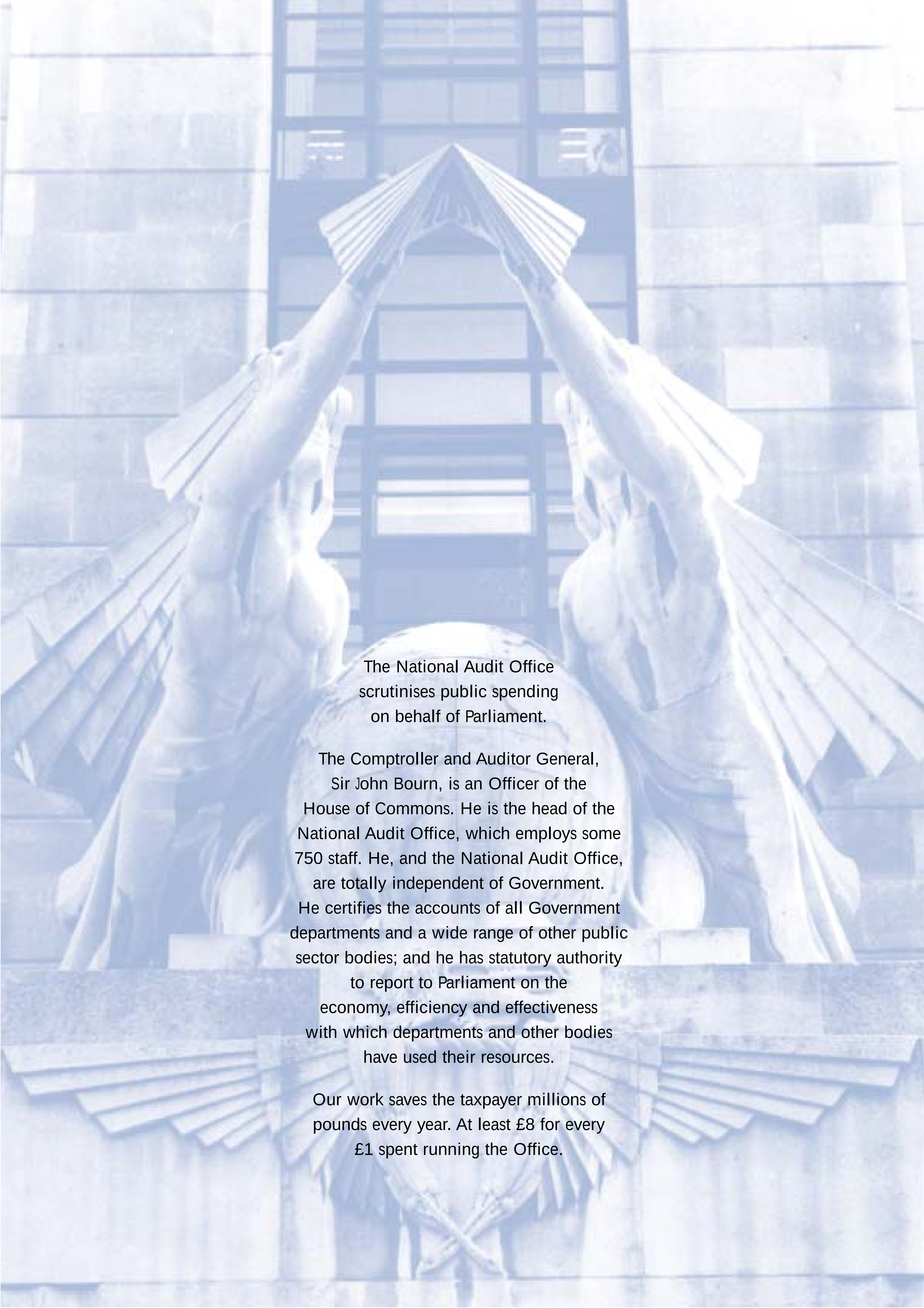
NATIONAL AUDIT OFFICE

Awarding the new licence to run the National Lottery

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 803 Session 2001-2002: 10 May 2002



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John Bourn
Comptroller and Auditor General

National Audit Office
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The competition process did not go as planned

2 The competition process for the second licence did not run smoothly. **Figure 1** outlines the main events leading up to the Commission's decision to award the licence to Camelot. There were weaknesses in both the bids the Commission received and, although the bidders made significant improvements, on 23 August 2000 the Commission rejected both bids because they failed to satisfy the statutory criteria. In the case of The People's Lottery, the Commission was not satisfied that the bid adequately protected the interests of participants; in the case of Camelot, the Commission was not satisfied that the Lottery would be run with all due propriety, given the actions of a key supplier and concerns about the ability of Camelot to manage the supplier.

3 At this point, there was a possibility that neither bid would meet the statutory criteria and the Commission would have been faced with a hiatus in the operation of the National Lottery when the first licence came to an end on 30 September 2001. After the Commision had decided to reject both bids, on 30 August 2000 officials of the Commission and the Department for Culture, Media and Sport discussed possible steps to keep the Lottery running but it is unlikely that these could have been implemented by the time the first licence expired. The Commission considered that, if neither bid proved acceptable, its most feasible course of action would be to negotiate an interim licence with Camelot, notwithstanding its concerns about due propriety.

1 Major events leading to the announcement of the preferred bidder for the next licence to run the National Lottery

1999				2000			
July	**September**	**October**	**November**	**January**	**February**	**April**	**May**
The Commission publishes its Statement of Main Principles and announces the timetable for the award of the second licence.	The Commission issues the draft Invitation to Apply and the draft licence.	The Commission holds a bidders and suppliers conference.	The Commission publishes the final version of the Invitation to Apply and the revised draft licence.	The Commission receives seven Letters of Intent to apply for the new licence.	The deadline for applications is 29 February. The Commission receives two compliant bids, from Camelot and The People's Lottery.	The Commission learns through a whistleblower of a fault with the lottery software supplied to Camelot by GTech. The Commission immediately investigates.	On 14 May the Commission confirms that the fault in the lottery software existed from the beginning of the Lottery until secretly corrected by GTech in July 1998.

2000					
June	**July**	**August**	**September**	**October**	**December**
The Commission originally intends to announce the preferred bidder by 30 June. On 23 June the Commission announces that it has decided to extend the timetable to allow both bidders to improve their proposals and will announce the preferred bidder by the end of August.	The Chairman/ Chief Executive Officer and Chief Operating Officer of GTech resign.	On 23 August the Commission announces that it has rejected both bids and that it intends to negotiate with The People's Lottery alone. On 24 August Camelot seeks a judicial review of the Commission's decision to negotiate with only The People's Lottery.	The High Court overturns the Commission's decision to negotiate solely with The People's Lottery and orders the Commission to readmit Camelot into the competition.	Dame Helena Shovelton, Chair of the Commission, resigns on the grounds that it is in the public interest that the work of the Commission should proceed without any unnecessary distraction. Lord Burns is appointed to the Commission, and is elected Chair.	On 19 December the Commission announces that, by a majority of four to one, the Commissioners have chosen Camelot as the preferred bidder for the new licence. Hilary Blume, the dissenting Commissioner, resigns.

Source: National Audit Office

4 The Commission considered negotiating with The People's Lottery alone to try to achieve an acceptable bid by the end of September 2000. After taking legal advice and carrying out an initial evaluation of the bids, the Commission decided to do this. Camelot sought a judicial review of the Commission's decision on the grounds of non-consultation, unfair exclusion contrary to the principles of fairness and natural justice, and failure to provide reasons.

5 On 21 September 2000 the Judge concluded that the Commission, while intending to be fair, had followed a procedure that was conspicuously unfair to Camelot. The Judge therefore quashed the Commission's decision. On the same day, the then Chair of the Commission, Dame Helena Shovelton, offered her resignation to the Secretary of State for Culture, Media and Sport but, with his encouragement, stayed on. However, on 4 October 2000, she announced her resignation as a Commissioner, saying that media coverage had led her to conclude that the interests of the National Lottery would be best served by her standing down.

6 Following the judicial review, Camelot was given a month to negotiate with the Commission and to submit a revised bid. On 10 November 2000 the Commission announced that both revised bids had the potential to meet the statutory criteria. The Commission then had to assess which bid was more likely to give the greater return to Good Causes, taking into account the range of returns each bid might produce and the risks associated with them.

7 Following detailed analysis of the bidders' business plans, on 19 December 2000 the Commission awarded the licence to Camelot. The Commission considered that, although The People's Lottery would contribute more to Good Causes than Camelot at the same level of sales, this advantage was outweighed by two considerations:

- the Commission's conclusion that Camelot was likely to generate more sales and as a result would contribute more to Good Causes than The People's Lottery over the period of the licence; and
- the accumulation of risks surrounding the bid from The People's Lottery, particularly in the early stages, which the Commission considered uncomfortably high in comparison with those related to Camelot's bid.

8 The difficulties in the competition process meant that it took the Commission longer than planned to award the licence. The Commission had intended to award the licence in June 2000 but the delay meant that only nine months would have been available for the preferred bidder to implement the requirements of the second licence, instead of the 15 months planned. This was likely to be too short a time for the new licensee to be ready and the Commission therefore negotiated an interim licence with Camelot, which had given an undertaking during the judicial review to accept such a licence. The interim licence ran from 1 October 2001 to 26 January 2002, giving a period of 13 months before the start of the second licence on 27 January 2002.

The Commission received two compliant bids

9 We examined how successful the Commission had been in achieving genuine competition for the second licence. Although wider interest had been shown by potential bidders when the Commission discussed the Invitation to Apply with them, by the closing date of 29 February 2000 two compliant bids had been received - from **Camelot Group plc** (the incumbent licensee) and **The People's Lottery Limited.** While this was significantly fewer than the eight bids received for the first licence, it was comparable with experience in two other countries (Ireland and South Africa) which run lotteries on a similar basis to the United Kingdom.

The Commission sought to address the constraints on bidding

10 The success of the National Lottery during the period of the first licence meant that there was less risk attached to taking on the second licence than there had been when the Lottery was first launched as the size of the market was known. While this might have encouraged potential bidders, the Commission was concerned that they might also have been discouraged by other factors, not least the existence of an incumbent licensee with its knowledge of the operation.

11 The Commission sought to stimulate competition but there were a number of constraints which may have deterred potential bidders:

- the cost and burden of preparing a bid to run the National Lottery was considerable. Based on reported experience from the competition for the first licence, the Commission believed that the direct costs of bidders were likely to be between £3 million and £4 million. It considered contributing to bidders' costs but concluded that competition would be strong enough without this support;
- until the competition was formally launched in July 1999, there was uncertainty about whether the Commission would favour 'not-for-profit' bids. This may have inhibited the formation of 'for-profit' bidding consortia. The Commission welcomed bids from bodies with different financial structures but made clear that it could not give an advantage to any particular structure, given its statutory duty to maximise the returns to Good Causes;
- there were few suppliers who could provide technology services for the Lottery and competition could have been limited if each supplier were 'locked in' to a single bid. Bidders need to identify their key suppliers so that the Commission can vet their fitness and propriety and assess their ability to deliver their commitments. The Invitation to Apply therefore required bidders to identify key suppliers, although the Commission had already stressed that it would welcome the involvement of any key supplier in more than one bid;
- without co-operation from the incumbent licensee, the level of risk that would have faced a new licensee on handover was considerable. For example, the new operator would have had to put in place its own network of retail outlets. The Commission gained the agreement of the incumbent (Camelot) to co-operate with any new licensee on handover, although it could not have required this under the terms of the first licence; and
- the incumbent's established lottery infrastructure and knowledge of lottery retailers gave it a clear competitive advantage. The Commission therefore decided to require the winning bidder (even if it were Camelot) to install new lottery terminals at the start of the licence period. It also sought to provide information about the retail network to bidders but was unable to provide full details due to limitations in the terms of the first licence.

12 The Commission's ability to address some constraints on bidding was limited by the inadequacy of its powers under the first licence. The Commission has strengthened its position under the second licence which will enable it to require the incumbent licensee to co-operate on handover, to transfer intellectual and real property, and to provide complete information about the lottery retail network.

The Commission had a sound basis for its decision to award the licence to Camelot

13 We reviewed how the Commission evaluated the two bids it received and whether the evaluation process provided a sound basis for its decision to award the licence to Camelot.

The Commission had clear objectives and evaluative criteria

14 The Commission provided a clear public statement of the outcomes it was seeking to achieve from the competition process and the criteria it would apply in evaluating bids. These were derived from the Commission's statutory duties under the National Lottery etc Act 1993.

The Commission had a clear plan for the evaluation process

15 The Commission began to plan for the competition soon after being appointed in April 1999. It issued a Statement of Main Principles and timetable for the award of the licence in July 1999; and an Invitation to Apply in November 1999, which set out the information it required to assess the bids. This provided a good foundation for the Commission's analysis. The Commission also prepared an evaluation manual that clearly set out the tasks that needed to be completed, ownership of them, and their aims, inputs and outputs. This provided a sound basis for the evaluation process, which was overseen by the Commission's Director of Licensing, supported by a project manager who checked that all tasks were completed as planned. In areas where the Commission did not have in-house expertise, it engaged consultants to assist in evaluating the bids.

The Commission critically reviewed the bidders' forecasts

16 The Commission's assessment of the likely returns to Good Causes was key to its evaluation of the bids. The forecasts in the bidders' business plans showed that The People's Lottery would provide returns of £13.1 billion over the period of the second licence, £933 million more than Camelot[1]. The Commission analysed the robustness and soundness of these forecasts, using a range of sensitivity tests to assess how changes in the assumptions made in the forecasts affected the returns to Good Causes. These showed that, at the same level of sales, The People's Lottery would be more generous to the Good Causes. This conclusion contributed to the Commission's decision to negotiate with The People's Lottery after both original bids were rejected in August 2000.

17 In the light of the level of ticket sales during the period of the first licence, the Commission judged that both bidders' forecasts were over-optimistic **(Figure 2)**. After receiving the revised bids in October 2000, the Commission's staff and consultants developed forecasts of sales for the period of the second licence. The forecasts took account of a range of qualitative judgements concerning marketing and game plans and the likely level of sales at the start of the second licence, and predicted much lower levels of ticket sales than the bidders had forecast. The Commission considered that these forecasts were unduly pessimistic and that sales were likely to be more in line with previous performance.

2 **Comparison of actual ticket sales during the first licence period and forecast sales during the second licence period**

Actual ticket sales during the first licence period	£31.9 billion
Forecast ticket sales for the second licence period:	
■ Camelot	£51.2 billion
■ The People's Lottery	£51.6 billion

Source: National Audit Office (based on National Lottery Commission data)

18 The Commission carried out extensive sensitivity testing to test the robustness and soundness of the forecasts. The tests predicted a range of likely revenues and returns to Good Causes for the two bidders. In some circumstances Camelot would be more generous to the Good Causes, and in others The People's Lottery would be more generous. At one end of the spectrum The People's Lottery was predicted to return £779 million more than Camelot, and at the other Camelot was predicted to return £1,622 million more than The People's Lottery.

1 *All figures are net present values, showing the present worth of the future flow of money.*

19 The Commission did not regard any of the forecasts as definitive but concluded that on balance Camelot was likely to generate more revenue and return more to the Good Causes over the period of the licence. In the light of that conclusion and taking account of the greater risks that the Commission considered were involved in The People's Lottery's bid, the Commission decided to award the licence to Camelot.

