



Commercial Services Overview

Purpose

The purpose of this document is to provide an overview of Camelot's proposed Commercial Services operation. It will cover the following areas of Camelot's Commercial Services proposals:

1. a description of the services to be offered
2. how the services will be offered
3. corporate structure of the Camelot entities
4. retailer arrangements
5. arrangements with service providers
6. signage and branding
7. pricing, revenue and costs

1. A description of the services to be offered

Camelot's proposed Commercial Services offering is made up of five main product groups. Each of these is considered in turn below.

Mobile top-up. The Commercial Services offering will enable consumers to top up their prepaid mobile phones through part of its retailer network. This will be for all principal mobile networks (such as Vodafone and Orange) and a wide range of virtual networks (such as Tesco Mobile and Virgin Mobile). Consumers will be able to top up in all available denominations, using either e-vouchers or a magnetic swipe card.

International calling cards. The retailer will be able to issue a printed voucher with a code allowing consumers to make international calls at preferential rates. By dialling the code prior to the dialled number, the user can then make the international call at the preferential rate.

Bill payment. Camelot is also proposing to offer 'over the counter' bill payments through its terminal network. Camelot proposes to co-brand this service with a well known retail brand.

The service will be offered in partnership with aggregators, Santander, the Cooperative Bank, Allpay and the Post Office,¹ which will enable consumers to pay, in the Commercial Services outlets, local council tax bills and utility payments (both pre-pay and post-pay) for around 2,500 different suppliers. The aggregators will maintain the relationship with the utilities and other payment receiving entities. Camelot's terminal will capture the transaction and the aggregator will complete the payment to the receiving entity. Camelot will not have a relationship with the utilities (or other entities) itself.

Consumers will be able to make these bill payment transactions using a range of different methods; Commercial Services retailers will have the equipment to process bar-coded utility bills (using a dedicated scanner), magnetic swipe-cards (using an Ingenico terminal) and pre-payment keys (via a peripheral Talexus key reader).

¹ Although Royal Mail Enterprises Limited is currently a shareholder in Camelot, the arrangement with the Post Office is at arms length and not subject to any requirement of exclusivity.

EFT and Tap & Wave: Provision of debit/credit card processing services to retailers. The Commercial Services offering will enable participating retailers to process chip and pin debit/credit payments over the Camelot network using the Ingenico terminal. These retailers will also be able to process contactless/NFC² payments, also known as “Tap & Wave,” using Camelot equipment

Future services. Camelot intends to offer two additional services at a future date. At this stage, it has not modelled the projected costs and revenues of these additional services. We describe them here for completeness, but they are not considered further in this paper.

- **Pre-paid vouchers.** Consumers will be able to purchase pre-paid vouchers from Commercial Services retailers. These vouchers will be available in a range of denominations. They will enable consumers to purchase a voucher in-store which can then be used to make purchases over the Internet.
- **Reloading of open and closed loop prepaid cards.** The Commercial Services offering will enable consumers to ‘top up’ prepaid cards in store by cash. ‘Open loop’ cards are those which can be used in any outlet (and are typically Mastercard or Visa branded). ‘Closed loop’ cards are those which can only be used in particular stores or locations (such as a shopping centre).

2. Arrangements with Service Providers

Camelot will not have a direct relationship with utility companies in relation to bill payment services, but will work with an aggregator. Camelot will have a direct relationship with other service providers. Commercial arrangements will be on an individually negotiated arms length basis and in line with market arrangements. Camelot’s arrangements with aggregators, utilities companies, mobile operators and other service providers for which Commercial Services are provided will be non-exclusive. They will not involve any discounts, rebates or bonuses to service providers based on volume or proportion of transactions, nor will they involve any financial terms that reward or lead to actual or *de facto* exclusivity.

3. How the services will be offered

The Commercial Services operation will use an entirely separate software platform which interfaces to the main Altura terminal through the existing communications network. Camelot will supply participating retailers with three devices to enable retailers to offer the products described above. These are:

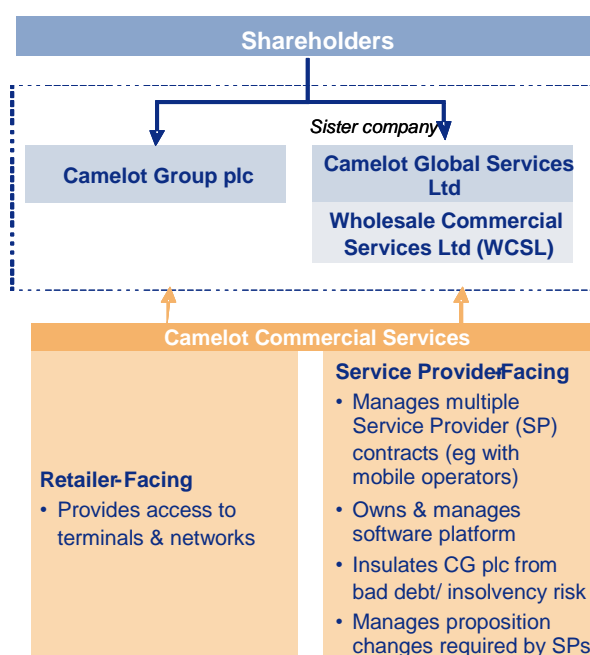
- i) an Ingenico magnetic swipe card, chip and pin and contactless card payment terminal
- ii) a Talexus key reader (for processing prepaid utility keys)
- iii) a handheld high-specification bar code reader.

