

Awarding the new licence to run the National Lottery



REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
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executive summary

- 1 The National Lottery was launched in November 1994 and by the end of the first licence period in September 2001 the public had spent almost £32 billion on it, raising £10.6 billion for the 'Good Causes' - the arts; charities; film; health, education and the environment; heritage; the Millennium; and sport. The National Lottery Commission (the Commission) replaced the Director General of the National Lottery (supported by OFLOT) as the regulator of the National Lottery in April 1999 and was responsible for awarding the second licence to run the Lottery. This report looks at the competition for the second licence and the Commission's evaluation of the bids it received from Camelot Group plc and The People's Lottery Limited.

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 Commission 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 Camelot¹. 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
<p>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.</p> <p>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.</p>	<p>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.</p> <p>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.</p>
<p>Steps should be taken wherever possible to reduce the burden on bidders and so promote competition.</p> <p>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.</p>	<p>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.</p> <p>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.</p> <p>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.</p>
<p>Bidders should be encouraged to develop realistic forecasts and to base their business models and cost bases on realistic levels of retained income.</p> <p>This could be achieved, for example, by giving bidders a forecast for total sales that the Commission considers realistic and asking them to demonstrate:</p> <ul style="list-style-type: none"> ■ how they would achieve these forecasts; ■ what additional sales levels they believe they could achieve; <p>and to prepare business models around these two scenarios.</p>	<p>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.</p>

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).

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.

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.

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.