

**CABINET - SUBJECTS FOR CONSIDERATION, 06 SEPTEMBER 1999 11:00 AM**

**1. New Initiatives/Policy Matters**

Not Relevant

**103. MGE090/99CS**

**South Australian Totalizator Agency Board ("SA  
TAB") / Lotteries Commission of South Australia  
("LCSA") Review and Associated Issues  
DEFERRED TO THURSDAY, 9/9/99**

*Premier & Cabinet Minister*

Not Relevant

# CABINET COVER SHEET

**CONFIDENTIAL**

1. **TITLE:** South Australian Totalizator Agency Board ("SA TAB")/Lotteries Commission of South Australia ("LCSA") Review and Associated Issues
2. **MINISTER:** Hon Dr Michael Armitage MP  
Minister for Government Enterprises
3. **PURPOSE:** It is proposed that Cabinet:-
  - note the various advices received, and progress to date, in relation to the SA TAB/LCSA Review and associated issues; and
  - determine its final policy position on the way forward, particularly in relation to strategies for the sale of SA TAB and LCSA and the possible introduction of gaming machine initiatives..
4. **RESOURCES REQUIRED FOR IMPLEMENTATION:** In the event of a decision to privatise substantial resources will be required, as outlined herein.
5. **RELATIONSHIP TO GOVERNMENT POLICY:** Consistent with Government policy concerning major asset reviews and sales.
6. **CONSULTATION:** Cabinet only.
7. **FAMILY IMPACT STATEMENT:** The financial and commercial benefits expected to be generated from a privatisation would provide added flexibility within the State Budget in reducing debt and in providing core Government services to the South Australian community, including families.
8. **URGENCY:** High
9. **RECOMMENDATIONS:** It is recommended that Cabinet:-
  - 4.1 note the advice that has been received to date, including most recently from CSFB, regarding risks associated with the continued ownership of SA TAB and LCSA;
  - 4.2 note the financial and risk analysis from CSFB which, together with the general principle of reallocating scarce resources to core Government services, supports the privatisation of both SA TAB and LCSA;

- 4.3 reaffirm its decision to sell both SA TAB and LCSA and endorse the most recent recommendation from CSFB to conduct a parallel sales program – offering a “blueprint” for a merger, rather than merging the businesses prior to sale;
- 4.4 agree that implementation of this decision should commence immediately - but with due care and preparation, to address stakeholders’ interests (including those of SARI) and their potential to impact on the implementation process;
- 4.5 determine its final position in relation to possible gaming machine initiatives;
- 4.6 note the overall cost of consultancies expected for the SA TAB/LCSA project; and
- 4.7 note the current position in relation to the possible ongoing appointment of CSFB, including its fee structure proposals.

**SIGNATURE OF MINISTER:**  
**PORTFOLIO:**  
**DATE:**

  
Hon Dr Michael Armitage MP  
MINISTER FOR GOVERNMENT ENTERPRISES  
3.9.99

**TO: THE PREMIER - FOR CABINET**

**RE: SOUTH AUSTRALIAN TOTALIZATOR AGENCY BOARD ("SA TAB") /  
LOTTERIES COMMISSION OF SOUTH AUSTRALIA ("LCSA") REVIEW  
AND ASSOCIATED ISSUES**

**1 PROPOSAL**

It is proposed that Cabinet:

- note the various advices received, and progress to date, in relation to the **SA TAB/LCSA Review** and associated issues; and
- determine its final policy position on the way forward, particularly in relation to strategies for the sale of **SA TAB** and **LCSA** and the possible introduction of gaming machine initiatives.

**2. BACKGROUND**

- 2.1 **Credit Suisse First Boston (CSFB)** has recently undertaken a **Feasibility Study** into possible merger and sale options for the Government's gambling assets, including gaming machine possibilities.
- 2.2 **CSFB** has also addressed a range of questions and issues arising from Cabinet's consideration of the **Feasibility Study** including, most recently, **LCSA** ownership risks and indicative retention values for **SA TAB** and **LCSA**.
- 2.3 Other consultants (**BZW/ABN Amro**, **Macquarie Bank** and **BT Wolfensohn**) have in the past advised the Government on the possible sale of **SA TAB**, **LCSA** and gaming machine assets. A summary of their respective findings and recommendations is included at **Attachment A**.

**3. DISCUSSION**

- 3.1 It is considered timely for Cabinet to reflect upon the various advice that has been received to date, including most recently from **CSFB**, and to settle on the appropriate strategy to carry the project forward from here, given especially:

- 3.1.1 the issues confronting SA TAB in particular (eg IT investment, SuperTAB pooling) which require early resolution in order to minimise risk/maximise value; and
- 3.1.2 the significant work that remains to be done (eg SARI negotiations/documentation, possible merger-related issues) before the assets could be offered to the market.

### **3.2 Previous Cabinet Decisions**

In taking stock of the progress made to date, and the future path to be taken, it is worthwhile recapping on the key conclusions of Cabinet in May 1998, following the Scoping Reviews of SA TAB and LCSA in March/April 1998.

In essence, Cabinet agreed:-

- to proceed with preparatory work for the sale of SA TAB, subject to the resolution of commercial and other issues identified in the scoping studies;
- to proceed similarly with LCSA, but noting the need for:
  - LCSA's new IT system to be implemented and "proved up" prior to a sale;
  - further examination of possibilities to enable a cash neutral impact on the Budget;
- in principle, not amalgamate SA TAB and LCSA but to keep open the possibility of a parallel sales program;
- not to pursue the sale of the Casino in conjunction with either SA TAB or LCSA;
- to give more detailed consideration to the possibility of adding value to SA TAB and/or LCSA via gaming machines;
- in principle, that the commercial value of any "value adding" initiatives should accrue to the Government - and taxpayers more generally - rather than as a means of providing direct financial benefits to SARI; and
- in respect of SARI, that
  - constructive, ongoing dialogue with SARI will be an important element in the SA TAB privatisation process;
  - the Government should pursue a commercial "supplier/purchaser" relationship between SARI/SA TAB;
  - to the extent the Government wishes to inject additional funding into SARI, this could be done directly from the Budget (ie rather than connecting the funding to the SARI/SA TAB business relationship).

Since that time, these various matters have been progressed subsequent to the Scoping Reviews, as part of BT's Principal Advisory assignment and, more recently, with CSFB.

The principal objective of CSFB's Feasibility Study was to review in more detail various merger/public float possibilities for Government-owned gambling assets (including gaming machine-related assets) - a matter which had been the subject of only high level examination in previous consultants' work.

On 2 August 1999, Cabinet approved in principle a merger and sale of SA TAB and LCSA together with a separate sale of the Adelaide Casino.

In arriving at that decision, Cabinet obtained advice from CSFB on various issues that have arisen as part of its consideration of the Feasibility Study, as discussed below.

While CSFB's first preference was to merge SA TAB, LCSA and the Casino and to privatise via a "Strategic Investor/IPO" sale strategy, it has now recommended, in light of Cabinet's decision to sell the Adelaide Casino by Separate trade sale (due, amongst other things, to FundsSA's preferred portfolio management strategies and regulatory considerations), a "parallel" trade sale of SA TAB and LCSA - but with a "blueprint" for a merger included in sale/marketing material for interested investors.

CSFB's view is that this approach will provide the best value to Government.

A copy of CSFB's on report on SA TAB/LCSA sale strategies (which also discussed associated implementation issues) is included at Attachment B.

CSFB has also provided subsequent high-level advice on:-

- a possible 100% IPO of a merged SA TAB/LCSA (not preferred by CSFB, essentially for value reasons);
- the possible sale of a 40% strategic stake in the merged entity, combined with an IPO for the remaining 60%, underwritten by the Strategic Investor (not preferred by CSFB, essentially for value reasons);
- the structure of the merged entity; and
- the indicative retention value of the merged entity, from the Government's perspective.

At its meeting on 16 August 1999, Cabinet requested further, more detailed advice on the retention value issues, with particular emphasis on LCSA and the risks to Government of continued ownership.

3.3 SA TAB/LCSA – Analysis of Privatisation vs Retention Scenarios

CSFB’s report on this matter can be found at Attachment C. Amongst other things, the report summarises the business risks for SA TAB and LCSA (pages 9 and 10 respectively).

In relation to LCSA, CSFB has indicated the following risks and potential impacts on profitability and business value:-

RISK	BASIS	PROFIT REDUCTION \$M	VALUE REDUCTION \$M
<b>High Probability</b>			
Pressure on Operating Costs	10% cost ↑	2.0	31.0
Pressure on Turnover	10% turnover ↓	3.0	178.1
<b>Medium Probability</b>			
Internet competition	50% turnover ↓ for Powerball and Saturday Lotto	8.0	429.1
New games introduced by competitor	50% turnover ↓ for Keno	3.3	191.4
	50% turnover ↓ for Keno	1.4	67.5
<b>Low Probability</b>			
Excluded from National Lotto Bloc	50% turnover ↓ for all Lotto Bloc products	9.2	502.1

CSFB’s adjusted discounted cash flow analysis suggests the following comparison of value outcomes:-

	Total Value to State (\$ Million) 50% Tax on LCSA
Sell Merged SA TAB and LCSA	2,098
Retain LCSA, sell SA TAB	2,071
Retain SA TAB and LCSA	1,993
Retain SA TAB, sell LCSA	1,989

Key Assumptions:-

- a lotteries tax of 50% of Net Gaming;
- a private owner would derive the cost savings/merger synergies identified by CSFB, but the Government could not extract/maintain these benefits;
- interest savings calculated at 6% pa.

It is noteworthy that CSFB has based its analysis on (modified) SA TAB/LCSA business forecasts. It is arguable that business growth under private ownership could well exceed the CSFB's relatively conservative projections – which would improve the above value outcomes for the sale scenarios.

### **3.4 The Hold/Sell Decision**

Although CSFB's analysis shows that there is a financial case for the sale of both SA TAB and LCSA, the differences in the values to Government of the individual scenarios are not great.

A decision on the way forward must therefore depend also upon the Government's perspective of:-

- the likelihood of the cited business risks materialising in the near term; and
- the capacity of the business to manage these risks (or, indeed, convert them into opportunities) under Government ownership.

On both counts, the answer is uncertain at best. The advice received from a series of consultants in various studies has noted that either or both of the above issues represent sound grounds for privatisation.

Additionally, the real and increasing tensions between the Government's ownership and regulatory roles in the gambling sector cannot be overlooked.

And, finally, with the financial challenges that still confront South Australia, there continues to be a strong case for exiting all commercial activities that currently (or, in future, are likely to) fall outside the Government's core areas of competency.

The reallocation of the Government's scarce financial resources from the risks, uncertainties, and competitiveness of the gambling sector into debt retirement (and, ultimately, improved core services), of itself, presents a strong argument in favour of privatisation.

It is therefore proposed that Cabinet reaffirm its approval for the sale of both SA TAB and LCSA, with implementation of that decision to commence immediately.

