REQUEST FOR EXECUTIVE DIRECTOR'S OR DEPUTY EXECUTIVE DIRECTOR'S ACTION

(Circle One)

Angela Zgabay-Zgarba	344-5310	Administration	11/10/10
From	Telephone	Division	Date

Summary of Issue or Information Attached:

Background:	**Time/Date Stamp:** (Received by Exec. Admin.)
Lottery Operations & Services RFP	
Analysis & Rationale: Financial Soundness Reports for GTECH, INTRALOT and Scientific Games International from the Office of the Controller and Battelle	

Has this been reviewed by Agency Attorney: ☐ No ☑ Yes Andy Marker (Name) Nov. 12, 2010 (Date)

Reviewed and approved by _____ General Counsel / Director Date

Requested Action:

- ☑ Sign where indicated / Approval requested
- ☐ Review draft and return with your comments
- ☐ Instruct me on how I should handle this matter / my recommendation is attached
- ☐ No action required – Attached materials provided FYI only
- ☐ Other _____

Comments:

For Executive Office Use Only

Instructions to Sender:

- ☑ OK – Complete by _____
- ☐ Let's discuss _____
- ☐ Have _____ review this, then report back to me
- ☐ Other _____

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FINANCIAL SOUNDNESS REVIEW

RFP: LOTTERY OPERATIONS AND SERVICES

Proposer Names: GTECH, INTRALOT, SCIENTIFIC GAMES INTERNATIONAL

STATEMENT OF FINANCIAL ACCOUNTING & REPORTING MANAGER:

As required by Section 4.7 of the RFP for Lottery Operations and Services, each Proposer submitted documentation supporting the financial soundness review with its Proposal. I have reviewed the financial documents and summarized my findings on the attached Report.

Benito Navarro, Financial Accounting & Reporting Manager — **Signature** — **Date** 11/10/10

Attached hereto are (1) a written report from the Office of the Controller; and (2) a written report from Battelle.

DETERMINATION BY THE EXECUTIVE DIRECTOR:

Based on my review, and considering the totality of the circumstances of this procurement, it is my determination all Proposers:

☑ **Demonstrated financial soundness and satisfied this RFP requirement.**

Gary Grief, Executive Director — **Signature** — **Date** 11/10/10

Texas Lottery Commission
Report on Financial Soundness
Lottery Operator and Services RFP

Background

Section 4.7 *Financial Soundness*, of the Request for Proposal (RFP), requires that the Proposers provide the Commission with information in order to evaluate the Proposers' financial ability to perform under the Contract. As a basis for making this determination Proposers were required to submit a written analysis of their estimated initial or start-up costs for a period consisting of Contract start date, including conversion of the Lottery system, through the end of the first complete calendar quarter of operations under the Contract. The cost analysis would be used in conjunction with information provided by the Proposers (i.e. Audited Financial Statements and/or documentation of external borrowing resources, etc.) to evaluate the sufficiency of the Proposers' financial resources to deliver the goods and services requested under the proposal.

In an effort to ascertain the reliability of each of the Proposers' estimated initial or start up-costs analysis, the Commission looked to an independent expert third party to analyze each cost analysis and provide information regarding the level of completeness and accuracy based on a complete review of each Proposers response to the proposal. Following confirmation from the expert third party of the cost analysis, staff in the Office of the Controller began a comprehensive review of each Proposers response to Section 4.7 of the RFP. The review consisted of reading the applicable sections of the Request for Proposal, including the Transmittal Letter, Executive Summary, Section 4.7 and all related financial statements and/or supplementary information.

Below is a summary of each Proposer's response to information requested in relation to Section 4.7 of the Request for Proposal.

GTECH

Response to Section 4.7 of the Request for Proposal was complete. The proposer provided the necessary financial statements along with proof of other financial resources available for determination of their financial ability to perform under the contract. Clarification of the other financial resources was requested in the form of monthly updates. The proposer was requested to submit monthly updated balances available on each of the "Facility Agreements" it provided in their response to the proposal. As of the date of this report, the proposer has complied with the request.

Intralot

Response to Section 4.7 of the Request for Proposal was complete. The proposer provided the necessary financial statements along with proof of other financial resources available for determination of their financial ability to perform under the contract. Clarification of the other

financial resources was requested in the form of monthly updates. The proposer was requested to submit monthly updated balances available on each of the "Facility Agreements" it provided in their response to the proposal. As of the date of this report, the proposer has complied with the request.

Scientific Games

Response to Section 4.7 of the Request for Proposal was complete. The proposer provided the necessary financial statements along with proof of other financial resources available for determination of their financial ability to perform under the contract. Clarification of the other financial resources was requested in the form of monthly updates. Scientific Games has provided quarterly updates which coincide with their 10-Q fillings with the Securities and Exchange Commission. The Office of the Controller determined this to be reasonable based on the reliability of the filings to an oversight agency in compliance with rules and regulations for publicly traded companies.