The Commission sought independent assurance on its decision-making process

20 The economic model used to simulate the effects of changes in the bidders' business plans on revenue, profitability and returns to Good Causes was an important tool in the assessment of the bids. The Commission therefore arranged for an independent audit by Mazars Neville Russell of the economic model in advance of using it to evaluate the bids. That exercise established that the base data in the model was consistent with the source data in the bidders' business plans and confirmed the reasonableness of the model. The Commission also engaged the UK managing partner of Mazars Neville Russell to carry out an independent review of the decision-making process. The review concluded that the process "was conducted in a comprehensive and conscientious manner" and "was complete and fair in the treatment of both bidders".

Conclusions and recommendations

21 The competition process did not go smoothly and it took the Commission longer than planned to award the licence. While the Commission was eventually able to satisfy itself that both bids met the statutory requirements for player protection and due propriety, in the absence of other contingency plans there was the possibility of the National Lottery being suspended had the Commission been unable or unwilling to agree an interim licence with Camelot.

22 Ultimately the Commission's decision to award the licence to Camelot reflected the judgements of individual Commissioners, although they were not in full agreement. However, the Commission conducted a thorough review of the bids and the process it used provided a sound basis for its decision.

23 In reaching its decision, the Commission took account of the level of risk associated with the two bids. It is evident, however, that the incumbent licensee has an inherent advantage because of the risks involved in changing to a new lottery operator. This suggests that to be successful a competitor must submit a bid that is sufficiently less risky or sufficiently more generous to the Good Causes to outweigh the risks involved in a handover. This could deter potential competitors from bidding for the licence.

24 There were significantly fewer competitors for the second licence than for the first (two compared with eight), although the number was consistent with comparable international experience and competition between the two bids was close. There is a real risk that there will be no competitive pressure when the next licence comes to be awarded.

25 The Commission is now considering the issues to be taken forward from the award of the second licence and applied to the third. **Figure 3** sets out a range of issues identified by the Commission, together with our comments.

3 Issues for the future

Issues identified by the Commission	National Audit Office comment
Arrangements for resourcing the conduct and oversight of the competition for the National Lottery licence (including making the decision itself) should reflect both the magnitude of that process and the Commission's continuing responsibilities for the regulation of the existing licence. One approach, for example, might be to form a full-time selection team comprising one or two Commissioners (who might be appointed primarily for the purpose of the competition), as well as members of staff and consultants. The selection team would then make recommendations to the full Commission on the choice of bidders to proceed beyond a qualifying stage.	It will be important to ensure that the competition process for the next licence does not affect the regulation of the existing licence. The events of the competition for the second licence, in particular the investigation of the GTech software defect cover-up, added to the pressure on the Commission. Although the Commission recognised the considerable burden of the competition process and employed outside consultants to assist it, it also had to continue in its day-to-day regulatory role in respect of the first licence. Camelot told us that during the competition period it took the Commission up to six weeks to approve some licences for scratchcard games; normally this took just two weeks. The Commission was set up only a few months before the start of the competition for the second licence. For the award of the third licence, the Department for Culture, Media and Sport has an opportunity to ensure that a body of experienced Commissioners and staff has more time to prepare before the start of the competition process.
Steps should be taken wherever possible to reduce the burden on bidders and so promote competition. This might be achieved, for example, by adoption of a two stage process whereby an initial short Invitation to Apply is amplified after the expressions of interest have been considered and before the second stage of the competition. It might also be possible to contribute towards bidders' costs.	The burden on bidders would be reduced if the Commission required bidders to provide less information, particularly in the early stages of the competition. This would reduce the costs of bidding and promote competition. The People's Lottery told us that it found it difficult to provide the Commission with some of the detailed information it sought, such as target dates for the appointment of senior staff. Whilst it would still be necessary for bidders to show at an early stage how they planned to meet the Commission's essential requirements, there would be no need for all the elements to be in place before the award of the licence. Some less important aspects might be agreed after the selection of a preferred bidder or at a later stage of a staged competition. This could help to counter some of the advantages that the incumbent operator has over rival bidders. The Commission is also considering making a contribution to bidders' costs. This may be the simplest and most effective way of reducing the cost of bidding, although it would be important for the Commission to guard against the risk of paying bidders simply to correct deficiencies in their bids.
Bidders should be encouraged to develop realistic forecasts and to base their business models and cost bases on realistic levels of retained income. This could be achieved, for example, by giving bidders a forecast for total sales that the Commission considers realistic and asking them to demonstrate: ■ how they would achieve these forecasts; ■ what additional sales levels they believe they could achieve; and to prepare business models around these two scenarios.	The Commission's assessment that the two bidders had been over-optimistic in forecasting ticket sales made its job of evaluating the bids more difficult. If the Commission were to give bidders a forecast for sales in future, it would need to ensure that they had clear incentives to maximise the returns to Good Causes. Although the Commission's forecast should avoid over-optimism, it would need to be challenging since it might be viewed by bidders as a target.

3 Issues for the future *continued*

Issues identified by the Commission	National Audit Office comment
The Commission needs to avoid prescriptive demands which might inhibit bidders from offering innovative solutions but in certain areas, such as participant protection and prize security, it should set out its requirements and the means of achieving them in greater detail, whilst not precluding alternatives. This would ensure that all bidders are clear what the Commission expects of them.	More prescription about the arrangements expected might ease the burden on bidders and help to ensure that bids reach the required standards in key areas. If such arrangements were free-standing it might be possible for them to be handed on from one licensee to the next. In some areas this could require agreement from third parties, such as trustees involved in holding prize fund monies, who might bear some risk.
The competition process should make much greater provision for negotiation with bidders as the evaluation proceeds. For example, the selection team could challenge points in bids at the time they arise, require bidders to defend their bids, and allow them to make changes. To help demonstrate fair treatment of all bidders, special consultants could sit in on dialogues with bidders.	Although the bidders made significant improvements to the bids, both Camelot and The People's Lottery felt that they could have rectified their bids much earlier if the Commission had made its requirements more explicit during the initial evaluation period. Camelot said that, whilst appreciating the seriousness of the Commission's concerns about GTech, it had not realised that these could lead to the failure of its bid. The People's Lottery considered that the Commission had not made its participant protection requirements clear. Both bidders told us that they did not feel involved in the evaluation process. There can be a tension between maintaining fairness in the competition process and achieving the best deal from it. However, there is no reason why the Commission cannot ensure fairness while seeking to maximise the returns to Good Causes through dialogue with the bidders, provided the rules under which this takes place are clearly set out in advance.
The Commission and the selection team should aim for public understanding of the issues from the start and use communications consultants throughout to that end. This would help to ensure proper public understanding of the issues that the Commission had to consider when awarding the licence and increase the transparency of the process itself.	Achieving understanding during the competition for the second licence was not helped by the duration and complexity of the process or by the apparent change from one preferred bidder to the other.
Alternative structures for the operation of the National Lottery should be considered to assess whether these would promote greater competition, while reducing the risks that competition brings (such as the handover arrangements). For example, a continuing 'Licence Company' could be set up to operate the infrastructure necessary to deliver the National Lottery. Bidders would compete to acquire the right to manage this company and promote on-line games.	Radical changes in the structure of the National Lottery would require legislative change. The Department for Culture, Media and Sport and the Commission need to come to an early view on such changes to avoid the uncertainty that prefaced the last competition. The second licence allows for a two year handover period and up to two further years may be needed for the competition process. Provision to set up a 'Licence Company' and similarly significant changes would therefore need to be in place by the end of 2004. The Commission will need to consider what is the appropriate length for the next licence, particularly in the light of any changes to the structure of the National Lottery. Alternative structures for the Lottery may change the scale and nature of the investment required of the operator and therefore have implications for the length of the licence period.

26 Our conclusions and recommendations will help to inform the review which the Department for Culture, Media and Sport is currently undertaking on the process of awarding the licence to operate the National Lottery. The Department's review will look at ways of increasing competition for the next licence to maximise the returns to Good Causes including:

- options for changes in relation to the structure of the licence and licensee;
- the process of licensing; and
- the nature and function of the current regulatory system.

The Department expects to publish a consultation document on these matters in Spring 2002.

27 The issues being considered by the Commission and the Department reflect a proper focus on the need to remove obstacles to competition and include the possibility of legislative change to alter the basis on which the licence is awarded. However, the Commission's experience in awarding the second licence underlines the need for contingency plans to be established for a situation where there are no suitable bidders, or indeed where there is only one suitable bidder.


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Part 1

Introduction

1.1 The United Kingdom National Lottery was launched in November 1994 and is one of the largest lotteries in the world in terms of sales. **Figure 4** provides some key facts and figures about the National Lottery. This report is about the competition for the second licence to run the National Lottery and the National Lottery Commission's evaluation of the bids it received from Camelot Group plc and The People's Lottery Limited.

1.2 The National Lottery etc Act 1993 (the 1993 Act) provides the statutory framework for the National Lottery to be operated by private sector organisations, with the objective of raising money to be paid to the National Lottery Distribution Fund. Money is then apportioned to other bodies (distributing bodies) specified in legislation for distribution within their sectors: the arts; charities; film; health, education and the environment; heritage; the Millennium; and sport. Together these are known as the 'Good Causes'. **Figure 5** outlines the flow of funds and the key responsibilities of those involved with the National Lottery.

4 Key facts and figures about the National Lottery

The National Lottery has been played by some 80 per cent of the adult population in the United Kingdom and is regularly played by around 65 per cent.

By the end of the first licence in September 2001:

- the public had spent almost £32 billion on the Lottery;
- players had won almost £16.5 billion;
- some £10.6 billion had been raised for the Good Causes; and
- the Government had received over £4 billion in lottery duty.

The **first** licence to run the National Lottery was awarded to Camelot Group plc (Camelot) and ran from 29 July 1994 to 30 September 2001.

As the award of the next licence was delayed, an **interim** licence was granted to Camelot to run from 1 October 2001 to 26 January 2002.

Camelot was awarded the **second** full licence, which runs from 27 January 2002 to 31 January 2009.

The National Lottery Commission

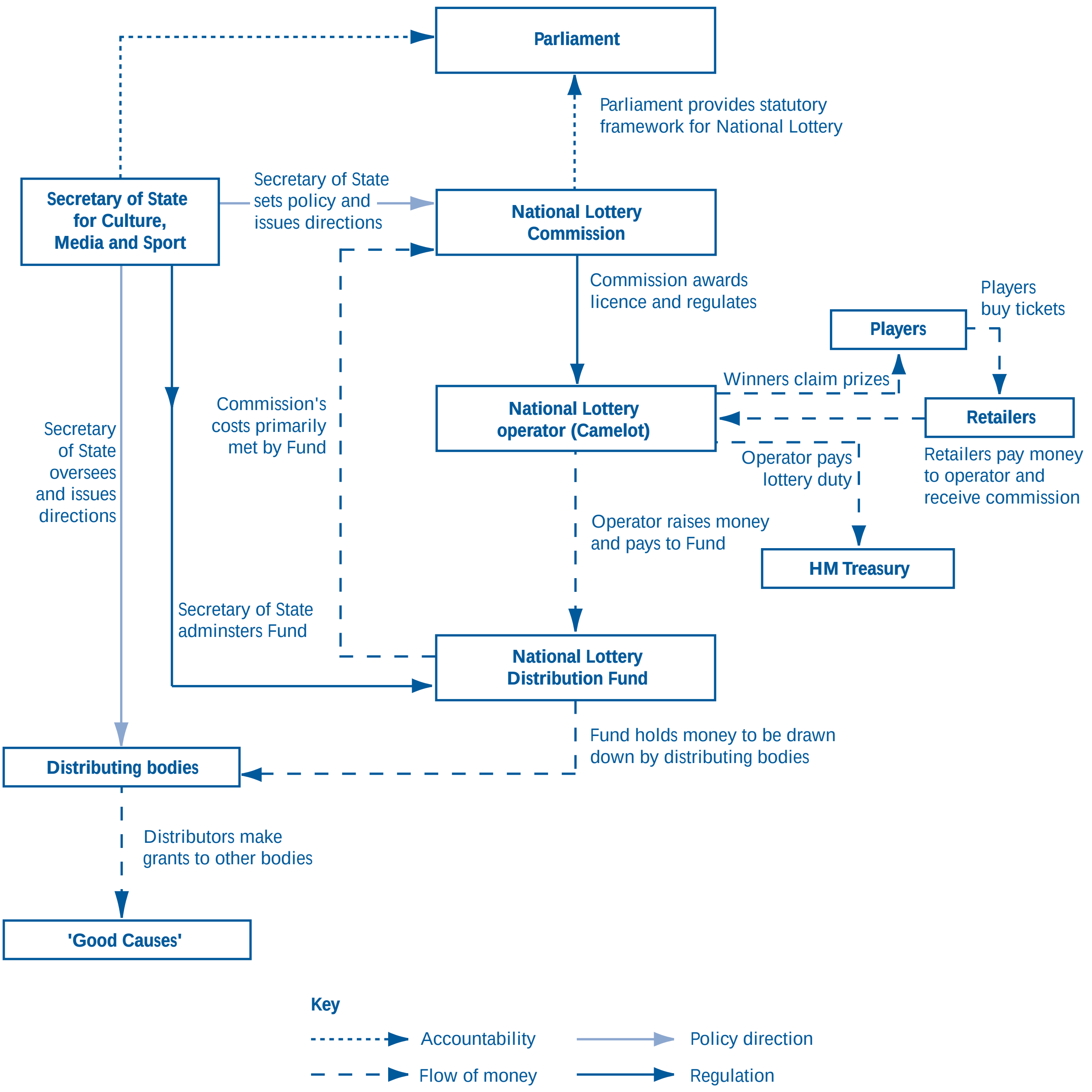
1.3 The 1993 Act provided for a regulator, the Director General of the National Lottery supported by the Office of the National Lottery (OFLOT), to select and then oversee the performance of the operator. In a White Paper[2] published in July 1997, the Government identified the need to make the selection of the next operator transparent, independent and objective in order to ensure public confidence. The White Paper proposed that the Director General should choose a new operator with the assistance of a panel "with expertise in business including the lottery market, with experience of lottery distribution, and able to reflect the views of consumers".

1.4 In April 1998 the then Secretary of State for Culture, Media and Sport announced that, rather than setting up a panel to assist the Director General, he proposed to establish a permanent collective body to bring a wider range of expertise and experience - of the lottery market, of business and industry, of consumer representation and of the interests of players - to the task of ongoing regulation as well as to the selection of the new operator. Consequently, in April 1999, under the National Lottery Act 1998, the Director General was replaced by the National Lottery Commission. The staff of the Director General (OFLOT) transferred to the Commission.

1.5 The National Lottery Commission (the Commission) is a non-departmental public body which had a staff of 33 in 2000-01, the period when most of the competition process took place. Its costs (£5 million in 2000-01) are met from the National Lottery Distribution Fund and from fees charged for the main lottery licence and the licences for individual games. The five National Lottery Commissioners, who hold part-time appointments for up to five years, choose their own Chair, who may hold office for at most 12 months and may not hold office again for at least as long. **Appendix 1** gives details of past and present Commissioners. The Commissioners are responsible for appointing the Chief Executive, who

2 *The People's Lottery (Cm 3709, July 1997).*

5 The flow of funds and the key responsibilities of those involved with the National Lottery



Source: National Audit Office

is designated Accounting Officer of the Commission by the Accounting Officer of the Department for Culture, Media and Sport. Unless otherwise stated, references in this report to the Commission refer to the Commissioners acting corporately.

