



National Lottery
Commission

A Lottery for the future

Shaping the structure
of the third competition

A discussion paper

January 2005

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Foreword

The UK National Lottery is one of the most successful lotteries in the world. Since 1994, it has achieved £48 billion in ticket sales, raised £16 billion for good causes and transformed Britain with 180,000 grants.

Having celebrated the 10th Birthday it is now the right time to look to the future. The current licence expires in 2009 and we are determined to create an attractive competition framework to select a single operator to run the Lottery. The Government, in the National Lottery Bill, has proposed some legislative changes which will help.

We believe that vigorous competition is the best way to generate the maximum return for good causes. But the market to run the National Lottery is not a market like any other. After the last competition, the National Audit Office¹ concluded that, "There is a real risk that there will be no competitive pressure when the next licence comes to be awarded." This is a view endorsed by the Public Accounts Committee and shared by us.

That's why the structure of the next competition will be critical. This document marks the start of the process. We are seeking views to ensure that the competition takes place on a level playing field and that any possible barriers to entry have been addressed. We have also set out our illustrative timetable for consideration.

We are offering potential bidders the prize of running a world class lottery and the opportunity to shape its future. We encourage you to share your views with us and help generate the debate drawing on your own areas of expertise. Only by hearing and understanding the most important questions can we address and resolve them.

The Commission is determined to run a fair and transparent competition and to do all it can to enable interested bidders to participate. So your views are very important to us.

We look forward to hearing from you.



Timothy Hornsby
Chairman



Mark Harris
Chief Executive



¹ 'Awarding the new licence to run the National Lottery', NAO, 10 May 2002.

Introduction

The current Lottery licence expires in 2009 and we anticipate that the competition for the next licence will need to take place in 2007 to allow for a transition period of between 12 to 18 months. Therefore, we have already started the preparatory work on the design of this competition.

Our aim is to:

- make the competition as attractive as possible to potential bidders, on the basis that a vigorous competition is the best means available to generate the highest returns for good causes;
- make any changes that are necessary to reflect developments since the 2001 competition in:
 - the operation of the Lottery, including a larger game portfolio and new methods of distribution²;
 - the market environment in which the Lottery operates;
 - the technology that supports the Lottery, including developments in gaming systems, terminal design and communications networks.

Since the last competition, the Government has been considering whether legislative change is needed to encourage greater competition. It announced in November 2004 that the presumption is to run the competition for a single licence. If there is no effective competition however, there may be flexibility to award a small number of licences through the exercise of a reserve power by the Secretary of State³.

As a starting point, we commissioned four strands of independent research to identify what factors might prevent a vigorous competition. These strands comprise:

- **economic barriers – investigated by NERA.**
A review by economists drawing upon economic analysis and the experiences of lotteries abroad and of other sectors of the economy where major licences or franchises are let;
- **commercial barriers – investigated by KPMG.**
A review by commercial consultants looking at the expectations of potential bidders and the business drivers most likely to influence them;
- **stakeholder audit – investigated by the London Communications Agency.**
A gathering of the confidential views of senior executives from a range of organisations which might participate in a bid consortium;

- **technological aspects – investigated by HEDRA.**
An assessment of the attributes of the gaming systems offered by four key providers worldwide in order to reach a view on how modern technology might influence the design of the next competition.

We have also taken account of:

- the recommendations made by the National Audit Office and Public Accounts Committee in their reports on the last licence process;
- the reports of the Select Committee for Culture, Media and Sport and the Joint Scrutiny Committee on the Gambling Bill;
- the work undertaken by the Department for Culture, Media and Sport in considering the options for the licensing framework (including the responses DCMS received to its consultation); and
- the knowledge held within the Commission itself.

The results of this research have further informed our thinking about three key areas:

- the timetable for the next competition;
- where potential barriers to entry might lie;
- potential strategies to address the barriers.

This discussion document is intended to set out the areas where we wish to stimulate an informed debate. We have posed a number of questions within the paper to help focus comments, but we do not expect these to be followed rigidly or for any respondent to address all the questions asked unless they wish to do so. We welcome views on the questions posed and on the potential strategies suggested. All responses will be treated as confidential. We are happy to receive written comments, or discuss points through face-to-face meetings.

A summary of the key findings from each strand of research is given on page 4 and the consultants' own summaries of the reports are in Annex C. Full copies of the reports are available from (www.natlotcomm.gov.uk/competition).

² Please see Annex A for a current overview of the National Lottery.

³ Please see Annex B for further details of the legislative review.

Timetable for the next competition

The table below shows the main stages in the competition process and an indicative timetable⁴. The timetable will need to be flexible, so that we can reflect any changes made as the result of responses to the discussion papers. For example, decisions on whether to adopt a two-stage process and on the period required for transition will affect the timing of the start and end of the bidding and evaluation processes respectively. We will also need to be sure that we have sufficient time to implement contingency arrangements should the competition for a single licence prove ineffective.

We believe that there is sufficient time, especially in stages 4 and 5, to implement contingency measures for any changes that we might be required to make to the timetable. We will keep the timetable under careful review, and revise it as necessary. In addition, we are putting in place rigorous management and comprehensive assurance processes to ensure that the competition is well run. Our basic approach is outlined in Annex D and we believe it will deliver a thorough and fair competition process.

We will seek the views of interested parties on the outputs of each of the first four stages of this process. For stage 2 (further work on available options) in particular, we will give early attention to those issues likely to have a significant impact on the timetable.

Work plan	Output	Timing
01 Identification of barriers to entry and potential strategies	This document	Completed
02 Further work on the options available	Discussion papers	January – September 2005
03 Evaluation of the options and broad structure for the competition itself	Statement of Main Principles	October – December 2005
04 Drafting of detailed terms of the competition	Draft Invitation to Apply	January – June 2006
05 Finalisation of the detailed terms of the competition	Final Invitation to Apply	July – October 2006
06 Bidders compile and submit bids	Bids	November 2006 – April 2007
07 Evaluation of bids	Announcement of preferred bidder	May – September 2007
08 Licence finalisation	Terms of licence to be issued	October 2007
09 Transition period	Commencement of new licence	November 2007 – January 2009

Questions for comment

- Q1 Do you have any views on the proposed timetable?
- Q2 In particular, do you believe that it allows enough time for bidding consortia to be formed, and for the bids themselves to be compiled?

⁴ This has evolved from the outline timetable published in our 2003-04 annual report, as reproduced in our 'Update 01' for stakeholders.



Conclusions from the work undertaken by our consultants

We commissioned independent research in June 2004 to assess likely market interest in bidding for the next National Lottery licence. This has involved detailed analysis of the economic and commercial incentives to bid, alongside an audit of key players to assess their perceptions of the current Lottery arrangements – what the attractions are, and what the barriers to entry might be.

Although the four strands of research focused on different areas, several clear themes have emerged. These may hold the key to where the critical barriers lie or they may prove to be of such little relevance that we can disregard them at the earliest opportunity. These issues are dealt with in more detail in the next section.

Core themes of the research

Five strong themes emerge from the research: cost of bidding; incumbent advantage; evaluation criteria; handover and transition arrangements; and technology.

The research suggests that the cost of bidding may not be such a significant factor in generating a successful competition as previously imagined. It suggests serious consortia would be willing to invest, as long as we do everything possible to minimise their costs and to reduce unnecessary requirements, incumbent advantage and uncertainty in the bidding process.

What is clear, however, is that any area of the competition framework which gives, or appears to give, the present operator an advantage will be critical. This advantage will not be judged purely in financial terms. It could be anything from access to sales information to a better understanding of the regulatory environment.

Another key driver will be the criteria we set to evaluate the bids received and the process which the competition will follow. The criteria will be critical to successful competition as it is only against these standards that bidders will be able to differentiate themselves.

Handover would be an issue if a bidder other than the present operator wins the competition. We took steps in the last competition to reduce the risks associated with handover at the end of this licence, but a ‘big bang’ transition is still likely to be required. Bidders will therefore need a clear understanding of how the handover can be made to work smoothly.

