

Confidential Presentation to:

The State of Florida



Regulatory Considerations for a Florida Lottery Lease Agreement

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Lottery Regulatory Considerations – Executive Summary

Executive Summary

Key Issues

- ◆ If Florida chose to enter into a lease of its lottery, the lease agreement reached between the state and the lottery's private operator (the lessee) would govern the terms of the management and operation of the Lottery for the length of the lease.
- ◆ The parameters of the lease agreement dictating what the lessee can and cannot do will have a material impact on the lease price.
- ◆ Topics ranging from oversight and regulation to taxation, advertising, auditing, types of games, retailer regulations, labor rights, prize payouts, and profit sharing will all be covered in the lease agreement, and need to be carefully considered beforehand.
- ◆ Some of the topics covered in the lease agreement are also likely to be included in or impacted by legislation authorizing the transaction, so full consideration of each issue as early as possible is critical.



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Oversight and Regulation

State Regulation of the Lessee

- ◆ What entity should regulate the lessee?
- ◆ How should the regulatory regime work?

State should prefer:

- ◆ A board or regulatory entity that has the authority to approve:
 - Advertising and marketing
 - New types of games and platforms
 - The lessee's business plan
- ◆ The state should also be able to regulate licensed vendors like lottery retailers
- ◆ The state should be able to modify operating rules to adapt to changing conditions
- ◆ Retention of ordinary criminal oversight activity (illegal ticket sales, selling to minors)

Lessee will prefer:

- ◆ Mutually agreeable operating standards set forth in advance and protected from material change
- ◆ Limits to the state's ability to require advance approval of ordinary business activities like advertising and new launching games
- ◆ A regulatory authority with industry expertise
- ◆ That the state use its criminal oversight powers to protect the lessee's exclusive franchise

Impact on Bid Price

- ◆ Generally limited, unless the state failed to legally protect the lessee's franchise or the operating standards are unreasonable
- ◆ Some bidders may be deterred by an overly burdensome regulatory environment, although bidders fluent in the gaming industry may see a complex regulatory environment as a competitive advantage in the bidding process



How Does State Regulation Work?

Oversight and Regulation

- ◆ What should the state approve in advance?
- ◆ Do new games and platforms require legislative approval?
- ◆ Should the state regulate prize payouts?
- ◆ How should the state regulate advertising?
- ◆ Should the state require the lessee to fund public programs?

State should prefer:

- ◆ The ability to approve marketing and advertising plans at regular intervals
- ◆ The ability to set standards for advertising to protect minors and other vulnerable populations, and to remove advertisements that do not meet those standards
- ◆ Regulation of minimum prize payouts (as well as providing public information about prize payouts)
- ◆ Prior approval of new types of games and platforms
- ◆ Requiring the lessee to fund public programs like gambling addiction hotlines and financial counseling for winners of significant prizes

Lessee will prefer:

- ◆ Limited state ability to approve and change the marketing and advertising plan
- ◆ No restrictions on amount of advertising, only on content or location
- ◆ No required pre-approval of new games or platforms
- ◆ No minimum prize payouts
- ◆ Limited costs on funding public programs

Impact on bid value

- ◆ Advertising restrictions could have a chilling impact on bidders
- ◆ Ability to institute new games or platforms without legislative approval is extremely significant to bid value
- ◆ Regulation of minimum prize payouts not significant if in line with industry standards



Auditing and Reporting

- ◆ What rights to audit should the state retain?
- ◆ Should special audit requirements remain to protect prize payouts?
- ◆ How does the state protect the security of player/game information?

- ◆ Regular financial and performance audits, conducted by outside auditors and state auditors

State should prefer:

- ◆ Lottery game results independently audited (consistent with the industry standard)
- ◆ Lottery assets held in trust with prize payouts protected against the lessee's creditors
- ◆ Limitation on the types of investments the trust can make
- ◆ Ability to conduct random audits upon request

Lessee will prefer:

- ◆ Regular audits by auditors chosen by the lessee at appropriate intervals
- ◆ Limited information request rights to minimize business interruption
- ◆ Option to insure prize payouts rather than operate a trust

Impact on Bid Price

- ◆ Negligible



Regulation of Investors

Oversight and Regulation

- ◆ Should the state control who bids on the lottery? ◆ How does the state manage changes in equity lease?
- ◆ How does the state control who invests on the lottery? ◆ Can the state protect the lottery from being flipped (sell of a leveraged)?