The existing lottery terminal printer will be used for printing of receipts etc.

² NFC – Near Field Communication

4. Corporate structure

The Commercial Services business will be operated by two legal entities.³ Wholesale Commercial Services Limited (“WCSL”) will contract with the 19 suppliers of the various cash handling products described in sections 1-2. WCSL is a subsidiary of Camelot Global Services Limited, an entity which has the same shareholders as Camelot Group plc.



In exchange for a commission from WCSL, Camelot Group plc will provide the Commercial Services products to its participating retailers. WCSL will bear the risk of any bad debt in the supply chain (either with retailers or suppliers), thereby insulating Camelot Group plc from this risk.

Payments from consumers will be held in a separate trust account for transfer to the product originators (such as the mobile phone companies, for example). Camelot Group plc will share any profits arising from operating Commercial Services with the Good Causes.

As outlined in the diagram above, WCSL also provides the underlying software platform on which Commercial Services are delivered, and manages the proposition changes as required by Service Providers.

5. Retailer arrangements

This section will consider the retailer arrangements for Commercial Services. It will cover those retailers included in the Commercial Services scheme, retailer choice over provision of Commercial Services and the absence of exclusivity arrangements.

³ The profitability analysis in section 7 considers the profitability of Commercial Services overall, combining the revenues and costs of both WCSL and Camelot Group plc.

Retailers included in the scheme. Our initial plans focus upon Camelot's independent retailers. However, the ability to offer Commercial Services would be open to all retailers.

Retailer choice over provision of Commercial Services and non-exclusivity.

The offering of Commercial Services will be entirely optional for retailers. There is no requirement that National Lottery retailers also offer Camelot's Commercial Services or any financial inducement offered to them to do so, including any form of better commission or pricing. There is no requirement that Retailers offer exclusively Camelot's brand of Commercial Services. They can choose to offer a range of providers' services. Camelot's price for each service is independently determined and does not vary in the event that the retailer offers all or just some of the services in question. There is no difference in the pricing between retailers or if the retailer chooses to offer another provider's services. There are no rebates, discounts or bonuses related to volumes or proportion of transactions, nor are there any terms that would reward or lead to actual or *de facto* exclusivity.

Geographic selection of retail sites. Camelot plans to offer Commercial Services at a range of geographic locations throughout the UK where the demographic fit and demand is thought most promising. The current distribution of Camelot's National Lottery retailer estate (based on regional electricity generation areas) is as follows. Although Camelot anticipates that only some National Lottery retailers will also retail Commercial Services, it believes that the dispersal of the retailers for Commercial Services will be along similar lines.

| <u>Distribution of Retailers</u> | |
|---|--------------------------|
| <u>Electricity Area</u> | <u>Percentage</u> |
| East Midlands | 8.33% |
| Eastern | 12.31% |
| Hydro | 2.43% |
| London | 7.86% |
| Manweb | 5.27% |
| Midlands | 8.72% |
| Northern | 4.99% |
| Northern Ireland | 2.80% |
| Norweb | 7.23% |
| Scottish Power | 6.27% |
| Seeboard | 7.30% |
| South Wales | 3.76% |
| Southern | 10.06% |
| Sweb | 4.79% |
| Yorkshire | 7.43% |
| Other | 0.45% |
| Total | 100 |

6. Signage and branding – extent to which Commercial Services will be associated with the National Lottery

Subject to the consent of the National Lottery Commission, Camelot will use National Lottery-branded rollstock to print Commercial Services receipts and vouchers. However, there will be a clear notice that the National Lottery terms and conditions on the reverse of the rollstock will not apply.

However, there will be no other use of, or association with, the National Lottery logo at retail. Stores will not be branded as belonging to any particular payment network. Also, the new devices described in section two will not use any National Lottery branding.

Consumers will be aware of the opportunity to vend the product in a retail outlet through the use of the recognised mobile top-up logo and other recognised logos using a simple 'available here' branding.

7. Pricing arrangements

In this section we consider whether the Commercial Services business proposes to charge prices that will cover its costs. We examine first the principles used by Camelot to determine prices, then the costs entailed in providing Commercial Services (describing the costs involved by reference to certain economic measures) and finally the extent to which the Commercial Services will cover those costs during its start up and subsequent operations.

We conclude that at all times the Commercial Services business will cover its average avoidable costs (described in more detail below) and in every year after the initial start up period, the business will cover its long run average incremental costs (described in more detail below). Revenue would also exceed these measures of cost in every year including the start up period if each service within the portfolio were considered separately.