Technology is the final core theme which emerges but is not now seen as such a critical element in the bid process. There was broad agreement that, although technology will be important, it may not be as significant a differentiator between bids as in previous rounds. The main theory is that technology has advanced to such an extent that off-the-shelf options may now be viable whereas, in the past, bespoke solutions were the norm.

As a regulator committed to a fair and transparent competition, we are publishing the full results of the research on our website (www.natlotcomm.gov.uk/competition). The executive summaries from each consultant are attached at Annex C for ease of reference. The only changes made to the reports have been made by our consultants themselves in order to ensure that the requirements of commercial confidentiality are maintained.

Key issues for debate

This chapter sets out the areas where we intend to carry out further work, to inform us fully in making the design of the next licence competition as attractive as possible to potential bidders.

The issues for debate are grouped as follows:

Encouraging competition	pages 6–12
Levelling the playing field	pages 13–15
Aligning incentives	pages 16–19

We can investigate each of the areas outlined in this chapter (and others which arise as our work progresses). Early priority will be given to areas which might impact on the competition timetable, such as a two-stage process; allowing a competition between key technology suppliers after the selection of the preferred bidder; and the transition period between the finalisation of the preferred bid and the start of the next licence period. We will give lower priority to areas that respondents indicate are of low importance.

We will be able to identify in more detail how the potential strategies might work, and the advantages and disadvantages associated with them. These analyses will be published to give potential bidders, suppliers and other interested parties the opportunity to comment. Once all the options have been evaluated, the preferred solutions will be incorporated in a draft Statement of Main Principles which will form the basis of consultation.

This work will be carried out during 2005. We expect to finalise the Statement of Main Principles by the end of the year.

01 The competition and regulatory frameworks

Bidders will wish to be clear how the framework we adopt, as regulator, is likely to impact both on their chances of success in the competition itself, and on the conduct of their business if they are successful.

Potential strategies

Treatment of risk – we recognise that there could be risks in terms of handover, and also in relation to gaming innovation. Bidders will want to be clear about how we will treat these risks and how this will affect the evaluation of the bids.

We will seek, as far as possible, to clarify our position on the assessment of risk in advance of bids being sought. We recognise that in some areas, such as transition and handover, the present operator may be at some advantage in its ability to manage risks. While we cannot discount the risks associated with bids, as to do so is likely to be inconsistent with our duty to achieve the greatest returns possible for good causes, we expect to be clear about how we will treat risks, and design the competition in a manner which reduces the risks for new bidders.

Evaluation criteria – we will also seek to define clear and objective assessment criteria in advance of the competition so that bidders can be clear how their bids will be evaluated.

Regulatory model – we expect to undertake a full review of our regulatory model over the coming year, to ensure that it meets the five principles laid down by the Better Regulation Task Force and that we regulate in accordance with best practice. In particular, we will aim to ensure that maximum commercial freedom is given to the operator whilst ensuring that the Lottery is run with all due propriety, that the interests of players are protected and that the operator does its best to maximise returns to good causes. This review will impact on regulation of the current licence, but will also set out our intentions for the next licence period.

The legal and policy framework – we will provide a clear statement of the legal and policy framework for the competition, to inform potential bidders at an early stage in the process. We expect to give clear guidance on the sorts of organisations that would be acceptable as bidders, the types of game that would be acceptable, our position on not-for-profit bids and expectations in respect of social responsibility and involvement. For example, provided that any 'fit and proper' requirements have been satisfied, we would have no objection to overseas or gaming companies playing a major role in bidding consortia.

Questions for comment

- Q3 Are you in agreement with the measures we intend to take?
- Q4 What else could we do in terms of competition or regulatory frameworks that would be helpful for potential bidders?

02 Reducing the costs of bidding

One important factor which potential bidders will consider carefully is the cost of bidding, relative to their perceived chances of success, the likely rewards of success and the opportunity costs of focusing resources on this rather than on other opportunities. If we can successfully reduce the costs of bidding, then the prospect of bidding may become more attractive.

Potential strategies

Meeting bidders' costs – we could make arrangements for unsuccessful bidders to receive funding for all, or a defined part, of their costs. If costs were to be partially met, we might consider whether these could be limited to: a set proportion of costs; certain categories of cost; or costs in excess of those incurred by the present operator. In order to justify such an arrangement, we would need to be satisfied that the cost would be outweighed by benefits resulting directly from a more vigorous competition. We would need to be sure that eligible costs can be defined clearly in advance and measured. We would also need to ensure that we were not paying the costs of rectifying deficiencies in bids received.

Two-stage process – under this arrangement, we would conduct the bid process in two stages. The first stage would require bidders to show they have the necessary corporate structure, backing and finance in place, as well as the management capacity, to compile a comprehensive bid. As far as possible, the criteria to be met at this stage should be designed for objective assessment, so that potential bidders could assess for themselves the likelihood of their meeting them. The shortlist of bidders would be taken forward to the second stage, when they would submit a comprehensive bid. Such an approach has the advantage that the costs of bidders who have little realistic prospect of success are minimised. A first stage might be essential if we decided to meet bidders' costs to some degree, and would also provide an early opportunity to assess whether the competition was attracting a sufficient number of bids. It would be of lesser value if only a small number of substantive bids were expected and might, by making the amount of potential competition clear, influence the content of bids or possibly discourage some who had participated in the first stage from continuing.

Simplification of the process – we could identify 'hurdles' where a certain standard is required but where the solution is reasonably clear cut. An example might include measures for player protection, including trusts to protect players' funds. We would define the standards to be met in detail and ask bidders to confirm that they would meet these (possibly allowing bidders to offer alternatives which achieved the same standard). Detailed arrangements might be deferred until the preferred bidder had been selected, so long as a clear solution had been agreed. In addition, the information required in bids might be reduced. For example, bidders might be asked to give a broad indication of their location plans, but the detailed location would be finalised after the preferred bidder had been selected.

Information requirements – we could aim to minimise the costs to bidders of collecting information. This might involve both minimising the levels of information required in bids and making as much of the information which bidders are likely to need freely available. Some of this is indeed already in the public domain. However, we would expect to ensure that commercially sensitive information is not made public unnecessarily, nor made available to potential competitors.

Length of bids – the length of bids and the degree of detail within them could be restricted, to reduce the costs both of compilation and of our evaluation, as long as no potential bidders were disadvantaged and that enough information was available to select the best bid.

Questions for comment

- Q5 How far do you believe the costs of bidding have deterred companies from bidding in the past?
- Q6 Which of the possible measures above would you strongly favour and why?
- Q7 Which would you definitely not favour?
- Q8 What else could we do to reduce bidding costs?

03 Choice of gaming systems providers

In previous rounds of competition, a critical requirement has been that bidders demonstrate a gaming technology solution that will meet the required standards. This has been necessary because gaming systems, and the supporting terminals, tended to be bespoke solutions (designed specifically to meet the needs of the UK National Lottery). This approach brings certain advantages. At the time the preferred bidder is selected, we know that the bid contains a technology solution that can be delivered, and that the costs of the solution have been fully provided for in the bid. The bidder will also have access to a supplier who understands lotteries and, in the case of bidding consortia who have not operated a national lottery before, can bring expertise on game and distribution plans as well as on lottery operations.

However, there are also disadvantages in this approach:

- there is a small number of gaming systems providers worldwide. Requiring bidders to have a provider as part of their bid may constrain the number of bids, if such providers are unwilling to participate in more than one bid;
- there is less competitive pressure on such providers to bring down their costs and bidders' costs may be increased. Assuming that costs are passed on, this will reduce returns to good causes;
- if such providers have a key role in the bidding consortia, they are in a strong position to push technological solutions that suit them best, rather than to provide solutions which best meet the needs of the bidder and of the UK National Lottery.

Modern lottery systems now have greater inter-operability and versatility in that they:

- are written with open interfaces capable of communicating more easily with other systems;
- are parameter driven, so that a change in the game portfolio is much simpler to implement;
- can support a range of terminals from other manufacturers; and
- are scaleable up to, and beyond, the size of the UK National Lottery.