Conclusion

Based on the cost analysis of estimated initial or start-up costs provided by the independent expert third party, who concluded that although the estimated initial or start-up costs varied widely, they were realistic enough that staff in the Office of the Controller could compare them to each proposer's financial soundness; staff in the Office of the Controller have concluded that each proposer has sufficient financial resources to perform under the contract in accordance with Section 4.7 of the Request for Proposal. The determination was based on "other financial resources (Facility Agreements) and Cash on Hand" provided by each of the proposers as a response to the Request for Proposal.

Staff in the Office of the Controller will continue to monitor each monthly (quarterly) update and provide an update should any of the proposer's financial soundness change significantly as to affect their ability to perform under the contract in accordance with Section 4.7 of the Request for Proposal

Battelle Assessment: TX10_Startup_Costs

September 15, 2010

Start-up and First Quarter Operating Costs

Executive Summary

Battelle reviewed the start-up cost items for GTECH, Intralot, and Scientific Games, as submitted in response to Appendix J of the Operations and Services RFP.

Based on industry experience we expected to see total start-up costs greater than $100 million, and we did from all three vendors. We expected to see Terminals costs dominate, and they did, for all three vendors. All three vendors have conducted numerous start-ups and are used to estimating such costs.

A number of cost details were difficult to interpret, but we feel that the vendors' start-up estimates are in the ballpark. Many of the cost items were under 10% of the vendor's total estimated start-up costs, thus even a large variation in such items does not represent a serious cost risk.

Battelle's conclusion is that although the cost estimates vary widely, they are realistic enough that the Office of the Controller can compare each to that vendor's financial situation and determine whether the vendors are capable of financing their proposed start-ups.

Background

As part of efforts to evaluate proposals from the Lottery Operations and Services RFP, the Texas Lottery issued solicitation RQ10-0837DB, Lottery Gaming Due Diligence Benchmarking. As the awarded contractor and in response to the requirements therein, Battelle agreed as follows:

> 4.2.4 To conduct a review of the estimated start-up and operating costs for each proposal and provide assistance to the Evaluation Committee in determining if the costs provided for each proposal are reasonable.
>
> 4.3.1.D To present written results of the estimated start-up and first quarter operating costs for each proposal.

This document fulfills Battelle's obligation for these requirements.

Attachment J. As the Lottery states in Operating and Services RFP Section 4.7.2, proposers submitting proposals for the Lottery Operations and Services RFP are required to provide estimated start-up costs through conversion and first quarter operating costs. Their responses to RFP Attachment J are the basis of Battelle's review.

Battelle notes that Attachment J does not identify costs to be directly billed to the Lottery. Start-up costs are amortized over the contract and reimbursed within Attachment H's percentage of sales. (Attachment H is for the vendor to price the gaming system contract and does not identify start-up costs.) The costs of Attachment J are simply those that the vendor must be able to cover before substantial gaming revenues arrive.

Thus the purpose of Battelle's assessment is not to determine whether the vendor will be charging a high or low price to the Lottery as a result of start-up, but whether the vendor has reasonably estimated their start-up financial obligations, and if awarded, can meet them. **No suggestion whatsoever for preference for one vendor proposal over the other is intended by this review of start-up costs.**

Methodology

Battelle initiated its review immediately upon receipt of the start-up cost data, in July 2010. The review was performed in concert with the Texas Office of the Controller. Indeed Battelle and the Controller's Office have addressed the matter from different perspectives:

> Battelle: Based on the technology and services offered, and lottery industry experience, whether the claimed financial obligation is a reasonable representation.
>
> Controller: Given the financial obligation that the vendor claims, and considering the vendor's financial status (as reported in audited financial statements and other sources), whether the vendor has the financial wherewithal to meet an obligation of that size.

This specialization made sense because Battelle's skill is technology and the lottery industry, while the Office of the Controller would be more effective considering financial ratios, free cash flow, extent of leveraging and ability to borrow, whether the vendor has cash on hand, etc.

Proposal Clarifications

Attachment J of the Operations and Services RFP gave the vendors a template on which to respond with the start-up cost line items. The eight items required by Appendix J were:

1. Primary and Backup Data Center
2. Software
3. Data Communications
4. Hot Line
5. Retailer Terminals
6. Retailer Installations
7. Lottery Support Representatives
8. Overhead

We will cite these several times in the following discussion.

Based on an initial review of the Attachment J responses, it became clear that the proposals had not been very highly constrained by the Operations and Services RFP with respect to what vendors should include and exclude from the line items noted in Attachment J. The results could have been problematic in the following ways:

1. Vendors might have additional line items beyond those allowed by Attachment J.
2. The RFP did not define the line items very precisely, nor did the proposals.
3. Vendors may account for their contract costs very differently.