The extent to which revenues exceed costs is set out in the following graphs:

- Revenues and defined costs measures⁴ over the period of the future operating plan⁵ from financial year 2009/2010 to 2014/2015;
- Revenues and costs over the period in the event that transaction volumes were to be 25% lower than projected.⁶

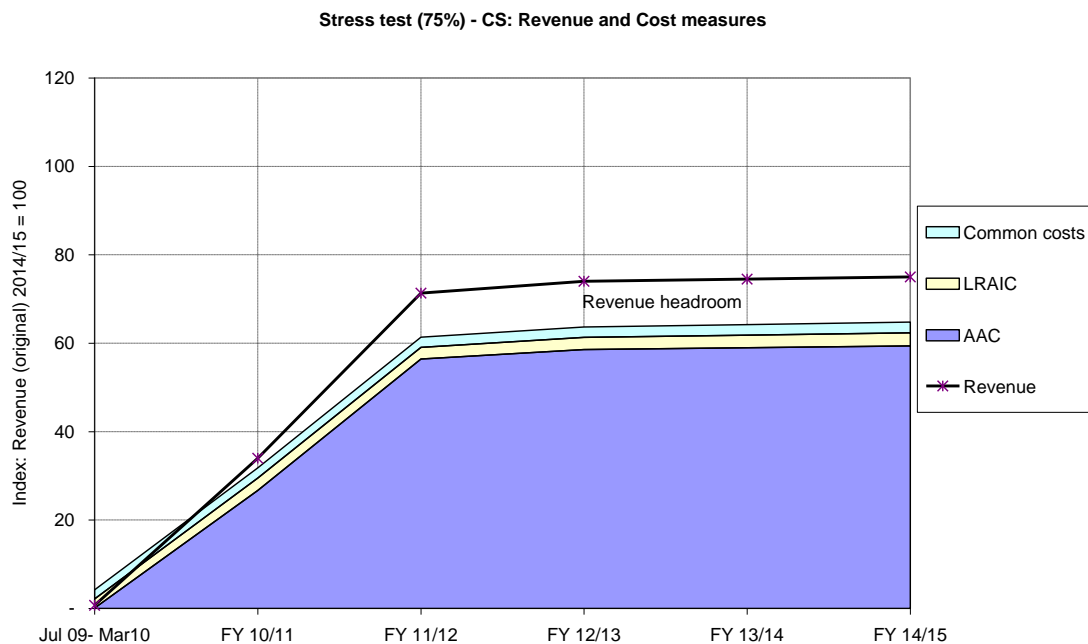
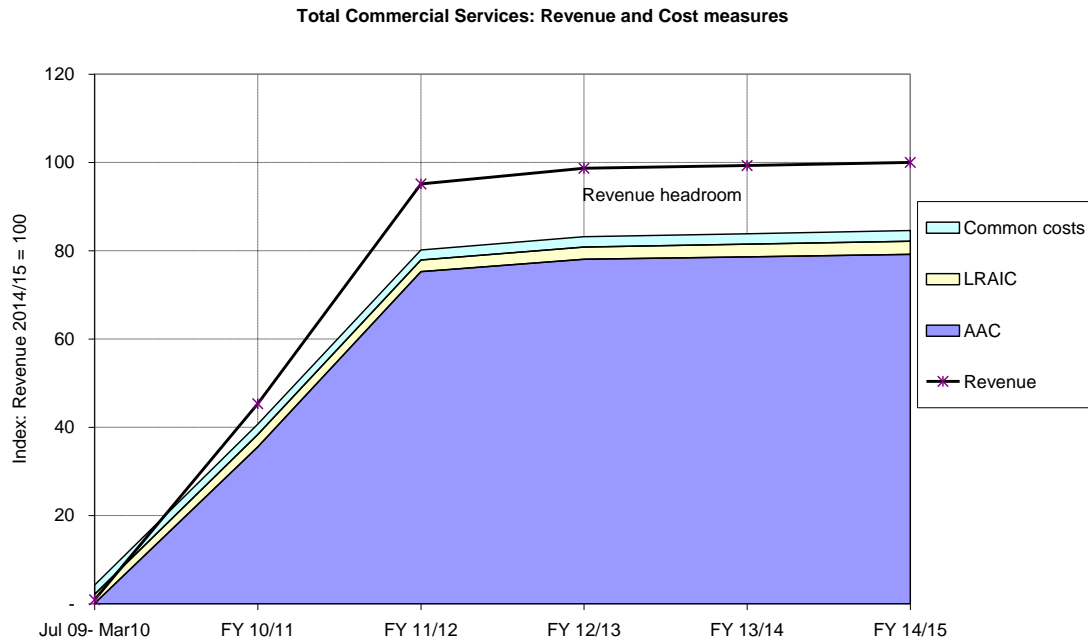
⁴ The graph takes into account all costs and revenues in Camelot's future operating plan and described in this paper, including upfront and one off costs. The latter are depreciated over their useful life, which does not exceed the period of the future operating plan to 2014/15, except in relation to bar code readers, which are depreciated over a longer period not exceeding the duration of Camelot's licence to run the National Lottery, namely until 31 January 2019.

⁵ The future operating plan is an internal Camelot document which sets out the projected revenues and costs of the business. This is the basis on which the management of Camelot has chosen to invest in the Commercial Services business. The projected revenues are based on businesses of industry peers and sets out a case for investment based on the lower quartile of the possible business projections.

⁶ The second graph is based on hypothetical transaction volumes being at a lower level than that projected and is prepared solely to assist consultees in providing their views. It does not form part of and is not Camelot's projection or model for the business.