Potential strategies

A 'dual competition' approach – these developments open the opportunity for us to design a competition where the technological solution is put in place after the preferred bidder is selected. Bidders would have to demonstrate their ability to select suppliers effectively

once they had been selected as preferred bidder, and that their core bid team contained sufficient skills to implement their chosen solution quickly and effectively. We would still need to specify the key criteria that the technological solution would need to meet (e.g. transaction times, security and change control). Bidders would then be clear what was expected of them and could confirm, at the time of bidding, that these standards would be met. The advantages would be that:

- the market would not be constrained by the limited number of providers of gaming systems;
- the bidder could obtain a 'best of breed' solution, which meets the needs of the UK National Lottery most effectively;
- the costs of the solution would be driven down by making potential providers compete to supply to the preferred bidder.

However, there are potential disadvantages:

- the process would take longer, and there is a risk that the preferred bidder might be unable to conclude a satisfactory solution;
- full costs would not be known at the time of selection of the preferred bidder. A mechanism for sharing any variance between expected and actual costs might be required. This would have to ensure that the preferred bidder does not achieve windfall profits by negotiating a low cost solution, or withdraw if the cost of the solution proves, in the event, to be significantly higher than expected;
- bidders who do not have direct lottery experience may be disadvantaged if this experience would typically come from inclusion of a gaming system provider in their bid consortium. If the market only includes a small number of operators (other than gaming system providers), then exclusion of providers could reduce competition for the operator's licence.

Questions for comment

- Q9 Do you consider the relatively small number of gaming systems providers to be a constraint on competition?
- Q10 Would you favour a competition where the technological solution is put in place after the preferred bidder is selected?
- Q11 If so, do you have views on how such an arrangement might work most effectively?

04 Bid realism and sustainability

A key issue for us is the realism and sustainability of the bids. This is because of the risks associated with an operator failing if it has not made sufficient provision to retain sufficient capital or reserves within the business to make it resistant to 'shocks'. Such events might arise from over-optimistic sales forecasts or from significant increases in costs or changes in the market situation. In such circumstances, the withdrawal of the operator is likely to result in significant losses to the good causes whilst a new operator is put in place or returns to the operator are renegotiated to sustain it through the interim period.

Therefore, whilst we wish to encourage bidders to achieve a level of sales which will deliver as great a level of returns to good causes as possible, we do not wish to encourage unduly over-optimistic bids.

Potential strategies

Setting central sales levels – we could ask bidders to submit bids structured around a central sales level. This would be a level which we, or independent analysts, consider to be realistic based on past performance. It might represent a range. Bidders would have to bid against the central sales level, but would also be able to indicate where they would expect to exceed those levels, providing a full explanation of how that excess would be achieved. This would ensure that we can assess the sustainability of bids at realistic sales levels, whilst encouraging bidders to demonstrate how those sales levels might be exceeded.

Arrangements for dealing with poor performance – where the successful bidder predicts a substantially higher level of returns to good causes than it in fact achieves, there is an argument that this should be recognised in the returns it receives. Whilst any 'penalty' for poor performance should not be so great as to threaten the operator's continued viability, it might be possible to include licence arrangements which either reduced the licence term in such circumstances, or took back a proportion of the operator's profits.

Arrangements for dealing with 'shocks' – whilst we would expect bidders to adopt financial structures which are viable across a wide range of circumstances, we might wish to adopt arrangements which respond to excessive gains or losses in the event of changes in the operating environment which could not reasonably have been foreseen at the time of bidding. The range might be set by bidders as part of their bids, or by the Commission as part of the Invitation to Apply.

Arrangements for dealing with operator withdrawal – we will consider what arrangements might be put in place to deal with the situation where an operator withdraws during the term of the licence, either as a result of licence revocation or because it is no longer financially viable for the operator to continue. Safeguards might include, for example, financial guarantees for a proportion of the revenues which would be lost to good causes over the period between the operator's withdrawal and the introduction of a new operator.

Questions for comment

- Q12 Which, if any, of these suggestions would you be able to support or object to strongly?
- Q13 What other measures do you think we should consider as a means of avoiding and addressing under-performance and shocks?
- Q14 Do you believe that it is possible for us to define in sufficient detail what might reasonably have been foreseen at the time of the bid?

05 Transition arrangements

There has to be a period between selecting the successful bidder and the start of the licence, so that the successful bidder has time to put a new infrastructure in place (in the case of a new operator) or to allow time to make changes to the existing infrastructure (if the present operator is successful).

We will also need to have made clear, in inviting bids, what features of the present arrangements we would expect to see replicated by, or passed over to, the successful bidder. These will include the payment of unclaimed prizes (as provided for in the present operator's licence), but might also include transfer arrangements for Scratchcards and subscriptions, as well as an interface with any third party interactive/electronic point of sale systems in place at the time of bidding and remaining in place at the end of the current licence period. This will be less of an issue for the present operator, but may still impact if, for example, we require new gaming systems.

Potential strategies

Transition period – we will need to balance two demands. The successful bidder will be looking for a longer transition period (up to 18 months) to allow as much time as possible for a smooth transition. On the other hand, a longer transition period risks problems for an outgoing operator in maintaining services if it finds, for example, that key staff are leaving before the end of the licence period. We will investigate both the time reasonably required for the transition and the period that the present operator could sustain a reasonable level of service if it were not the successful bidder.

Transition of services – the more services that are required to transfer from the present operator, the greater the likelihood that a new operator's systems will need to be adapted to incorporate those services. Such adaptation is likely to increase both costs and risk to the new operator, but will reduce the inconvenience to players (and so disruption to returns to good causes). We will investigate which services might be transferred, and, for those services, whether the risks of transfer outweigh the player (and sales) benefits from greater continuity.

Questions for comment

Q15 Are there any additional factors that we should take into consideration in determining the duration of the transition period?

Q16 What do you consider to be a realistic transition period?

06 Consortia arrangements that might restrict future competition

We are aware that consortium members may enter into agreements amongst themselves, whether formal or informal, which may restrict the ability of the organisations involved to participate in other bids, either current or in future rounds of licence competition. One example is where a key supplier is tied exclusively to a single bid consortium. Another is where agreements remove the freedom of consortium members or suppliers (or, potentially, third parties) to participate in future competitions as part of another bid. We are concerned that such arrangements may reduce competition.

Potential strategies

Restrictions on such arrangements – we will consider whether we are lawfully able to make it a condition of competition that such arrangements should not be entered into. If we consider that we have this ability, we would then expect to consider whether there would be benefit in using it, and how it might be applied. For example, we might require bidders and their main suppliers to disclose any arrangements which might limit future competition at the time of submission of their bid.

Questions for comment

Q17 What would be your view on our making it a condition of competition that restrictive arrangements should not be entered into?

07 Criteria for determining whether reserve powers should be adopted

The Government has decided that the next competition should offer a single licence to operate the National Lottery, but that it will retain reserve powers used after consultation with the Commission to allow more than one licence to be offered in the event that a single licence does not generate an effective competition. We are committed to do all we can to generate a successful competition for a single licence, but support the need for a contingency arrangement should a competition for a single licence prove ineffective.

The Secretary of State has asked us to identify, in advance of the next competition, the criteria which would be used to determine whether these reserve powers should be put into effect. Our starting point is the requirement that, subject to propriety and player protection, we should do our best to ensure that returns to good causes are as great as possible. A strong competition is the most straightforward way we have to demonstrate this. But we should not rule out the possibility that we might be satisfied that the requirement is met even where we receive a single bid. We intend to develop a clear definition of what would constitute a failed competition. Our working definition is that we receive less than two credible bids, and that (in the case of a single bid) there is evidence that the sole credible bidder had not bid as keenly as possible in the expectation of real competition.

In developing criteria, we will be alert to the risk highlighted in the Department for Culture, Media and Sport's decision document that there may be a perverse incentive for bidders not to bid for a single licence in the hope of triggering a competition for more than one licence. We will set the criteria in advance of the start of the competition; ideally, at the time we publish our Statement of Main Principles.