1.6 The Commission has the following functions:

- **selecting the operator**: choosing the licensee to run the National Lottery;
- **licensing games**: considering applications for and awarding the separate licences required for each lottery game; and
- **enforcing the licences**: ensuring that the provisions of the licences that it has granted are complied with. The Commission has a range of remedies available to it, which include fines, powers to seek enforcement in the High Court, and, in extreme cases, power to revoke the licence.

1.7 The Commission must exercise its functions under the 1993 Act in the manner that it considers the most likely to secure:

- that the National Lottery is run with all due propriety; and
- that the interests of every participant in the National Lottery are protected.

Subject to these requirements, the Commission must do its best to maximise the net proceeds of the National Lottery.

The role of the Secretary of State for Culture, Media and Sport

1.8 The Secretary of State for Culture, Media and Sport is responsible for setting the general policy framework for the National Lottery. The 1993 Act places the same overriding duty on the Secretary of State as it places on the Commission. The Secretary of State must act in a manner most likely to ensure that the Lottery is run with all due propriety and the interests of participants are protected and, subject to these requirements, to secure the greatest possible return to Good Causes. The Secretary of State is responsible for appointing the five National Lottery Commissioners, who are solely responsible for the award of the licence to run the National Lottery.

The main principles for the competition for the second licence

1.9 In planning the competition for the second licence to run the National Lottery, the Commission recognised that the situation had changed significantly since the award of the first licence in 1993. In particular:

- the volume of sales had demonstrated the size of the market that existed, reducing the risks to the operator;
- the experience gained in regulating the Lottery would allow the Commission to base its Invitation to Apply more in terms of the outcomes that bidders should deliver; and
- developments in technology gave opportunities for bidders to provide players with new forms of access to games.

1.10 In July 1999, taking account of the views of prospective bidders and others, the Commission issued a statement of the main principles it would adopt for the competition for the new licence. The statement made clear that the Commission would choose the next operator in line with its statutory duty to maximise money for the Good Causes, subject to the overriding issues of protecting participants and ensuring the fitness and propriety of bidders and key suppliers. **Appendix 2** provides a more detailed summary of the Commission's statement.

The timetable for awarding the licence

1.11 The Commission aimed both to allow adequate time for the preparation and evaluation of bids and to give a new operator enough time to prepare for taking up its responsibilities. The Commission's intended timetable was to:

- publish a draft Invitation to Apply and draft licence for comment in September 1999;
- issue the final Invitation to Apply and revised draft licence by November 1999;
- receive bids no later than 29 February 2000;
- announce the preferred bidder in June 2000; and
- start the new licence in October 2001.

1.12 In the event, the process of awarding the second licence took longer than the Commission had planned and the preferred bidder was not announced until 19 December 2000. To allow sufficient time for the preferred bidder to implement the requirements of the second licence, the Commission agreed an interim licence with Camelot (paragraphs 4.5 and 4.6). This ran from 1 October 2001 to 26 January 2002, giving a start up period of 13 months. The new licence therefore started on 27 January 2002.

The National Audit Office examination

1.13 We examined how the Commission decided who should be awarded the new licence to run the National Lottery. In particular, we considered:

- whether the Commission secured the strong competition for the licence that it sought; and
- whether the Commission's evaluation of the bids provided a sound basis for its choice of preferred bidder.

The methods we used are described at **Appendix 3**.

1.14 The structure for the remainder of the report is:

- **Part 2** - looks at the bidding for the second licence, including the Commission's efforts to encourage strong competition and the breadth of competition achieved;
- **Part 3** - looks at the concerns that led to the two bids received being rejected, the Commission's decision to negotiate with The People's Lottery alone, and its eventual decision to award the licence to Camelot; and
- **Part 4** - looks at how the Commission evaluated the two bids.

1.15 The Committee of Public Accounts has been interested in how the Commission and before that the Director General of the National Lottery have carried out their statutory duty to satisfy themselves that applicants to run the Lottery are fit and proper. The Government has agreed to activate provisions in relevant legislation to designate the Comptroller and Auditor General as entitled to see certain documents provided to the Commission specifically to inform the vetting process, subject to satisfactory arrangements to protect the material being put in place. An order to amend the Financial Services and Markets Act 2000 was made in November 2001 and further orders to amend the Companies Act 1985, the Financial Services Act 1986 and the Criminal Justice Act 1987 are expected to be made shortly.

Part 2

Bidding for the second licence

2.1 Under the National Lottery etc Act 1993, the Commission is required to seek to maximise the returns to Good Causes and, whilst it is not bound to hold a competition, it saw competitive pressure as the best way to achieve this. The stronger the competition, with its incentives for operator efficiency and performance, the greater the likelihood of maximising the returns to the Good Causes.

2.2 This part of the report looks at the competition for the second licence to run the National Lottery. In particular, we examined:

- what was being bid for;
- the bids received; and
- the constraints on bidding.

What was being bid for

2.3 The Commission sought bids for the licence to 'run', that is to promote and operate, the National Lottery on the basis that bidders would, after the payment of prizes and lottery duty, contribute a percentage of the revenue they raised to the Good Causes. Taking a percentage of lottery revenues is not the only way of achieving a return to the Good Causes. In his 1995 report on the award of the first lottery licence[3], the Comptroller and Auditor General observed that arguably the simplest way of maximising the net proceeds to the Lottery would be to award the licence to the applicant offering the highest cash bid. The then Director General of the National Lottery considered that this would not maximise returns to the Good Causes, as it was difficult to forecast the revenue generating potential of the Lottery. He considered it more appropriate for bidders to specify what proportion of total ticket sales income would go to Good Causes.

2.4 The Commission adopted the same approach for the competition for the second licence as it did not consider that the alternative option based on the highest bid would be practicable. The Commission was sceptical about the extent to which the amount pledged to Good Causes by the winning bidder could in practice be guaranteed from future revenue or borrowing. The Commission was concerned that the uncertainty of future revenue and the relatively narrow profit margin meant that there was a real risk of the operator becoming unviable and the National Lottery folding. There was also a risk that the operator's performance would exceed expectation but that this would benefit only the operator and not the Good Causes.

2.5 The Commission also had to decide whether the second licence should be for the same length of time as the first, which ran for seven years from 1994 to 2001. The Commission considered the impact different lengths of franchise would have on the extent of competition, the level of investment the operator might make in the lottery infrastructure, and the incentive for the operator to reduce costs and improve performance. The Commission decided that the licence period should remain at seven years as it was concerned that the longer the franchise the less likelihood of alternative operators mounting a bid when the licence was next competed for.

The bids received

2.6 The Commission announced the competition for the second licence in May 1999. By September 1999, 16 parties had contacted the Commission to express an interest in the process. At this point the Commission invited interested companies to send it a non-binding Letter of Intent to bid for the next licence. The Commission received seven Letters of Intent **(Figure 6)**. One was subsequently withdrawn and two were from a parent company and its subsidiary, effectively giving five potential bidders.

2.7 In the event, two compliant bids were received by the deadline for applications of 29 February 2000. These were from Camelot Group plc and The People's Lottery Limited. A third applicant (the Charity Consortium), which had not sent a Letter of Intent, also submitted a

3 *Evaluating the applications to run the National Lottery (HC 569, 1994-95).*

6 Companies who sent a Letter of Intent to the Commission

Camelot Group plc	Sumraj Limited
Rockdean Limited (Ireland)[1]	The People's Lottery Limited
Siemens Business Services Limited[2]	Trigger 7 Lotto
SISAL spa (Italy)[1]	

NOTES

1. Rockdean Limited is a subsidiary of SISAL spa
2. Siemens Business Services Limited later withdrew its Letter of Intent

Source: National Audit Office

bid by the deadline. However, this bid did not comply with the Invitation to Apply and was subsequently withdrawn. Another applicant (Trigger 7 Lotto) asked for more time to put together a bid after the deadline but, after taking legal advice, the Commission decided not to allow this as it considered it would have caused unacceptable delay to the competition.

2.8 At two, the number of compliant bids received was considerably fewer than the eight that had been received for the first licence. We reviewed recent experience of holding competitions for lotteries in other countries. There are few international comparators, as most of the world's major lotteries are state-operated, with private sector suppliers competing for contracts to provide products and services. Only South Africa and Ireland operate on a comparable basis to the United Kingdom in licensing an operator to run the lottery. Both had recently held competitions for their lottery licences and had experienced similar levels of competition to the United Kingdom. South Africa attracted three bids for the award of its first licence in 1999. In 2000 in Ireland, the Government received just one bid to run its lottery (from the incumbent operator), although it completed its evaluation to ensure its requirements would be met.

The constraints on bidding

2.9 The competition for the second licence took place under different circumstances from the first, not least the existence of an incumbent operator, which risked discouraging others from bidding. The Commission needed actively to stimulate competition and therefore:

- in May 1999 it invited those organisations interested in bidding for the next licence to approach it for informal discussions;
- in July 1999 it held a press conference to coincide with the publication of its Statement of Main Principles; and
- in October 1999 it held a conference for potential bidders and suppliers, which gave interested companies the chance to meet and possibly form bidding consortia, and provided the Commission with an opportunity to gather views on the draft Invitation to Apply.

2.10 During these discussions, many companies stressed the importance of there being a 'level playing field' if they were to bid. However it was apparent from the Commission's own considerations and the views expressed by potential bidders that there were a number of constraints on bidders and these are set out in paragraphs 2.10 to 2.26 below.

The cost and burden of bidding was considerable

2.11 Running the National Lottery is a major operation and preparing a full bid for the licence to run it is a major and costly task. Based on reported experience from the competition for the first licence, the Commission believed that the direct costs of bidders were likely to be between £3 million and £4 million. Recognising that high bidding costs might deter potential bidders, the Commission considered making a contribution to bidders' costs but concluded that competition would be strong enough without this support.

2.12 The Commission is now considering ways in which it might reduce the burden on bidders in future competitions. These include holding the competition in stages and/or selecting a small number of bidders, who would receive a fixed contribution to their costs. Further financial assistance might be available if specific work from bidders were called for during the selection process, although the Commission would need to guard against the risk of paying bidders simply to correct deficiencies in their bids.

Uncertainty about the treatment of 'not-for-profit' bids

2.13 In March 1999 the Director General of the National Lottery drew the attention of the Commissioners to the uncertainty amongst potential bidders about the Government's position on not-for-profit operation of the Lottery. For-profit bodies were unsure whether they were eligible to bid for the licence, or whether during the evaluation of bids the Commission would favour not-for-profit operators. Some potential bidders felt that this was inhibiting the formation of bidding consortia. In its Statement of Main Principles issued in July 1999, the Commission welcomed bids from bodies with different financial structures, including those who did not benefit from distribution of profits. The Commission made clear that it could not favour any particular type of operator, given its statutory duty to maximise the returns to the Good Causes.

There were few suppliers of the required technology services

2.14 The Commission recognised that there were few suppliers capable of providing technology services for large on-line lotteries such as the National Lottery and, that if each supplier were 'locked in' to a single operator, this could limit competition. In evidence to the House of Commons Culture, Media and Sport Committee in February 2001, the Secretary of State for Culture, Media and Sport said that only two companies, GTech (which was part of Camelot's bid) and AWI (which was part of The People's Lottery's bid), were capable of providing the software for the National Lottery. The Secretary of State concluded that if "each of these companies has signed an exclusive agreement with a particular bidding operator, you inevitably end up in the situation that you have only two bids".

2.15 Before granting the licence, the Commission must vet bidders and key suppliers to ensure that the National Lottery is likely to be run with all due propriety and that the parties are capable of delivering the commitments made in their bid. In June 1999 The People's Lottery asked the Commission whether it would accept bids that did not specify key suppliers so that it could bring in the best suppliers should its bid be successful. This would also address the problem of key suppliers being 'locked in' to a single bidder. In its Statement of Main Principles issued in July 1999, the Commission said that although it considered it strongly desirable that bids should identify key suppliers, it was prepared to discuss the possibility of accepting bids which did not fully specify key suppliers.

2.16 In August 1999 The People's Lottery told the Commission that it would prepare a bid that specified key suppliers to enable its bid to be evaluated on a like for like basis with other bids but, if it were awarded the licence, it would like a period of up to four weeks to evaluate any key supplier not included in its bid to satisfy itself that the best supplier was in place. The Commission decided that such an approach was consistent with its statutory duties, although it would evaluate initial bids without making allowance for possible later improvements. The Commission's Invitation to Apply therefore required bidders to identify key suppliers, although the Commission had already stressed that it would welcome the involvement of any key supplier in more than one bid.

2.17 The Commission is considering whether this potential constraint on bids could be avoided in future competitions. For example, the competition could be held in stages with key suppliers identified only in the later stages, although the Commission would need to ensure that this did not compromise its ability to undertake timely vetting of suppliers. Other approaches being considered by the Commission include contracts with key suppliers being 'inherited' from the incumbent operator; or setting up a company to hold the lottery licence and contract with key suppliers for the necessary infrastructure - bidders would then compete to run this company.

Handover to a new operator

2.18 The Commission recognised the considerable size of the task that would face a new operator, who would be required essentially to replace the existing structure of the National Lottery (for example, the network of retail outlets and terminals). The first licence did not require the incumbent (Camelot) to co-operate with the incoming licensee or to hand over any of its existing infrastructure, and some potential bidders felt that this would force a 'big bang' approach on handover. A phased implementation of lottery systems would be less risky for the new operator but would require Camelot to co-operate and bear a degree of risk, as the two operators' systems would have to run in parallel for a time.

2.19 Camelot agreed to do all it could to ensure that the National Lottery came to no harm and to co-operate with an incoming operator, provided that this did not conflict with its responsibilities to its shareholders and staff. This assurance was included in the draft Invitation to Apply, which also made clear that the Commission had no powers to impose requirements on the incumbent licensee to transfer assets to a new operator or to assist them in other ways. Given the size of the task that would face a new operator, the Commission planned the competition timetable to allow 15 months for a handover.

2.20 The Commission has strengthened its position under the new licence. During the two years preceding expiry of the licence, the Commission will be able to require the assistance and co-operation of the incumbent operator to help the new licensee establish the facilities necessary for the operation of the National Lottery. The Commission may also require the transfer of property and rights that it regards as an integral part of the Lottery and that ought reasonably to be available for use by the subsequent licensee.

The incumbent operator had a competitive advantage

2.21 In 1996 the Committee of Public Accounts stressed that Parliament expected the lottery regulator to ensure that all potential licensees were treated fairly[4]. The Commission recognised that the incumbent operator, Camelot, had a significant advantage due to its

4 *Evaluating the Applications to Run the National Lottery and the Director General's Travel and Hospitality Arrangements, Committee of Public Accounts Forty-first Report (HC 96, 1995-96).*

established infrastructure and its knowledge of National Lottery retail distribution. Many potential bidders had stressed to the Commission the need for a 'level playing field' if they were to bid. The Commission considered that it could not adjust the bids to suppress the advantages of the incumbent licensee, as this would have run contrary to its legal duty to maximise the returns to the Good Causes and could have resulted in legal challenge on the grounds of unfairness. However, the Commission did seek to overcome the two main aspects of the incumbent's advantage.