In each case, initial start up losses will be recovered within a reasonable period of time and in any event within the 2009/2010 to 2014/2015 plan period and this remains the case even if transaction volumes were to be 25% lower than projected.

The graphs include the allocation of a proportion of the common costs which the Commercial Services business shares with the Camelot's National Lottery business, though for the reasons examined below we do not consider such allocation appropriate.



Note: the costs and revenues are presented on a 0-100 index with 100 being the revenues of the business in 2014/2015.

Principles governing pricing. Camelot's prices, that is to say the commission that Camelot agrees with the service provider that it may deduct from the gross amount paid by the consumer for the transaction in question, will be based on competitive market rates.⁷ The prices are calculated as a percentage of the transaction value, with no volume or exclusivity rebates, discounts or bonuses. There are a limited number of providers of commercial services currently in the market with Payzone and PayPoint having the most substantial share of the business. ePay also has a strong position focusing on EPOS systems in supermarkets. Camelot will also price its services to take full account of any applicable obligations under competition law.

Profitable standalone business. It is intended that Commercial Services will be profitable as a standalone business after taking into account all applicable fixed and variable costs, as well as contributions to Good Causes.⁸ The nature of the relevant cost, cost driver, the legal entity bearing the cost and the method of cost allocation is included in the Annex. In this section 7, we examine aggregate revenues and costs relating to the business of the two entities involved in Commercial Services, WCSL and Camelot Group plc, rather considering the costs and revenues of each entity separately.

Average avoidable cost (AAC). AAC is the average of the costs that could have been avoided if the company had not produced a discrete amount of (extra) output. At its simplest AAC is the cost that a company avoids by foregoing the production of each new unit. In this case, those costs are the direct costs of engaging in each transaction with a consumer, being retailer and bank commissions, consumables (such as printing paper), bad debt provision and a software interface fee payable to GTECH. The costs included within AAC, however, vary according to a range of factors, as we describe below. Some costs may be included in the definition of AAC to the extent that over the relevant period of assessment they are directly linked to the volume of transactions, such as some types of staff costs (for example, sales).

AAC for individual services. AAC for individual services are the direct costs of engaging in each transaction with a consumer in relation to each such service, being retailer (or as the case may be bank) commissions, consumables (such as printing paper), bad debt provision and a software interface fee payable to GTECH.

Long Run Average Incremental Cost (LRAIC). LRAIC includes all costs that can be avoided in the long run if Camelot were not to provide Commercial Services. These include, in addition to AAC, product specific fixed costs relating to the product line in question. We take LRAIC to be the following:

- Fixed costs incurred in setting up the retailer network and systems to offer commercial services: expenditure on the bar code scanner, key reader, Ingenico device, hardware and technology licences. This includes the

⁷ In relation to each service provider agreement, Camelot earns commissions on transactions between the service provider and the consumer. There are no penalty or minimum volume provisions that would require Camelot to make payments to the service provider.

⁸ As described below, the business will not cover long run average incremental costs (as described below) during the initial start up period, but will cover long run average incremental costs and a proportion of common costs (though we do not consider common cost allocation appropriate for the reasons explained below) during the second and subsequent years of operation based on the FY09/10-FY14/15 future operating plan.

development costs of upgrading terminals to accommodate Commercial Services transactions, development and testing of the interface between the Altura terminal and Camelot's Commercial Services software and changes to Camelot's network and back office systems. The cost of these investments is depreciated over their useful economic life.

- Overhead costs include staffing, legal fees and marketing.
- Incremental costs incurred in running the commercial services network, such as additional field maintenance costs, ongoing additional leased line costs and ongoing retailer recruitment.

There are no incremental data or transmission costs arising from the operation of Commercial Services.

In allocating costs as LRAIC, we have made a number of assumptions:

- All field maintenance will be an incremental cost specific to Commercial Services equipment. In fact there will be synergies with the maintenance of the Altura terminals since the same engineers maintain both lottery and non-lottery equipment. By assuming there are no such shared costs, all field maintenance costs are categorised as LRAIC without any deduction for common costs.
- Staff costs are increased by 50% to take into account possible additional staff costs not reflected in their gross salary, such as non-salary benefits (a company car for example). These costs are categorised as LRAIC in full.
- The barcode readers are intended for use for both the National Lottery (for stock recording) and Commercial Services, although the extent and timing of the use by the National Lottery is not yet established. Rather than exclude as common costs, we allocate 50% of the cost of this equipment to LRAIC.⁹

LRAIC for individual services. We have also identified LRAIC for individual services (as set out below). To do this we distinguish between costs which are common for all Commercial Services and product specific costs for particular individual services. The fixed costs, overhead and most other incremental costs identified in the previous section are not specific to any individual service, but common across the Commercial Services portfolio. Accordingly, they would not be categorised as LRAIC in relation to any individual service. On the other hand, some capital costs are specific to particular products, and should be classified as LRAIC in relation to individual services. The Annex provides additional detail as to how we categorised these costs.