Potential strategies

Two-stage process⁵ – this would allow the early identification of those entering the bidding process. It would enable us to assess whether sufficient interest existed from credible consortia to provide the competitive pressure that the bidding process is designed to provide. Lack of interest at the first stage of a two-stage process would give us early warning of a lack of competition and allow us to discuss contingency arrangements with the Secretary of State immediately. If only one bidder comes forward at the initial stage, this could be strong evidence that the competition had failed.

Converting initial bids into full bids – whilst the first stage of a two-stage process might provide a strong indication of the likely degree of competition, it does not provide certainty⁶. We will need to seek initial bids which give a clear indication of the standing and intent of the bidders. We may also seek to design further incentives to encourage bidders to convert their initial bids into full bids. These might include requiring a deposit which would be forfeit if a full bid were not received. If bidders' costs were to be met, this would probably be on condition that a full and credible bid was received.

Reserve pricing – if we received more than one credible initial bid but only one full bid, it remains possible that the single bid would be acceptable. This might be the case where the single bidder believed that it faced strong competition and constructed its bid accordingly. However, we would not be in a strong position to assess whether this was the case. One approach that we might adopt is to set a reserve price prior to the competition, to be used as a measure of the acceptableness of a single bid. It is likely that we would not disclose the reserve price before receipt of bids, as to do so might well distort the competition. We would need to be confident that we had sufficient information and advice to set a realistic reserve price.

Questions for comment

Q18 What criteria for determining whether the competition had failed would bidders expect to see before deciding whether to bid?

Q19 How detailed should those criteria be?

Q20 What are your views on the potential criteria outlined above?

⁵ As described under 'Reducing the cost of bidding'.

⁶ When an invitation to tender for the Irish Lottery was issued in 1999 there were 3 companies that launched a bid for the licence. However, by January 2001 two companies had withdrawn and the process continued with a single bidder.

08 Access to information

Given that the UK National Lottery has only ever had one operator, potential competitors will inevitably have less information on which to base their bids than the present operator. This may discourage potential bidders if they consider that the costs of collecting such information are likely to be excessive and that the quality of their bid will be reduced without such information. We took significant steps, in terms contained in the present licence, to make more information available to potential bidders than was available in the last competition; and we would expect to assess again the sufficiency of such information.

Potential strategies

Availability of key information – we will seek the views of potential bidders on the key information that they require to submit a bid. This might include, for example, retailer locations; transaction volumes; and game performance data. If satisfied that such information is essential to construct a competitive bid, we would make this available either under the powers contained within the present licence or, to the extent we are able to, by negotiation with the present operator.

Access to the regulator – we will seek to provide as much information to potential bidders about our own views of the market, and about regulatory constraints, within the Invitation to Apply. But we recognise the possibility that the present operator has an advantage from its day-to-day dealing with us on the regulation of the present licence. In order to minimise this risk, we might consider:

- running workshops for potential bidders to explain regulatory issues or to set out in detail key requirements (such as trust arrangements to protect players funds);

- encouraging potential bidders to seek the Commission's informal views before the Invitation to Apply is issued and, potentially, before bids are received;
- if a two-stage process is adopted, by allowing feedback to bidders on the evaluation of their first stage bid so that any regulatory issues arising can be addressed in the final bids;
- provision for improvement of bids received, or negotiation of the terms of bids, so that any regulatory issues arising can be addressed before the preferred bidder is selected.

But in all cases, we will wish to be certain that the arrangements can be applied in a manner which is fair to all bidders and which does not create risks of successful legal challenge to the process. This will be a key factor in the further work we intend to undertake in this area.

Questions for comment

- Q21 What is the key information required to submit a bid?
- Q22 How can we best familiarise bidders with our view of market and regulatory constraints, so that this is no longer a potential source of advantage for the current operator?
- Q23 At what point in the process should we begin this familiarisation?
- Q24 Would it be helpful, if a two-stage process were adopted, to allow feedback to bidders on their first stage bid so that any regulatory issues can be addressed in final bids?
- Q25 Would it be valuable to make provision for improvement of bids before the preferred bidder is selected?

09 Requirements for new gaming systems and equipment

The present operator has a competitive advantage in that it has gaming systems and terminals in place which it can operate into the next licence period. Consequently, it can reduce its costs to make a more competitive bid, and minimise the risks associated with the handover period, by phasing any technology changes over a longer period.

We can level the playing field in this respect by requiring all bidders, including the present operator, to introduce new technology (terminals, gaming systems or both). But we would only be justified in doing so if we considered that such a requirement would result in increased returns to good causes.

There are two aspects to consider:

- such a requirement might result in a more vigorous competition and so place greater pressure on bidders (including the present operator) to maximise the returns they offer to good causes;
- introduction of modern systems might well increase the flexibility available to the successful bidder to innovate and to make changes to the game portfolio more quickly. If so, such systems might enable the successful bidder to generate greater returns to good causes.

Potential strategies

Requirement for new technology – we will consider whether there are sound arguments, from a good causes perspective, for requiring all bidders to commit to the introduction of modern gaming systems and/or terminals as part of their bids. We will need to decide whether such a requirement would be likely to increase returns to good causes.

Timing of introduction – if we consider that there would be benefits in requiring bidders to introduce new technology, we will need to consider whether the timing of such introduction should be the same for all bidders, including the present operator. We will need to decide whether the advantages from a good causes perspective of a more vigorous competition outweigh the costs, if the present operator were successful, of a faster implementation than it might otherwise choose to adopt.

Questions for comment

Q26 Would it benefit returns to good causes to require all bidders to commit to the introduction of modern gaming systems and/or terminals as part of their bids?

Q27 Would it be reasonable that the time available for introducing any new gaming systems and/or terminals should be the same for all bidders, including the present operator?

10 Handover arrangements

We recognise that handover is a critical issue for any bidder other than the present operator. The requirement that we can grant only one operator's licence at a time has the practical effect that any handover to a new operator is likely to be a 'big bang' rather than a phased handover. We sought, in the present licence, to minimise the risks by making arrangements for the transfer of intellectual property, terminals and key information. The transfer of terminals will be at an agreed valuation to be not less than £10 million. There is also an agreement that the present operator will co-operate fully in any handover. On the transfer of other assets, including key contracts, we were able to secure that the present operator will decide, within three months of the selection of the preferred bidder, whether it is prepared to transfer assets at an agreed valuation. It is for the new operator to decide whether it wishes to take over these assets, if they are offered.

Potential strategies

Co-operation – potential bidders will need to understand what degree of co-operation they can expect from the present operator, and what steps we intend to take to ensure that such co-operation takes place, should they bid successfully for the next licence. We expect to discuss this with the present operator and make the arrangements clear in advance of the next competition. We expect this to cover such categories as the transfer of data and the potential for access to the current infrastructure prior to handover (e.g. to the communications network for overnight testing purposes).

Terminals – if potential bidders plan to take over the present operator's terminals, they will need to know what they are taking over and be clear that the price does not give the present operator an unfair advantage. We expect to assess the specification and likely cost of the terminals, and to make our conclusions known in advance of the next competition. We will also consider, if we believe that there is a strong likelihood that potential bidders will wish to take over the present operator's terminals, whether the existing arrangements provide the present operator with an unfair advantage. If we conclude that they do, we will consider whether there are arrangements for reducing this advantage (for example, by making an allowance in bids).

Transfer of assets – we hope to be able to discuss with the present operator (and possibly with its key suppliers) whether greater clarity could be given before the bidding process begins on the assets (and in particular the key contracts) that might be available for transfer. This would facilitate a greater degree of phasing within the handover period and beyond. We note the encouragement that the Government has given, in both its decision documents, to such discussions taking place.

Arrangements to be incorporated in the next licence – we expect to consider whether there would be benefits in making yet stronger handover arrangements mandatory in bids for the next licence (i.e. for handover at the end of the next licence period). At the extreme, the outgoing operator would, in effect, pass its business over to the next operator, who would have an agreed period in which to implement the changes proposed in its bid. Such an arrangement is likely to provide a lower-risk transition which is seamless from the player's perspective, but might incur greater costs and inflexibilities if the new operator wished to take a significantly different approach to the business from that taken by the outgoing operator.