(i) The incumbent faced significantly less risk because of its established infrastructure

2.22 The Commission considered that Camelot's existing infrastructure gave it such an advantage that it would deter potential bidders from competing for the licence. The Commission therefore stipulated that the winning bidder, even if it were Camelot, would be required to install new terminals. The Commission considered that the existing terminals would need to be replaced at some point during the next licence period and had to weigh the effect of bringing forward the full cost of new terminals (which it estimated to be no more than £90 million and possibly significantly less) to the start of the licence period, which would ultimately reduce the money available to the Good Causes, against any improved return to the Good Causes that enhanced competition would bring. The Commission concluded that requiring new terminals at the start of the licence period would increase the likelihood of competition and cause Camelot to improve its bid to an extent that would compensate for the effect on the return to Good Causes. The Commission also noted that the frequency of faults with the existing terminals was increasing and believed that bringing forward the replacement of the terminals to the beginning of the licence period would benefit the National Lottery.

2.23 The Commission considered whether actual replacement of terminals was necessary for Camelot. The alternative was to apply the notional replacement cost to Camelot's bid to enable a comparison with other bidders. However, after taking legal advice, the Commission concluded that a notional adjustment to the bid would not affect Camelot's actual return to the Good Causes, which was what the Commission was statutorily required to consider.

(ii) The incumbent faced less uncertainty due to its knowledge of the retail network

2.24 Under the terms of the first licence, Camelot was obliged to provide the Commission with management information, such as sales by region and type of retailer, which the Commission could then publish. Although the Commission required bidders to provide only a strategy for their planned retail network, potential bidders sought more detailed information about the location of National Lottery retailers on which to base their bids, which fell outside the terms of the first licence. In December 1999 the Commission secured Camelot's agreement to the release of information about its independent retailers (such as newsagents, convenience stores and grocers). As data protection rules required retailers' active consent to this, Camelot wrote to retailers, inviting them to provide details of their names and addresses to the Commission by 15 December 1999.

2.25 Almost 9,800 independent retailers (64 per cent) responded in time for the Commission to send a database to interested parties on 24 December 1999, two months before the deadline for receipt of bids. The database listed independent retailers by postcode and 'multiple' retailers (such as supermarket chains and petrol companies) by local authority area. Potential bidders had to contact the multiple retailers directly for further information on which of their outlets had lottery terminals. However, the multiples were sensitive about their retailers appearing on the database, as they feared that competitors might register as bidders simply to obtain the list. All in all The People's Lottery considered the retail data to be of little use to its bid since it was incomplete, was unrepresentative of the retail network, and was presented in two different forms.

2.26 The Commission has improved the position under the new licence, which requires the licensee to transfer to the Commission, upon its request, any databases concerning the lottery retail network. Retailers' consent will be secured in advance as part of their agreement with the operator. In future, the Commission will be able to provide this information to other organisations for the purpose of bidding for the National Lottery licence.

Part 3

Awarding the licence

3.1 This part of the report sets out the twists and turns of the process of awarding the second licence to run the National Lottery. In particular, we examined:

- the concerns that led the Commission initially to reject both bids;
- the Commission's decision to negotiate with The People's Lottery alone;
- the overturning of the Commission's decision on judicial review and the resignation of the Chair of the Commission; and
- the Commission's decision to award the new licence to Camelot and the resignation of the dissenting Commissioner.

The Commission had concerns about both initial bids

3.2 The Commission received bids from The People's Lottery and Camelot on 29 February 2000. The Commission's initial evaluation indicated that there were weaknesses in both bids and between April and June 2000 the Commission sought clarification from the bidders about various aspects of their bids, with a view to securing improvements. In both cases, the key concerns related to the Commission's statutory duties (paragraph 1.7):

- in the case of The People's Lottery's bid, the Commission's evaluation work raised concerns about the ability of The People's Lottery to satisfy the Commission that its bid adequately protected the interests of participants (paragraphs 3.4 and 3.5); and
- in the case of Camelot's bid, information the Commission received from a 'whistleblower' raised concerns about the fitness and propriety of one of Camelot's key suppliers, GTech, and about Camelot's ability to manage the supplier (paragraphs 3.6 to 3.14).

3.3 On 23 June 2000 the Commission announced that it had decided to extend the timetable to allow both bidders further time to improve specific aspects of their proposals and that it now intended to announce the preferred bidder by the end of August 2000. **Appendix 4** provides further details of the improvement process. However, although the bidders made significant improvements to their bids, the Commission's concerns remained so fundamental that, on 23 August 2000, it announced that neither bid met the statutory criteria for granting a licence. The Commission decided to withdraw the Invitation to Apply and adopt a new process to award the next licence.

The Commission's key concern about The People's Lottery bid

3.4 Amongst other issues, The People's Lottery was asked in April 2000 about its arrangements for safeguarding players' money and prize money. The Commission needed to ensure that all prizewinners would receive the prizes due to them and that any holders of tickets in a draw that did not take place for any reason would be reimbursed. Although The People's Lottery had improved its bid, the Commission remained concerned about the extent to which players' money and prize money would be held and controlled separately from other funds. The Commission felt that there was a risk of players' money and prize money being used to support The People's Lottery's general cashflow. **Appendix 5** gives a chronology of the Commission's concerns and The People's Lottery's responses.

3.5 In July 2000, as a consequence of the dialogue with the Commission, The People's Lottery put forward a proposal for the protection of the interests of players involving a trust corporation (Trustco). Trustco would hold two trusts: a prize payment trust (to hold the share of ticket sales to be paid in prizes) and a failed draw trust (to hold the remaining share of sales until a draw took place). According to The People's Lottery, the security arrangements for these trusts were "...subject to satisfactory resolution of associated stamp duty, asset transfer and tax issues; and Counsel's opinion about the ... assignment of the right to income from ticket sales to Trustco". The Commission considered that, for it to be satisfied, a bid had to contain unequivocal commitments which were clearly capable of being put into effect both legally and practically, which were not contingent on the agreement of any other party, and which would secure in full the interests of players. After taking legal advice, the Commission concluded that The People's Lottery's new proposals were so conditional and uncertain that it had to reject them.

The Commission's key concern about Camelot's bid

3.6 On 12 April 2000 the Commission received a letter sent to the Secretary of State for Culture, Media and Sport by David Armitage, a former GTech employee, which alerted it to the secret correction by GTech (the supplier of lottery gaming systems to Camelot) of a defect in the National Lottery software. GTech had failed to disclose the fault or its correction to Camelot or to the Commission's predecessor, OFLOT, in breach of established software change control procedures.

3.7 The Commission investigated the allegations and established that the software fault had been present from the start of the Lottery until corrected in July 1998. In certain limited circumstances, the fault caused duplicate transactions to be recorded on the system with only a single ticket being produced. This resulted in Camelot collecting money from retailers for 'phantom' tickets and, if the ticket were a prizewinner, other legitimate prizewinners being underpaid. **Figure 7** gives details of the financial impact of the software defect. **Appendix 6** covers the Commission's investigation in more detail.

3.8 The Commission viewed the concealment of the software fault and its correction from both the regulator and Camelot as an extremely serious matter. Before the Commission had been set up, the Director General of the National Lottery had established procedures regulating the notification of changes in gaming software to the operator and to OFLOT. And in March 1998, a few months before the correction of the fault, the Director General had reiterated key objectives for the regulation of the licensee's day-to-day activity, which sought to strengthen internal controls and corporate conduct within Camelot and its key suppliers. These included requirements that the licensee should have a strong and effective internal control framework and should adhere to the highest standards of corporate conduct, and that all persons involved in key aspects of the Lottery's operations should be 'fit and proper'.

3.9 Furthermore, the GTech senior executives involved in the software defect cover-up had given personal assurances to the Director General that GTech would introduce and rigorously apply a code of conduct intended to reinforce proper corporate behaviour. Yet only four months later the executives had significantly failed to meet the standards of conduct promised, in particular in failing to disclose the fault which ran directly counter to participants' interests.

7 The financial impact of the Lottery software defect

Camelot, under the scrutiny of the Commission and Camelot's external auditors, analysed virtually all transactions made between the launch of the National Lottery in November 1994 and the secret correction of the software defect in July 1998. Camelot concluded that out of over 14 billion transactions, 156,493 duplicate transactions had occurred; around 0.001 per cent of all transactions. These had resulted in an underpayment to prizewinners in nine draws totalling almost £57,000 and affecting almost 56,000 prizewinners.

No prizewinner was underpaid by more than £3 and the vast majority was underpaid by only £1. Most were 'match 4' prizewinners, who matched four out of the six winning numbers. Few prizewinners could be identified because records are not required for wins below £500.

The Commission agreed with Camelot that it should pay compensation of twice the value of the underpayment. Some £115,000 was added to the 'match 4' prize fund for the draw on 28 April 2001. Camelot also reimbursed retailers for the amounts incorrectly collected.

3.10 The GTech senior executives involved in the software defect cover-up had been subject to fit and proper vetting by the Director General in respect of the first licence and the Commission had carried out similar checks in relation to the award of the second licence. However, GTech's actions cast serious doubts over whether the company was 'fit and proper' to be involved in such an important role in the operation of the National Lottery.

3.11 On 23 June 2000 the Commission reached a provisional view that it was minded to find GTech not fit and proper. If that finding had been confirmed, the Commission would have had to decide whether GTech could continue to act as a supplier to the National Lottery. Removing GTech as a supplier would have put the continued operation of the Lottery at risk.

3.12 GTech responded by giving a number of undertakings including changing the structure and membership of its Board. The individuals involved in the decision not to notify Camelot or the regulator left the company and GTech undertook to improve its arrangements for monitoring ethical conduct and corporate governance. GTech also planned to arrange independent reviews of its software development processes and make these available to Camelot and the Commission. For its part, Camelot proposed to extend the scope of its reviews of GTech's performance, to improve its arrangements for managing suppliers and control over software development, and to incorporate its commitments, and those of GTech, into contracts to ensure they were delivered.

3.13 On 25 July 2000 the Commission decided that it would "take no further steps towards a finding that GTech is not a fit and proper person to manage part of the business of running the National Lottery, given that the substance of the Commission's concerns will be met if the undertakings given by GTech and Camelot are discharged". Camelot, with GTech as a key supplier, therefore continued as operator of the National Lottery under the first licence, but the Commission decided that it would review compliance with the undertakings and their adequacy in November 2000 (when Camelot and GTech were found to be making good progress in delivering them).

3.14 Nonetheless, the Commission regarded GTech's performance and track record as relevant factors to take into account when considering GTech's suitability as a key supplier for the next licence. Until the Commission was assured that appropriate measures had been implemented and were effective, it considered it could not be satisfied that the Lottery would be run with all due propriety or that the protection of participants' interests was most likely to be secured if the new licence were granted to Camelot with GTech as a key supplier. Consequently, on 23 August 2000, the Commission rejected Camelot's bid.

The Commission decided to negotiate exclusively with The People's Lottery

3.15 Having decided that it could not accept either bid, the Commission felt that it would be unfair to make a further approach to The People's Lottery within the existing competition process without also giving Camelot an opportunity to improve its bid. But the Commission did not consider that a negotiation process involving both bidders could be completed quickly enough to allow The People's Lottery, if it emerged the winner, the time it would need to prepare for the new licence to start on 1 October 2001. The Commission considered that there was an undue risk of suspension of the Lottery at the end of the first licence period if it was unable to convert one of the two bids into an acceptable form within a month. In the Commission's view, it would take at least three months for Camelot and GTech to demonstrate that they were complying with the commitments they had made and it could not therefore be satisfied that Camelot could meet the due propriety test in time. However, the Commission judged that The People's Lottery's bid did have the potential to be remedied within a month.

3.16 Before announcing its decision to reject both bids, the Commission obtained advice from Counsel via the Treasury Solicitor that if the current competition process was brought to an end the Commission had the legal capacity to negotiate with either bidder alone. The Commission also sought advice on the question of whether it was reasonable for it to negotiate with one bidder. Counsel advised that the Commission could only justifiably abandon the competition process for single party negotiations if it took the view that Camelot was not a viable bidder since it could not satisfy the 'all due propriety' test. However, to conduct negotiations with both bidders once this view had been taken would reek of inconsistency. It would be unfair both to that bidder (Camelot), whose costs for bidding would be unnecessarily increased, and to the rival bidder (The People's Lottery), whose bid might be artificially driven up by the false prospect of further competition. Counsel advised that, while negotiating exclusively with The People's Lottery would carry a significant risk of legal challenge by Camelot, there were grounds for defending such a challenge on the basis that the Commission had no alternative but to choose between a remediable bid and a bid that was not remediable on propriety grounds within a realistic timetable for awarding the next licence.

3.17 The Commission had carried out its initial evaluation of the bidders' business plans and their returns to the Good Causes before reaching its decision to reject both bids. The Commission noted that, if both bidders achieved the same level of sales, The People's Lottery would contribute more to the Good Causes than Camelot over the period of the licence. In view of this, the Commission decided to abandon the existing process and to negotiate with The People's Lottery alone with the aim of achieving a solution that addressed its concerns about participant protection within a month. The Chair of the Commission announced on 23 August 2000 that "in the event that this negotiation fails to reach our required threshold [for participant protection], based on our legislative responsibility, we intend to ask the Government to take such steps that will keep the Lottery running".

3.18 Before announcing its rejection of both bids on 23 August 2000, the Commission informed the Secretary of State for Culture, Media and Sport on 21 August 2000 of its decision and the potential consequences of failing to negotiate a satisfactory bid that would need to be discussed between officials. On 30 August 2000, officials of the Commission and the Department for Culture, Media and Sport considered possible steps, including the Commission itself running the Lottery (although this would have required primary legislation to amend its role). The possibility of the Government setting up a body to run the Lottery was also raised. However, there was concern within the Commission and the Department about whether the Commission could grant a licence to such a body and about the conflict of interest if the Government was to appoint the regulator and, effectively, the operator. The Commission considered it unlikely that either of these options could be implemented without a break in the operation of the National Lottery. It therefore concluded that, notwithstanding its concerns about due propriety, its most feasible course of action would be to negotiate an interim licence with Camelot (paragraphs 4.5 and 4.6).

The Commission's decision was overturned

3.19 On 24 August 2000 Camelot sought a judicial review of the Commission's decision to negotiate with The People's Lottery on the grounds of non-consultation, unfair exclusion contrary to the principles of fairness and natural justice, and failure to provide reasons. Camelot sought to get the decision declared unlawful and quashed.

3.20 Meanwhile, pending the outcome of the judicial review, Camelot sought to overcome the Commission's concerns about its bid. On 29 August 2000 Camelot wrote to the Commission about possible new arrangements to enable Camelot to operate independently of GTech as a supplier for the next licence period, while continuing to use GTech's software. Camelot anticipated that distancing itself from GTech would resolve the remaining propriety concerns of the Commission and considered that it could deliver this solution quickly, certainly within a month of 23 August 2000. On 6 September 2000 Camelot told the Commission that negotiations with GTech were already underway on the finer points of the arrangements.