Distinguishing AAC and LRAIC. Whether a cost can be allocated to AAC or LRAIC depends on many factors. Firstly, time frame is important. Ultimately considered over the lifetime of the project of providing Commercial Services, AAC and LRAIC will be the same. This is because over the lifetime of the project all costs of entering this business line would be avoidable. Depending on the time frame considered some fixed or overhead costs could be included within AAC. For example, an annual licensing fee would not be avoidable (and so not AAC) if a period shorter than one

⁹ Note that even if 100% of the bar code readers were considered LRAIC, the profitability assessment in respect of FY2010/11 to FY 2014/15 would not change (and this is also the case regardless of whether common costs are allocated).

year were examined, but avoidable if considered over a period of more than a year (at least in relation to the period after the annual renewal fee is due).

How the cost arises is also relevant to its assessment. Marketing can sometimes be considered AAC if the marketing expenditure can be associated with particular transactions (for example, free gifts or rebates to a consumer) or it can be a fixed cost if it is of a more general nature. Here the marketing proposed, primarily retailer signage, trade events and dinners, is of a general nature and therefore better considered within LRAIC. Additionally, an asset may become an avoidable cost (within AAC) if it is re-deployable. For example, an employee on a fixed term contract or during his or her notice period would be a fixed cost, outside of AAC, since his or her salary must be paid (cannot be “avoided”) regardless of whether production continues, but could be avoidable if – depending on the time frame under consideration - the employee has skills that can be readily redeployed in the business.

Ultimately, as will be examined below, since regardless of allocation of costs as LRAIC or AAC, Camelot’s future operating plan assumes that it will price above these cost measures – except when incurring start up costs which competitors have already incurred and therefore cannot be disadvantaged by - this paper does not consider all the possible scenarios in which a cost might be classified as AAC or LRAIC.

Common costs. LRAIC relates only to product specific costs, that is to say those costs incurred by Camelot entering into the provision of Commercial Services. It excludes “common costs” that is to say those costs which are shared with other business lines. The principal common costs are the Altura terminals, printers and network connections of National Lottery retailers. This infrastructure is required for the provision of the National Lottery. The terminals and network will be used by Camelot to provide Commercial Services. Data relating to Commercial Services will be transmitted between retailers and Camelot’s central system over the network. The Altura terminal provides a network connection.¹⁰ The terminals and network services have spare capacity available for the operation of Commercial Services, such that no additional costs arise, for example due to additional transmission of data, other than those already identified, in readying the network for Commercial Services or providing Commercial Services over the terminals and network. There may also be common costs in terms of use of premises, HR, treasury and other back office functions not specific to the Commercial Services business.

Common costs for individual services. In addition to the common costs identified in the previous section for all Commercial Services, each individual service within the portfolio will have costs shared with other Commercial Services. If each service is considered individually, those costs will be considered common costs, as we describe in more detail in the Annex.

Should common costs be allocated? Camelot takes the view that it is not appropriate to allocate a proportion of common costs.

- Common costs were not relevant to Camelot’s decision to enter into the Commercial Services segment since the costs were already incurred in relation to Camelot’s operation of the National Lottery. Camelot’s licence under Section 5 of the National Lottery etc Act 1993 commits Camelot to have

¹⁰ The Ingenico device provided to retailers could, even without the Altura terminal, provide a network connection. However, we make the conservative assumption that Altura terminals may be considered a common cost.

in place the systems, network and facilities which enable it to run the National Lottery. There is no commercial subsidy linking the two business areas. The incremental costs incurred in the Commercial Services segment are fully covered by projected revenues.

- Particularly in relation to Altura terminals, common cost allocation is inappropriate. The Ingenico equipment for Commercial Services provides similar functionality to the Altura terminals and could, even if retailers did not have Altura terminals, provide for a similar network connection. Allocation of a proportion of common costs for Altura terminals will therefore inflate Camelot's cost base.
- The relevant National Lottery assets used by Camelot in relation to Commercial Services are not unique to Camelot. Existing providers (or any company) can purchase network terminals and services suitable for the provision of Commercial Services.
- Camelot's ability to spread common costs between businesses so as to be able to operate efficiently across multiple product lines is also not unique to Camelot or the National Lottery. Any company which offers a range of products can achieve cost efficiencies by spreading common costs, such as network costs, between product lines. Providers of commercial services seek to broaden the services they offer over their networks and back office systems, providing services that Camelot does not (for example, transport tickets, internet payment services, parcel collection, money transfer and ATM networks) and in countries where Camelot does not. In some cases existing service providers are the exclusive provider of certain commercial services, such as TV licence fees (Payzone) or congestion charge payment (ePay). Existing providers also seek advantages that are not part of Camelot's proposed strategy, such as entering into exclusivity agreements with utility companies or retailers.

These factors suggest that a proportion of common costs should not be allocated to Camelot's Commercial Services business. It is economically rational and pro-competitive for Camelot to compete in a new market where it makes a profit in excess of its incremental product specific costs (LRAIC). Were Camelot required to allocate a proportion of common costs it might hinder Camelot's ability to compete by artificially holding its prices above its competitors'. Rivals capable of gaining similar efficiencies through diversification would be unduly shielded from competition by such a requirement. The outcome would risk damaging competition by maintaining prices and incumbents' margins at an uncompetitive level.