Questions for comment

- Q28** Do you agree that transfer of data and access to the current infrastructure prior to handover are the areas in which it is most critical that a new operator has an agreed level of co-operation with an outgoing licence holder?
- Q29** Is it important to you that we assess the specification and likely cost of terminals in advance of the next competition?
- Q30** Would you support the proposal that stronger handover arrangements should be made mandatory in bids for the next licence?
- Q31** If so, how do you think that these might be designed?

11 Balancing retention rates and funds for good causes

We designed the current operator's licence to provide the greatest returns at the point where returns for good causes are maximised. Under the present licence each bidder was asked to bid a proportion of the value of total sales which it would retain after prizes and Lottery Duty had been deducted⁷. The successful bidder's profits represent its retention less the costs it incurs.

The retention rates the bidders were asked to bid is applied in aggregate across all games, regardless of the prize payouts and costs associated with each game. This may impact on the incentives to the successful bidder ('operator') in two ways:

- games with a high prize payout ratio will only generate a very small marginal return to the operator, as it has bid on an aggregate basis. Hence, it may not pursue such opportunities vigorously;
- games with a high variable cost base will be comparatively less attractive, as the operator bears all the costs. In some cases, the game might be viewed from the operator's perspective as loss-making, even though additional sales would increase returns to good causes.

Each bidder manages risk by bidding in tranches; that is, different retention rates at different sales levels. At low sales levels, a bidder may bid a higher retention rate in order to cover its fixed costs. At higher sales levels, the retention rate will fall to cover variable costs. The danger is that a risk-averse bidder will cover its costs at low sales levels and have comparatively little incentive to grow sales as its retention will be very small at high sales levels. This results in an operator which is relatively unlikely to become loss-making, but which is relatively unmotivated to grow sales. Indeed, it may be better able to increase profits by managing its costs down than by seeking additional sales.

Potential strategies

Differential retention structures – we might ask bidders to propose different structures for different classes of game. This would allow bidders to structure retentions for games with lower prize payouts and lower variable costs (such as Lotto) differently from retentions for games with higher prize payouts and higher variable costs (such as Scratchcards). The benefit would be that, if bid properly, the operator would have similar incentives to grow sales in both classes of game. However, differential retention structures would be more complex to bid and evaluate. If too complex, they might favour the present operator, which would have detailed knowledge about its cost base and so be able to fine tune its bid with greater confidence. A compromise might be to introduce a limited number of structures, say three or four, for games of a similar type.

Retention structures – we might give bidders less flexibility in the tranche structures that they bid to increase the incentives to grow sales. One option would be to require bidders to adopt a pre-determined profile for retention levels, which would give higher marginal returns than at present for higher sales levels, so that the incentives to grow sales are increased. This might be combined with pre-determined tranche structures to reduce the degree that bidders rely on lower sales levels to generate the majority of their returns. However, this might weaken the bidders' financial robustness at lower sales levels.

Questions for comment

- Q32** What would be your view on a structure that allowed different levels of retention for different games?
- Q33** What would be your view on a structure that allowed higher marginal returns at higher sales levels, so that incentives to grow sales are increased?

⁷ The proportion varies between years and, through the tranche structure explained below, between different sales levels.

12 Licence duration

In determining the licence duration, we need to balance two competing demands:

- a more frequent competition ensures that the market is tested regularly and so demonstrates that returns to good causes are set at the optimum market level. This is particularly important where an operator might under-perform;
- a longer licence term allows a greater period for the operator to recover its initial investment and to make further investment over the term of the (longer) licence. A longer licence also reduces the disruption to the operator's business (as a proportion of the licence term) that holding a competition causes.

Potential strategies

Licence term – we expect to consider the arguments for and against a longer licence term, both through economic/technology analysis and through consultation with organisations that might be involved in bidding. One aspect we expect to consider is the expected life of assets (in particular, gaming systems and terminals) which would be utilised during a licence period.

Licence extensions/break points – we plan to assess whether it would be practical and beneficial to grant a licence whose term could be varied, either by means of extension or a break point. For example, we might grant a seven-year licence with the potential for a three-year extension (to be agreed well before the expiry of the seven-year period) if we were satisfied that the operator was performing well and the returns to good causes were as good as could reasonably be expected. The possibility of renegotiation on renewal also appears worthy of investigation. However, this will only be possible if the legislation recently announced by the Government comes into effect.

Questions for comment

Q34 Do you consider the seven-year duration of past licences to be the right length? If not, what length do you consider most suitable?

Q35 Would you consider it practical or beneficial to have a licence with a variable term using an extension or break point? If so, what lengths of initial licence and extension would be best?

Q36 How would you suggest that such a licence might best be structured?

13 Recovery of investment

Under the present financial arrangements, the operator bears most investment costs from its share of sales, allowing for recovery of its investment costs over the licence period by calculating appropriate levels of retention. Typically, this will mean that retention rates are higher at lower sales levels to ensure that the operator's fixed costs are covered.

This approach has served the Lottery well where the investment needed has been predictable at the start and relatively static over the life of the licence. However, it does not adapt well to circumstances where investment costs are difficult to predict at the time of bidding, or where significant new opportunities arise during a licence period which were not provided for at the start. In both situations, an operator will look at the business case for investment purely from its own perspective, and this will reflect the investment provision it made in its bid and the time remaining within the licence period to recover its costs. This may lead to rejection of an investment opportunity where it would not recover its costs within the licence period, although the sales benefits would increase returns to good causes.

Whilst we would expect the bid to provide for both the initial investment and a degree of continuing investment, we can see arguments in favour of new arrangements to support substantial investment during the term of the licence where this was not provided for in the bid process.

Potential strategies

Different arrangements to finance investment – the aim would be to fund significant investment in a manner which aligns the benefits from the operator's viewpoint with the optimal solution from the good causes' perspective. For example, the licence might provide that:

- an amount be retained by the operator each year to provide a reserve for significant investment. Clear arrangements would be needed for the regulator to approve use of the reserve, and to deal with the balance left at the end of the licence. Incentives would need to be aligned so that the operator would only have the incentive to use the reserve when benefits would flow to good causes as well as to itself;
- we would have the ability to adjust the operator's retention in any year to allow it to recover a proportion of the cost of an investment which had been agreed with us in advance, having reviewed the business case from the good causes perspective;
- where the investment would have a continued benefit beyond the end of the licence period and the remaining licence period is too short to allow the operator to recover the costs of its investment, the next licensee should either purchase or lease the assets created from the investment by the current operator at an agreed valuation.

Any of the above will require careful design to ensure that: benefits are shared between the operator and good causes in proportion to their additional contribution; the operator has the incentive to manage costs effectively; and the Commission does not become over involved in the investment decision.

Questions for comment

- Q37** Are you broadly in favour of changing the arrangements for the recovery of substantial investment made during the licence term?
- Q38** Which, if any, of the arrangements suggested would you favour?
- Q39** Are there any other arrangements that you believe we should be considering?
- Q40** How do you believe that such arrangements should best be managed?

14 Restrictions on other activities that the Lottery operator can undertake

The present licence arrangements require the licensee itself to take the form of a single purpose vehicle. This is in order to ensure that the operator focuses fully on the successful operation of the National Lottery. However, some suggestions have been made that this might be a disincentive for potential bidders as it may limit their ability to increase shareholder value by using the expertise developed in operating the National Lottery to support other, non-competing business opportunities. We therefore propose to consider whether this requirement might sensibly be relaxed.

Potential strategies

Ringfencing – it may be possible to ringfence the operator’s core Lottery business in a more flexible manner than the present requirement for a single purpose vehicle. We will look at arrangements adopted by other regulators and assess how they might be applied to the National Lottery. However, we will need to be satisfied that more liberal arrangements would bring benefits from the perspective of good causes (rather than operator shareholders) before going down this route.

Rules on group and sister companies – we accept that bidders will wish to have clarity about how a single purpose vehicle might fit within a group of companies, in order that lottery expertise might be used to pursue other business opportunities that do no damage to the long term operation of the National Lottery. Again, we will look at arrangements adopted by other regulators and assess how they might be applied to the National Lottery, so that we can set some clear principles prior to the bidding process.