3.21 The Commission met on 12 September 2000 and was told that the judicial review was scheduled to begin on 18 September 2000. One Commissioner, Hilary Blume, suggested that the Commission should settle with Camelot and agree to negotiate with it as well as with The People's Lottery, as this would save the time and money involved in a judicial review. After taking legal advice, the Commission decided not to follow this course as it did not consider that Camelot had provided sufficient information to address its concerns and it was reluctant to cause further delay to the process by negotiating with Camelot as well as with The People's Lottery. The Commission considered that such a course would also have raised issues of unfairness in its treatment of The People's Lottery.

3.22 On 21 September 2000 the Judge concluded that the Commission, while intending to be fair, had followed a procedure that was conspicuously unfair to Camelot. The Commission believed the deficiencies in The People's Lottery's bid, but not those in Camelot's bid, were probably capable of being addressed within a month and that The People's Lottery's bid was preferable in terms of the returns to the Good Causes. However, the Judge considered that the Commission's justification was not sufficiently compelling to override the procedural unfairness. As an exercise of statutory powers was subject to a requirement of procedural fairness, a decision to carry on exclusive negotiations with only one of two bidders for a licence was so unfair as to amount to an unlawful exercise of that discretion. Accordingly, the Judge quashed the Commission's decision. Camelot was given one month to negotiate with the Commission, focusing solely on the propriety issue that had caused the Commission to reject Camelot's initial bid.

3.23 During the course of the judicial review, Camelot had given an undertaking to the High Court that it was prepared to run the Lottery under an interim licence. Taking this into account, the Commission decided that it would not appeal against the Court's decision. In a statement on 21 September 2000, the Commission explained that its decision to negotiate solely with The People's Lottery had been based on the fact that time was of the essence in securing a new licence to operate from October 2001. A swift resolution of the competition process was needed and any appeal could only cause further delay.

The Chair of the Commission resigned

3.24 On 21 September 2000 the then Chair of the Commission, Dame Helena Shovelton, offered her resignation to the Secretary of State for Culture, Media and Sport. With the encouragement of the Secretary of State, she carried on as a Commissioner and Chair. However, on 4 October 2000, she announced her resignation as a Commissioner. She cited media coverage that had led her to the conclusion that, much as she would have preferred to see the competition process through to a conclusion, the interests of the National Lottery would be best served by her standing down. On 12 October 2000 Lord Burns was appointed a Commissioner and on 16 October 2001 was elected as Chair.

The Commission awarded the next licence to Camelot

3.25 By 25 October 2000 the Commission had received revised bids from The People's Lottery and Camelot, and on 10 November 2000 it announced that both had the potential to meet the criteria on player protection and due propriety and would go forward to the next stage of evaluation.

- In considering the revised bid from The People's Lottery, the Commission concluded that The People's Lottery appreciated the complexities of the prize fund arrangements required. The Commission had some continuing concerns about the strength of The People's Lottery's trust arrangements to protect prize funds and the assurance of adequate funding to keep the company financially viable at low levels of sales. However, the Commission agreed that these matters could be addressed during the later stages of the evaluation and, on balance, The People's Lottery's revised bid was adequate to remain in the competition.

- In considering the revised bid from Camelot, the Commission considered the extent to which Camelot had succeeded in becoming independent of GTech as a supplier and thereby addressed the Commission's concerns about propriety. The Commission recognised that it had not been possible for Camelot to sever all links with GTech while it continued to use GTech's gaming software. However, the Commission concluded that the revised bid addressed the Commission's concerns, met the statutory criteria and should continue in the competition.

3.26 The Commission then carried out detailed analysis of the bidders' business plans to assess which bid was more likely to provide the greater return to the Good Causes. The Commission focused in particular on the likely impact of different levels of ticket sales on the bidders' revenue and returns. The Commission's work to evaluate the bids is considered in detail in Part 4 of this report.

3.27 On 19 December 2000 the Commission announced that, by a majority decision of four votes to one, it was awarding the next licence to Camelot. The Commission concluded that the uncertainty relating to achievable sales was greater with The People's Lottery than with Camelot and saw greater risks in The People's Lottery's bid in terms of costs and financial soundness, risks that combined with those inherent in a change of operator.

3.28 The Commission considered that although The People's Lottery offered higher returns to the Good Causes than Camelot at the same level of sales, this advantage was outweighed by two considerations:

- the Commission's conclusion that Camelot was likely to generate more sales and as a result would contribute more to Good Causes than The People's Lottery over the period of the licence; and
- the accumulation of risks surrounding the bid from The People's Lottery, particularly in the early stages, which the Commission considered uncomfortably high in comparison with those related to Camelot's bid.

3.29 The Commission published a detailed Statement of Reasons to explain its decision. In summary, the decision was based on the following factors.

(i) Ability to operate the National Lottery

3.30 The Commission evaluated the bids to establish whether each applicant's systems and processes covered the full scope of the proposed lottery operations; were capable of supporting the applicant's business plan, customer expectation and the Commission's requirements; and were robust, reliable, secure and fit for purpose.

3.31 The Commission concluded that Camelot would be able to operate the National Lottery satisfactorily after it had absorbed GTech's United Kingdom operations. Overall Camelot's IT systems had demonstrated a high level of operational reliability. However, the Commission noted that the gaming software proposed by Camelot was not as up to date as that in use in many other lottery jurisdictions and that this carried some risk as regards maintenance, development and adaptability. As the impact of these risks was more likely to be felt in the longer term, the Commission considered them less critical.

3.32 The Commission considered that The People's Lottery was capable of delivering a structure to operate the National Lottery. The IT system proposed by The People's Lottery was more modern than that proposed by Camelot and would have considerable potential to benefit the National Lottery. However, the Commission was concerned that The People's Lottery might have underestimated the resources required to manage the start-up and subsequent operation of the National Lottery.

3.33 The Commission recognised that the risks associated with a change of operator and systems were a possible consequence of the National Lottery legislation. The Commission did not regard these risks as sufficient in themselves to prevent the appointment of a new operator. However, it considered the risks were considerable when combined with other risks in The People's Lottery bid and greater than those in Camelot's bid.

(ii) Game plans

3.34 The Commission evaluated each bidder's overall plan, objectives, and strategy for games over the period of the licence. It looked at how the game plans supported the revenue projections in the business plans, and their robustness under alternative scenarios. The soundness of the bidders' plans was assessed with reference to games offered to date to the public and sales achieved.

3.35 The Commission noted that Camelot proposed to retain the existing format for the main on-line game (selecting six numbers from 49) and the popularity of Camelot's portfolio of on-line games. In contrast, Camelot had been less successful with 'Instants' (scratchcard games).

The Commission was also uncertain whether Camelot's proposed European-wide game was capable of introduction within the next licence period.

3.36 The People's Lottery proposed to change the main on-line game to selecting six numbers from 53. This would increase the number of occasions when the jackpot prize would not be won and would be carried forward to the next draw (a 'rollover'). The People's Lottery expected that this would lead to increased sales. The Commission accepted that there was an argument for changing the main game, given the large number of National Lottery players and the small number of rollovers that the present format generated. However, the Commission took the view that, although more rollovers might increase player appeal, equally the longer odds might cause some players to defer buying a ticket until rollovers occurred. On balance, the Commission was not convinced that a change to the main game would have a net beneficial effect on sales. The People's Lottery also proposed to introduce a considerable number of new games at the start of the licence and a regional game. The Commission considered that The People's Lottery's assumptions about players' willingness to change were unrealistic and was not convinced that the regional game would be workable.

3.37 Overall, the Commission judged that The People's Lottery's game plans offered some advantages over those of Camelot, notably with regard to scratchcard games, but carried considerable risks in combining a major change in the main game with the early introduction of many new games. The Commission was therefore not convinced that The People's Lottery's game plan was superior to Camelot's and considered it carried greater risks.

(iii) Expected sales

3.38 Over the period of the first licence, annual ticket sales averaged £5.1 billion, varying between £4.5 billion and £5.6 billion a year. Camelot forecast average annual ticket sales over the period of the second licence of £7.3 billion and The People's Lottery forecast £7.4 billion. These represented increases of more than 40 per cent over the average sales achieved during the first licence. The Commission considered that both bidders were over-optimistic about the level of sales that they could achieve, having failed to address satisfactorily either the effects of new games on the sales of existing games or the question of competition from outside the National Lottery.

3.39 Although The People's Lottery's game plan had the potential to increase ticket sales, it relied heavily on the success of the change to the main game and the early introduction of new games. The evidence submitted by The People's Lottery did not convince the Commission that The People's Lottery's status as a not-for-profit organisation would produce a significant increase in sales. On balance, the Commission concluded that Camelot was more likely to deliver more sales over the licence period than The People's Lottery.

(iv) Start-up and operating costs

3.40 The Commission examined bidders' start-up and operating costs since these, along with any profit taken by a bidder, determined the revenue that could be contributed to the Good Causes. The costs that The People's Lottery included in its bid were considerably lower than those included by Camelot. Although the Commission accepted that the difference was explicable, it considered that there was a risk that The People's Lottery had underestimated costs, particularly at lower levels of sales. The Commission's concerns were increased because The People's Lottery had not made express provision for contingencies. The Commission considered that if its concerns about costs were well-founded, it reduced the extent to which Camelot had to generate higher sales than The People's Lottery in order to contribute the same amount to the Good Causes. It would also increase the risk of The People's Lottery going into financial deficit.

(v) Financial viability

3.41 The Commission considered the profitability or financial security of the bidders during the period of the licence. If a bidder ceased to be financially viable, this threatened the continuity of the return to the Good Causes and the total amount raised over the period of the licence.

3.42 The Commission considered a wide range of sales scenarios. Since Camelot was profitable in all of them, the Commission concluded that the risk of Camelot becoming loss making was low. Once it had repaid its start-up loan, The People's Lottery intended to pass each year's profits to the Good Causes and there was therefore no provision to build up reserves as a cushion against future deficits. While the improvements in its revised bid increased The People's Lottery's ability to deal with short-term cash flow requirements and could help it in lower sales scenarios, the Commission's view was that they gave only limited assistance in the event of continuing losses.

The dissenting Commissioner resigned

3.43 One commissioner, Hilary Blume, resigned because she could not agree with the decision to award the licence to Camelot. Ms Blume believed that The People's Lottery would achieve sales as high as, or higher than, Camelot's and this, together with The People's Lottery's greater generosity, would generate more for the Good Causes. She considered that The People's Lottery's game plan afforded better player protection and the technology offered by The People's Lottery was superior to that of Camelot. In her judgement, the concerns about financial soundness in The People's Lottery bid were overstated, whereas she had continuing concerns over issues of propriety and Camelot's continued dependence on GTech. With a choice of appointing Camelot or taking the much higher risk of appointing a new operator, she concluded that the latter was a risk worth taking. She saw this as a choice between watching a steady erosion of the return to the Good Causes with Camelot and choosing a new operator committed to giving more to the Good Causes and with a proven flair for marketing. However, she thought that the evaluation process had been rigorous and understood why her fellow Commissioners had reached their decision.

Each of the two bids contained over 9,000 pages and filled a security cupboard.

Part 4

Evaluating the bids

4.1 This part of the report considers whether the Commission's decision to award the second licence to run the National Lottery to Camelot was soundly based. In particular, we examined whether the Commission:

- had clear objectives and evaluative criteria;
- had a clear plan for the evaluation process;
- critically reviewed the bidders' forecasts of returns to Good Causes; and
- based its decision on its evaluation.

The Commission had clear objectives and evaluative criteria

4.2 The National Lottery etc Act 1993 sets out the Commission's duties (paragraph 1.7), which essentially define its objectives in appraising bids for the lottery licence. The Commission derived from these duties a Statement of Main Principles (issued in July 1999) that set out the key outcomes that it was seeking to secure from the competition process. The Statement of Main Principles (summarised at Appendix 2) also detailed the criteria for the evaluation of bids, which were also included in the Invitation to Apply (issued in draft form in September 1999 and final form in November 1999). These documents provided a clear and public statement of the Commission's objectives and the evaluative criteria it would apply to bids, well before the deadline for receiving bids of 29 February 2000.

4.3 There was, however, some discussion about the Commission's statutory duties relating to 'due propriety' and 'player protection'. Following the receipt of revised bids from Camelot and The People's Lottery in October 2000, Commissioners considered whether the duties should be applied only as 'threshold requirements' (hurdles) that the bids needed to meet before the Commission compared the returns to Good Causes, or whether they should also be used in comparing the bids. After taking legal advice, the Commission decided that if both revised bids cleared the hurdles, then the criteria would also be used as comparators if necessary.

The Commission had a clear plan for the evaluation process

4.4 Planning for the competition began almost immediately when the Commission was appointed in April 1999. The Commission drew up a timetable which, recognising the task that would face a new operator, allowed 15 months between announcing a preferred bidder and their beginning to operate the National Lottery. As the challenger to the incumbent operator, The People's Lottery told us that it saw the original timetable as giving sufficient time to prepare a bid and for a handover between operators. In the event, the delay in awarding the licence meant that there would have been just nine months for the preferred bidder to implement the requirements of the second licence.

4.5 The Commission had not planned for an interim licence but, during the course of the judicial review, Camelot gave an undertaking to the High Court to use its best endeavours to agree an interim licence to allow the uninterrupted operation of the Lottery. The Commission and Camelot agreed that it would be inappropriate to discuss the detail of the interim licence during Camelot's period of negotiation on the next full licence. Camelot wrote to the Commission on 17 October 2000 repeating its commitment to accept an interim licence, whatever the outcome of the competition. In a statement on 25 October 2000, the Commission referred to Camelot's commitment and said that it always intended that there should be a 12 month start up period and that the start up should not fall during the Christmas period. Although the details of the interim licence could be agreed before the award of the second licence, the precise length of the interim licence would be agreed afterwards.

4.6 The terms of the interim licence were approved by the Commission on 30 November 2000. On 18 December 2000, Camelot wrote to the Commission repeating its commitment to accept an interim licence, agreeing the terms and seeking to discuss the duration of the interim licence as soon as possible after the announcement of the award of the next licence. The memorandum of understanding covering the interim licence was formally agreed between the Commission and Camelot on 18 January 2001. The interim licence ran from 1 October 2001 to 26 January 2002, giving a start up period of 13 months.

4.7 The Commission set out in the Invitation to Apply the information it required to assess the bids and this provided a good foundation for the Commission's analysis. However, some requirements were difficult for bidders other than the incumbent to meet. In this regard, we noted that while Camelot considered the Invitation to Apply to be well-formulated, The People's Lottery considered that some requirements, such as details of future headquarters, could have been agreed after the award of the licence.

4.8 To give a clear structure to the evaluation of the bids, the Commission prepared an evaluation manual similar to that used for the first licence, which the Comptroller and Auditor General described in his 1995 report as "detailed and logically sound" [5]. The manual used for the award of the second licence clearly set out:

- the tasks that the Commission needed to complete (**Appendix 7**);
- who owned each task;
- the relationship of the task to the Invitation to Apply;
- the aims of the task;
- the inputs to the task and where they would come from;
- any interdependencies between tasks;
- the processes to be followed; and
- the outputs to be produced.

The process of evaluating the bids was overseen by the Commission's Director of Licensing, supported by a project manager seconded from the Audit Commission for that purpose. Before the Commission finalised its decision to award the licence, the project manager conducted an audit to ensure that those responsible for each task had completed it and produced the various outputs required.