As a result, Battelle suggested that the vendors be sent a proposal clarification letter, which resulted in significant supplementation of start-up costs in SGI's case (nearly $43 million). The letter also required vendors to identify contributing elements included in their line items. (Reference: Cost supplement letters from GTECH, Intralot, and Scientific Games, 8/6/2010)

Even with the proposal clarifications we do not believe that the start-up costs are yet perfectly normed for a detailed accounting review. However in our opinion further clarification is not necessary to fulfill the purpose of this assessment: to determine whether the vendor representations of expenses are reasonable and whether vendors can meet them, if awarded.

X-Y-Z Analysis

Battelle tabulated vendor responses to the line items cited in Appendix J (spreadsheet attached). This alignment permitted the expenses to be reviewed for reasonableness as line item buckets across the three vendors (x), line item buckets within a vendor total (y), and line item buckets as they stand alone, relative to the market pricing of what is offered (z).

X-Analysis. Contrasting one vendor's particular line item with another vendor's similar item is not an assessment of comparative merit. There is no attempt to determine which

of the offers may be "better" according to this analysis; no rating or ranking is involved. We only assess whether a vendor's response is an outlier compared to the others. (For example, twice as high, one-fourth as much, etc.)

If a response is either high or low, that is not necessarily problematic, but worthy of consideration. We could question whether different cost elements entered into the equation. May there have been an estimating error? Could underlying costs be so different across vendors? We are simply looking at the vendor's quoted value with respect to the norm of a small sample.

Y-Analysis. Looking down the list of eight items for a particular vendor, this analysis considers whether the costs seem to be spread appropriately as a proportion of the vendor's total start-up estimate. Based on industry experience we have notions of which cost items should be large relative to the others. For example, building, delivering, and installing the retailer terminals should be the dominant start-up expense. We are looking for reasonableness and consistency within a vendor's string of numbers.

Z-Analysis. Given a particular cost item for a particular vendor, we want to consider whether the number seems reasonable for what is to be delivered, based on IT industry expenses and other lottery experiences. Is a particular cost customary and reasonable?

Comparability (Same, Outlier, Scattered). If all three vendors are about the same on a line item, or have similar cost distributions, then they are probably using similar bidding assumptions, have similar inclusions/exclusions, etc. If two are similar and one is an outlier, far from the average, then it may be the one has a legitimate special cause why it is so different. If all three are very different, then the vendors' assumptions are probably all over the place and the numbers may not be easy to explain without clarification.

Anomalies. We refer to a cost number that is somehow "different" from the norm or from expectations based on experience as an anomaly. Anomalies may arise from different technical approaches, different internal cost structures, different supplier costs, or inconsistent cost item definitions and inclusions/exclusions. Of course they can also be caused by vendor cost estimate errors.

Since the vendors are in the same business and provide generally similar products and services in a competitive market, and each competes with some success against the others, radically different technical approaches, internal costs, and supplier costs are unlikely. Reviews of the vendors' other proposals and demonstrations at their business sites support this conclusion.

Accuracy. Since we cannot know details of the vendor costs we cannot determine whether a given number is slightly inaccurate. Therefore anomalies cannot be declared

for something that is near a mean or consistent with market pricing, but only when a number is far away.

Importance of Accuracy. We should be concerned whether a vendor has radically over-estimated, or especially under-estimated their start-up costs. They may be financially at risk if large under-estimates are present. On the other hand, even large estimation errors in a percentage sense may not be material if they represent a small fraction of the whole. For example if a $100K line item is estimated low by a factor of 10 but $1 million is "small change" as part of total start-up costs, there is no extraordinary risk.

Results of Analysis

The X-Y-Z analysis led to a number of anomalies being identified. In some cases explanations can be suggested, especially with the help of the vendor's proposal clarification letter explaining what cost elements they included in line items.

X Anomalies. There are several outlier observations when looking across the start-up cost line items:

1. GTECH's PDC/BDC cost is an outlier (low), but this may be because their data center facilities are already established, and the others have to build.
2. GTECH Software cost is an outlier (high). They are converting their own system which would conventionally suggest their being less expensive.
3. Intralot's Software cost is an outlier (low).
4. GTECH is an outlier (low) in Communications, which could be true if their technical solution is different.
5. GTECH's Hotline number is an outlier (low), to be expected since they already are running the Texas hotline service. The others have to make major expansions of staff and facilities.
6. Intralot's Terminals cost is an outlier (high). Since all vendors are having comparable terminals manufactured in Asian plants it is unlikely to be a natural variation in expenses.
7. GTECH's Install cost is an outlier (low). All of the vendors are installing the same number of similar terminals.
8. Intralot's LSR cost is an outlier (high). All the vendors would employ approximately the same number of LSRs, hired and trained similarly, and from the same market.
9. Intralot is an outlier (high) for Overhead, although all the numbers vary widely. Their clarification letter suggests they include more in the Overhead calculation.
10. Intralot's Total Cost is an outlier (high) although the numbers vary widely. Intralot did not just re-distribute the start-up expense estimates differently, the total itself

is higher. (GTECH: $103M, Intralot: $209M; SGI: $119M not including supplement)