In any event, however, Camelot considers that the Commercial Services business would cover costs even if an appropriate allocation of common costs were also made. The analysis of common costs and their allocation is described in greater detail in the Annex.

Contribution to good causes. Camelot will also pay c.80% of any profits from Commercial Services to Good Causes. This cost is specific to Camelot and not generally applicable to other providers of Commercial Services. Since this payment represents a proportion of profit, and is specific to Camelot rather than existing providers of Commercial Services, we do not allocate it within the costs framework described above.

Review of Camelot's Future Operating Plan. For the purposes of analysing Camelot's future operating plan for Commercial Services¹¹ against these costs criteria we have considered first revenues and costs during the start up phase during the part year July 2009 to March 2010. This part of the future operating plan assumes that this part year will include substantial pre-launch costs, as the business readies itself for commercial launch, and two months of sales. We have then considered revenues and costs for each financial year between 2010/2011 to 2014/2015 as the business progresses to maturity. Camelot has not modelled in detail the business after 2015, but we believe that these two periods provide a sufficient understanding of costs.

Start up: part year July 2009 to March 2010. During the part year July 2009 to March 2010 Commercial Services revenues exceed the costs categorised for the purposes of this paper as AAC. This is the case for each service considered individually and for Commercial Services as a whole.

We take the view that Camelot would not regard sales staff as being AAC during this time period. Aside from whether it would be feasible contractually to terminate and/or redeploy the staff in question during the two months of commercial operations covered by this start up period, we consider that during the start up of a new business a company would not temporarily terminate its sales staff in reaction to a sudden drop off in transactions over such a short period of time. They would properly regard such staff as fixed costs during the start up phase as they will be essential for successful launch.¹²

When the remaining costs are considered, that is to say adding those costs classified as LRAIC in this paper, there is a loss during this first part year. This loss is solely attributable to the expenditure required during the entry period into this business, being primarily the pre-commercial launch staff and systems costs, entirely consistent with the start up profile of any new business. Camelot's future operating plan does not envisage special introductory or low pricing at this stage including inducements such as sign on bonuses or overrides. Such start up costs would be incurred by any new entrant to the business. They cannot unfairly disadvantage existing providers or cause them to exit the market since they represent costs that existing providers have already incurred in the establishment of their own service and retail network. Put another way, if a new entrant to a market were not allowed to incur start up costs, then existing providers would never face new competition.

Growth/Maturity: Financial Years 2010/2011 to 2014/2015. After the start up period, Camelot projects that revenues will exceed both AAC and LRAIC.

Profitability after allocation of common costs for financial years 2010/2011-2014/2015. Camelot has also assessed the outcome when allocating a proportion of common costs to Commercial Services in the growth/maturity phase of the business.

The method of calculating common costs is as follows:

- **Altura terminals and network services:** Common costs primarily arise from the Altura terminals and network services. The use of these terminals is related to the number of transactions, and therefore an appropriate fully

¹¹ Camelot future operating plan, Commercial Services Income Statement Combined (July 2009 to Financial Year 2014/2015)

¹² Camelot future operating plan, Commercial Services Combined Cashflow Statement projects that from April 2010 onwards, the transaction revenues would cover AAC even if all staff costs were included.

allocated cost methodology is calculated based on the number of transactions. Allocation of these costs between the National Lottery and Commercial Services is therefore done proportionately to the number of transactions for the National Lottery and Commercial Services.¹³

- **Common overhead (premises, treasury, HR and other common back office functions).** The use of these premises and back office functions is likely to be proportionate to the number of staff active in Commercial Services. Allocation of these common costs to Commercial Services is done proportionately to the number of staff involved in this business segment.
- **Consumables distribution.** Rollstock for the use of Commercial Services will be delivered to retailers using delivery arrangements in place for National Lottery rollstock. The amount of rollstock used by Commercial Services will be determined by the number of transactions, and therefore allocation of these common costs is done proportionately to the number of transactions for the Commercial Services business segment relative to the National Lottery.

We conclude that revenues from Commercial Services will exceed costs even if it were appropriate to allocate a proportion of common costs in this way.

¹³ The number of transactions relating to the National Lottery is the transactions numbers for the latest available 12 month period. The number of transactions relating to Commercial Services is the projected volume in Financial Year 2014/2015 (reflecting the run rate of Commercial Services when the business reaches maturity).

Conclusion on Pricing. As may be seen from the summary table below, revenues from Commercial Services as a whole, and in relation to each individual service, will exceed costs during the period covered by Camelot's future operating plan to financial year 2015/2016, save for the entry period during which additional costs may legitimately and properly be incurred in establishing Camelot's business. Further, revenues would continue to exceed costs even if a proportion of Camelot's costs from the National Lottery were allocated to the Commercial Services business.