4.9 In areas where the Commission did not have in-house expertise, it engaged consultants to assist in the evaluation of bids. The consultants were selected via a competitive process, with the requirements advertised where necessary in the Official Journal of the European Communities. The consultants were used to assess and provide advice on:

- marketing plans and player access (Grosvenor) - for example, analysing the suitability of the level of marketing expenditure in supporting the revenue forecasts in the bids;
- security of funds and banking (Lawrence Graham) - for example, analysing the security and practicality of the bidders' processes for payments to prizewinners and transfers between retailers, the lottery operator and the National Lottery Distribution Fund (see Figure 5);
- IT systems and security (Hedra) - for example, assessing the robustness, reliability and security of the computer-based systems proposed in each bid;
- corporate and financial structure and management approach (Mazars Neville Russell) - for example, analysing the bidders' funding arrangements to ensure they were capable of financing the operation of the National Lottery;
- business plans (Europe Economics) - for example, analysing the bidders' business plans, including their forecasts of returns to Good Causes, and assessing their adaptability and robustness; and
- issues of public law (Treasury Solicitor's Department to September 2000, Freshfields from October 2000 onwards) and commercial law (Lawrence Graham).

The Commission critically reviewed the bidders' forecasts

4.10 A key decision for the Commission in comparing the two bids was to decide which was more likely to give the greater returns to Good Causes. The Commission needed therefore to identify how changes in the assumptions made in the forecasts in the bidders' business plans would affect the returns to Good Causes.

4.11 The bidders' forecasts showed that, over the period of the second licence, The People's Lottery would contribute £13.1 billion to the Good Causes, £933 million more than Camelot **(Figure 8)**.

4.12 As recognised in the Department for Culture, Media and Sport's guide 'Option Appraisal of Expenditure Decisions' ('The White Book')[6], an important element of the appraisal process is evaluating risk and uncertainty. The Commission assessed the robustness and soundness of the bidders' forecasts by subjecting them to a range of sensitivity tests covering variations in:

- the revenue from games;
- operating costs;
- marketing expenditure;

5 *Evaluating the applications to run the National Lottery (HC 569, 1994-95).*

6 *The White Book (March 2000) is intended for use by the Department for Culture, Media and Sport and its sponsored bodies and reflects closely the Treasury's Green Book (Appraisal and Evaluation in Central Government, 1997).*

8 The bidders' forecasts

	Camelot £ million[1]	The People's Lottery £ million[1]	Difference £ million[1]	Comment
Revenue[2]	41,379	41,952	573	The People's Lottery generates more revenue.
Retained profit	184	0	184	The People's Lottery pays its surplus to the Good Causes.
Return to Good Causes	12,188	13,121	933	The People's Lottery returns more to the Good Causes.

NOTES

1. All figures are net present values, showing the present worth of the future flow of money. Future values are reduced using a discount rate to give a value in the base period (in this case October 2001). The Commission used a discount rate of six per cent, in line with Treasury guidance set out in 'Appraisal and Evaluation in Central Government' ('The Green Book') (HM Treasury, Second Edition 1997).

2. Revenue is the gross income from ticket sales and other ancillary activities.

Source: National Audit Office (based on National Lottery Commission data)

- prize payout percentages; and
- real Gross Domestic Product.

4.13 While recognising that the difference of £933 million between the two bidders' returns to Good Causes appeared substantial, the Commission considered it small in relation to the uncertainties surrounding the business plans and the total amounts at stake. The return to Good Causes is not guaranteed and relatively small movements in sales by either Camelot or The People's Lottery would have led to a reversal of the ranking.

4.14 In the light of the level of ticket sales during the period of the first licence, the Commission judged that both bidders' forecasts were over-optimistic - their starting point for sales under the new licence was considerably higher than sales were expected (and proved) to be at the end of the first licence; and the growth in sales they predicted was much greater than the Commission considered could be justified. Nevertheless, the Commission's initial evaluation of the bidders' forecasts showed that, at the same level of sales, The People's Lottery would be more generous to the Good Causes. This conclusion contributed to the Commission's decision to negotiate with The People's Lottery after both original bids were rejected in August 2000 (paragraph 3.17).

4.15 After receiving the revised bids in October 2000, the Commission's staff and consultants developed forecasts of sales for the period of the second licence. The forecasts took account of a range of qualitative judgements concerning marketing and game plans and the likely level of sales at the beginning of the second licence, and predicted much lower levels of ticket sales than the bidders had forecast. The Commission considered that these forecasts were unduly pessimistic and that sales were likely to be more in line with previous performance. **Figure 9** shows actual sales of National Lottery tickets during the period of the first licence, and the levels of sales forecast for the second licence by the two bidders.

4.16 We confirmed that the Commission tested the robustness and soundness of the forecasts and their effects on the returns to Good Causes. It subjected the significant qualitative judgements and other assumptions it had made to a wide range of sensitivity tests. These are listed in **Appendix 8** and covered variations in:

- the quality of marketing;
- revenue, both overall and different elements of the bidders' game plans;
- growth in real Gross Domestic Product;
- inflation;
- the rate of decline in sales of old games as new games are introduced; and
- the effect of rollovers in generating additional sales.

4.17 The extensive sensitivity testing predicted a range of likely revenues and returns to Good Causes for the two bidders. These are shown in full in Appendix 8. The tests forecast that in some circumstances Camelot would be more generous to the Good Causes, and in others The People's Lottery would be more generous **(Figure 10)**. At one end of the spectrum The People's Lottery was predicted to return £779 million more than Camelot, and at the other Camelot was predicted to return £1,622 million more than The People's Lottery.

4.18 The Commission did not regard any of the forecasts as definitive but concluded that on balance Camelot was likely to generate more revenue and return more to the Good Causes over the period of the licence. It was on the basis of this analysis of the forecast returns to Good

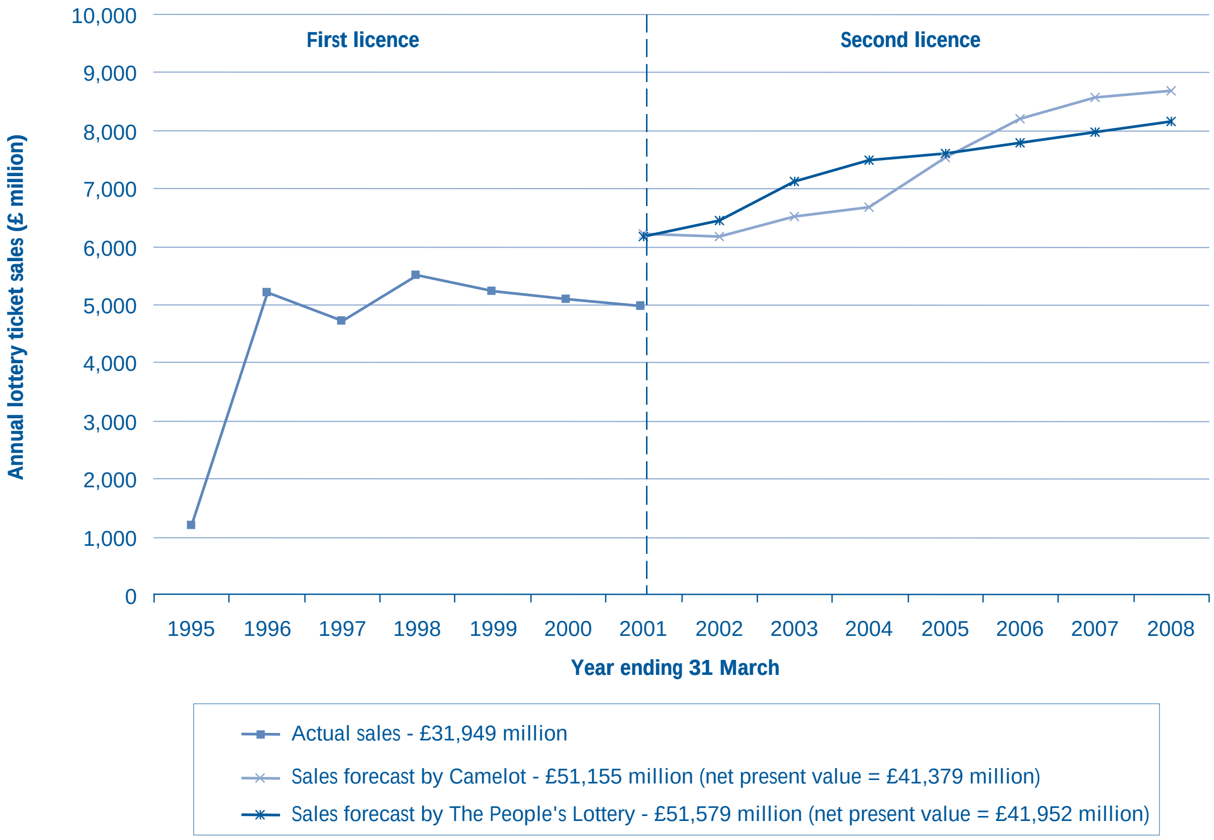
Causes, together with its assessment of the risks associated with the two bids, that the Commission decided to award the licence to Camelot.

The Commission sought independent assurance on its decision-making process

4.19 The economic model used by the Commission to assess the bidders' business plans and conduct sensitivity testing was an important tool in its assessment of the bids. When the first licence was awarded, we tested the model the Director General of the National Lottery used to help him evaluate the bids by re-performing the data analysis. This time the Commission arranged an independent audit (by Mazars Neville Russell, a firm of chartered accountants) of the model produced by consultants (Europe Economics) that was used to simulate the effects of changes in the business plans on revenue, profitability and returns to Good Causes. The audit was carried out in advance of the Commission using the model to help evaluate the bids and confirmed that the base data in the model (drawn from the business and other plans submitted by bidders) was consistent with the source data. As part of that audit, the reasonableness of the model was tested by running simulations and checking the results against expected outcomes.

4.20 The Commission also engaged the UK managing partner of Mazars Neville Russell to carry out an external review of its decision-making process. He was not part of the Mazars Neville Russell team who provided advice to the Commission during the evaluation of the bids (paragraph 4.9). He reviewed the papers prepared for the Commission and observed various meetings leading up to the final decision in December 2000. He presented his initial findings to the Commission on 14 December 2000 and submitted a detailed written report on 31 January 2001, concluding that the

9 National Lottery ticket sales



NOTES

Sales in the year ending 31 March 1995 reflect the start up of the National Lottery in November 1994.

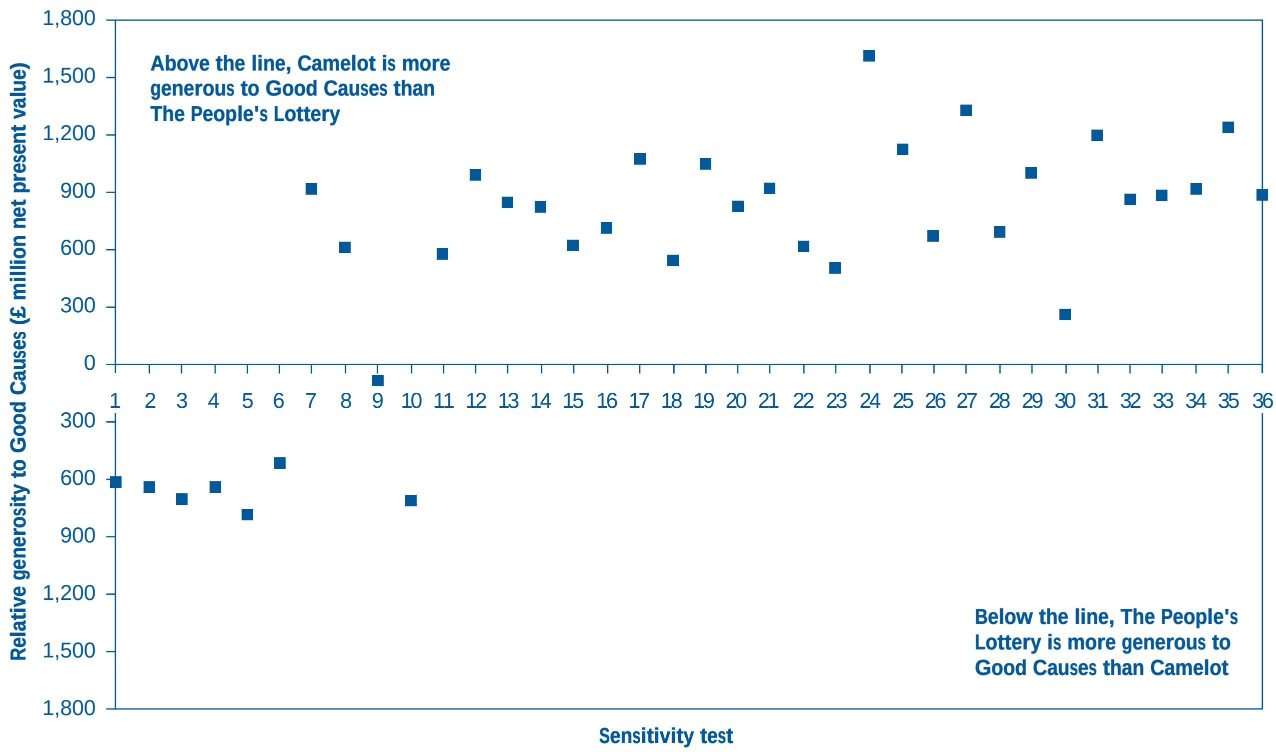
Forecasts for 2001 and 2008 are equivalent annual figures since the licence was due to begin and end half way through the financial year.

Source: National Audit Office (based on National Lottery Commission data) decision-making process "was conducted in a comprehensive and conscientious manner" and "was complete and fair in the treatment of both bidders".

4.21 In summary, the external review found that:

- the Commission properly defined and covered the issues to be addressed during the evaluation process and upon which the Commission was obliged to base its decision. The process would have been improved by being expressly stated in terms of the three key criteria (propriety, participant protection, and return to Good Causes);
- documents were generally well structured, researched, reasoned and written, and highlighted key issues for those involved in the decision. The risk that documentation might be too comprehensive and mask the focus of the decision-making process was addressed by preparing and considering: an executive summary that considered the three key selection criteria for the basis of the decision, summary financial projections at different levels of sales, and a considered debate on the changes between the initial evaluation and the final evaluation in respect of both bids;
- sensible and comprehensive use was made of aids recognised as helpful in supporting decision-making in complex situations, for example financial modelling and statistical analysis techniques. The knowledge and competence of Commission staff was impressive. All had a clear grasp of the issues involved in the process and a breadth and depth of knowledge of the detailed areas of their work; and
- all issues were properly considered by the Commissioners and the Statement of Reasons explaining their decision was thoughtfully written, reflected fully the conclusions drawn by the majority of the Commissioners, and was based on the underlying documents and discussions that took place.

10 The relative generosity to Good Causes of the bids across the range of sensitivity tests applied to the revised bids



Each point on the graph shows the difference between the returns to Good Causes from Camelot and The People's Lottery across the range of assumptions and variations applied by the Commission.

Points above the line show Camelot to be more generous to Good Causes, below the line The People's Lottery is more generous. Sensitivity test numbers refer to the sensitivity tests detailed in Appendix 8.