State should prefer:

- ◆ Broad ability to set standards for individuals involved in the operation of the lease
- ◆ Universal disclosure of equity interests (and debt interests) from the lessee
- ◆ Requirement of background checks of any new owners on transfer of investment
- ◆ Lock-up period to prevent flipping of ownership (prevents state loss of windfall profit and transfer of lease to bidders not previously disclosed to state in bid process)
- ◆ Right of first refusal in the event of a lease transfer
- ◆ Ability to force lease transfer if the state uncovers a significant contractual violation

Lessee will prefer:

- ◆ No exclusions from right to bid (or to seek equity investment in consortium)
- ◆ No requirements on passive institutional investors
- ◆ Limited disclosure requirements for passive institutional investors
- ◆ No probity review on transfers of equity without a change in control
- ◆ Unlimited right to transfer the lease, as well as no or short lockup period with allowances for equity syndication and other events with current contract terms applying to new lessee
- ◆ Right to cure violations of the lease agreement

Impact on Bid Price

- ◆ Limiting bidder universe will impact an investor's ability to maximize equity participation
- ◆ Unreasonable probity/disclosure requirements will chill private equity investors
- ◆ Lockup periods will reduce overall value and may chill some potential investors



State Remedies for Non-Compliance

- ◆ What are the state's options for lessee non-compliance?
- ◆ What are the state's options for contract/will/lessee non-compliance?
- ◆ Can the state sue lessors, lessees, and assignors for the same?

- ◆ Ability to terminate lease on repeated and uncured violations of operating standards (or for significant incurable violation) without compensation
- ◆ Alternative remedies for non-compliance (increased revenue share, penalty provisions, additional security)
- ◆ Short, effective dispute resolution structure
- ◆ Use of Florida law to govern disputes

State should prefer:

- ◆ No right to termination (or limited to significant uncured breaches)
- ◆ Right to forced lease transfer or payment of fair market value by the state upon termination
- ◆ Access to federal courts and waiver of state sovereign immunity
- ◆ Short, effective dispute resolution
- ◆ Multiple extended cure periods
- ◆ Use of Delaware or New York law to govern disputes

Lessee will prefer:

- ◆ Overly broad termination rights can adversely impact ability to secure affordable financing
- ◆ Right to forced lease transfer or termination payment (at least of outstanding debt) would have a significant positive impact on financing
- ◆ Sovereign immunity and forum choices could have a material impact on financing

Impact on Bid Price



Lessee Responsibilities

Types of Games

Lessee Responsibilities

- ◆ What types of games will be included in lease?
- ◆ Are all current lottery games included?
- ◆ How will new games be allowed in?
- ◆ How will internet/wireless/other platforms be treated?
- ◆ Will the lessee be allowed to choose to enter/exit new multi-state games?
- ◆ Can the lessee sell tickets out of state?
- ◆ How will the state share benefit of changed circumstances?

State should prefer:

- ◆ Direct control of approval of new game categories
- ◆ Enhanced revenue sharing on new types of games and platforms
- ◆ Limitation of games allowed by lottery to 'lottery games' only (not bar games, casino style games, etc.), and only those specified in agreement
- ◆ State to retain approval rights on multi-state games
- ◆ New platforms/delivery mechanisms (internet/wireless) treated like new games

Lessee will prefer:

- ◆ All current games included in lease
- ◆ Ability to roll new games into current lease without additional revenue share
- ◆ Ability to join Powerball or MegaMillions
- ◆ Free ability to initiate new brands of current games without undue burden
- ◆ No competition from new games or delivery mechanisms (if not in lease, then no one else can have)
- ◆ New platforms/delivery mechanisms should not be subject to incremental revenue sharing
- ◆ Limited interference with ticket sales out of state



Types of Games (continued)

Lessee Responsibilities

- ◆ What types of games will be included in leases? ◆ Will the lessee be allowed to choose to enter/exit Are all current lottery games included? ◆ new multi-state games?
- ◆ How will new games be approved? ◆ Can the lessee sell tickets out of state?
- ◆ How will internet/wireless/other platforms be created? ◆ How will the state share benefit of changed circumstances?

Impact on Bid Price

- ◆ **SIGNIFICANT**
- ◆ Protection from competition from new games critical to bid
- ◆ Revenue sharing on new games/platforms is material to valuation
- ◆ Ability to add games without legislative approval impacts value
- ◆ Ability to sell tickets out of state/online in compliance with federal law is material to value
- ◆ Ability to control multi-state gaming rights is material to value



Labor/Employment

Lessee Responsibilities

- ◆ How will the lessee treat current Lottery employees?
- ◆ Will the lessee maintain the state's commitment to diversity?

