

**NOTICE OF DECISION OF THE NATIONAL LOTTERY COMMISSION  
IN RELATION TO A NOTICE OF INVESTMENT OPPORTUNITY  
SERVED BY THE HOLDER OF THE NATIONAL LOTTERY LICENCE**

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## **Summary**

1. On 23 May 2011 Camelot UK Lotteries Limited (“Camelot”) served the National Lottery Commission (the “Commission”) with a Notice of Investment Opportunity (“the Proposal”) in accordance with the provisions of licence condition 23 of the third licence (“the Licence”), which was granted to Camelot on 1 February 2009.
2. The Proposal was initially that Camelot would increase the number of terminals by 8,000 in return for a five year extension of the Licence. Following a considered and thorough process of evaluation and consultation by the Commission, Camelot revised its Proposal by offering to increase the number of terminals by 8,000 in return for a four year extension of the Licence.
3. The Commission, having completed the consultation and evaluation process, met on 14 February 2012 to consider the Proposal. The Commission decided to accept the Proposal (as revised), as the Commission is satisfied that the Proposal is likely to:
  - a. Secure a significant increase in the net proceeds of the National Lottery; and
  - b. Continue to ensure that the National Lottery is run with all due propriety and the interests of every participant in the National Lottery are protected.

## **Background**

4. In November 2005, the Commission published the Statement of Main Principles, which marked the formal start of the competition to award the Licence. That document set out the principles that underpinned the competition for the Licence to run the National Lottery.
5. The Commission published the Invitation to Apply document, in June 2006, which invited bids for the Licence to run the Lottery. That document was accompanied by a copy of the draft licence to run the Lottery, which set out the detailed conditions relating to the operation of the Lottery that bidders had to take into account when responding to the invitation to bid. The Commission’s aim throughout the competition process was to design a framework that supported good causes and protected players, whilst allowing greater flexibility in order to encourage competition. Central to the Commission’s approach was the alignment of incentives for the Licensee with the maximisation of returns for good causes.
6. In 2009, the Commission awarded the Licence to run the National Lottery to Camelot. As had been indicated in the Statement of Main Principles, the Invitation to Apply and the draft Licence, the Licence was awarded for ten years, with the possibility of an extension of up to five years (see clauses 1.2 and 23.1 of the Licence). These documents all envisaged the grant of a Licence extension in return for a substantive investment by the Licensee beyond that committed to in its bid for the Licence, in circumstances where there would be a significant benefit to good causes and where the costs of the investment to the Licensee would not be recovered from its share of increased revenues over the remainder of the Licence period.

7. In May 2011 Camelot served the Commission with its Proposal, in which it proposed to increase the number of terminals by 8,000 in return for a five year extension of the Licence. Camelot calculated that the additional terminals would increase returns to good causes by between £105m and £128m per annum.
8. Since May 2011, the Commission has been engaged in a considered and thorough process of evaluation and consultation. The Commission established a Reference Group of Commissioners to monitor progress of the evaluation and consultation process. The Commission also appointed a team of advisers to analyse Camelot's proposals comprising:
  - a. Halkin / April Strategy to advise on sales and returns
  - b. NERA to advise on incentives, costs and sensitivity analysis
  - c. Detica to advise on technology issues
  - d. Mazars to advise on accounting, tax and financial health matters
  - e. Ernst & Young to advise on the Internal Rates of Return from a commercial perspective
  - f. Gambling Commission legal team to advise on legal issues
9. The Commission's officials and advisers have held a number of meetings with Camelot about the Proposal. Commissioners also received a presentation from Camelot on 21 July 2011 and met with representatives from Camelot on 18 October 2011 and 10 January 2012.
10. Following these meetings and discussions, which formed part of the consultation process, Camelot revised its Proposal by offering to increase the number of terminals by 8,000 in return for a four year extension of the Licence, together with consequential amendments to its original proposal.
11. The Licence provides that at the end of the consultation and evaluation process the Commission may accept the Proposal, propose modifications to the Proposal, or reject the Proposal. That decision is subject to the Commission's overriding statutory duty to secure that:
  - a. The National Lottery is run, and every lottery that forms part of it is promoted, with all due propriety;
  - b. The interests of every participant in a lottery that forms part of the National Lottery are protected; and
  - c. Subject to the provisos in (a) and (b) that the net proceeds of the National Lottery are as great as possible

## **Decision and reasons**

12. The Commission has decided to accept the Proposal (as revised), as the Commission is satisfied that the Proposal is likely to:
  - a. Secure a significant increase in the net proceeds of the National Lottery; and
  - b. Continue to ensure that the National Lottery is run with all due propriety and the interests of every participant in the National Lottery are protected.
13. The Commission's reasons are set out below.

