



MEMORANDUM

To: California State Lottery Commission **Date:** July 16, 2008

From: Joan M. Borucki
Director

Prepared By: Ellen Ishimoto, Deputy Director
Information Technology Services

Subject: Item 9(b) – On-line Gaming Contract Extension

ISSUE

Should the California State Lottery Commission (Commission) approve an amendment to Gaming Contract #7871 with GTECH Corporation (GTECH) that will extend the term for four additional years at an amount not to exceed \$310 million?

RECOMMENDATION

Staff recommends that the Commission approve an amendment to extend the term of the gaming system contract with GTECH for four additional years while maintaining the current base compensation rate of 1.36% of sales. GTECH is providing the Lottery with a total value of over \$40 million that consists of equipment, gaming system software enhancements, and discounts on future equipment orders. There will also be a tiered compensation structure that will reduce GTECH's compensation rate for sales above \$4 billion. The amendment will total an estimated \$310 million to cover additional costs through October 13, 2013 and will provide critical services necessary to support the implementation of the Lottery's Business Plan.

BACKGROUND

In 2002, as the result of a formal, competitive solicitation, the California State Lottery (Lottery) awarded a six-year contract to GTECH Corporation with a total expenditure authority of \$300 million based on a sales compensation rate of 1.36%. The term of the contract began on October 14, 2003 and will expire on October 13, 2009, but allows the Lottery to extend the term of the contract for up to four additional one-year periods. The Lottery must provide written notice to GTECH at least one year prior to exercising an extension. GTECH's sales compensation rate during the extension period as established as part of the original bid, is 1.16%.

The services being provided under this contract include an integrated gaming system that manages millions of gaming related transactions through a satellite telecommunications network; provide, install and maintain 50,000 gaming equipment units in over 20,000 retailer locations across the State; software development and support for the core gaming and administrative applications; and marketing and research services that support our gaming operations.

DISCUSSION

The Lottery's long term Business Plan calls for retailer recruitment and improving our gaming systems. In order to achieve these goals, the Lottery needs to acquire significant amounts of equipment and gaming system enhancements. The negotiated terms of the proposed extension agreement provides the equipment needed for new retailers and an upgraded gaming system.

Under the terms of the existing gaming contract, the Lottery may exercise four one-year extensions by giving GTECH at least one year's advance notice. The terms of this unilateral extension include a 1.16% compensation rate and equipment pricing at a predetermined rate.

In anticipation of future operational needs, the Lottery has negotiated contract revisions with GTECH that will provide the Lottery with greater value than would have existed under the contract's current extension terms. In exchange for the Lottery's agreement to exercise a four-year extension at the current 1.36% base compensation rate GTECH will provide the Lottery with a total value of over \$40 million that consists of equipment, gaming system enhancements, a 15% discount on additional equipment orders, as well as a discount on certain equipment maintenance fees. There will also be a tiered compensation structure that will reduce the compensation rate for sales above \$4 billion. In addition, GTECH will begin providing the equipment and programming immediately upon approval of the extension – more than a year before the beginning of the extension period.

As presented to the Commission at the May 20, 2008 meeting, the Lottery's Retailer Recruitment Plan goal is to strategically increase the number of retailers. The Lottery has increased the number of retailers by 1,000 over the last year and currently have an additional 600 new retailers waiting for equipment. One of the challenges to adding more retailers is the cost of the equipment. With this extension, GTECH Corporation will provide equipment over the next two fiscal years that will allow the Lottery to expand from 20,300 retailers to our target 21,658 retailers by the end of June 2010. The discounted equipment provided in the extension will support further expansion of our retailers to 22,433 by the end of June 2011. The structure of this extension also provides for scheduled delivery of equipment over the course of the extension period,

which will eliminate the current problem of having retailers wait four months or longer for equipment.

The gaming system software enhancements include improvements to the Lottery's electronic point of sale system called ePOS, an enhanced reporting solution and improved tracking of Scratchers[®] ticket sales and inventory. The ePOS system is a point of sale marketing system that consists of a flat screen monitor to electronically display messages and advertising. The gaming system enhancements will allow for easier management of advertising and messages, better graphics, the running of regionalized or vendor specific messaging, and faster deployment and changes to new advertising or messages. The enhanced reporting solution is an integral part of the Lottery's business intelligence initiative that will identify information needed to make business decisions and then deliver that information to Lottery staff in an easy to use web-based reporting tool. Through the connection of Scratchers[®] ticket dispensing devices to the gaming system, the Lottery will have improved tracking of sales and inventory resulting in greater efficiency and profitability for these devices. All of these items are important to achieving the Modernizing Operations Strategy in the Business Plan.

As the Business Plan is implemented and sales begin to grow, staff has negotiated a tiered compensation structure that will be effective during the contract extension period. The compensation rate is structured as follows:

<i>Sales Amount</i>	<i>Compensation Rate</i>
Up to \$4 billion	1.36%
From \$4 billion up to \$5 billion	1.20%
From \$5 billion up to \$7 billion	1.10%
From \$7 billion and above	1.00%

Fiscal Analysis

Assuming average sales of \$3.3 billion over the four years of the extension period, the dollar difference between a 1.36% and a 1.16% compensation rate is approximately \$26.4 million. However, the equipment, system upgrades, and equipment discount represent a \$40 million value to the Lottery.

Viewed a different way, if the Lottery exercised the extension terms at 1.16% the Lottery would have to spend an additional \$13.6 million to receive the same equipment and system upgrades than it would under the negotiated extension at 1.36%.

The current gaming contract is funded at \$300 million for six years. As of June 2008, \$34 million in approved expenditure authority was available for the remainder of the initial gaming contract term. Staff is requesting \$310 million in additional expenditure authority to cover the proposed extension and the remainder of the original contract.