keno and interactive value drivers. Over the next twenty years, that analysis shows that the PMA will result in at least \$3.0-\$4.5 billion of incremental funding for senior programs.

The reason I state "at least" \$3.0 - \$4.5 billion in incremental funding is that the PMA annual profit commitments essentially are floor commitments. Camelot must exceed these annual profit commitments in order to make any money. Historically, the Lottery budget projections have been more like a target or ceiling, and not a commitment. In sum, Camelot's bid on the Lottery PMA will allow us in the coming fiscal year to invest \$50 million more than we did this year on programs that support older Pennsylvanians. It will provide approximately \$460-\$530 million in

¹ Technically, AFSCME had the binding bid version of the PMA longer than the bidders had time to develop the business plan.

incremental value over the next five years and \$1.3 - \$1.8 billion in incremental value over the next 10 years, over state budget and historical projections.

In summary, the procurement process for this project was conducted strictly in accordance with the Pennsylvania Procurement Code. It was timed strictly to coincide with the commonwealth's fiscal calendar. Despite assertions to the contrary, it was a transparent and deliberative procurement process. The administration engaged in extensive outreach, including legislative updates, through each phase of the procurement process. This involved hosting as well as participating in more than 100 individual meetings with legislators and staff since April. As mentioned we've made sure to update stakeholders – including those in the aging community, retailer community and hospital community – through every step of the procurement process. At every milestone we provided updates not only to stakeholders and the General Assembly but also to the public with regular update on a publicly accessible website, www.revenue.state.pa.us/lotterypma.

Again, thank you for the opportunity to provide clarification and context to this very important matter. I look forward to any questions you may have.