### **3.5 Implementation Issues**

These matters have been dealt with in detail previously but it is important to note again that various key issues will need to be addressed quickly and carefully, once a final decision on sales strategy is taken.

In many instances, this will need to occur before a public announcement of the Government's intentions, in order to avoid any compromise of the Government's commercial position and/or unrest within the businesses, eg:-

- negotiations with SARI on its future commercial relationship with SA TAB;
- confidential discussions/negotiations with some business counterparties in an endeavour to resolve outstanding business issues (eg TABCorp's SuperTAB Agreement); and
- finalisation of HR/IR issues (eg redundancy arrangements for LCSA).

A commitment to a sale decision at this time will enable issues of this kind to be worked through.

It may take some time to reach a point where a public announcement can be made and it will be imperative in the meantime for absolute confidentiality to be maintained.

### **3.6 Gaming Machines**

CSFB has provided various advices on gaming machine possibilities and associated value issues.

Fundamentally, much of the value in gaming machines already resides with machine owners. However, with a change in the currently policy framework (and consequential impacts upon the supply/demand equation), it would be possible for the Government to create, and sell, additional value.

There would be a considerable number of logistical, social and political issues arising from such a policy change but, at the same time, the financial benefits are significant.

CSFB has reported (Attachment D, circulated previously) on the commercial and other issues associated with one potentially viable gaming machine concept, viz:-

- impose an aggregate **State** gaming machine limit (which is lower than current total machine numbers);
- conduct a buy back of machines from existing owners;
- increase the venue limit from 40 to 60; and

- reissue, on a commercial basis (eg via competitive tender), some of the repurchased machine licences – but still achieving a lower aggregate number of machines in the State.

The following table summarises, in round terms, the value to Government (as estimated by CSFB) arising from the repurchase of 2000 machines and the reissue of 500 licences:-

	(\$M)
Repurchase 2000 machines	(30)
Reissue 500 machines	60
Net Value	30
Present Value of Increased Tax Revenues	45
Total NPV	75

### 3.7 Project Costs

The forward budget for the project will depend, amongst other things, on the sales strategy approved and the Principal Adviser's input on specialist advice required.

Estimated consultancy costs from this point are shown at Attachment E. Including an approximate Success Fee for the sale of both SA TAB and LCSA (\$5.4 million), future consultancies are estimated to total \$9.7 million.

Costs up until August 1999 total roundly \$2 million, representing in the main:-

- BZW/ABN Amro's scoping study of SA TAB/LCSA (completed January 1998);
- BT Wolfensohn's Scoping Review of LCSA (completed May 1998);
- Macquarie Corporate Finance's Scoping Review of SA TAB (completed May 1998);
- BT Wolfensohn's preparatory work for an SA TAB privatisation (put on hold early 1999); and
- CSFB's Feasibility Study (ongoing).

All up, costs may amount to some \$11.7 million – ie approximately 0.55% of the total present vale of SA TAB/LCSA, including future dividend/tax streams (ie roundly \$2.1 billion).

### 3.8 CSFB's Appointment

CSFB has expressed formal interest in an ongoing role in connection with the merger and sale of SA TAB/LCSA. Its position is not clear in relation to the sale of a single asset only. At a minimum, it is likely that CSFB would wish to revisit the proposed fee structure in these circumstances.

Attachment F provides an analysis of CSFB's currently proposed fee structure and notes issues that the Project Team would wish to address as part of the negotiation process.

Probity advice is being sought at present on issues relating to CSFB (NZ)'s wish to act for Sky City (NZ) in connection with the Adelaide Casino sale. There may also be other potential conflict issues to address for the Australian firm, once a sale decision is made and substantive negotiations regarding CSFB's ongoing role can commence.

## 4. RECOMMENDATIONS

It is recommended that Cabinet:-

- 4.1 note the advice that has been received to date, including most recently from CSFB, regarding risks associated with the continued ownership of SA TAB and LCSA;
- 4.2 note the financial and risk analysis from CSFB which, together with the general principle of reallocating scarce resources to core Government services, supports the privatisation of both SA TAB and LCSA;
- 4.3 reaffirm its decision to sell both SA TAB and LCSA and endorse the most recent recommendation from CSFB to conduct a parallel sales program – offering a "blueprint" for a merger, rather than merging the businesses prior to sale;
- 4.4 agree that implementation of this decision should commence immediately - but with due care and preparation, to address stakeholders' interests (including those of SARI) and their potential to impact on the implementation process;
- 4.5 determine its final position in relation to possible gaming machine initiatives;

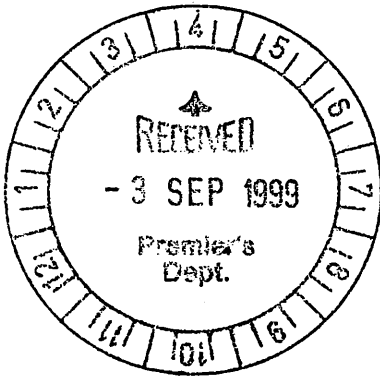
- 4.6 note the overall cost of consultancies expected for the SA TAB/LCSA project; and
- 4.7 note the current position in relation to the possible ongoing appointment of CSFB, including its fee structure proposals.

*deferred Thursday next  
6.9.99*

*Michael Armitage*

Hon Dr Michael Armitage MP  
MINISTER FOR GOVERNMENT ENTERPRISES

Date: *3.9.99*



SA TAB/LCSA REVIEW – SUMMARY OF CONSULTANTS' KEY FINDINGS

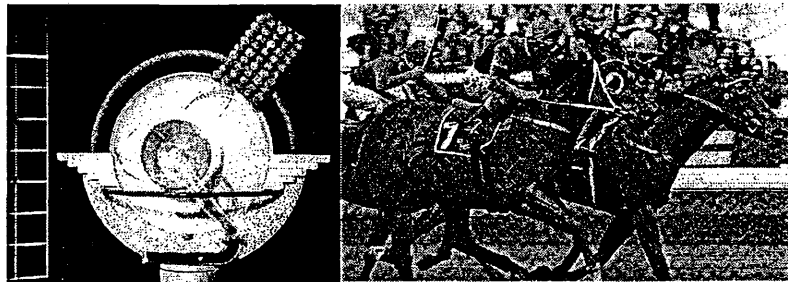
ATTACHMENT A

	<b>BZW VIEW</b> December 1997 - January 1998	<b>MACQUARIE VIEW</b> March - May 1998	<b>BANKERS TRUST VIEW</b> March - May 1998	<b>CSFB VIEW</b> August 1998
<b>Perceived Risks</b>	<p>SA TAB - increased competition (inc TAB privatisations), technology, Gentlemen's Agreement, exposure to SARI, expansion beyond core competencies, conflict in Government roles.</p> <p>LCSA - increased competition, technology, Lotto Bloc, expansion beyond core competencies, conflict in Government roles.</p>	<p>SA TAB faces a more uncertain future than ever before, due to a combination of inherent characteristics of SA TAB's businesses and increasing competitive tensions.</p> <p>Competitive tensions come from broader range of gambling and leisure products, privatisation of other TAB's, NSW TAB ownership of SKY TV, TABCorp pooling, technological developments.</p> <p>Also, inhibited access to capital and management talent.</p>	<p>LCSA essentially given a "clean bill of health" – investment risk/capital at risk relatively low; little to suggest private sector can outperform Public Sector.</p> <p>However, BT noted that, if other SA gambling entities privatised and only LCSA remained Government-owned, may be difficult for Government to perform its regulatory role.</p> <p>BT saw little immediate threat from technological developments but noted many lottery operators were anticipating more volatility. While BT saw internet gambling as more an opportunity than threat, it noted the medium term was unclear.</p>	<p>The risks confronting SA TAB and LCSA are significant and represent a serious threat to their viability and value to the Government, as owner and taxpayer.</p> <p>SA TAB – pooling arrangements; reliance on SARI for product/information; and NSW TAB's ownership of SKY TV.</p> <p>LCSA – alternative lotto and similar products and new distribution channels, particularly internet; the Lotto Bloc.</p> <p>Risks are compounded by Government ownership.</p>
<b>Preferred Method of Sale</b>	<p>Don't commit to method of sale at this point.</p> <p>However, on basis of value maximisation and risk minimisation, individual trade sales should provide best result (perhaps 20-35% control premium).</p> <p>Suggest further look at Strategic Investor/IPO.</p> <p>At least 5-10% discount for full IPO.</p>	<p>Stand-alone trade sale was preferred for SA TAB alone.</p> <p>IPO not appropriate due to lack of scale /relatively low value.</p>	<p>LCSA sale not recommended by BT – suggested review performance of LCSA after IT implementation, then make a "sell/no sell" decision.</p> <p>If sale proceeded, stand-alone trade sale would be preferred option – in parallel with SA TAB, if practicable</p> <p>IPO not recommended for LCSA – price discount of 20-30%, time delays - but can address broader Government considerations.</p>	<p>Strategic Investor/IPO option preferred - gives good value and achieves other Government objectives, but is complex and time-consuming, may be difficult to locate a strategic investor.</p> <p>Considered "merge and trade sale" (including Casino) as the next best option - \$22m of synergies available to maximise sale value, offers the prospect of retaining a head office and deeper investor interest.</p> <p>Now recommends parallel sale of SA TAB/LCSA</p>
<b>Merger of TAB/LCSA</b>	<p>Not preferred - lack of apparent synergies and/or growth profile, may transfer value to SARI.</p> <p>Forgoes opportunity to sell assets separately.</p> <p>Adds scale to an IPO.</p>	<p>Merger may offer scope for enhanced development/distribution/ cost savings (approx synergies: \$3-5 million pa).</p> <p>Would facilitate IPO if Government preferred this sale methodology.</p> <p>Merger would be received well by IPO investors but may deter some trade investors.</p>	<p>Not preferred - unlikely to produce a better financial outcome, although a simultaneous trade sale may attract a strategic premium.</p> <p>Lotteries not seen as "hard gambling - rationalisation of outlets risks alienating "soft gambling" Lottery customers.</p> <p>Some scope for cost synergies of up to \$1 million pa</p>	<p>In light of decision to sell Casino separately, next recommendation was for merge and trade sale of SA TAB/LCSA – \$22m synergies still achievable to extract maximum sale value.</p> <p>No problem with mix of "soft" and "hard" gambling</p> <p>Takes time and could be tough road for Government – therefore current recommendation is for "parallel" sales program, including a "blueprint" for merger.</p>
<b>Merger with Casino</b>	<p>Possibly some synergies, given SA TAB also a "hard" form of gambling.</p> <p>Adds scale to IPO but offers no growth.</p>	<p>No advantage - operation of a casino differs substantially from managing widely distributed gaming operations.</p>	<p>No advantage - no significant cost or revenue synergies from merger of casino with LCSA.</p>	<p>Yes - would add "fizz" for investor and facilitate preferred sale strategy.</p> <p>Minimal merger synergies/cost savings</p>
<b>Merger with Gaming Machine Business</b>	<p>Adds growth profile and investor appeal, though may present political difficulties.</p> <p>Adds scale to an IPO.</p>	<p>Yes - eg - increased gaming machine limit per venue, together with an aggregate limit.</p> <p>Challenges include the developed state of the gaming machine market.</p>	<p>Yes - eg - increased gaming machine limit per venue, together with an aggregate limit.</p> <p>Challenges include the developed state of the gaming machine market.</p>	<p>Yes - eg - increased gaming machine limit per venue, together with an aggregate limit.</p> <p>Challenges include the developed state of the gaming machine market.</p>

**Confidential**

# **South Australian Gambling Industry**

**Merger and Sale of SATAB and SA Lotteries  
Review of Implementation Issues**



**August 1999**

**CREDIT  
SUISSE**

FIRST  
BOSTON

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# 1. Executive Summary

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## 1.1 Introduction

Credit Suisse First Boston Australia Limited ("CSFB") was engaged by the Government of South Australia (Asset Sales Unit – Gaming) in June 1999 to undertake a Feasibility Study of the options available to the Government for privatising the gambling businesses which it owns. These businesses include SA Lotteries, SATAB and the Adelaide Casino.