Source: National Audit Office (based on National Lottery Commission data)

Appendix 1 Details of National Lottery Commissioners - past and present

Commissioners are listed in alphabetical order and current Commissioners are shown in bold

Name	Appointed	Resigned	Background
Hilary Blume	April 1999	December 2000	Founder and Director of the Charities Advisory Trust; Vice Chair of the Finnart House Trust.
Lord Burns of Pitshanger Chair, October 2000-October 2001	October 2000	October 2001	Chief Economic Adviser to the Treasury 1980-1991; Permanent Secretary to the Treasury 1991-1998; Member of the House of Lords Select Committee on the Monetary Policy Committee of the Bank of England; Chairman of the Financial Services and Markets Joint Committee 1999; non-executive Director of Pearson plc and the British Land Company plc; Chairman of Glas Cymru Ltd; chaired the Committee of Inquiry into 'The Impact of Hunting with Dogs in England and Wales'; Director of Queens Park Rangers Football Club.
Rosalind Gilmore CB	April 2000		Director of the Zurich Financial Services Group AG, the Moorfields Eye Hospital NHS Trust and a number of other companies and organisations; worked in HM Treasury from 1960; executive Chairman of the Building Societies Commission and Chief Registrar of the Friendly Societies 1991-1994; Director of the Securities and Investments Board 1993-1996.
Timothy Hornsby	March 2001		During a civil service career from 1965 to 1991, he held senior appointments at HM Treasury and the Department of the Environment; Director General of the Nature Conservancy Council 1988-1991; Chief Executive of the Royal Borough of Kingston upon Thames 1991-1995; Chief Executive of the National Lottery Charities Board 1995-March 2001.
Brian Pomeroy Chair, April 1999-March 2000	April 1999		Former Managing Director and Senior Partner at Deloitte & Touche Consulting Group; former Chair of Centrepoint, a charity working for young homeless people; Member of the Government's Disability Rights Task Force (now disbanded); Member of the Department of Trade and Industry's Public Appointments Panel and Competition and Consumer Affairs Panel.
Dame Helena Shovelton Chair, April 2000-October 2000	April 1999	October 2000	Chair of the National Association of Citizens Advice Bureaux; Chair of the Audit Commission 1998-2001; Member of the Better Regulation Task Force 1998-2000; Member of the Competition Commission 1998 onwards; Director of the Banking Code Standards Board; Director of the Energy Saving Trust.
Harriet Spicer Acting Chair, October 2000; Chair, October 2001-September 2002	April 1999		Managing Director of Virago Press until 1996.
Robin Squire	April 1999	November 1999	Member of Parliament 1979-1997; Parliamentary Under Secretary of State at the Department of the Environment 1992-1993; Parliamentary Under Secretary of State at the Department for Education and Employment 1993-1997. He is a Chartered Accountant and a member of the Conservative Party.

Commissioners are paid £6,378 a year and the Chair is paid £33,026 a year.

Appendix 2 Summary of the Commission's Statement of Main Principles

Finance and structure

The Commission would choose the next operator in line with its statutory duty to maximise money for the Good Causes, subject to the overriding issues of protecting participants and the fitness and propriety of bidders and key suppliers.

The Commission expected the new licence to prescribe contributions to the National Lottery Distribution Fund based on the value of ticket sales ('primary contributions') and invited proposals for contributions from surpluses generated by operating the Lottery ('secondary contributions').

The Commission welcomed both not-for-profit and other bids; all bids had to be financially sound. The Commission was open to suppliers participating in more than one bid and, since it was highly desirable that main suppliers were identified at the time a bid was submitted, intended to invite bids on this basis. However, the Commission was prepared, before issuing the draft Invitation to Apply, to discuss with interested parties the possibility of accepting bids that did not fully specify suppliers, subject to adequate safeguards and assurances.

Operating the new licence

The Commission sought to secure the following key outcomes:

- an operator with a strong and effective internal control framework;
- games that enhance the image of the National Lottery;
- convenient access to games for players, with a retail network covering the United Kingdom and the Isle of Man, possibly augmented by the innovative use of technology;
- marketing that offered fun and excitement to the British public through the opportunity to win a range of prizes, with advertising and public relations activities conducted in an appropriate and responsible manner;
- fair treatment of players, with effective and rigorous arrangements in place to counter under-age and excessive play;
- safeguards for the funds required to meet obligations to prizewinners, with prize validation and payment taking place in a quick, secure and efficient manner without unduly inconveniencing players;
- computer-based systems that were robust, reliable and secure, provided confidentiality, integrity and availability and supported the likely volume of transactions and processing;
- systems used for the collection of proceeds from lottery activities that ensured that revenue was collected in full and that the correct amounts were paid to the National Lottery Distribution Fund and secured for prizes;
- security of all lottery games, materials and premises; and
- consistency of ancillary activities with the overall objectives of the lottery.

Criteria for evaluation

In accordance with its statutory responsibilities, the Commission would:

- assess the probity of each applicant, including whether all who were likely to be concerned with managing the lottery or for whose benefit the business was likely to be conducted were 'fit and proper'. The Commission would also need to be satisfied with bidders' plans and capacity for ensuring continued probity; and
- assess bidders' plans for consumer protection and their ability to fulfil them.

The paramount consideration, provided that the Commission was satisfied with the results of the assessments mentioned, would be an evaluation of the prospective proceeds for the National Lottery Distribution Fund. This would take account of all the contributions referred to above.

In assessing the ability of bidders to fulfil their commitments, the Commission would take into account the extent to which their bids had the following attributes:

- financial soundness;
- robustness of business plans under various scenarios;
- overall ability of management, capacity of organisational structures and attention to handling of risk;
- competence and robustness of plans for game design, marketing and retail distribution;
- ability to adapt and modify plans to deal with adverse developments so as to protect sales revenues and hence contributions to the National Lottery Distribution Fund;
- evidence that applicants have, or can demonstrate the ability to deliver, systems, procedures and equipment that can handle all aspects of the task and would support the likely volume of transactions and processing; and
- thoroughness and clarity in any transition planning that may be necessary.

Appendix 3 Study methodology

Why did we do this work?

1 The award of the licence to operate the National Lottery is a major public sector competition. In producing the report, our aims were to provide Parliament with an account of the events which extended the competition process, to provide Parliament with assurance about the conduct of the competition and about how the National Lottery Commission discharged its statutory duties, and to help identify issues for the future.

Previous National Audit Office coverage

2 In July 1995 we reported on the award of the first licence to run the National Lottery (Evaluating the applications to run the National Lottery, HC 569 1994-95). In that report, we concluded that the arrangements for evaluating the bids had been comprehensive, consistent, logical and properly controlled.

The questions we addressed

3 The report focuses on the processes followed by the Commission in awarding the second licence to run the National Lottery and how the Commission sought to assure itself that its decision to award the licence to Camelot (which reflected the judgements of individual Commissioners) was soundly based and reasonable. The two key questions we addressed were:

Did the Commission secure the strong competition for the licence that it sought?

The Commission took the view that competitive pressure was most likely to maximise the returns to Good Causes and invited bids for the next licence on the basis of what proportion of revenue raised would go to Good Causes. We identified the constraints that may have deterred bidders from entering the competition and examined what the Commission did to minimise the effect of these constraints. We also identified appropriate international comparisons for the competition, which provided a benchmark for the extent of competition that the Commission achieved.

Did the Commission's evaluation of the bids provide a sound basis for its decision to award the licence to Camelot?

We considered whether the Commission had established clear objectives and evaluative criteria before bids were received and had a clear plan for evaluating the bids. In view of the Commission's statutory duty to maximise the returns to Good Causes, we examined whether the Commission critically reviewed the bidders' forecasts of revenue and returns to Good Causes. We also checked whether the Commission sought independent assurance on the model it used to assess the bidders' business plans and on its decision-making process as a whole.

Collection of information

4 We undertook a detailed examination of the key papers used by the Commission in reaching its decision to award the licence to Camelot, including papers prepared by the Commission's staff and consultants and the minutes of meetings of the Commissioners. We interviewed senior staff in the Commission to ensure we had a proper appreciation of events and discussed our findings with them. We also met and discussed the competition process with the two bidders, Camelot and The People's Lottery.

Appendix 4 The improvements process

1 On 23 June 2000 the Commission notified both bidders that it intended to extend the competition process to allow the bidders to make improvements to their bids. The extension was in line with the provisions of the Invitation to Apply. The Commission consulted with the bidders before finalising the timetable for the improvements process. Bidders were notified of the timetable and procedural arrangements on 30 June 2000.

2 Improvements could only be made to specified areas of the bids to address concerns that had arisen during the Commission's evaluation of the bids between March and June 2000. To help bidders understand the improvements that were required, the Commission provided each with a detailed written explanation on 26 June 2000 and followed this with meetings with members of the evaluation team (including the relevant consultants) on 30 June and 3 July 2000 to discuss further the Commission's concerns.

3 For The People's Lottery, improvements were sought in the following areas:

- the adequacy and completeness of the arrangements for security over prize funds;
- financial robustness over the period of the licence should revenues be significantly lower than forecast, including the availability of sufficient funding to support cashflows;
- the provision of financial contingency should costs be higher than forecast;
- the availability of insurance in respect of the Millionaires' Game;
- assurance that support would continue to be available for the software that The People's Lottery planned to use and that effective processes would be in place for software configuration management and change control;
- target dates for the appointment of key senior staff and provision for such staff to include appropriately skilled and experienced line management to exert full control in the selection, supervision and management of key suppliers, especially in the field of technology; and
- the coherence and resilience of the start-up plan with regard to possible contingencies.

4 For Camelot, improvements were sought in the following areas:

- arrangements for the handover of Lottery-related intellectual property;
- arrangements for a handover in the event that a new operator was appointed for the period of the third licence;
- arrangements to clarify Camelot's relationship with, and the position of, CISL, including public transparency as regards National Lottery work undertaken by CISL for Camelot;
- the position of the Commission in the event that it judged an agreement between Camelot and CISL to be prejudicial to the National Lottery;
- assurance that support would continue to be available for the software that Camelot planned to use and that effective processes would be in place for software configuration management and change control; and
- Camelot's capacity to manage key suppliers, especially in the field of technology.

5 In addition a separate letter was sent to Camelot on 30 June 2000 in connection with the investigation into GTech's fitness and propriety. The letter explained that, as well as responding to the Commission's letter of 26 June 2000 in respect of the first licence, Camelot was entitled to make representations in respect of its bid for the second licence within the improvements process.

Appendix 5 The Commission's concerns about player protection and The People's Lottery's responses

3 April 2000
The Commission sought clarification from both applicants for the licence to run the National Lottery about aspects of their bids. Amongst a number of issues, The People's Lottery was asked about its arrangements for safeguarding prize money.

26 April 2000
The People's Lottery provided information about the trust status, arrangements and deed covering prize monies.

18 May 2000
The Commission sought further assurance about the security of the trust fund to cover liabilities to players.

30 May 2000
The People's Lottery provided assurance based on the integrity and financial probity of the proposed trustee and stated that a trust deed was being drawn up. Further legal documentation would be drawn up within eight weeks of the announcement of the preferred bidder.

7 June 2000
The Chief Executive of the Commission wrote to The People's Lottery, expressing the view that it was essential for the Commission to understand that there was a fully considered and detailed arrangement agreed between the bidder and the trustee of the trust fund in order for the Commission to be satisfied that the interests of players would be adequately protected.

8 June 2000
The People's Lottery and the Commission met. The People's Lottery provided a draft of the proposed trust document, which would be finalised if The People's Lottery were selected as preferred bidder, with detailed procedures agreed with the Commission before the next licence began.

23 June 2000
The Commission wrote to both bidders seeking improvements to some of the commitments they had offered. Among other things, the Commission wished The People's Lottery to address "the adequacy and completeness of the arrangements for security over prize funds". The Commission proposed to extend the deadline for announcing the preferred bidder from the end of June to the end of August.

26 June 2000
The Commission provided bidders with a more detailed schedule of improvements. The Commission invited The People's Lottery "to confirm the position it has reached on detailed prize security arrangements and to offer suitable changes accordingly". If selected as preferred bidder, "it would be necessary to make considerable improvements to the draft of the trust deed".

30 June 2000
The Commission met with The People's Lottery and provided further clarification.

14 July 2000
The People's Lottery responded to the Commission proposing further protection for players' interests under its original proposal. It also offered an alternative structure involving setting up a new trust company. The People's Lottery considered that this better 'ring fenced' prize monies and therefore proposed this structure over its original proposal.

7 August 2000
The Commission discussed The People's Lottery's bid and concluded that its submission had failed to resolve the problems over prize security arrangements.

23 August 2000
The Commission announced that it had rejected both bids. In the case of The People's Lottery, the Commission concluded that "the arrangements proposed were so conditional and uncertain that they were not capable of acceptance. Neither could it be satisfied that the application was likely to secure that the interests of every participant would be protected". The Commission took the view that, had The People's Lottery's proposed arrangements been incapable of implementation, there would have been no proposals in the final application to secure participants' interests.

Appendix 6 The Commission's investigation into duplicate transactions

Introduction

1 On 12 April 2000 the Commission received a letter sent to the Secretary of State for Culture, Media and Sport by David Armitage, a former GTech employee, which alleged that a defect had existed within GTech's lottery software which caused it to record duplicate transactions. The Commission sought further information and Mr Armitage, in a letter dated 25 April 2000, set out how the duplicate transactions arose. This enabled the Commission to look for such transactions and to confirm their existence.

The problem

2 The problem was caused by a fault in the on-line terminal software, which caused duplicate wagers to be recorded on the gaming system without the production of a lottery ticket. This occurred when the on-line terminal printer went off-line whilst waiting for a response from the central computer - for example, if the printer cover was opened. This prevented the on-line terminal from printing the ticket when the central computer had validated, recorded and replied to the wager. The on-line terminal did not recognise that it had received a reply and sent the wager to the central computer system again. Since the on-line terminal did not identify the repeat wager as a 'retry' transaction, the central computer system recorded two wagers instead of one but only one ticket was produced.

3 Consequently, the retailer was charged twice for a single transaction. Also, if the wager was a prizewinner, an extra prize was allowed for, so distorting the prize structure for that draw and reducing the value of each individual prize. The extra prize would be unclaimed and so would pass after six months to the National Lottery Distribution Fund. Mr Armitage had identified this problem in July 1998 when employed by GTech UK (the GTech subsidiary supporting the National Lottery).

The Commission's investigation

4 The Commission sought to determine whether the problem had ever existed, whether it continued to exist and, if so, who within Camelot and GTech was aware of it. The Commission independently checked the six months of data in its own possession. It was unable to find duplicate transactions in that data which gave it confidence that the integrity of current draws was not affected.

5 Data older than six months was sought from Camelot and on 4 May 2000 the Chief Executive of Camelot was informed that the Commission was conducting an investigation (but not the nature of it). The Chief Executive was asked for and gave an assurance that all relevant data would be secured. By checking the data on a sample basis, the Commission was able to establish that the problem had existed as described by Mr Armitage and that it had been corrected at some point between June and September 1998. The Commission's analysis suggested that the correction had been part of an update to the gaming system which was implemented on 27 July 1998.

6 The Commission completed its analysis on 14 May 2000 and on 17 May 2000 met the Chairman and then Chief Executive of Camelot to inform them of the problem and to seek further information, which was required within one week. The Chief Executive of Camelot assured the Commission that he was not aware of the problem or that it had been rectified. Subsequent checks by the Commission did not identify anyone within Camelot who had been aware of the problem at the time it was identified and corrected.