| Commercial Services Business | | | | | |
|-------------------------------------|-----------------------------|-------------------------------|-----------------------------|-------------------------------|--|
| | July 09 – March 10 | | 2010/11 – 2014/15 | | |
| | Revenues Exceed AAC? | Revenues Exceed LRAIC? | Revenues Exceed AAC? | Revenues Exceed LRAIC? | Revenues Exceed LRAIC and allocated Lottery Common Costs? |
| All Commercial Services | Yes | No | Yes | Yes | Yes |

| Individual Services | | | | |
|------------------------------------|-----------------------------|--|-----------------------------|--|
| | July 09 – March 10 | | 2010/11 – 2014/15 | |
| | Revenues Exceed AAC? | Revenues Exceed Product-Specific LRAIC? | Revenues Exceed AAC? | Revenues Exceed Product-Specific LRAIC? |
| Mobile top-ups | Yes | Yes | Yes | Yes |
| International Calling Cards | Yes | Yes | Yes | Yes |
| Bill payments | Yes | Yes | Yes | Yes |
| Electronic Fund Transfer | Yes | Yes | Yes | Yes |
| Tap & Wave | Yes | Yes | Yes | Yes |

Annex 1: Commercial Services Cost Driver Analysis

The table below sets out the all the cost categories included in the Camelot future operating plan for the proposed Commercial Services business, and provides a summary of the underlying cost drivers, the entities which bear the cost and the incremental nature of the cost. The table was compiled with the assistance of KPMG.

The two cost-bearing entities considered were Camelot Group plc's Commercial Services business (CCS) and Wholesale Commercial Services Limited (WCS). Two types of cost were considered: Average Avoidable Costs (AAC); and Long Run Average Incremental Costs (LRAIC). These costs are defined and discussed in the paper. We also indicate the extent to which costs apply to all Commercial Services or particular individual service lines.

The table highlights that the Camelot future operating plan for the proposed Commercial Services business includes a comprehensive range of incremental cost projections. The model does not include common cost types for the reasons provided in the paper.

Following this table, we provide some outline thoughts on the common costs which might be included in a fully allocated costing methodology, but do not consider such allocation appropriate for the reasons described in the paper.

We conclude by explaining the method of allocation of costs between each service line within the Commercial Services portfolio.

| Category | Cost | Overview | Key cost driver | Cost-bearing entity (WCS vs Camelot Commercial Services 'CCS') | Cost type | Specific to individual service or common to all services? | Comments |
|---------------|----------------------|---|--|--|-----------|---|--|
| Cost of sales | Retailer commission | Out-payments to vending retailers (% of face value of transaction/per pence per transaction) | Face value of transaction/ transaction volumes | CCS: 100% | AAC | Product-specific cost data | |
| | GTECH fee | Fee to interface with software | Transaction volumes | CCS: 100% | AAC | Product-specific cost data | |
| | Other direct costs | Costs paid to banks for provision of EFT/Tap & Wave services | Transaction volumes | WCS: 100% | AAC | Product-specific cost data | |
| Overheads | Staff | Incremental staff costs (across sales, finance, IT, regulatory, content support, call centre and PR). Includes a 50% uplift to capture any additional staff related costs such as non-salary benefits | Staff numbers, by function | CCS: sales, call centre, IT, regulatory, finance, PR WCS: content support sales, director | LRAIC | Common to all Commercial Services | Certain staff functions, such as sales staff, may be considered AAC depending on the time scale considered and the extent to which such salaries may be avoided by termination and/or re-deployment within the business during that time period. |
| | Legal & professional | <ul style="list-style-type: none"> Set-up: costs associated with contracting with new suppliers Ongoing: general legal costs | Contract volume & complexity | WCS: 100% | LRAIC | Common to all Commercial Services | |

| Category | Cost | Overview | Key cost driver | Cost-bearing entity (WCS vs Camelot Commercial Services 'CCS') | Cost type | Specific to individual service or common to all services? | Comments |
|----------|--------------------|--|---|--|-----------|---|---|
| | Field maintenance | Maintenance of installed peripheral equipment | New sites Volume and frequency of equipment breakdown rates (as per lottery actuals) | CCS: 100% | LRAIC | Common to all Commercial Services | Although there may be field repair synergies resulting from the same engineers maintaining the Altura (National Lottery) terminals and Commercial Services equipment, we take the conservative approach of not excluding those potential common costs from LRAIC. |
| | IT maintenance | Ongoing annual maintenance charge for the BPS software required to support new commercial services | Time & materials for external support | | LRAIC | Common to all Commercial Services | |
| | Paper/ consumables | Paper used to print retailer and customer receipts | Transaction volumes | CCS: 100% | AAC | Can be allocated to products relative to number of transactions | Minor additional common costs are excluded (eg consumables distribution) |
| | Warehouse services | Costs associated with storing and packaging peripheral equipment pre-delivery | Establishing retail network | CCS: 100% | LRAIC | Common to all Commercial Services | |

| Category | Cost | Overview | Key cost driver | Cost-bearing entity (WCS vs Camelot Commercial Services 'CCS') | Cost type | Specific to individual service or common to all services? | Comments |
|----------|---|---|--|--|-----------|---|----------|
| | Distribution of peripherals | Logistic costs associated with delivery of peripheral equipment to retailers | Establishing retail network | CCS: 100% | LRAIC | Common to all Commercial Services | |
| | Marketing & signage | Additional marketing (for trade shows, dinners), signage & retailer training materials | Establishing retail network | CCS: 100% | LRAIC | Common to all Commercial Services | |
| | Branded Payment Solutions (BPS) maintenance | Maintenance of software required for new service delivery | Maintenance of central systems | WCS: 100% | LRAIC | Common to all Commercial Services | |
| | Retailer recruitment | Salary and expense costs of temporary sales staff employed to develop new relationships | Establishing retail network | CCS: 100% | LRAIC | Common to all Commercial Services | |
| | Network / Leased lines | Lease of additional network infrastructure to allow back-office connectivity provision with mobile/telecoms operators and other service providers | Establishing network infrastructure for retail network | CCS: 100% | LRAIC | Common to all Commercial Services | |