Following completion of the Feasibility Study, we have been asked to provide further advice in relation to implementation issues, particularly with respect to the timing of an announcement of the Government's privatisation strategy and an appropriate communications strategy. Based on discussions with Government officers and the Asset Sales Unit (Gaming), we understand that the Government is currently considering a preferred privatisation strategy which would involve:

- (a) a merger of SATAB and SA Lotteries (together, the "Businesses");
- (b) a trade sale of the merged entity;
- (c) a possible allocation of gaming machine licences to the merged entity; and
- (d) a separate sale of the Adelaide Casino.

The analysis and advice in relation to implementation issues set out below assumes that the above privatisation strategy is adopted. However, we have not specifically reviewed the steps required to implement changes to the gaming machine sector in this report.

## 1.2 Key Recommendations

Both the merger and trade sale of SATAB and SA Lotteries will require legislation to be amended. While the merger/sale legislation should be relatively straight-forward to prepare, other legislative amendments will be required, including defining a new regulatory regime and on-going arrangement with the South Australian Racing Industry ("SARI"). It is unlikely that these aspects could be completed in time for legislation to be passed in the Spring 1999 session. If this is the case, the timetable for the merger/trade sale will be driven by the next opportunity to introduce legislation, ie. late March 2000.

Given this timeframe, there is no immediate need to announce the proposed merger/trade sale process. However, as work progresses, there is a risk that the Government's preferred approach will "leak", which could justify an announcement relatively early in the process. We recommend not making any announcement within the next six weeks to allow for the following important steps to be taken:

- (a) management of SATAB and SA Lotteries to work together to develop an initial merger business plan. If management are told that the Government intends to conduct a merger/trade sale before a merger business plan is prepared, they will have little incentive to co-operate in the process (absent other arrangements such as bonuses);
- (b) initial negotiations on a product supply agreement with SARI to take place. Post-announcement, SARI is likely to seek a share of SA Lotteries' income; and
- (c) an analysis of any competition issues that may arise under Section 50 of the Trade Practices Act from merging and selling SATAB and SA Lotteries, including a scenario where the purchaser has also acquired Adelaide Casino.

During this timeframe other preparatory steps would also be taken, including a review of human resources issues, attempting to resolve SATAB's pooling arrangements with TABCorp and commencing the design of a new regulatory regime.

If the Businesses are to be merged and integrated prior to undertaking the sale process, it is unlikely that a transaction could be completed before late 2000, as activities of the Businesses could not be combined until legislation is passed. Alternatively, SATAB and SA Lotteries could be privatised by way of a parallel trade sale process, with a detailed merger implementation plan and post-merger financial forecasts provided to bidders. The successful purchaser would then implement the merger. We believe that the parallel trade sale approach could be completed up to three months earlier, without sacrificing value. This approach also leaves flexibility to sell each business to a different purchaser if this provides greater value.

Successful completion of the merger/trade sale requires strong process management and control. In the following Sections, we outline proposed structures for management of the process by the Government and its advisers. It may also be desirable to restructure the Boards and management teams of the Businesses shortly after announcement, to ensure that they are understanding and supportive of Government objectives throughout the process.

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## 2. Summary Implementation Timetable

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### 2.1 Overview

CSFB recommends that an announcement of a decision by the Government to merge the Businesses and conduct a trade sale should be deferred for a period of at least six weeks following an in-principle decision to allow for:

- (a) the risk of management not co-operating fully in the sale process once they become aware of a decision to privatise by way of a trade sale and not an IPO. Management of the Businesses will be required to undertake a detailed Merger Feasibility Analysis and the State will benefit from management "buying-in" to the process of quantifying merger synergies before they become aware of the Government's final decision on the form of sale;
- (b) Government to determine its position with respect to SARI including negotiating team, parameters and timeline, and commence negotiations for a future product supply agreement. Ideally an agreement would be struck prior to announcement, although we consider this unlikely. However, it may be possible to reach agreement on key principles; and
- (c) an analysis of competition issues in respect of the proposed merger to be undertaken and, if any concerns arise, for the ACCC or the NCC to be approached.

Other elements of the preparations for the trade sale and merger could also occur during this pre-announcement period, including a review of the proposed treatment of employees in the sale and merger process and a review of SATAB business issues.

As noted in our Feasibility Study, there are different approaches to conducting trade sales which could be applicable to the Businesses, namely:

- (a) implementing a merger of the Businesses and realising the majority of the synergies before conducting a sale process. The timeframe under this approach could be quite long, as a merger cannot be implemented until legislation is passed; or
- (b) a trade sale of the two separate Businesses as part of one sale process (ie. bids for both Businesses are received at the same time). A merger business plan would also be prepared and would be the basis for financial forecasts used in the sale process.

We would not expect the sale values achieved by the Government in parallel trade sales of the Businesses to be materially different from the value achieved in a sale of the merged entity. The merger business plan should set out the cost reductions and revenue enhancements likely to be achieved through a merger and implementation strategies to achieve those synergies. Each of these approaches is discussed in more detail below.

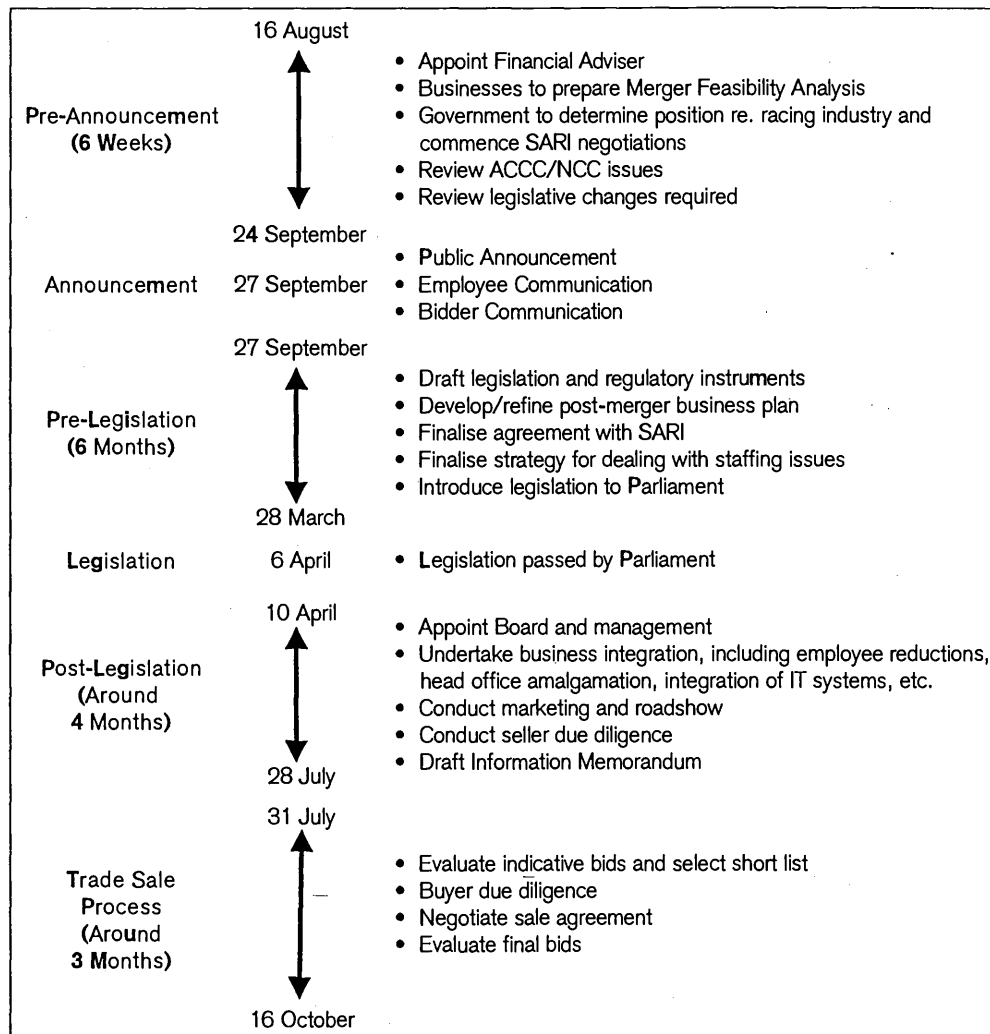
### 2.2 Trade Sale of Merged Businesses

The introduction of legislation is a key driver of the post-announcement timetable for implementing a merger and conducting a trade sale of the merged entity. It is not possible to implement a full-scale merger of the operations of SATAB and SA Lotteries without amending the legislation. If legislation enabling a merger of the Businesses is not passed in the Spring sitting, it will not be possible to implement the merger before the next Parliamentary sitting in March 2000. As the legislation will need to cover a merger, sale, arrangements with SARI and a new regulatory regime appropriate for the privatised Businesses, we do not think it is realistic to expect that legislation could be prepared

and passed by Parliament during the Spring 1999 session.

A summary timetable, on the basis that the merger is implemented before the trade sale process commences, is set out below.