State should prefer:

- ◆ Lessee interviews existing employees
- ◆ Lessee maintains diversity in hiring standards
- ◆ Require compliance with all labor laws and prevent anti-union practices

Lessee will prefer:

- ◆ No requirements for existing employees
- ◆ No stated diversity requirements -- diversity goals only

Impact on Bid Price

- ◆ Negligible



Contracts With Existing Vendors and Retailers

Lessee Responsibilities

- ◆ Will/No will approve/forfeet retail licenses and outlets?
- ◆ Will contractors continue to meet diversity requirements?
- ◆ Will the lessee have an obligation or an opportunity to maintain/extend current vendor purchases?

- ◆ Approval of vendor licensees and the ability to revoke licenses for violation of rules or other state laws

State should prefer:

- ◆ Approval of types of establishments that can have licenses
- ◆ Ability to require the lessee to maintain state WBE/MBE/DBE requirements
- ◆ Ability to require the lessee to retain contracts the state cannot terminate and create an effective transition plan from current vendors to new vendors

Lessee will prefer:

- ◆ No state oversight of vendor licensees or of retail outlets who can be licensees
- ◆ Limited oversight of contracting – especially on time sensitive negotiations
- ◆ No MBE/WBE for technical operators
- ◆ Ability to retain/extend existing contracts at the discretion of the lessee

Impact on Bid Process

- ◆ Limited bidder impact
- ◆ Effective and reasonable transition plan may improve bids



Prize Payouts

- ◆ Who pays out prizes?
- ◆ How to ensure that prizes are paid out on time?

State should prefer:

- ◆ State pays prizes or a trust fund to protect assets
- ◆ Requirement that balance build up to protect prize payouts

Lessee
will prefer:

- ◆ Trust fund is set up

Impact on bid price

- ◆ State retention of trust fund could hurt value



State Responsibilities

Enforcement of Lottery Franchise

State Responsibilities

- ◆ How does the state protect the lessee against competing lotteries?
- ◆ What are consequences if the state allows competing lotteries?
- ◆ What duties does the state have to protect the lessee competitiveness?
- ◆ What's interaction between lotteries and casino gaming?

- ◆ Ability to enforce its laws without interruption

- ◆ Ability to terminate contract for cause without repayment

- State should prefer:**
- ◆ No additional duties to protect the lessee from competition (other than maintaining the exclusive franchise)

- ◆ Ability to expand casino gaming without creating adverse action

- ◆ Absolute protection from competing lottery activity in the state during term of the agreement

Lessee will prefer:

- ◆ Ability to terminate with right to repayment at fair market value for state initiation of competing lottery activity

- ◆ Ability to reduce state revenue share for competing lottery activity

- ◆ No expansion of casino/other gaming (or limited to physical geography of casinos)

- ◆ Additional protection against encroachment from foreign gaming and internet gaming

Impact on Big Parks

- ◆ Protection of lottery monopoly critical to value
- ◆ Ability to terminate with repayment significant to ability to obtain affordable financing
- ◆ Expansion of gaming will reduce Lottery value, especially if new slots are allowed outside of casinos



Taxation

State Responsibilities

- ◆ How does the state tax the lessee?
- ◆ How does the state tax the sale of lottery tickets?
- ◆ What rights does the state have to taxation changes in the future?
- ◆ What happens if the state reduces value of lottery by taxing?

State should prefer:

- ◆ Ability to tax lottery activity as it sees fit
- ◆ Lessee should be subject to state taxation
- ◆ No forced repayment of tax receipts if the lessee chooses to terminate

Lessee will prefer:

- ◆ Immunity from taxation for its own activities and/ or sale of lottery tickets
- ◆ Remedies against the state if the state levies taxes of unique applicability against the Lottery (e.g., excise tax on lottery tickets, additional tax on lottery operators), as opposed to corporate or income tax of general application
- ◆ Remedies should include ability to terminate with repayment of fair market value before taxation

Impact on Bid Price

- ◆ Ability to tax lessee uniquely without recourse by the lessee will significantly reduce lessee's interest in the lease
- ◆ Imposing a sales tax on tickets would have a materially adverse effect on bid prices



State Mandates

- ◆ What rights does the state have to force the lessee to act?
- ◆ Can the state require the lessee to initiate new lottery games?
- ◆ What are the consequences of state requirements?