### Propriety and player protection

14. The Commission has not identified any issues that lead it to conclude that the Proposal is likely to have an adverse impact on the propriety of the running of the Lottery or player protection. In particular, the Commission is satisfied that Camelot will extend its arrangements for prevention of underage play to cover the new terminals.

### Returns to good causes

15. According to Camelot's forecasts, the addition of 8,000 terminals is likely to increase the returns to good causes by between £723 million and £754 million over the current Licence period.
16. Camelot's forecasts have been the subject of extensive consultation with Camelot and evaluation by the Commission's advisers. The conclusion from that work is that the Proposal is likely to generate significant additional returns to good causes during the current Licence period. Whilst by definition it is difficult to be precise about forecasts, the Commission's advisers have concluded that the addition of 8,000 terminals is likely to generate a minimum of £419 million over the current Licence period and probably substantially more.

### Contingency arrangements

17. The Commission considers it important that there should be some contingency arrangements built into the Licence<sup>1</sup>. Camelot argued in their original proposal that the need for contingency arrangements could be met by the award of further interim licences after the expiry of the Licence. As an alternative, Camelot argued that, in the event that contingency arrangements were required during the next licence competition, the Commission could call upon the Secretary of State to bring section 6A of the National Lottery etc Act 1993 into force. Neither suggestion was acceptable to the Commission for the following reasons:
  - a. The maximum period for a licence awarded by the Commission is fifteen years, per section 7(1A) of the National Lottery etc Act 1993. As a result there was room for doubt about whether Camelot's proposals were lawful, which introduced an element of legal uncertainty that is undesirable and avoidable.
  - b. Even if Camelot's analysis of the legal position was correct, a five year extension would have introduced significant uncertainties that might have limited the Commission's ability to take necessary actions quickly in a situation where there is a risk of a hiatus in the operation of the National Lottery.
  - c. The risk of needing contingency arrangements is not a remote one. They would have been of considerable value in the second licence competition, and were a major recommendation of the Public Accounts Committee in its report on that competition.
  - d. In the event that contingency arrangements were required, but implementing them ran into legal or practical difficulties, a break in the operation of the National Lottery would have a very significant impact on returns to good causes.
18. The Commission was therefore not prepared to grant a five year extension, as it considered that the risks of doing so were too great. The Commission is satisfied that the revised Proposal, whereby a four year extension will be granted, provides reasonable contingency arrangements.

### Duration of the Licence extension

19. The Commission gave careful consideration to the term of the additional licence period required to support the investment. In doing so, it took specialist advice as well as consulting Camelot on the point. The Commission noted, based on the advice that it received, that:
  - a. The returns to the Licensee were sensitive to the levels of sales growth achieved over the current Licence period and Licence extension period;
  - b. It is difficult to find comparators against which to benchmark Camelot's returns;

- c. It is normal industry practice, in the event of an extension or variation to an original contract in the absence of competition, to set returns at the same level as in the original contract;
  - d. Camelot's initial proposal appeared to generate relatively high returns when benchmarked against broadly similar sectors, but the reduced Licence extension period and amended sales forecasts reduced these returns;
  - e. Camelot agreed, in its revised proposal, to ring fence certain of the key expenditure areas contained in its proposal, such that any under spend would pass to good causes.
20. The Commission concluded that the revised proposal for a four year Licence extension period struck a reasonable balance between the levels of reward that might accrue to the Licensee and the significant additional returns to good causes that were likely to be achieved during the current Licence period.