### Summary Implementation Timetable Trade Sale of Merged Businesses

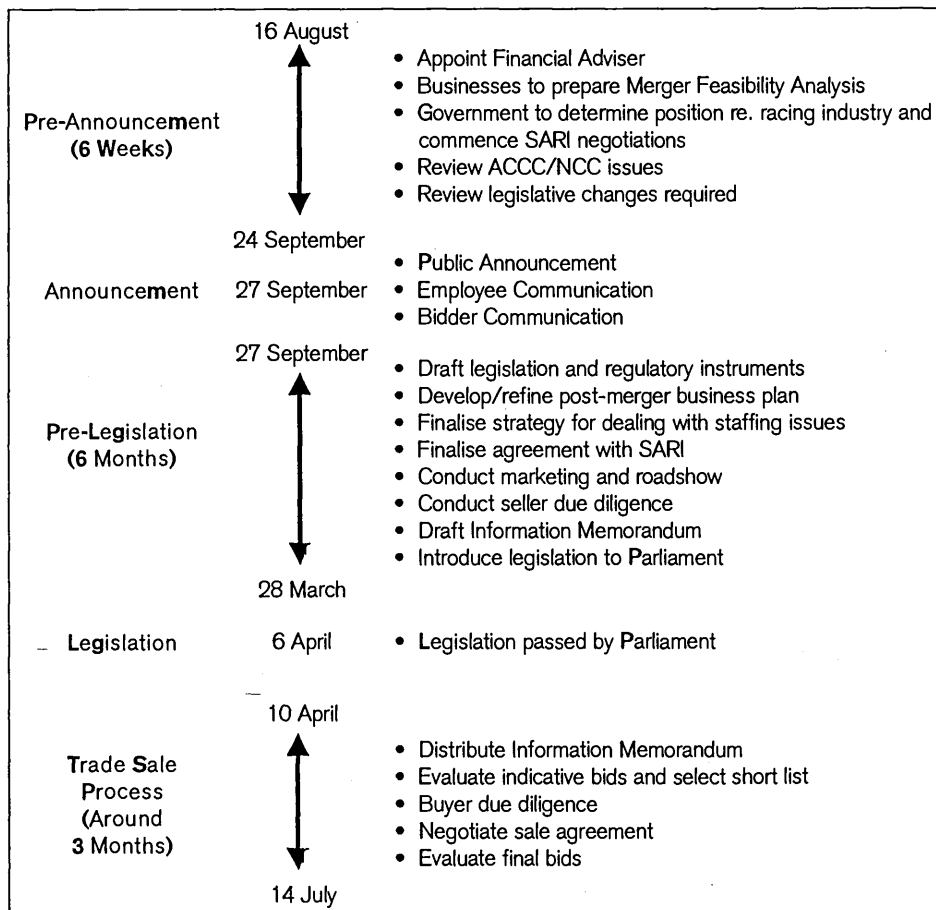


Even if the legislation is passed by Parliament in April 2000, enabling the implementation of the merger to commence in the first half of the year 2000, the approach set out in the above timetable does not allow sufficient time for many of the merger synergies to be realised and demonstrated before sale. As a result, implementing the merger before conducting the sale process would only have a marginally positive, if any, impact on sale value, relative to a separate but parallel sale of the Businesses, where a merger implementation plan is made available to bidders.

## 2.3 Parallel Trade Sale of Businesses

If the merger of the Businesses is not implemented prior to sale, the trade sale process can commence immediately after the legislation is passed by Parliament. Preparations for the sale process, including marketing, seller due diligence and preparation of an Information Memorandum, could commence prior to legislation being passed. We note, however, that the product supply agreement with SARI and the merger business plan (including post-merger financial forecasts) would need to be finalised before the Information Memorandum can be prepared. A summary implementation timetable for this scenario is set out below. A more detailed timetable is provided in Appendix 1.

### Summary Implementation Timetable Trade Sale of Businesses Separately



We note that the main timing constraint is amending the legislation. If this could be achieved in the Spring 1999 session, the process could be completed up to four months sooner.

The parallel trade sale approach offers the following advantages:

- it could be implemented quicker than the alternative, as the sale process (rather than the merger implementation) could commence as soon as legislation is passed;
- it transfers merger implementation risks to the purchaser; and
- in the event some parties wish to bid for one business only, it facilitates consortium bids and

may therefore attract wider interest, particularly from smaller companies.

The possible disadvantages of this approach are:

- (a) it would take longer to implement an IPO as a fall-back in the event that market conditions changed materially from today and an IPO was an attractive alternative (which is only likely to be an issue if there is a very small field of bidders); and
- (b) if there is political opposition to the privatisation of SA Lotteries, opponents may view it easier to separate SA Lotteries from SATAB under this approach than under a merger and sale approach.

We believe that the advantages of the parallel sale process are such that this process should be adopted, rather than merging the Businesses under State ownership prior to sale.

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## 3. Management Framework

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### 3.1 Overview

We recommend that planning and implementation of the merger of the Businesses and their subsequent sale be overseen by a Steering Committee, reporting to the Minister for Government Enterprises. The Steering Committee would have overall responsibility for reviewing progress, identifying and monitoring policy issues, elevating policy decisions to Government level and co-ordinating cross-government resources. The Steering Committee would comprise representatives of the Asset Sales Unit (Gaming), other key departmental representatives (such as Crown Law) and the Government's Financial Adviser.

Responsibility for day-to-day project management and implementation would rest with the Financial Adviser. While all support advisers, working groups and committees would report to the Steering Committee, the Financial Adviser would be responsible for co-ordinating these resources.

### 3.2 Pre-Announcement

Before the announcement of the Government's privatisation strategy, the number of participants in the preparation process should be minimised, in order to reduce the possibility of information leaks.

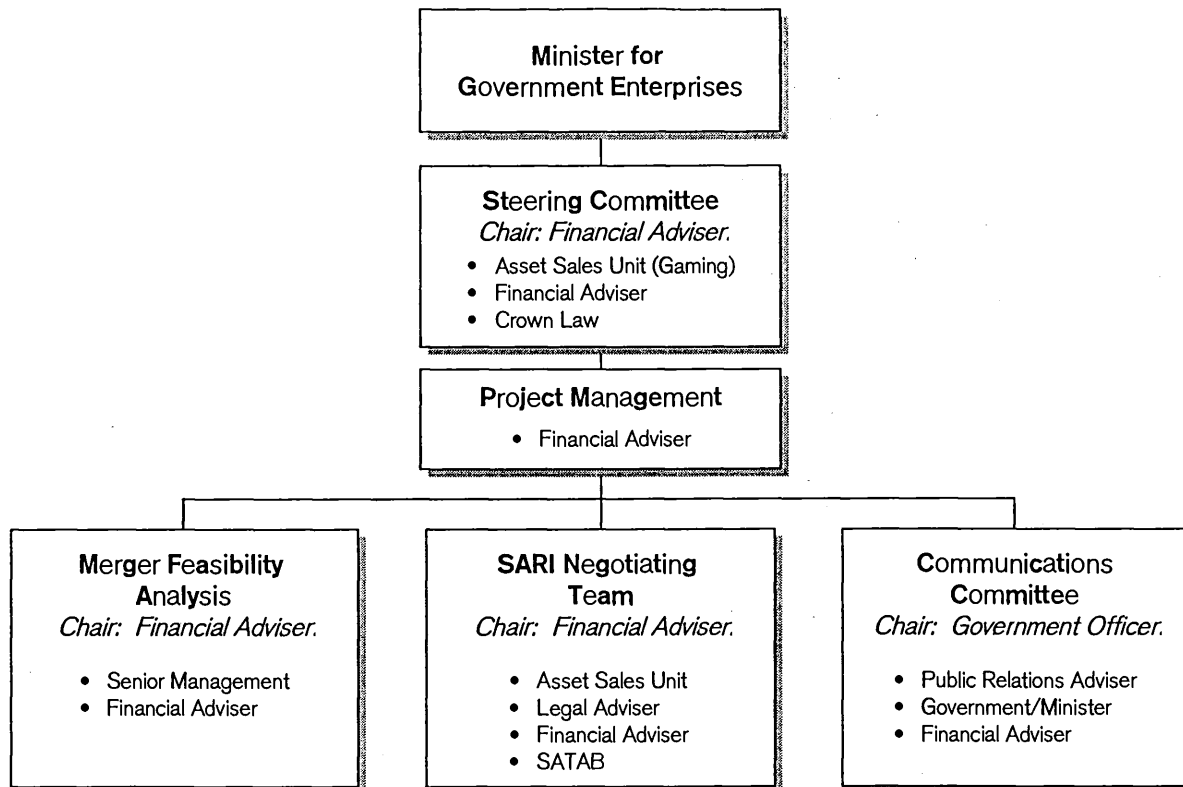
A small working group, comprising senior management from each of the Businesses (CEO and CFO) and the Financial Adviser, should be formed to undertake a Merger Feasibility Analysis. As discussed in Section 4.3, management of the Businesses would not be advised of the Government's in-principle decision to proceed with a merger/trade sale, in order to maximise their incentives to co-operate in identifying merger synergies. The Financial Adviser would chair the working group. The objective of this process is to enable management to "buy-in" to the merger process and feel that they have helped to develop a business case for proceeding with the merger. Management are likely to have an interest in this process if they think that there is a possibility of a transaction (preferably an IPO from their perspective).

As management's participation in this process may not strictly form part of the charter for each business, the co-operation of the management (and Board) of each entity will be required. It may also be necessary for the Minister to issue appropriate directions to the Businesses.

A negotiating team will also need to be formed to undertake discussions with SARI, upon finalisation by Government of policy decisions in relation to the racing industry. The negotiating team should comprise representatives of the Asset Sales Unit and the Financial Adviser. Legal counsel will also play a key role in the negotiations and in documenting the arrangements with SARI. Due to the commercial issues involved, we would recommend using an external Legal Adviser in the negotiations. The Financial Adviser would chair the working group.

More detailed planning and preparation will also be required for the announcement (refer Section 5). A Communications Committee should be formed to oversee these preparations, comprising Government officers, a public relations consultant and the Financial Adviser. A Government officer, such as a Government media spokesperson or senior Ministerial adviser, would chair the Communications Committee.

## Management Framework Pre-Announcement



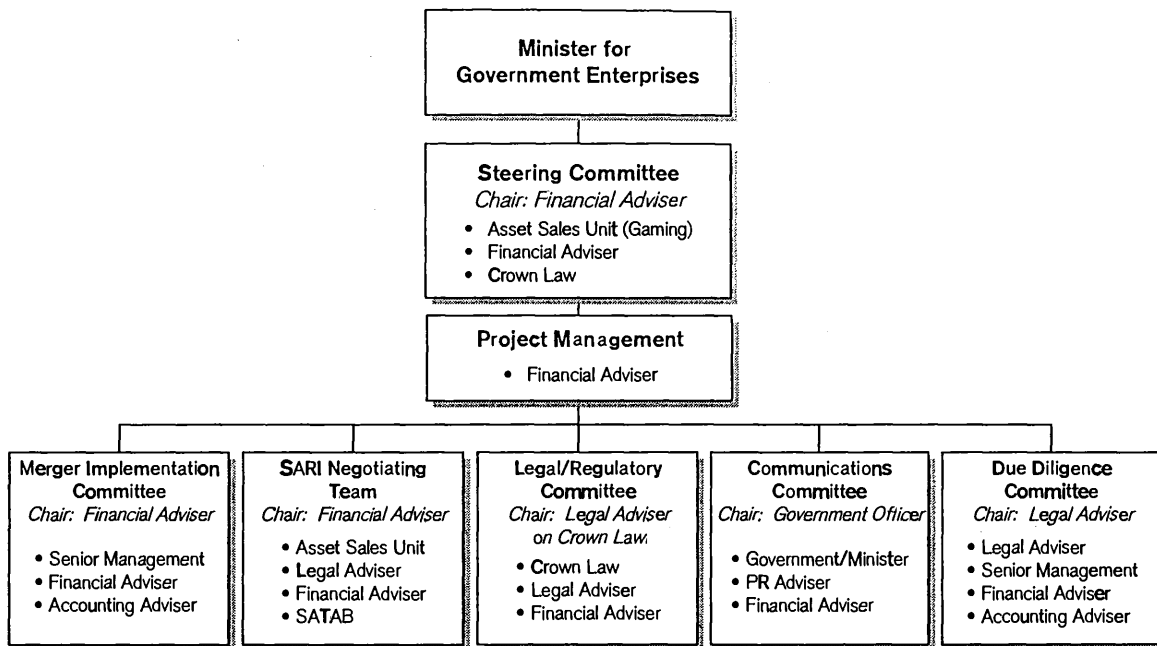
### 3.3 Post-Announcement

Following announcement of the Government's privatisation strategy, the working group formed to prepare the Merger Feasibility Analysis would form the core of a formal Merger Implementation Committee, responsible for finalising the merger implementation plan and post-merger financial forecasts. The Government's Accounting Adviser would participate in this Committee, focusing specifically on pro-forma financial-statements and the preparation of post-merger financial forecasts and providing advice on tax issues. This Committee would be chaired by the Financial Adviser.