Questions for comment

- Q41 What is your view of the likely impact of the requirement for the operator to be a single purpose vehicle?
- Q42 Do you consider that the requirement for a single purpose vehicle is unlikely to inhibit competition?
- Q43 If you believe that we should relax this requirement, how might this be done without risking damage to the long-term operation of the Lottery or the contribution to good causes?



How to respond

We welcome views of any interested parties on the analysis and proposals for further work that this document contains. We would also be happy to discuss the document, the thinking behind it and our progress more generally. We would be particularly interested in your views on the questions in this document, but equally we would be prepared to discuss and explore any other issues which might affect ways of maximising competition.

Early responses would be appreciated, (ideally by mid-March) so they can be considered thoroughly and fed in to our work on future options. Feedback received after this will of course be taken into account and all comments will be treated as confidential⁸. We would be happy to meet any interested parties, as well as to receive any written comments.

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Written comments to:

Mark Harris
Chief Executive
National Lottery Commission
101 Wigmore Street
London W1U 1QU
Email m.harris@natlotcomm.gov.uk

Other comments and requests please to:

Email publicaffairs@natlotcomm.gov.uk
Tel +44 (0)20 7016 3430/3440

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⁸ Subject only to disclosure to the National Audit Office and Parliamentary Committees, if required by them, or under any other legal obligation.

Annexes

- A** Overview of the UK National Lottery
- B** National Lottery Bill and National Lottery licensing and regulation
- C** Executive summaries from research reports
- D** Managing the competition

A Overview of the UK National Lottery

Background

The UK National Lottery was launched on 4th November 1994. The first draw took place on 19th November 1994.

In terms of returns to society, measured both by returns to good causes and to the Treasury, the UK National Lottery is the highest ranked lottery in the world. In 2003, the UK Lottery contributed 40.8% of sales to good causes and the Government, with the next highest lotteries being Spain and Ireland at 33%⁹.

The Lottery licence

Camelot Group plc was awarded the first 7-year licence to run the National Lottery in May 1994. The second licence was awarded to Camelot in December 2000, commencing in January 2002. The second licence is due to end on 31 January 2009.

The regulatory framework

The Department for Culture Media and Sport (DCMS) has overall policy responsibility for the Lottery.

The National Lottery Commission regulates the UK National Lottery, it monitors and reports on the performance of Camelot (the operator), and enforces its licence. It also selects the operator of the Lottery.

The current operator of the UK Lottery is Camelot Group plc, a consortium with the following shareholders:

- Cadbury Schweppes;
- Royal Mail Enterprises;
- De La Rue;
- Fujitsu Services;
- Thales Electronics.

There are currently 14 distribution bodies (see page 24), responsible for dispensing the Lottery money to good causes. Neither the operator nor the Commission have any role in deciding or distributing Lottery funds. The distribution bodies assess applications for funding independently of Government, but within guidelines set by DCMS.

The National Audit Office (NAO) scrutinises public spending on behalf of Parliament. It monitors the distributors to ensure that DCMS guidelines are not being breached and monitors the DCMS to ensure that the distributors and the National Lottery Distribution Fund (NLDF) are being managed effectively.

The National Lottery Promotions Unit (NLPU) is a joint venture between Camelot, the Lottery distributors and the Department for Culture Media and Sport created in October 2003 to raise public awareness of the benefits of the distribution of Lottery funding across the UK.

Olympic Games

If the London bid to host the Olympic Games in 2012 is successful, the National Lottery will be contributing towards the cost of staging the Games. Legislation is currently being passed to allow the proceeds from specially designated Lottery games to go directly to a fund dedicated to the staging of the Olympic Games. Therefore designated Olympic games could be a feature of the next operator's portfolio between 2009 and 2012.

Sales

After a period of decline, in the financial year 2003/04 overall sales stabilised at over £4,614 million representing growth of some 0.9% on the previous year.

Sales (£ millions)	2003-04
Lotto	3,225
Thunderball	351
Lotto Extra	78
Christmas Millionaire Maker	15
Scratchcards (inc. Instants since launch Feb 03)	641
Hotpicks	244
Daily Play	45
EuroMillions	15
Total	4,614

How to play

There are currently the following ways to play the Lottery (plans are also underway to pilot play by Electronic Point of Sale (EPOS) in the near future):

- At a retailer;
 - via at least 25,500 online terminals (OLTs), selling draw-based tickets and Scratchcards or 1,500 Scratchcard only terminals (GVTs);
 - independent retailers account for around 63% of all outlets, while multiples (such as supermarkets) account for around 37%;
- On the internet;
- Via interactive television;
- Via text message on mobile phones.

⁹ Source: 2004 Henley Centre, The impact of The National Lottery 1994-2004.

Games

There are currently eight different types of game in the portfolio which can be played by everyone aged 16 and over.



Lotto

- The main National Lottery game, with the Saturday draw launched in November 1994
- Players pick 6 out of 49 numbers
- Has cost £1 to play since launch
- First Wednesday draw took place in February 1997
- 65% of the population play¹⁰



Thunderball

- First Saturday draw took place in June 1999
- First Wednesday draw took place in October 2002
- Fixed prize game of £250,000



HotPicks

- Launched in July 2002
- Like Thunderball, a fixed prize game of £7,000
- Made up of three different games: Pick 2, Pick 3 and Pick 4



Lotto Extra

- First draw took place in November 2000
- Jackpot only game. Players must match all six numbers from the 49 to win
- To play, players must first buy a ticket for the main Lotto draw



Daily Play

- The first daily game, launched in September 2003
- Draws are held every day of the week except Sundays and Christmas Day
- The only game that offers a prize (free lucky dip ticket for Daily Play) for matching no numbers
- Highest prize is £30,000 for matching 7 numbers from 27



EuroMillions

- The first cross-European game, launched in February 2004
- Initial participating countries were UK, France and Spain
- In October 2004 EuroMillions was expanded to six new countries: Austria, Belgium, Ireland, Luxembourg, Portugal and Switzerland



Scratchcards

- The first Scratchcard games were launched in March 1995
- There is currently a range of Scratchcards on sale at £1, £2, £3 and £5
- 12% of adults regularly play¹⁰

Interactive Instant Win Games (IIWGs)

- Launched in February 2003
- Scratchcard games that are played on the internet. (see www.national-lottery.co.uk)

¹⁰ Source: 2004 Henley Centre, The impact of The National Lottery 1994-2004.

Players¹¹

- Over 73% of adults over the age of 18 claimed to have played the Saturday Lotto game at least once in the previous year, and the game attracts in total nine in ten players at least monthly. Wednesday Lotto pulls in only slightly fewer weekly players and 88% play at least each month¹².
- Lotto is the biggest single consumer brand in the UK.
- The National Lottery 'crossed fingers' logo is instantly recognisable to 95% of the UK population.
- The average spend per player is less than £3 per week.
- Participation in Lotto by social grade is very close to the overall demographic of the UK.
- In the first quarter of 2004, 16% of Lotto players played as part of a syndicate.

Problem gambling¹³

The National Lottery accounts for 27% of the UK betting and gaming market. However, evidence suggests that it has the lowest prevalence of problem gambling. For example, research by Sproston et al (2000) indicates that the National Lottery Draw has the lowest prevalence of problem gambling amongst past year gamblers (1.2%). The prevalence of problem gambling among people who have uniquely played the National Lottery and played no other gambling activities in the past year is 0.1%. Furthermore, in 2002/2003 only 0.4% of people calling GamCare's helpline quoted problems with lottery draws and 0.2% with scratch cards (www.gamcare.org.uk).

Breakdown of the Lottery pound

The precise breakdown of the Lottery pound depends on the actual level of sales and the relevant (and fairly complex) arrangements within the licence. However, a rough breakdown to date is as follows:

- 50% returned in prizes;
- 28% to good causes;
- 12% to the UK Government in Lottery Duty;
- 5% to the retailer;
- 5% retained by the operator.