Y Anomalies. Looking down the table for each vendor yielded a few observations:

1. Most of GTECH's start-up expense (67%) is in terminal manufacturing and delivery, which is credible. Other large start-up categories include Communications (12%) and Software (9%). As expected these are major but much less than Terminals. The PDC/BDC category at first glance appears to be light as a proportion of the total (3%), as does Hotline (1/10 of 1 percent) but these may result from GTECH being established in Texas already.
2. Most of Intralot's start-up expense (62%) is for terminal manufacturing and delivery, as expected. Communications (12%) and PDC/BDC (7%) are also major, as expected. The Overhead category (12%) is as large as Communications and this may be anomalous, without knowing exactly what constitutes Overhead. The Software category seems light at ½ of 1%. The software conversion is a major effort and it is surprising that it covers this little of start-up costs.
3. Most of SGI's start-up cost is in Terminals, as expected (52%). Other large categories include Communications (18%) and PDC/BDC (11%), more or less as expected. Software is only 3% and that is a major effort to represent such a small percentage of the total start-up cost. (The percentages for SGI here are not adjusted for the additional line items in their clarification letter.)

Z Anomalies. Some of the individual cost items seem high or low depending on our industry experience:

1. GTECH's PDC/BDC number of $3.4 million seems light but may cover mostly equipment while there are few build-out charges. This is credible since GTECH already has Texas PDC/BDC facilities under the current contract.
2. GTECH's Hotline number is only $100 thousand. GTECH already has a Texas hotline, so perhaps training and equipping operators is easy for them.
3. GTECH LSRs are shown as costing $1.7 million during start-up. Since GTECH's LSRs are already available by virtue of working on and being covered under the current contract, hiring and training should surely not take long.
4. Intralot Software is shown as only $1 million. There should be a team of several programmers at significant cost each, for months. Thus this expense seems light.
5. Intralot terminals are shown as taking over $130 million to build and deliver. This would be about $7,000 per terminal, a number higher than our past industry experience.
6. Intralot's start-up Overhead cost is shown as $25 million, seemingly high. This implies many staff equivalents and other expenses for the start-up time period.

Perhaps it is because their clarification letter indicates that leasehold improvements are included.

7. SGI's Hotline expense is $1.4 million, seemingly high. We expect that staff would only come on near the end of implementation. This number may have a significant facility or system upgrade figured in.

Low Impact Items and Cost Risk. As part of the X-Y-Z analysis we observed that only a few of the cost line items are strong drivers of the total start-up cost. (Chiefly these are Terminals and Communications.) Most of the other line items are under 10% of the vendor's total. Thus even a substantial uncertainty in the low-end items would not have a material effect overall. In those cases it is unnecessary to have great precision.

First Quarter Cost Estimates

The three vendors have produced very similar first quarter cost estimates. The high to low range is under 14%. The cost for Texas-specific products and services is very much in line with industry norms. Thus the cost estimates are all reasonable.

Conclusions

What do we make of these findings? Based on industry experience we expected to see start-up costs greater than $100 million, and we did from all three vendors. We expected to see Terminals costs dominate, and they did, for all three vendors. The vendors' start-up estimates are in the ballpark whether or not we can explain the details.

That may be the best we can say. We suggest that for the stated purpose -- determining whether a vendor can meet these start-up costs -- speculation on the fine details of the line items may be a case of "too much information." Indeed many of the cost items are below 10% of the vendor's total, so even a large variation in such items does not represent a major risk. All three vendors have made a diligent effort to estimate their start-up costs and all three have conducted numerous start-ups. They are used to estimating and covering these expenses.

Battelle's conclusion is that although the start-up cost estimates vary widely, they are realistic enough that the Office of the Controller can compare them to each vendor's financial situation and conclude whether the vendors are capable of financing their start-ups.

Spreadsheet

Start-Up Cost Clarification Letters

Although GTECH and Intralot made no changes with their start-up cost clarifications, Scientific Games incorporated several new line items not included in Attachment J, as follows.

Scientific Games Supplemental Start-Up Costs (in millions)

Instant Ticket Warehousing/Distribution/Tel-Sell	$7.58
Consultants	$2.73
Offered Options Selected by Lottery	$6.41
Marketing Equipment*	$7.81
All Other**	$18.40
	$42.93

*Marketing Equipment includes signs, spinning wheels, playstations, etc.

**All Other includes retailer training, recruitment/relocation, vehicles, computers, and operating costs prior to go-live.