A separate Legal/Regulatory Working Group would be formed to drive the legislative reform process. The Legal/Regulatory Working Group could be chaired either by Crown Law or by an external Legal Adviser. Provided confidentiality could be maintained, this group (or a sub-set thereof) could commence work in the pre-announcement period.

Once the business preparation and merger stage has been completed, a Due Diligence Committee would be formed to oversee seller due diligence, drafting of the Information Memorandum and to facilitate buyer due diligence. It would be preferable for the Due Diligence Committee to be chaired by an external Legal Adviser, who has prior experience in managing due diligence processes in sale transactions. A framework for management of the process (post-announcement) is set out below.

## Management Framework Post-Announcement



### 3.4 Ministerial Delegations

In our experience with industry reform and privatisation processes, we have found that the most effective and timely decision making structures are characterised by clear Ministerial accountability for the entire process and regular, frequent briefing and decision making meetings between the key advisers, senior bureaucrats and the Minister. We recommend that the Steering Committee should meet weekly to review progress and to identify key policy issues that need to be dealt with at government level. Briefings between the Minister, senior bureaucrats and Financial Adviser should take place at least fortnightly, and possibly more regularly when issues require regular attention (ie. during SARI negotiations).

To facilitate an efficient decision making process and avoid the need to refer each issue to Cabinet or to a Cabinet Committee for consideration, the Minister should have delegated authority to deal with implementation issues, within the parameters of the overall reform and privatisation strategy approved by Cabinet. For example, the Minister should have delegated authority to make decisions in respect of commercial negotiations undertaken on behalf of the Businesses (including SARI product supply and TABCorp pooling arrangements), to approve business restructuring initiatives and to appoint management. Decisions that would require approval by Cabinet or the Cabinet Committee include appointment of Directors and key regulatory issues with a substantial impact on value, such as gaming tax rates or decisions on broader policy areas, such as probity.

### 3.5 Role of SATAB and SA Lotteries Boards

The current boards of directors of the Businesses are:

SATAB	SA Lotteries
John Branson, Presiding Member Vickie Chapman, Deputy Presiding Member David Seymour-Smith Richard Krantz John Patten Janet Grieve (One position currently vacant)	Warren Wilson, Chairman Suzanne Briggs Peter de Messurier Philip Plummer

We understand that current legislative provisions in respect of the Boards include:

	SATAB	SA Lotteries
Number of directors	Seven (including minimum of two men and two women)	Minimum of three and maximum of five
Ability to remove	Government can remove	Can only remove for misconduct or incapacity to perform duties
Qualifications/experience	Financial, marketing, legal, carrying on business or racing industry	None specified

Careful consideration will need to be given to Board membership to ensure that Board members' own agendas align with the objectives of the Government. We note that the SA Lotteries Chairman is currently a director of TABCorp Ltd, which could give rise to a conflict of interest.

A restructuring and sale transaction such as that contemplated for SATAB and SA Lotteries is a complex and difficult process. In our experience, it is highly desirable to have Boards (and management teams) that are understanding and supportive of the Government's objectives. We would therefore normally recommend relatively small boards largely performing an administrative role during the transition period. Given the existing legislative restrictions, this is not possible prior to legislation. However, we recommend reviewing each of the current Boards with a view to taking the following actions:

- (a) discussing with the SA Lotteries directors the Government's plans to try to encourage any directors who are not supportive or have conflicts to resign. The minimum number of directors (three) would be appointed, if necessary; and
- (b) removing any SATAB directors who are unlikely to be supportive of the Government's proposals and reasonably compliant throughout the process or have potential conflicts of interest. It may be possible to replace these directors with directors who are also members of the SA Lotteries Board.

These steps should be undertaken after completion of the Merger Feasibility Analysis (ie. post-announcement).

## 4. Steps to be Considered Before Announcement

### 4.1 Overview

We recommend deferring any announcement of the Government's privatisation strategy for a period of at least six weeks while the following "pre-announcement" steps are taken:

<b>Management Framework</b>	<ul style="list-style-type: none"> <li>• Appoint Financial Adviser.</li> <li>• Form Steering Committee and establish decision-making framework.</li> <li>• Brief Public Relations Adviser to prepare announcement.</li> </ul>
<b>Racing Industry Negotiations</b>	<ul style="list-style-type: none"> <li>• Determine Government position; establish parameters (including any entitlement to a share of non-racing income) and team for negotiations.</li> <li>• Commence negotiating product supply agreement with SARI.</li> <li>• SARI should not be advised of in-principle decision to merge Businesses as this would weaken the State's negotiating position.</li> </ul>
<b>Merger Feasibility Analysis</b>	<ul style="list-style-type: none"> <li>• Form working group to prepare Merger Feasibility Analysis.</li> <li>• Businesses should not be advised of in-principle decision regarding method of sale to ensure co-operation in identifying cost reductions.</li> </ul>
<b>Competition Issues</b>	<ul style="list-style-type: none"> <li>• Seek Crown Law advice on implications of merger for ACCC/NCC issues.</li> <li>• If necessary, approach ACCC/NCC regarding merger of the Businesses.</li> </ul>
<b>Regulatory Review</b>	<ul style="list-style-type: none"> <li>• Crown Law to undertake review of legislative changes required to implement Government's preferred privatisation strategy.</li> </ul>
<b>HR/IR Review</b>	<ul style="list-style-type: none"> <li>• Review proposed treatment of employees in the sale and merger process.</li> </ul>
<b>SATAB Business Issues</b>	<ul style="list-style-type: none"> <li>• Review status of pooling arrangements and IT requirements.</li> </ul>

Each of these pre-announcement steps is discussed in more detail below. In our view, it is particularly important to involve management in preparing a detailed assessment of cost reductions and synergies, through management's participation in the Merger Feasibility Analysis, before management become aware of a preference to conduct a merger and trade sale. Once management become aware of a decision to conduct a trade sale, they may not co-operate fully to identify merger synergies.

Given the timeframe for introducing and passing legislation, it is not essential that an announcement occur after six weeks. An announcement could be delayed provided no leaks were occurring.

### 4.2 Racing Industry Negotiations

SATAB does not currently have a formal agreement with SARI for the supply of local and interstate racing information. Given the fundamental importance of racing information to SATAB's business, investors in a privatised SATAB would require the arrangements to be formalised, in order to mitigate the risk of loss of supply.

In other States, industry reform and privatisation has led to significant increases in the remuneration provided to the respective racing industries as part of the renegotiation of a formal product supply agreement with the respective TAB. In Victoria and NSW, a key driver of the increased returns to the racing industry has been an entitlement to a share of non-racing profits. In Victoria, for example, 25% of TABCorp's surplus from gaming machine operations is distributed to the racing industry.

Once SARI becomes aware of the Government's intention to merge the Businesses, it is likely to seek a share of returns from SA Lotteries (and gaming machines, if a block of licences is to be issued to the merged entity) based on precedents in other States. In the event of a merger of the Businesses, a decision by Government to allow SARI to participate in the returns from non-racing products would represent a transfer of value from the State to SARI.

If the Government intends to prevent a value transfer to the racing industry, its negotiating position would be stronger while SARI is not privy to the Government's consideration of merging the Businesses. On this basis, we recommend that negotiations with SARI should commence ahead of an announcement of the Government's preferred privatisation approach. However, we note that there is still some risk the Government's consideration of a merger of the Businesses will leak to SARI, particularly once the Businesses become involved in preparing the Merger Feasibility Analysis.

In our view, it is unlikely that the Government will succeed in concluding negotiations with SARI in the six week timeframe before an announcement. However, in view of the issues discussed above, negotiations should commence as soon as possible, with the aim of at least reaching in-principle agreement with SARI on key issues before an announcement is made. We note that, should an agreement not be finalised in time for the preparation of financial forecasts to be included in the Information Memorandum, the trade sale process will be delayed.

Given that the outcome of negotiations will have a direct impact on the value of the Businesses, the negotiations should be undertaken by a group of Government representatives and advisers, with SATAB management, rather than by SATAB management alone. We recommend a small negotiating team comprised of the Asset Sales Unit (Gaming), the Government's Legal Adviser and its Financial Adviser and the Chief Executive of SATAB. The negotiating team would report to the Steering Committee.

We note that, before negotiations can commence, the Government will need to determine its position on the following key issues:

- (a) whether it is prepared to transfer value to SARI by allowing SARI to share in returns from non-racing products (ie. lotteries and/or gaming machines);
- (b) at what level SATAB's future payments to SARI are to be set and on what basis those payments are to be calculated. We note that SARI currently receives around \$33 million from SATAB per annum (amounting to around 32% of net wagering revenue), which is at risk as it is tied to SATAB's performance;
- (c) any conditions to be imposed on SARI, such as reforms to the racing industry;
- (d) whether the State will provide additional funding directly to the racing industry. We note that RIDA is currently receiving around \$3.5 million per annum of funding from the State;
- (e) the future structure of the industry, particularly the role of RIDA; and
- (f) the nature of the relationship between SATAB and SARI (eg. joint venture vs. buyer/supplier arrangement).

#### **4.3 Merger Feasibility Analysis**

Early in the business preparation/merger process a working group should be formed to prepare a comprehensive Merger Feasibility Analysis. The working group would be responsible for identifying

cost reduction opportunities and merger synergies and preparing detailed implementation strategies. The working group should prepare a business plan for the merged entity, including post-merger financial projections.

The working group responsible for preparing the Merger Feasibility Analysis would be comprised of the Chief Executive Officers and the Chief Financial Officers from each of the Businesses. The Government's Financial Adviser would also participate, providing independent feedback and analysis to the Steering Committee on progress made in identifying cost reductions and synergies.