State should prefer:

- ◆ Ability to require lottery to take certain actions due to changed circumstances
- ◆ Ability to require new games if so directed by legislature
- ◆ Compensation for state actions limited to actions that have a materially adverse impact on value

Lessee will prefer:

- ◆ Limiting the state's ability to direct the lessee to the provisions set forth in the lease agreement
- ◆ Ability to get compensation for any cost incurred in following state mandates
- ◆ Strict restrictions on number/types of new games created by the legislature

Impact on Bid Price

- ◆ Both the ability to issue mandates and to direct the lessee to offer games have some impact on value, with magnitude depending on the reasonableness of the rights and restrictions set forth in the lease agreement



Lease Terms/Revenue Sharing

General Lease Terms

- ◆ How long should the lease last?
- ◆ Can the lease be extended?
- ◆ What does the state get back after lease ends?
- ◆ How does the state handle lessee default?
- ◆ How do transitions work?

- ◆ Lease period that maximizes value to the state

- ◆ Certainty on lease end-date and that state will be able to operate the Lottery immediately upon termination of lease

- ◆ Rights to step-in and ensure continued ordinary operation of the Lottery in the event of lessee default/insolvency

- ◆ Letter of Credit at close of lease to guarantee ordinary course maintenance of the franchise
- ◆ Rights to intellectual property generated by the lessee during term of the agreement

State should prefer:

- ◆ Lease period long enough to obtain stable financing (leveraged with timely refinancing)
- ◆ Right to extend lease to recoup revenue lost as a result of state action
- ◆ Right to intellectual property it creates during the life of the lease
- ◆ Automatic extensions to lease on same terms and conditions
- ◆ Right to bank step-in on default (necessary for financing)

Lessee will prefer:

- ◆ Length of term will impact value materially
- ◆ Extension/step-in rights important for financing
- ◆ Intellectual property rights important to strategic investors

Impact on Bid Price



Profit Sharing and State Revenues

Lease Terms/Revenue Sharing

- ◆ How much revenue does state get immediately?
- ◆ How will profit sharing work for new ideas/newly authorized games?
- ◆ What profit sharing should state retain in existing operations?
- ◆ How will unclaimed prize money be treated?

State should prefer:

- ◆ Maximize up-front revenues (time value of money) to meet goals
- ◆ Maintain sufficient profit sharing to retain state interest in successful operation
- ◆ Additional profit sharing for new games, keep profit sharing for new games subject to negotiation
- ◆ Revenue sharing to include rights to advertising and franchise rights
- ◆ Unclaimed prizes go to the state

Lessee will prefer:

- ◆ Varying preferences for up-front payment versus revenue sharing
- ◆ State to retain sufficient revenue share to reduce risk of adverse action
- ◆ No change in profit sharing for new games, as they are part of lease agreement
- ◆ Unclaimed prizes used to support social causes, charitable spending

Impact on Bid Price

- ◆ Up-front payment versus revenue sharing has material impact on overall value
- ◆ State revenue sharing will reduce up-front revenues
- ◆ Profit sharing has impact on value
- ◆ Unclaimed prizes treatment impacts value of lease



Compensation and Process for New Revenue Ideas

Lease Terms/Revenue Sharing

- ◆ What is the process and how is the state compensated for ways of generating revenue apart from increased ticket sales like advertising on tickets, Florida licensing rights, sales in other states, and internet sales?
- ◆ How are new, currently unforeseeable ideas handled?

State should prefer:

- ◆ Determine the value of specific new ideas and include in lease agreement during bidding process
- ◆ Retain approval right for new ideas not included in lease agreement
- ◆ Dictate terms and parameters for issues like advertising on tickets in lease agreement
- ◆ Establish a strong regulatory framework if a third party operates an offshore internet-based Florida Lottery
- ◆ Require direct involvement in negotiations with other states
- ◆ Set up a process to decide on approval and compensation for currently unforeseeable ideas and opportunities that will arise during the term of the lease

Lessee will prefer:

- ◆ Opportunity to launch new ideas with minimal state approval
- ◆ Avoid upfront payments for each additional new idea
- ◆ Establish a clear process for approval and compensation for currently unforeseeable ideas and opportunities that will arise during the term of the lease

Impact on Bid Price

- ◆ The opportunity to generate revenue independent of ticket sales could be material to bidders and a clear process for state approval and compensation could have an impact on bids
- ◆ Permitting new ideas in the lease agreement should increase the value of the bids