| Category | Cost | Overview | Key cost driver | Cost-bearing entity (WCS vs Camelot Commercial Services 'CCS') | Cost type | Specific to individual service or common to all services? | Comments |
|---------------------|--------------------|---|--|--|-----------|--|--|
| | Bad debt provision | WCS takes the risk of commercial services inventory and is liable to pay the operators the transaction value (less Camelot margin) if retailers cannot pay. | Transaction volumes | WCS: 100% | AAC | Can be allocated to products relative to volume of cash receipts | |
| Capital Expenditure | Hardware | New routers required for commercial services only | Establishing network infrastructure retail network | CCS: 100% | LRAIC | Common to all Commercial Services | |
| | Ingenico equipment | New equipment needed to process EFT/ Tap & Wave transactions | Establishing retail network | CCS: 100% | LRAIC | Specific to EFT/ Tap & Wave | While intended primarily for EFT/Tape & Wave, Ingenico could be used to deliver other commercial services. |
| | Technology licence | One-off fixed licence fee (for new BPS software) | Establishing central systems | WCS: 100% | LRAIC | Common to all Commercial Services | |
| | Key reader | To facilitate the supply of the prepaid utility services | Establishing retail network | CCS: 100% | LRAIC | Specific to prepaid utility services | |
| | Bar code reader | To facilitate the supply of international calling calls and | Establishing retail network | CCS: 100% | LRAIC | Treated as being | Bar code readers are intended for use both with |

| Category | Cost | Overview | Key cost driver | Cost-bearing entity (WCS vs Camelot Commercial Services 'CCS') | Cost type | Specific to individual service or common to all services? | Comments |
|----------|------------------------------|--|-----------------------------|--|-----------|--|--|
| | | the bill pay services | | | | specific to international call card and bill pay services, although see discussion | Commercial Services and the National Lottery (barcode scanning on tickets and scratch-card stock taking). To account for this potential dual use we have allocated half of the costs of the bar code reader to LRAIC |
| | P1 Atos software | To aid compatibility of WCS/Camelot Group ERP data | Establishing retail network | CCS: 100% | LRAIC | Common to all Commercial Services | |
| | Camelot software development | Systems Integration and testing of new software and IT (with separate Lottery systems) | Central systems | CCS: 100% | LRAIC | Common to all Commercial Services | |

Common Costs

Common costs are costs that are not incremental due to the provision of Commercial Services – i.e. Camelot would have to make this expenditure for the operation of the National Lottery with or without Commercial Services. The table below describes how selected key common costs could be allocated to Commercial Services in a fully allocated costing (FAC) framework.

| Common Cost | Overview | Key cost driver | Cost bearing entity | Cost type | Comments |
|--|---|------------------------|---------------------|-------------|----------|
| Common overheads (HR, finance, other SG&A) | The cost of property, HR and finance is probably best linked to the number of staff involved in the provision of the services. Overhead costs allocated to staff numbers in an FAC framework | Staff numbers | CCS | Common cost | |
| Terminal and network costs | The cost of the existing National Lottery terminals and network, comprising mainly of depreciation costs (terminals) and annual network fees. This does not include the cost of any additional services (which are included as incremental costs above). As the use of the terminals and the network is primarily a function of the number of transactions, the appropriate FAC framework is transaction volumes. | Number of transactions | CCS | Common cost | |
| Consumables distribution | Camelot provided an estimate of the cost of consumables distribution for National Lottery rollstock. We allocated this common cost between National Lottery and Commercial Services based on transaction volumes (which determine the amount of consumables used). | Number of transactions | CCS | Common cost | |

Individual Service Cost Allocation Methodology

Direct costs, AAC and product-specific LRAIC were also allocated to individual service lines, as summarised above. The following methods were used to allocate costs:

- AAC were identified by individual service line under the future operating plan, except for:
 - Consumables (AAC): allocated to service lines using the forecast annual number of transactions for each year, as the use of consumables is linked to the number of transactions
 - Bad debt provisions (AAC): allocated to service lines using the forecast cash receipts for each year, as the forecast level of bad debt provisions is determined by cash receipts
- Ingenico capital costs (LRAIC) were allocated to EFT and Tap & Wave as they are the primary users (although we note that there is the option to use this technology to deliver all Commercial Services and so, strictly speaking, one should consider option value, which we have not done here). We allocated costs between EFT and Tap & Wave proportionately to expected revenue over the operating plan period
- Key reader capital costs (LRAIC) were allocated to bill payment service line
- Bar code scanner capital costs (LRAIC) were split 50% to National Lottery and 50% to the mobile top-up service line (though the service remains profitable even if 100% is allocated.)