The unfettered co-operation of management of both Businesses is critical in identifying the full extent of cost reduction and revenue enhancement opportunities arising from the merger. Members of the existing management teams have strong views about the future of the Businesses, that is, whether or not they should be merged and whether they should be sold by way of a trade sale or an IPO. In particular, SATAB's senior management have strongly advocated a merger and IPO of the Businesses. Once management become aware of any decision by the Government to move ahead with a trade sale of the merged entity, rather than an IPO, management may not co-operate fully in identifying cost reduction opportunities and synergies.

As a result, we recommend that the working group should be given a suitable timeframe (around three to four weeks) in which to commence preparing a merger implementation plan by identifying and assessing cost reduction/revenue enhancement strategies and post-merger financial projections, before the Government's preferred sale strategy is announced. Under this approach, we would expect the elements of the management teams who advocate an IPO to co-operate to the fullest extent possible, in the hope of the Government adopting their preferred approach. Care should be taken to ensure that the Government's preference for a trade sale approach is not disclosed or "leaked" to SATAB or SA Lotteries management ahead of any announcement.

Furthermore, there is a risk that disclosure of the Government's strategy not only impacts management's openness and willingness to participate in planning the merger, but could precipitate the departure of some senior executives before an initial merger plan can be completed. It is desirable that the initial merger analysis be conducted before any changes in Boards or management occur.

As an alternative to undertaking the Merger Feasibility Analysis before the announcement, the Government may wish to consider providing financial incentives to key management, linked to the identification of merger synergies. The Chief Executive Officer and the Chief Financial Officer of each of the Businesses could be paid a bonus for delivering a business plan which sets out justifiable savings that could be achieved through the merger. The bonus payment may be linked partly to the level of savings included in the post-merger financial forecasts and partly to the sale proceeds achieved. This scheme would be implemented, if necessary, after the Feasibility Analysis is substantially complete, if it is apparent that management has not been forthcoming in fully identifying merger benefits. We understand that it may be difficult for the Government to implement such a scheme, as it may have consequences for other assets being privatised.

It should be noted that the cost reductions and revenue enhancements incorporated in the valuation analysis undertaken by CSFB and set out in our Feasibility Study include synergies resulting from a merger of the Businesses and synergies achieved by merging the Businesses with the existing operations of the purchaser. As a result, the synergies identified by the Businesses, even with the full co-operation of management, are likely to be below the total synergies incorporated in our trade sale valuation. Bidders will assess the additional benefits that can be achieved by combining the Businesses with their existing operations.

#### 4.4 Competition Issues






Before the Government's intention to merge the Businesses is announced, Crown Law should review competition issues in respect of the proposed merger, possibly with assistance from external counsel with expertise in Section 50 of the Trade Practices Act. If any concerns arise from this review, the ACCC and/or NCC should be approached prior to an announcement, in order to avoid any embarrassment caused by the competition regulators raising concerns after the announcement. The Financial Adviser would assist in preparing presentations to the ACCC and/or NCC, if necessary.

#### 4.5 Review of Legislative Changes Required

Crown Law has advised that it will not be possible to implement a merger of the Businesses without new legislation (refer Section 6.1). Parliament's spring sitting ends during the week of 22 November 1999 and the next sitting does not commence until March 2000. Hence, drafting of the reform legislation enabling the merger would need to be finalised within three months, if the legislation were to be introduced to Parliament before the end of the year.

While drafting of legislation to enable a sale of State-owned businesses may be relatively straightforward, the legislative changes necessary in this case would involve the creation of a new regulatory body and licensing regime, and would need to reflect the agreement reached with SARI. We believe that it is unlikely that the detailed planning required for the new regulatory and licensing regime and the associated Government decisions, as well as the negotiations with SARI, can be completed quickly enough to facilitate finalisation of legislation before the end of Parliament's spring sitting. As a result, it is unlikely that a merger of the Businesses can commence this year.

In order to expedite drafting of the legislation after announcement of the Government's privatisation strategy, a detailed plan of the post-privatisation regulatory framework and a review of the legislative changes required to effect that framework should be undertaken as soon as possible. This process would be co-ordinated by Crown Law and should address:

	Establishment of single regulatory body to oversee SATAB, SA Lotteries and the Adelaide Casino.
	Licensing framework for Businesses (including expiry, exclusivity, products covered, maximum deduction rates, etc).
	Corporatisation of the Businesses.
	Transfer of the Businesses to private ownership.
	Changes to facilitate gaming machine licence buy-back/re-issue programme and allocate block of licences to merged entity (subject to Government policy decision).

#### 4.6 Human Resources and Industrial Relations Review

The number of employees of each Business as identified in CSFB's Feasibility Study in June 1999 are:

	SATAB	SA Lotteries
Full time	114	95
Part time	69	-
Casual	<u>393</u>	<u>-</u>
	<u>576</u>	<u>95</u>

Some rationalisation of jobs is an inevitable outcome in the event of a merger and/or trade sale if full value is to be realised. The likely scope of job losses following a merger of SATAB and SA Lotteries will be identified in the Merger Feasibility Analysis. In CSFB's Feasibility Study, we estimated possible job losses of 235 from a merger and trade sale (including eight positions from the Casino). These estimates reflect an assessment that, in a trade sale, the purchaser is likely to be an existing industry operator who will realise additional savings, over and above those achieved by combining the South Australian businesses, from combining some operations across States. The estimates set out in CSFB's Feasibility Study reflect a closure of the SATAB and SA Lotteries head offices and SATAB's telephone betting centre, as well as some reductions in SATAB's agency staff.

As part of the preparations for the announcement, it will be necessary to undertake a review of the relevant industrial Awards and Enterprise Agreement to ensure that there is no scope for unions to claim change of ownership payments.

To the extent that job losses are a sensitive political issue, the Government will need to develop a policy for dealing with employees in the process. The alternatives could include:

- (a) allowing the purchaser to determine appropriate employment levels and achieve reductions through redundancy arrangements in the current Enterprise Agreements. We understand that both Businesses have Enterprise Agreements which provide mechanisms for redundancies and that SATAB's Enterprise Agreement also quantifies redundancy payments;
- (b) Government transferring those employees who are not offered employment by the purchaser to positions elsewhere in the public sector. This would merely transfer the problem elsewhere in Government and would likely represent a financial burden for the State;
- (c) require the purchaser to maintain minimum employment levels through either:
  - (i) the sale agreement stipulating minimum levels; or
  - (ii) Government taking offers to maintain/enhance South Australian employment levels (eg. through maintaining a call centre in or moving operations to Adelaide) into account in the final bid evaluation. We note that valuing such measures is somewhat subjective and may cause some concerns to bidders about the "fairness" of the bid evaluation process.

The Government should recognise that commitments aimed at maintaining employment levels are not necessarily effective in the long-term.

It is desirable to establish a policy with respect to employees prior to the legislation being presented to Parliament, and possibly before any announcement.

#### **4.7 SATAB Business Issues**

There are several issues with SATAB's business which will have important value consequences in any trade sale, including:

##### *Pooling Arrangements*

SATAB currently relies on TABCorp for pooling arrangements to increase the size of prize pools for SATAB customers. Absent such arrangements, South Australian punters may use interstate TABs. The current pooling arrangement is a continuation of previous arrangements, although that contract has expired. TABCorp is seeking to enter a new long-term agreement.

It would be desirable for the privatisation if a formal pooling arrangement is in place, however, this should only be a relatively short-term arrangement. Given the reliance on pooling arrangements, the risk of not having an arrangement in place is that bidders other than existing TABs (ie. TABCorp and TAB Ltd) will be in a much weaker position in the bidding process. There may be an opportunity for the Government to become involved in discussions with TABCorp on the basis that privatisation will not proceed without a satisfactory agreement.

### *IT System*

We understand that SATAB is seeking Government approval for a new wagering information technology system. Sharing of IT infrastructure represents one of the key areas for potential cost reductions in a merger of SATAB with SA Lotteries (which has recently replaced its IT system) and/or with the existing operations of a purchaser in a trade sale. As a result, it would not be desirable for SATAB to undertake significant capital expenditure for a new IT system before the implementation of the merger.

The Government and SATAB will need to assess whether SATAB can continue to operate using its existing IT system until the merger or sale is implemented. If this is not possible, SATAB should be directed to enter into an arrangement with SA Lotteries, under which SA Lotteries provides access to its IT infrastructure on commercial terms (subject to confirmation that the SA Lotteries systems are capable of handling SATAB's needs). This arrangement should be covered by a short-term contract, enabling a purchaser of SATAB (in the event that it is sold separately) to make new arrangements. Although the cost of developing software to operate wagering products on SA Lotteries' system is likely to be significant, this is expected to be less costly than purchasing both hardware and software for SATAB and maintaining/staffing a separate IT centre.








## 5. Announcement

### 5.1 Overview

We understand that the Asset Sales Unit (Gaming) has already appointed a Public Relations Adviser in relation to the proposed privatisation of the Businesses. During the pre-announcement period, the Public Relations Adviser should be briefed about the Government's preferred privatisation approach and, under the guidance of the Communications Committee, make all necessary preparations for the announcement.

### 5.2 Details of Public Announcement

The public announcement of the Government's privatisation strategy should cover the following issues:

-  A review of SA Lotteries and SATAB has shown that the Businesses operate in an increasingly competitive environment, which poses risks to the State or owner.
-  The Government will proceed with preparing the Businesses for privatisation.
-  SATAB and SA Lotteries may be merged as part of the sale process.
-  New arrangements with the racing industry are to be implemented (principles agreed to date, if any, could also be announced).
-  A trade sale of the merged Businesses is to be completed by mid-2000.
-  New gaming taxes are to be introduced for SATAB and SA Lotteries.
-  A new regulatory regime will apply, which will require probity checks, maximum deduction rates and other consumer protection measures.

### 5.3 Employee Announcement

Immediately prior to making the public announcement, Government representatives should brief the Board of Directors and senior management team of each of the Businesses about the Government's plans. Management can then convey details of these plans to SATAB and SA Lotteries staff, either by way of a staff meeting (if time permits) or by circulating a written communication to all staff. To assist with this process, the Public Relations Adviser should draft a written employee communication as part of the preparations for the announcement.

The briefing provided to the Board and management and the draft employee communication may need to include details of the Government's intentions with respect to employee reductions. As indicated in Section 4.6, a review of human resources and industrial relations issues will need to be undertaken prior to any announcement.

## 5.4 Bidder Communication

Immediately following the public announcement, the Government's Financial Adviser should notify potential bidders of the Government's privatisation strategy. This would be undertaken by way of a global mailout to potential bidders. As well as providing details of the announcement, the mailout would also seek to position the Businesses as an attractive investment opportunity and would precede regular follow-up by the Financial Adviser. Effective communication of developments and Government decisions to potential bidders will be crucial in generating and maintaining awareness of and interest in the process prior to commencement of the formal marketing campaign for the sale of the Businesses.