Good causes

There are currently 14 distribution bodies, awarding Lottery grants to the arts, sports, heritage, charities, health, education and the environment. On 1 June 2004 the Big Lottery Fund was launched, merging the Community Fund and the New Opportunities Fund and representing charities and the voluntary sector and health, education and the environment. The Big Lottery Fund therefore accounts for around 50% of funding proceeds to good causes. The Millennium Commission is now winding down and the Big Lottery Fund will take on its ability to fund large-scale regenerative projects in the future):

- Arts Council England
- Arts Council of Northern Ireland
- Scottish Arts Council
- The Arts Council of Wales
- Awards for All
- Big Lottery Fund
- UK Film Council
- Scottish Screen
- UK Sport
- Sport England
- Sport Scotland
- Sports Council for Wales
- Sports Council Northern Ireland
- Heritage Lottery Fund

¹¹ Unless stated Source: 2004 Henley Centre, The impact of the The National Lottery 1994-2004.

¹² Source: ORC International, Gamblertrack 2002.

¹³ Unless stated Source: 2004 Henley Centre, The impact of the The National Lottery 1994-2004, and the British Gambling Prevalence Study June 2000 (National Centre for Social Research).

B National Lottery Bill and National Lottery licensing and regulation

The Government issued a consultation document in June 2002, *Review of Lottery Licensing and Regulation*. The purpose of this was to consider whether there was scope to introduce more competition into the running of the Lottery.

Following this consultation, a decision document, *Review of Lottery Licensing and Regulation* was published in 2003 setting out the Government's proposed changes to the licensing and regulation of the Lottery. This was considered by both the Joint Committee on the draft Gambling Bill and the Culture, Media and Sport Select Committee in 2004.

Further work was subsequently undertaken by the Government and the National Lottery Commission. The final decision document, *National Lottery Licensing and Regulation, Review Decision Document*, was published in November 2004¹⁴. It sets out the main responses to the review and the changes that the Government proposes to make. It concluded that the current system for awarding a single licence has served the Lottery well in the past and should do so again and set out the Government's determination to see a successful competition for a single licence. The report also takes account of other views including the Committee of Public Accounts' 2002 report, National Audit Office report on the award of the second Lottery licence, and the Culture, Media and Sport Select Committee's 2004 report.

The Government has also introduced the National Lottery Bill¹⁵ which includes aspects of licensing the National Lottery. The key proposals relating to the licensing and regulation of the Lottery include:

- running the competition for a single licence but introducing a reserve power to offer for competition a small number of licences to run different parts of the Lottery, which would come into play only if the single licence competition that the Government and the NLC wants to be successful became unworkable;
- retaining the National Lottery Commission as regulator of the Lottery;
- enabling the Secretary of State to appoint a permanent Chairman for the Commission;
- allowing for licences to be extended, subject to a maximum licence term of 15 years.

¹⁴ www.culture.gov.uk/global/publications/archive_2004/natlot_review_dec_doc04.htm
¹⁵ www.publications.parliament.uk/pa/cm200405/cmbills/007/2005007.htm

C An economic perspective: NERA

Our review of the NLC's files, and interviews with key participants, has not identified major potential bidders who might have been considering bidding in the second round competition but did not do so. It is possible that other potential bidders did not come forward because of the high profile of The People's Lottery as an alternative to Camelot, but we have found no actual evidence of this.

Our conclusion is that the major barriers to entry are the need to access suitable technology and to arrange the handover from one system to another. Future bidders will need to ensure that they have access to a technology supplier and that the handover from the existing operator's system to their own can be handled smoothly. As it goes into the next competition, it is essential that the NLC fully understands technical needs and capabilities, and considers the options available for dealing with these issues in both the tender process itself and the licence that is subsequently awarded. We understand that the NLC has commissioned some initial work on this issue.

There is considerable experience in a number of industries (such as the UK rail industry, as well as many US state lotteries) of successfully transferring a franchise or licence to a new owner. But there have also been some difficulties affecting some US state lotteries, especially in cases where the existing operator was unhappy about the basis on which the new contract was awarded. It was suggested to us that the incumbent operator should be required to hand over its sales network as a going concern to the incoming operator, which could only be implemented with the incumbent's agreement at present. More generally, the handover process is likely to be smoother if the "rules of the game" are established in advance and if the NLC's decision to award the licence to a new operator is understood and accepted by all parties.

Other possible barriers to entry, such as the cost of bidding for the licence or uncertainty about how the NLC will reach its decision, should be unlikely to deter a serious potential bidder. Neither do we believe that either the current profitability of the Lottery or the restrictions on other activities that the Lottery operator can undertake are likely to act as barriers to entry. But it is important, nevertheless, that the tender process for the next licence is designed carefully so as to avoid unnecessary costs to bidders and to minimise any incumbent advantage – either actual or perceived – that Camelot might enjoy.

Overall, therefore, we consider that access to the required technology and possible handover difficulties are the factors that are most likely to deter potential bidders for the next Lottery licence. We do not believe that other factors are sufficient, on their own, to deter a serious potential bidder.

C A commercial perspective: KPMG

Competencies for lottery provision and possible bidders

We consider the competencies required to operate the Lottery; the types of companies that might provide those competencies and the relative importance of the competencies in establishing an effective operator of the Lottery licence.

This notes that the technological aspects of the Lottery (both the IT infrastructure and gaming software) were becoming increasingly commoditised and the market increasingly dominated by a small number of players. Whilst essential aspect of successfully operating the Lottery along with the provision of finance and channels to the consumer, such companies are not necessarily core to the bidding consortia, but could be 'bought in'.

We conclude that key competencies for a Lottery operator would include: branding and marketing expertise to generate and maintain sales of existing and new games formats; and experience of the gambling and gaming industry. We consider there are potentially a large number of companies with these competencies which might potentially be interested in bidding.

Business drivers, attitudes to risk and willingness to form partnerships

We highlight that the different categories of companies would potentially take a different risk seeking approach to the Lottery licence and will seek to leverage changes in the market place and consumer attitudes to maximise the competitiveness of their bid.

Based on the competencies identified, we conclude that, all other things being equal, companies which are likely to bid for the Lottery are those with the following characteristics:

- often driven by changes in market share, changes in consumer attitudes, effects of globalisation and technological developments;
- risk seeking and willing to innovate rather than consolidate; and
- willing to form joint ventures/partnerships to achieve their business goals.

The drivers of potential bidder interest in the Lottery licences

After considering the type of companies that have the required competencies to operate the Lottery and the likely approach of any bidding company, we show how the process for letting the Lottery licence would impact potential bidder interest. This considers the importance of the view that bidders would take on their probability of success (in the context of the likely costs of bidding and the risk and return associated with the licence).

We conclude that the probability of success and the effect of the Commission assessment criteria would be the most significant drivers of bidder interest, and that the Commission should consider its approach to the licensing process to provide new entrants with the maximum ability to differentiate themselves from the incumbent (and for this to be recognised in the assessment). Considerations included:

- removing restrictions which prevent new entrants from achieving the benefits they seek;
- the acceptability of high returns to the operator: the Commission will need to consider the size of financial benefits to the operator that are publicly justifiable; and
- how best to recognise and incentivise innovation through the competition, whilst mitigating against any additional risk created by a more innovative approach.

Structuring the licensing process to maximise competition

We consider the interaction between the opportunity presented, the licensing process and the interest of potential bidders, providing an indication of how the competitive tension between different types of bid structure might be flexed by the Commission to maximise bidder interest and competition in the next Lottery licence process.

A number of alternative bid vehicles are reviewed and assessed in relation to changes in the licence opportunity (in terms of risk, return and licence length) and the licensing process (essentially the NLC assessment criteria). Risk, return and licence duration are not surprisingly factors which will have a significant impact on bidder interest, based on the types of bid vehicles reviewed. With respect to the process, assessment criteria likely to impact significantly on bidder interest included maximising money for good causes, games that enhance the image of the National Lottery, and marketing that offers fun and excitement. None of the criteria was identified as likely to have a low impact, based on the bid vehicles reviewed, but a number of criteria provide a lower ability for new entrants effectively to differentiate their bid. It should be noted that the different factors considered did have a different effect on the different types of bid vehicle which means that the Commission will need to consider carefully how it seeks to maximise competition to ensure that it has it does not have any unintended effects on a particular type of bid vehicle.