7 In response to the Commission's questions, on 24 May 2000 GTech confirmed that the problem had existed since the start of the Lottery in 1994 and GTech had identified it in June 1998 during its investigation of a defective on-line terminal. The problem had been corrected by a software 'patch' included in an update of the National Lottery gaming system on 27 July 1998. In breach of established procedures, neither Camelot nor the then regulator (OFLOT) had been told of the problem or its correction, although very senior personnel within GTech had been aware including the then Chairman and Chief Executive Officer and the then Chief Operating Officer.

8 The effect of the fault was to distort the prize structure of every draw in which duplicate transactions were winners and to overstate sales by retailers. GTech was aware of this but could not have known with any certainty, given the information available to it, what the effects on prizewinners had been or whether it had affected any major prizes. Concealing the software 'patch' meant a delay of two weeks in correcting the fault and lengthened the period in which prizes were liable to be wrongly calculated. GTech's circumvention of proper computer change controls could have compromised the existing software and other parts of

the gaming system. Its decision not to inform Camelot or OFLOT prevented either organisation from assessing the impact and taking corrective action. OFLOT was prevented from exercising its statutory duty to ensure that the interests of players are protected.

9 On 14 June 2000 the Commission asked GTech for further information and evidence. This made it clear that the decision to fix the problem without informing Camelot or OFLOT was taken by the then Chairman and Chief Executive Officer (with the then Chief Operating Officer and then Vice-President Europe present) against written advice from the General Manager of GTech UK. The decision was in breach of GTech's own code of conduct which, along with new corporate management arrangements, had been introduced in March 1998 following the departure of Guy Snowden as Chairman and Chief Executive Officer. The decision secretly to fix the software problem breached the code of conduct but no one involved disclosed the decision even within the new GTech corporate governance framework. But for the intervention of Mr Armitage, the decision would not have come to the notice of the Commission.

Impact

10 Camelot analysed over 14 billion transactions under the scrutiny of the Commission and Camelot's external auditors and concluded that 156,493 duplicate transactions had occurred; around 0.001 per cent of all transactions. These had resulted in an underpayment to prizewinners in nine draws totalling almost £57,000 and affecting almost 56,000 prizewinners. No prizewinner was underpaid by more than £3 and the vast majority was underpaid by only £1. Most were 'match 4' prizewinners. Few could be identified because records are not required for wins below £500. The Commission agreed with Camelot that it should pay compensation of twice the value of the underpayment. Some £115,000 was added to the 'match 4' prize fund for the draw on 28 April 2001. Camelot also reimbursed retailers for the amounts over-charged.

Regulatory action by the Commission

11 The Commission was concerned that the corporate management arrangements had been wholly ineffective in securing maintenance of the standards which OFLOT had been led to expect would be followed. The Commission viewed the concealment of the software fault and its correction from both the regulator and the operator as an extremely serious matter. On 23 June 2000 the Commission reached the provisional view that it was minded to find GTech not fit and proper and formally required GTech and Camelot to show why GTech should not be found not fit and proper. In response, a number of immediate measures were taken by both GTech and Camelot and a total of 31 undertakings were made, including:

GTech

- changed its Board structure. The individuals involved in the decision not to notify Camelot and OFLOT of the problem or its resolution left the company. The posts of Chairman and Chief Executive Officer were permanently separated and the membership and structure of the Board were strengthened;
- created a new committee of the Board - the Compliance and Corporate Governance Committee - to oversee the proper handling and resolution of ethical issues. Its Chairman would provide an annual certificate to Camelot and the Commission and would meet Camelot's Chairman on a regular basis;
- fully reviewed its code of conduct and arrangements for monitoring compliance with the code;
- agreed to the appointment of a dedicated account manager responsible for the Camelot account and with access to the Board; and
- would have independent reviews undertaken of all its software development processes and process documentation and make these available to Camelot and the Commission. A member of Camelot's staff would work full-time alongside GTech's quality assurance team. GTech would obtain certification against a number of international industry standards. Compliance with these procedures would be independently audited and certified to Camelot and the Commission annually.

Camelot

- would extend the scope of its reviews of GTech's performance;
- would improve its arrangements for management of suppliers and control over the software development lifecycle; and
- would ensure delivery of undertakings by itself and GTech through revised contract terms and additional licence conditions.

The Commission's conclusion

12 The Commission remained very concerned that GTech, as a key supplier to the National Lottery on whom the operator placed considerable reliance, should have acted in this way. Following a further meeting with the GTech Board on 19 July 2000, the Commission concluded that the substance of its concerns would be met if the undertakings given were discharged fully. However, this would take time and although the Commission decided not to proceed with its provisional view that GTech was not fit and proper, there was a risk that the Commission might have to give further consideration to terminating GTech's involvement in running the National Lottery. The Commission therefore concluded that it could not, at that stage, be satisfied that granting a new licence to Camelot, with GTech as a key supplier, would be consistent with its overriding duty to ensure that the National Lottery would be run with all due propriety. The Commission considered that granting such a licence at that point would pose an unacceptable risk to the returns to Good Causes since any termination of the licence might well cause the Lottery to close down for a period.

Appendix 7 The Commission's primary evaluation tasks, their objectives and task owners

Task (Owner)	Aim
A - Fit and proper (NLC Vetting Team)	To vet directors and key employees of the applicants and any subsidiaries or holding companies. To vet shareholders and other connected parties of the applicants. To assess the safeguards to ensure due propriety of staff in the applicants' recruitment and employment procedures.
B1 - Compliance (Central Team, NLC)	To identify any bids that do not comply with the requirements of the Invitation to Apply.
B2 - High level summaries (owners of tasks E - O)	To help the gaining of an overall understanding of each bid.
C - Initial presentations by bidders (Central Team, NLC)	To let the NLC hear each bidder's view of its application and ask questions. To let bidders demonstrate their intended terminals, printers and other player interfaces.
D - Sift (Central Team, NLC)	To exclude any bids which, while compliant, are seen at this early stage to stand no chance of success. [This task was not needed.]
E - Consumer protection (Head of Consumer Protection, NLC)	To determine whether the applicants' plans, procedures, player and advertising codes, strategies on excessive and under-age play, and performance standards are likely to ensure that the National Lottery is conducted with due propriety, and that the interests of participants are adequately protected. To determine whether the resources that applicants plan to devote to customer support, retailer support and system development are adequate to achieve the target standards of service embodied in the codes of practice and performance standards, and to otherwise deliver the plans.
F - Game plan (Head of Business Affairs, NLC)	To evaluate the applicants' overall portfolio objectives and strategy over the length of the licence, their game plans in supporting the revenue projections in the business plan, and their robustness under alternative scenarios, and the soundness of the applicants' plans with reference to games offered to date to the public and sales achieved. To consider planned portfolio developments in the light of maximising sales within the licence period yet avoiding long-term 'burn-out'.
G - Marketing plan (Grosvenor*)	To evaluate the applicants' overall objectives and strategy and their marketing plans in supporting the game plans and business plans, especially the forecast revenues. To ensure that applicants' bids demonstrate management and marketing competence in their plans and determine whether the applicants have a thorough understanding of the domestic lottery market, the wider gambling and entertainment markets, ability to call upon relevant experience from the international lottery market and insights into likely future competitive frames of reference.
H - Player access (Grosvenor *)	To evaluate the applicants' player access plans in supporting the marketing plan, game plan and business plan and the soundness of their plans with regard to the relationship to the current lottery retail universe and the use of appropriate technological changes envisioned for the licence period. To ensure that the plans demonstrate a thorough understanding of the current and future retail and technological environments in which the lottery will be operating.
I - Security of funds and banking (Lawrence Graham*)	To assess whether the arrangements proposed by applicants provide adequate security for prizewinners and banking arrangements are secure and appropriate.
J - Systems and security (Hedra*)	To establish whether each applicant's systems and processes: ■ cover the full scope of the proposed lottery operations; ■ are capable of supporting the applicant's business plan, customer expectation and NLC requirements; ■ are robust, reliable, secure and fit for purpose; and ■ can be implemented within the planned timetable.

Task (Owner)	Aim
K - Start-up (Head of Business Affairs, NLC)	To assess the adequacy of start-up plans.
L - Risk management (Director of Licensing, NLC)	To assess the adequacy of risk management plans.
M - Corporate and financial (Mazars Neville Russell*)	To understand and verify both the corporate and legal structure of each applicant.
	To ensure that all applicants are properly incorporated, are fully capable of financing the National Lottery, possess proper financial commitment to support their business plan, and can continue as a going concern.
N - Management approach (Mazars Neville Russell*)	To assess the ability and capacity of each applicant to plan and operate the National Lottery.
O - Business plan (Europe Economics*)	To analyse and comment on the applicants' business plan forecasts, covering both the principal forecast and the range of sensitivity tests.
	To analyse and assess the applicants' bid generosity (the proportion of revenue to be paid to the NLDF) in their principal forecasts and in the range of sensitivity tests.
	To assess the applicants' ability to adapt and to modify its plans in the face of an uncertain market environment so as to protect both revenues and the contribution to Good Causes.
	To assist in assessing the revenue potential of the applicants' marketing plans, game plans, retail plans, ancillary activities and system plans.
	To check the business plans for consistency and to check the plausibility of the commitments given on primary and secondary contributions, minimum marketing activity and ancillary lottery activities.
P - Consistency / integration (Central Team, NLC)	To check whether each application is consistent within itself, ensure that the evaluation process and standards have been consistently applied across all applications and ensure that any cross-tasks have been fully taken into account.
Q1, Q2 and S - "Invitation to Apply" NLDF rankings, full rankings and revenue potential (Europe Economics*)	To derive the adjustments to forecasts to be used in the ranking process by evaluating the revenue potential of relevant aspects of the bidders' business plans.
	To rank the applications remaining in the process in order of the prospective contribution to the NLDF, on the basis of: ■ applicants' forecasts; ■ adjusted applicants' forecasts; ■ common forecasts; and ■ common forecasts adjusted.
T - Main presentations by bidders (NLC)	To allow the Commissioners to ask questions directly of the applicants.
U - Site visits (NLC)	
V - Final comparisons (Central Team, NLC)	
W - Possible suspension (NLC)	
X - Selection (NLC)	For Commissioners to select the application that is the most likely to maximise proceeds to Good Causes subject to the over-riding requirements of due propriety and participant protection.
Y - Review (NLC)	To review the validity of the decision taken in Task X.

* consultants to the National Lottery Commission (NLC)

Appendix 8 The range of sensitivity tests applied by the Commission to the revised bids

Sensitivity test	Returns to Good Causes		Difference	
	Camelot	The People's Lottery	Camelot is more generous by	The People's Lottery is more generous by
	£ million (net present value)	£ million (net present value)	£ million (net present value)	£ million (net present value)
1 Common forecasts of £5.3 billion revenue from ticket sales in each year	8,728	9,332		604
2 Common forecasts of 10 per cent more than £5.3 billion revenue from ticket sales (£5.8 billion) in each year	9,710	10,346		636
3 Common forecasts of 30 per cent more than £5.3 billion revenue from ticket sales (£6.9 billion) in each year	11,680	12,376		696
4 Common forecasts of 10 per cent less than £5.3 billion revenue from ticket sales (£4.8 billion) in each year	7,747	8,382		635
5 Common forecasts of 30 per cent less than £5.3 billion revenue from ticket sales (£3.7 billion) in each year	5,789	6,568		779
6 Common forecasts of £5.3 billion revenue from ticket sales in each year but The People's Lottery start 21 days late resulting in lost ticket sales and a late commencement penalty	8,728	9,235		507
7 Commission forecast	8,584	7,663	921	
8 Commission forecast, but with The People's Lottery's marketing assumed to be as good as Camelot's	8,584	7,967	617	
9 Commission forecast, but with The People's Lottery's marketing assumed to be as good as Camelot's and the 'Good Causes effect' for The People's Lottery main game lasting for the entire licence	8,584	8,668		84
10 Commission projection of The People's Lottery revenues applied to both bidders	6,957	7,663		706
11 Commission forecast, but with no regional games (The People's Lottery) or EuroBloc game (Camelot) revenues	8,075	7,499	576	
12 Commission forecast, but with regional games (The People's Lottery) or EuroBloc game (Camelot) revenues increased by 20 per cent	8,686	7,696	990	
13 Commission forecast, but with regional games (The People's Lottery) or EuroBloc game (Camelot) revenues reduced by 20 per cent	8,482	7,630	852	
14 Commission forecast, but with The People's Lottery revenues from Instants 10 per cent higher	8,584	7,761	823	
15 Commission forecast, but with The People's Lottery revenues from Instants 30 per cent higher	8,584	7,956	628	
16 Commission forecast when there is no real GDP growth and a unit GDP growth in the model	7,839	7,123	716	
17 Commission forecast when there is 4 per cent real GDP growth and a unit GDP growth in the model	9,063	7,988	1,075	
18 Commission forecast with 5 per cent inflation (compared to 2.5 per cent in the past) and a zero inflation effect in the model	7,157	6,614	543	
19 Commission forecast for game revenues	8,720	7,669	1,051	
20 All games produce only 90 per cent of revenues forecast in the Commission's forecast, and operating costs are 5 per cent higher than assumed in the bidders' forecasts	7,739	6,907	832	

Sensitivity test	Returns to Good Causes: Camelot £ million (net present value)	Returns to Good Causes: The People's Lottery £ million (net present value)	Difference: Camelot is more generous by £ million (net present value)	Difference: The People's Lottery is more generous by £ million (net present value)
21 The main draw game produces only 75 per cent of the revenue in the Commission's forecast	7,214	6,290	924	
22 All games other than the main game produce only 75 per cent of the revenues in the Commission's forecast	7,774	7,151	623	
23 All games produce only 75 per cent of the revenue in the Commission's forecast	6,261	5,750	511	
24 Games produce 125 per cent of the revenue in the Commission's forecast	11,175	9,553	1,622	
25 Commission's forecast but The People's Lottery start 21 days late resulting in lost ticket sales and a late commencement penalty	8,720	7,599	1,121	
26 Decay effect (rate of automatic decline in sales) in the Commission's sales model doubled for each game	7,081	6,403	678	
27 Decay effect (rate of automatic decline in sales) in the Commission's sales model halved for each game	9,696	8,361	1,335	
28 Rollover effect (additional sales in rollover weeks) in the Commission's sales model doubled for the main game	8,837	8,138	699	
29 Rollover effect (additional sales in rollover weeks) in the Commission's sales model halved for the main game	8,461	7,456	1,005	
30 All cannibalisation effects in the Commission's sales model halved for each relevant game	7,652	7,390	262	
31 All cannibalisation effects in the Commission's sales model doubled for each relevant game	9,059	7,857	1,202	
32 Competition (other operators' games on new media) in the Commission's sales model increasing by 5 per cent each year	8,355	7,489	866	
33 Competition (other operators' games on new media) in the Commission's sales model doubled	8,463	7,576	887	
34 Competition (other operators' games on new media) in the Commission's sales model halved	8,645	7,721	924	
35 Internet sales of National Lottery doubled: Internet players and those switching to Internet doubled	9,041	7,796	1,245	
36 Internet sales of National Lottery halved: Internet players and those switching to Internet halved	8,355	7,464	891	