## 5.5 Other Stakeholders

The Government's communications strategy will also need to deal with other stakeholders, including SARI, RIDA, PubTAB outlets and SA Lotteries' agencies. To facilitate effective communication of the Government's approach to these stakeholders as quickly as possible following the announcement, the necessary written materials should be prepared in advance by the Public Relations Adviser and the Communications Committee.

The announcement would be communicated to PubTAB outlets and SA Lotteries agencies through a mail-out. SA Lotteries and SATAB staff who are responsible for managing the distribution outlets will also need to be briefed to deal with questions from the outlets.

As the negotiations with SARI are unlikely to be completed prior to the announcement, and in light of the political sensitivities associated with the racing industry, it would be appropriate for the Minister for Government Enterprises and the Minister for Racing to brief SARI and RIDA about the proposed changes shortly after the public announcement. Preparations for this briefing should also be made in advance and should take into account any considerations arising from the negotiations with SARI.

## 5.6 Impact on Adelaide Casino Sale Process

If the Government decides to embark on a separate sale of the Adelaide Casino, there is no reason to prevent FundsSA from continuing to pursue a sale of the Casino ahead of an announcement of the Government's intentions with respect to SATAB and SA Lotteries. In particular, management of the Businesses involved in preparing the Merger Feasibility Analysis would already be aware of the exclusion of the Casino from that analysis.

We believe there are several potential implications of a decision to merge and trade sale SATAB and SA Lotteries on the Casino sale process, namely:

- (a) the proposed sale of the Businesses would provide growth potential for the Casino buyer and may result in a strategic premium being paid for the Casino; and
- (b) there may be competition issues under Section 50 of the Trade Practices Act if the Casino purchaser also wished to acquire the Businesses (which we would consider as part of our analysis in respect of SATAB and SA Lotteries).

Although there is no reason to delay the sale of the Casino, it would be preferable to announce the Government's approach with respect to SATAB and SA Lotteries before final bids for the Casino are received, to ensure that the Government receives the benefit of any strategic premium Casino bidders may be prepared to offer (subject to any competition issues).

## 6. Steps to be Taken After Announcement

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### 6.1 Pre-Legislation

The Lotteries and Gaming Act 1936 generally prohibits gambling by way of conducting lotteries and totalizator betting. The Lotteries and Gaming Act is to be read subject to the Lotteries Act 1966, which authorises SA Lotteries to conduct lotteries, and the Racing Act 1976, which authorises SATAB to conduct totalizator betting. Whilst it is possible for the Minister to confer additional functions on SA Lotteries, the Lotteries and Gaming Act prohibits SA Lotteries from conducting totalizator wagering. Furthermore, it is not possible to confer additional functions on SATAB under the Racing Act. As a result, it is not possible to establish a single entity which conducts lotteries and totalizator wagering, without enabling legislation.

The Boards of SATAB and SA Lotteries are appointed by the Governor on the recommendation of the Minister. Whilst the Governor may remove members of the SATAB Board from office on any ground that the Governor considers sufficient, members of the SATAB Board can only be removed by the Governor on grounds of misconduct or incapacity to perform duties. As a result, it is not possible to effectively combine the Boards of the Businesses, such that they are managed under a single umbrella, without enabling legislation.

The Boards of both Businesses are subject to the general control and direction of the Minister. It would therefore be possible for the Cabinet to approve a plan for implementing measures (based on the implementation plan prepared by the Merger Working Group) which would achieve cost reductions across the Businesses, and for the Minister to direct the Boards to implement that plan. However, it would be necessary to review each measure in the plan to determine that there is no breach of either the Lotteries Act, the Racing Act, or the Lotteries and Gaming Act.

As a result of these constraints, it would not be feasible to undertake an extensive restructure of the Businesses and combine their operations before legislation enabling the merger becomes effective. In any event, if steps were taken to combine the Businesses before legislation is introduced, there would be a risk that legislation is not passed by Parliament or is amended substantially, and that these steps would have to be reversed.

Instead of seeking to implement a full-scale merger of the Businesses (as per the implementation plan prepared by the Merger Working Group), the Government and its advisers will need to make an assessment of each specific implementation strategy. Only those strategies which do not lead to a breach of the existing legislation and which can be left in place or reversed at minimal cost in the event that legislation is not passed, should be actioned ahead of the reform legislation taking effect. For example, it may be possible for the Businesses to enter into commercial agreements for the sharing of some cost centres, such as an IT centre, call centre or combining communication lines with pubs. Directions from the Minister would be required to implement these steps.

Business issues which arise during the period between the announcement and legislation taking effect would need to be dealt with in a similar manner. One example may be the need for SATAB to install new IT infrastructure. If steps cannot be taken to defer the issue until the full-scale merger is implemented (ie. post-legislation), the Government and its advisers will need to consider whether it is possible for the Minister to direct the Businesses to enter into suitable arrangements under which SA Lotteries provides its infrastructure to SATAB.

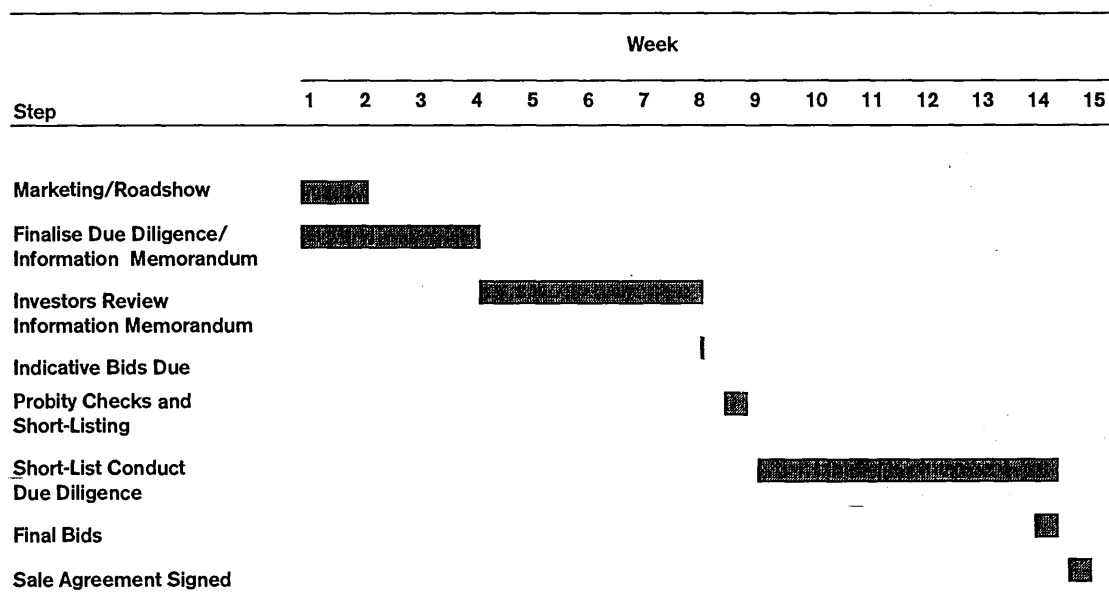
All of the planning for the merger/sale process should be completed in the period prior to legislation being passed (assuming legislation in the Autumn 2000 session). This would include:

- (a) defining the regulatory regime and drafting all regulatory instruments;
- (b) identifying Board/management post-merger (which may be the same as pre-merger assuming suitable arrangements can be made);
- (c) preparing a detailed post-merger business plan; and
- (d) preparing the Businesses for sale, including due diligence, preparation of Information Memorandum, data room, etc.

The trade sale process would commence immediately after legislation is passed.

## 6.2 Trade Sale Process

At this stage we envisage a reasonably standard two stage sale process involving the following key steps:



The key elements of the process are:

- (a) all qualitative judgements and probity checks are completed by the time of short-listing, so that final bids can be evaluated based on price and contract conditions; and
- (b) final bids are required to be fully financed and the sale agreement is 'negotiated' prior to final bids being submitted. This results in the Government negotiating contract conditions with maximum leverage. As the winning bid is likely to be selected quickly, the competitive tension is high.

As set out in the detailed timetable provided in Appendix 1, preparations for the trade sale process, including detailed planning of the probity process, initial marketing and initial vendor due diligence, would commence prior to the reform legislation being passed by Parliament. Vendor due diligence and the Information Memorandum would be finalised after the legislation is passed by Parliament.

## Appendix 1: Indicative Timetable

Stage	Week Beginning	Steps	Primary Responsibility
Government Policy Decisions	August 16 (Week 1)	• In principle decision to conduct parallel trade sales of Businesses with merger plan	Government
		• Establish overall objectives to be pursued throughout sale process (eg. value maximisation vs. job losses)	Government
		• Government policy decisions in respect of gaming tax rates, gaming machine initiatives, etc.	Government
		• Consider Government position and parameters for SARI negotiation	Government
		• Delegate decision-making authority to Minister	Government
		• Consider appointment of Financial Adviser	Government
		• Draft Ministerial Direction to Businesses to participate in Merger Feasibility Analysis	Government
		• Approach Crown Law re. review of competition issues and legislative changes	Government
Pre-Announcement	August 23 (Week 2)	• Appoint Financial Adviser	Government
		• Appoint Public Relations Adviser	Asset Sales Unit
		• Establish Steering Committee to oversee reform/sale process, with direct and frequent reporting to Minister	Government
		• Finalise Government position and parameters for SARI negotiations	Government
		• Establish SARI negotiating team and confirm authority of Racing Industry Chairman's Group	Steering Committee
		• Finalise and issue Ministerial Direction to Businesses to participate in Merger Feasibility Analysis	Minister
		• Establish group to prepare Merger Feasibility Analysis and commence work	Steering Committee
	August 30 (Week 3)	• Crown Law undertakes review of competition issues	Crown Law
		• Crown Law commences review of legislative changes required	Crown Law
		• Establish Communications Committee	Steering Committee
		• Commence preparations for announcement	Communications Committee
		• Commence negotiations with SARI	SARI Team
		• Commence preparing Merger Feasibility Analysis	MFA Group
		• Crown Law finalises review of competition issues	Crown Law
		• Consider Crown Law's advice re. competition issues and prepare ACCC/NCC presentations (if necessary)	Steering Committee