C A potential bidders' perspective: London Communications Agency

LCA's key conclusions are:

- 01** There was a general lack of well-informed, in-depth knowledge about the regulatory framework in the UK, the role of the NLC and the Commissioners, even among those audiences who might be defined as 'key.' Only a handful of interviewees really displayed serious, in-depth knowledge of the lottery and lottery regulation.
- 02** In terms of categories and sectors, the majority of Potential Leaders and Significant Players demonstrated a reasonable level of knowledge as well as certain Specialists from the Leisure Sector. Those sectors showing the least knowledge were Potential Leaders/ Significant Players from abroad, in the Leisure and Technical Sectors, and Specialists from the UK not in the Leisure Sector. Communicating as early as possible the timetable and process for the next franchise should help address this issue.
- 03** The numbers looking to be involved in bidding for the third licence to run the Lottery might not be quite as low as feared. It is particularly interesting that in an audit explicitly pitched as a means of assessing likelihood of bidding among key audiences, the majority received the approach favourably – they did, after all, agree to be interviewed – and from an early stage in the interview, gave open and receptive responses.
- 04** A significant majority of those interviewed said that even with the current framework as it is, they would possibly or very likely be involved in bids for the third licence. Most of these however are in the conventional gaming sector, so there may not be any radically different newcomers to the UK bidding table when the competition starts.
- 05** The biggest factors for potential bidders are seen as the cost of bidding and the perceived advantages of the incumbent. Views vary widely about how and to what extent the cost and some other technical aspects may be addressed, but there is a clear sense that it should be done sooner rather than later and that this change must be clearly communicated.
- 06** Broadly, views of the incumbent are that they are good at what they do, but have benefited from the current framework which, if it were tackled therefore, would put them on a more level footing with other bidders. Interviewees are much less clear on how this might be done, however.
- 07** Given the mixed views about the proposal to break up the Lottery licence, the NLC could consider conducting more in-depth analysis of this option. It is clear that more detailed knowledge is displayed by those opposed to the idea than supported it – suggesting that opponents of the proposal have done more research or thought more deeply about it than its supporters.
- 08** There are suggestions that relatively minor adjustments to the actual bid process might go a long way to satisfying those currently more reluctant to bid.
- 09** There is a lack of focus on the bigger, broader questions about the Lottery's legislative and regulatory framework and it might be worth considering some communications activity to improve knowledge of the issues at stake, among defined audiences.
- 10** There is a slight difference of view about whether the NLC has given itself enough time to conduct this work and prepare for the next franchise process. Although no specific question was asked, most feel the timing is either appropriate or, if anything, too early. The NLC will not be able to please everybody on the timing issue. There will inevitably be some potential bidders who are simply in the wrong corporate 'cycle' or position to be able to bid.
- 11** When asked about other issues, and indeed throughout the interviews generally, respondees had two main, over-arching concerns at the heart of their answers. These were: firstly, the desire to see a political will to create a genuinely level playing field, whatever the current view of the incumbent; and secondly, the desire for a simple, clear, open and well-managed bidding process.

C A technological perspective: HEDRA

The importance of technology in the competition

Broadly speaking, the technology for all four manufacturers examined during this report is very likely to meet the technical requirements for the UK National Lottery. Although the technologies offered have different advantages and disadvantages, the choice of technical solution is very unlikely to be a major deciding factor for the 3rd lottery licence. Despite this, the NLC should not ignore this matter during the competition. There must be agreement over the technology solution before the licence is awarded.

Tasks that bridge the two licences

There will be a number of tasks that span the two licences, for example, a winning lottery ticket purchased during the second licence period may be claimed during the third licence period. Each one of these tasks will require data held by Camelot to be converted to the new system. It is very important that the tasks that are to bridge the two licences are identified, and the data conversion and transfer requirements understood. An agreement must be made with Camelot to supply these data and to co-operate in the conversion process if they do not win the third licence themselves.

Project management

The implementation of the new system is likely to be a high risk project, and needs to be closely monitored. A lot of this high risk is due to the cut-off date for the current licence. This cut-off date implies that a “big bang” approach will have to be taken for implementation. Mechanisms to smooth the “big bang” should be considered in order to reduce the risk.

The lottery system manufacturers will be able to manage the technical implementation, but the lottery operator will need to provide overall programme management to ensure that the implementation is co-ordinated with the rest of the implementation of the lottery and ensuring that it meets all business as well as technical requirements. The NLC should consider the bidders’ ability to perform such programme management a key aspect of the competition.

Timescales

The timescales allowed for the implementation must be sufficient to avoid raising the risks, and to avoid giving the incumbent a large advantage in the competition. Initial estimates suggest a timescale of 12 to 18 months should be allowed (probably closer to 18 months). However, this cannot be properly evaluated until the scope of the implementation project is better defined.

Length of licence period

A reduction in the length of the licence period is likely to be a barrier to potential bidders. The NLC should not consider reducing the licence period unless the advantages of doing so outweigh the disadvantages of a reduction in the number of bidders.

Change in technology

If the incumbent operator is not required to change the technology it is using as part of its bid, then other bidders are likely to consider this to be an unfair advantage, which will discourage their participation in the competition.

On the other hand, requiring Camelot to change its technology (in the same timescales as the other bidders) is likely to cause them to have to take business risks. This is likely to cause them to provide a less favourable bid, which will have a knock on effect on the NLDF should they win.

Timescales for changes in technology

Assuming that Camelot is required to change technology, then it will be a barrier to bidding for other potential operators if Camelot is not required to change in the same timescales.

Opportunities

The advances in technology offer a number of opportunities that the NLC could consider adopting.

The technology now allows a range of organisational structures for the operation of the lottery, such as having a separate technology supplier together with competing lottery operators. When choosing how to structure the licence, the NLC should not feel constrained by the current organisational structure.

The technology also allows the services provided by the lottery operator(s) to be structured differently. For example, increasing the use of player registration to extend the number of sales channels; increasing the number of games offered, or the speed at which games are changed; using the infrastructure to supply a range of other transaction based services.

These opportunities can be considered by the NLC as potential methods of increasing funds for the NLDF.

D Managing the competition

We recognise the wide range of experience that managing such a significant competition requires, and the demands that it places on a group of part-time Commissioners and the relatively small organisation that supports them. We therefore intend to put the following arrangements in place to manage the competition:

Creation of a Project Board: we intend to create a Project Board to oversee the detailed conduct of the competition and to support the work of our Chief Executive and his staff. The Board will be made up of two Commissioners, the Chief Executive and an independent member. One Commissioner will chair the Board throughout the competition process to provide stability and continuity. We have asked the Department for Culture, Media and Sport to appoint, as one of the new Commissioners, someone with the right commercial, procurement and public sector skills and expertise to fulfil this role. We will also appoint an independent expert to sit on the Project Board. This appointment will bring expertise in public sector procurement and/or the leisure industry. We expect to have the Board in place by the Spring of 2005.

Appointment of a Programme Director: we are appointing a Programme Director with relevant expertise. This Director will provide our Chief Executive with day-to-day support in managing the process.

Independent scrutiny of the process: we expect the competition to be subject to the gateways process developed and administered by the Office of Government Commerce. We expect to augment this with further independent review at key stages in the process; for example, during any negotiation with bidders. This independent scrutiny will provide the Commission with assurance that the process has been properly conducted when it comes to make its final decision on the preferred bidder.

Clarity about the role of the Commission itself: the Commission will be kept informed of progress at all key stages in the competition. These will be defined in advance. It will receive reports from the Project Board and will subject these to full scrutiny. By being distanced from the detailed management of the competition itself, the Commission will be able to focus fully on the key decisions which it is required to make.

Use of external expertise: input from staff on their areas of expertise will be heavily supplemented by external consultants in order to support the additional workload, and maintain a separation of bid evaluation activities from day-to-day contact with the operator.

We believe that these arrangements should give all potential bidders every confidence that the competition will be conducted in a rigorous and fair manner.

National Lottery Commission
101 Wigmore Street
London W1U 1QU

Tel +44 (0)20 7016 3400
Fax +44 (0)20 7016 3401

www.natlotcomm.gov.uk