#### Earlier investment in Player Point of Sale (PPOS)

21. Play stations, screens and associated player point of sale materials are an important element in attracting players to participate in the Lottery in an increasingly competitive and crowded retail environment. Accepting the Proposal will mean that PPOS will be refreshed sooner than would otherwise be the case, which in itself is likely to increase participation in the Lottery. The costs in the Proposal that relate to the investment in PPOS appear to be broadly reasonable, and returns to good causes are safeguarded by the ring-fencing of the planned expenditure for the refresh.

#### Capacity for funding future investment opportunities

22. The Commission has weighed the benefits from the current proposal against any benefits foregone due to an inability to use licence extensions for any future proposal. In making that judgement the Commission has considered whether there are any foreseeable developments which would justify a licence investment proposal on the near horizon, and concluded that none are foreseeable at present. Furthermore, as the current Licence is already three years into its original ten year term, there is a diminishing likelihood of further opportunities to be identified, proposed and evaluated before the proximity of the competition for the fourth licence would make further investment opportunities unlikely.

#### Technology and communications risks

23. The Commission considered the technology and communication risks of the proposal. The Commission has been advised that:
- a. The technology could be maintained and remain fit for purpose for the extended Licence period. Furthermore, the evaluation process did not identify any potential step change in lottery technology in the foreseeable future (although this can never be discounted), and noted that the technology infrastructure was a very modern one at the time of its installation in 2008-09; and
  - b. The planned retender of the communications network will allow technical developments in this area to be adopted for the Licence extension period.
24. In any event, Camelot is already obliged under the Licence to maintain licence assets (including technology) as 'fit for purpose' for the entire Licence period and two additional years. The risk of increased terminal maintenance and communications costs falls on Camelot, not on returns to good cases. As such, the technology and communications risks are, in the Commission's view, outweighed by the likelihood that accepting the Proposal will secure a significant increase in the net proceeds of the National Lottery.

## Competition

25. The Commission recognises the value and importance of competition in encouraging innovation and efficiency. The Commission therefore gave very careful consideration to the implications of deferring the next licence competition for four years.
26. Whilst the third Licence competition had generated substantial benefits to good causes - generosity benefits have been calculated at between £600 million and £1 billion over the ten year Licence period – the Commission considered that the prospect of even greater benefits being generated as a result of a licence competition in 2019 needed to be weighed against the following factors:
  - a. The additional benefits that accrued from the third Licence competition will continue to be received through the Licence extension period;
  - b. It is not possible to assess so far ahead whether further benefits of the magnitude achieved in the third Licence competition could be replicated in the next licence competition process;
  - c. There are savings associated with deferring a competition by four years. The costs of running the third Licence competition were £17 million.
27. The Commission also considered whether there was a risk that Camelot's performance might deteriorate without the prospect of competition. The Commission did not consider that such an outcome was likely, as the Licence incentive structure should continue to encourage good performance. The Licence also provides for third party performance reviews to take place if there are concerns about performance under the Licence.
28. Another issue, which the Commission gave careful consideration to, was the risk that the grant of a Licence extension may cause potential competitors to be more reluctant to bid for the fourth licence, so increasing incumbency advantage. It is not possible to assess the climate for competition so far in advance, but it was noted that the Licence extension would be in return for further investment as opposed to some form of endorsement of Camelot's performance.
29. On balance, whilst recognising the importance of the competitive award of the Licence, the Commission concluded that potential risks and disbenefits of a four year extension were outweighed by the benefits to good causes as evidenced by the evaluation of the Proposal.

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<sup>i</sup> The Licence provided that:

*23.9 To facilitate the handover of the National Lottery to a Successor Licensee or where the Commission, in its absolute discretion, considers that the competitive environment is not conducive to a Competition, or where the Commission considers, in its absolute discretion, that the Competition may take longer than it originally envisaged, the Commission may, in its absolute discretion, require the Licensee to continue to run the National Lottery on the terms set out in this Licence by extending the duration of the Licence for a period of six months, subject to a maximum of four such extensions, and the Licensee shall be obliged so to act provided that written notice of such requirement is given to the Licensee by the Commission no later than three months prior to the Expiry Date.*