Stage	Week Beginning	Steps	Primary Responsibility
		<ul style="list-style-type: none"> <li>Review of legislative changes continues</li> <li>Preparations for announcement continue</li> </ul>	Crown Law Communications Committee
	September 6 (Week 4)	<ul style="list-style-type: none"> <li>Discussions with SARI continue</li> <li>Merger Feasibility Analysis continues</li> <li>Approach ACCC/NCC (if necessary)</li> <li>Review of Legislative changes required continues</li> <li>Preparations for announcement continue</li> </ul>	SARI Team MFA Group Steering Committee Crown Law  Communications Committee
	September 13 (Week 5)	<ul style="list-style-type: none"> <li>Discussions with SARI continue. Aim to agree key principles at this stage</li> <li>Merger Feasibility Analysis continues</li> <li>Discussions with ACCC/NCC completed</li> <li>Review of legislative changes required is finalised</li> <li>Preparations for announcement continue</li> </ul>	SARI Team  MFA Group Steering Committee Crown Law  Communications Committee
	September 20 (Week 6)	<ul style="list-style-type: none"> <li>Review status of negotiations with SARI</li> <li>Merger Feasibility Analysis finalised. Draft business plan and financial forecasts finalised</li> <li>Review results of Merger Feasibility Analysis</li> <li>Review outcome of ACCC/NCC discussions</li> <li>Review Crown Law's assessment of legislative changes required</li> <li>Finalise preparations for announcement</li> </ul>	Steering Committee/ Minister MFA Group  Steering Committee/ Minister Steering Committee/ Minister Steering Committee/ Minister Communications Committee
Announcement	September 27 (Week 7)	<ul style="list-style-type: none"> <li>Public announcement of privatisation strategy</li> <li>Brief Boards/management and conduct employee announcement</li> <li>Advise potential investors</li> <li>Advise other stakeholders, including SARI, RIDA, agencies/outlets</li> </ul>	Government Communications Committee Financial Adviser Government/ Communications Committee
Pre-Legislation	October 4 - March 20 (Weeks 8-32)	<ul style="list-style-type: none"> <li>Revision to Board/management teams</li> <li>Continue negotiations with SARI</li> <li>Appoint Accounting Adviser</li> <li>Appoint Legal Adviser for sale process</li> <li>Appoint probity auditor</li> <li>Develop detailed merger implementation plan based on merger Feasibility Analysis</li> <li>Commence drafting legislation</li> <li>Finalise regulatory model</li> </ul>	Steering Committee SARI Team Asset Sales Unit Asset Sales Unit Asset Sales Unit Merger Implementation Committee Legal/Regulatory Committee Legal/Regulatory Committee

Stage	Week Beginning	Steps	Primary Responsibility
		<ul style="list-style-type: none"> <li>Finalise negotiations with SARI and document agreement</li> <li>Deal with business initiatives etc. on case-by-case basis</li> <li>Establish preferred process and timetable for trade sale including detailed bidding rules</li> <li>Determine and implement process for conducting probity review</li> <li>Approach/market to potential bidders and seek expressions of interest</li> <li>Establish Due Diligence Committee</li> <li>Commence vendor due diligence</li> </ul>	<p>SARI Team</p> <p>Merger Implementation Committee</p> <p>Steering Committee</p> <p>Steering Committee</p> <p>Financial Adviser</p> <p>Steering Committee</p> <p>Due Diligence Committee</p>
Legislation	March 27 (Week 33)	<ul style="list-style-type: none"> <li>Finalise draft legislation</li> <li>Introduce legislation to Parliament</li> </ul>	<p>Legal/Regulatory Committee</p> <p>Government</p>
	April 3 (Week 34)	<ul style="list-style-type: none"> <li>Legislation passed by Parliament</li> </ul>	<p>Government</p>
Trade Sale Execution	April 10 – May 1 (Weeks 35-38)	<ul style="list-style-type: none"> <li>Complete vendor due diligence</li> <li>Finalise Information Memorandum</li> <li>Commence collation of data room information</li> <li>Conduct investor roadshow</li> </ul>	<p>Due Diligence Committee</p> <p>Due Diligence Committee</p> <p>Due Diligence Committee</p> <p>Government/ Financial Adviser</p>
	May 8 – May 29 (Weeks 39-42)	<ul style="list-style-type: none"> <li>Distribute Information Memorandum to potential bidders who have expressed interest</li> <li>Finalise collation of data room materials while awaiting indicative bids</li> <li>Determine final bid requirements and reserve price</li> <li>Receive and evaluate indicative bids and select short list (bids due Friday 2 June)</li> <li>Conduct probity checks</li> </ul>	<p>Financial Adviser</p> <p>Due Diligence</p> <p>Steering Committee</p> <p>Financial Adviser/ Steering Committee</p> <p>Steering Committee</p>
	June 5 – July 10 (Weeks 43-48)	<ul style="list-style-type: none"> <li>Short-listed parties conduct buyer due diligence and participate in sale contract negotiations</li> <li>Receive Final Bids (due Friday 14 July)</li> <li>Evaluate final bids against requirements and reserve price</li> <li>Select successful bidder and execute sale agreement</li> </ul>	<p>Financial Adviser</p> <p>Financial Adviser</p> <p>Financial Adviser</p> <p>Financial Adviser/ Government</p>

**Confidential**

# **South Australian Gambling Industry**

## **Merger and Sale of SATAB and SA Lotteries Analysis of Privatisation vs. Retention Scenarios**



**September 1999**

**CREDIT  
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## 1. Executive Summary

### 1.1 Introduction

Following completion of CSFB's Feasibility Study provided to the Government of South Australia, we were requested to consider a further scenario: a merger of SA Lotteries with SATAB (the "Businesses") and a separate sale of the Adelaide Casino. On 6 July 1999, we provided advice about the impact on sale proceeds of excluding the Adelaide Casino from the merged entity under the different sale scenarios (trade sale, IPO, strategic stake sale/IPO).

We have now been asked to consider what minimum level of sale proceeds would need to be achieved to exceed the value of the Businesses under continued State ownership.

It should be noted that the underlying basis for this additional analysis is the Feasibility Study completed in June. The cost savings, synergies, business enhancements, discount rates and tax assumptions used in this analysis are drawn from the Feasibility Study and are necessarily subject to the conditions, caveats and assumptions which were applicable to that Study. We believe it is important that a final decision on whether to retain or privatise either SATAB or SA Lotteries should be based on more detailed business plans, tax rates, interest rates and other factors which will be more fully and accurately known after the preparation phase.

There are a number of critical sensitivities which should be noted, as small adjustments in the parameter can lead to significant changes in values and relative outcomes.

### 1.2 Key Recommendations

CSFB has analysed the valuation outcomes of the different options available to the State in respect of selling or retaining SATAB and SA Lotteries. The analysis of retention/privatisation decisions on a financial basis is one of the most complex and vexed forms of analysis that can be undertaken in a privatisation study. This is caused principally by definitional analysis in respect of cashflows available to respective owners, the cost of equity and the interaction of federal company tax.

We have necessarily made certain assumptions to provide a consistent basis for comparing the options open to Government. The major assumptions are:

- (a) constant discount rate for gaming tax cashflows across the Businesses;
- (b) consistent cost of equity calculation under private and public ownership;
- (c) a new gaming tax is introduced on a consistent basis under private and public ownership;
- (d) cashflows to the Government under the retention scenario are limited to 100% of distributable profits; and
- (e) the analysis is based on the Feasibility Study completed in June this year.

The valuation outcomes under the different scenarios are set out in the table below. The merger/sale outcome is slightly greater than the sell SATAB/retain SA Lotteries outcome. When taking into account the risks facing the Businesses and the restricted capacity for the Businesses to manage these risks in Government ownership, we believe a reasonably strong case exists for pursuing a merger and sale of the two Businesses.

## Comparison of Value Outcomes

	Total Value to State (\$ Million)	
	50% Tax on SA Lotteries	60% Tax on SA Lotteries
Sell Merged SATAB and SA Lotteries	2,098	2,245
Retain SA Lotteries, sell SATAB	2,071	2,146
Retain SATAB and SA Lotteries	1,993	2,069
Retain SATAB, sell SA Lotteries	1,989	2,106

## 2. Calculation of Minimum Sale Proceeds

### 2.1 Approach

The cashflows accruing to the State (and therefore the basis for valuing the Businesses) under privatisation vs. retention are as follows:

#### Value of Businesses to the State

<u>Privatisation Scenario</u>		<u>Retention Scenario</u>	
<b>Interest Saving</b>	<ul style="list-style-type: none"> <li>Up-front sale proceeds are used to reduce State debt.</li> </ul>	<b>Earnings Distribution</b>	<ul style="list-style-type: none"> <li>The ongoing profits of the Businesses are distributed to the State.</li> </ul>
<b>Annual Gaming Tax Revenue</b>	<ul style="list-style-type: none"> <li>New gaming taxes are levied on future revenue of SATAB, SA Lotteries.</li> </ul>	<b>Annual Gaming Tax Revenue</b>	<ul style="list-style-type: none"> <li>New gaming taxes are levied on future revenue of SATAB, SA Lotteries.</li> </ul>

Setting the level of gaming tax to be levied on the Businesses in a privatisation represents a trade-off between up-front sale proceeds and an ongoing interest in the performance of the Businesses. Increasing the gaming taxes levied on the Businesses post-privatisation would increase the State's share of the Businesses' future cash flows and the State's exposure to the risks faced by the Businesses, while reducing the upfront sale proceeds achieved (and therefore the ongoing interest savings).

The annual tax revenue under the privatisation scenario will reflect the revenue enhancements achieved through the merger and privatisation, while the upfront sale proceeds (and therefore the annual interest saving) will reflect both cost reductions and revenue enhancements achieved through the merger and sale. The cost savings and revenue enhancements incorporated in our analysis are discussed in more detail in Section 2.3.

The distributions of earnings from the Businesses received under continued Stated-ownership will reflect the underlying performance of the Businesses. We have not incorporated any cost reductions or revenue enhancement arising from a merger of the Businesses in our analysis of the retention scenario (refer Section 2.3 below).

## 2.2 Methodology

We set out in Section 2.4 a comparison of the value of the Businesses to the State under privatisation and retention scenarios. We have considered privatisation of the merged Businesses as well as the privatisation of SATAB and SA Lotteries separately by way of trade sale.

Our analysis of the privatisation scenario is based on the following parameters:

- (a) our estimated sale proceeds for the merged SATAB/SA Lotteries and for separate trade sales of the Businesses. The sale proceeds were estimated using a discounted cash flow ("DCF") approach, with the projected cash flows incorporating cost reductions and (in the case of a merger) revenue enhancements. The projected cash flows were discounted at the relevant cost of equity (8.4% for SA Lotteries, 14.3% for SATAB and 11.5% for the merged entity – refer Section A.1.2.2 of the Feasibility Study);
- (b) the annual interest saving reflects a reduction in State debt by the estimated sale proceeds and an interest rate on State debt of 6.0%;
- (c) a gaming tax rate of 15% has been applied to SATAB's wagering revenue and 50% to SA Lotteries' revenue. We have also reviewed the impact of a 60% tax rate on the value outcome for SA Lotteries. Alternative tax rates are discussed in more detail in Section 4; and
- (d) the gaming tax revenue stream has been discounted a rate of 7.5%;

Our analysis of the retention scenario is based on:

- (a) earnings distributions to the State which essentially reflect the same underlying assumptions about the performance of the Businesses (ie. sales growth, payments to SARI, etc) as used in the privatisation scenario, except that all cost reductions and revenue enhancements achieved through privatisation of the Businesses are assumed not to occur (refer Section 2.3 below);
- (b) the earnings distributions to the State have been discounted at the cost of equity of each business. The cost of equity estimates used were the same as those set out in Section A1.2.2. of the Feasibility Study, subject to an adjustment to reflect the absence of leverage and a franking credit utilisation rate of zero under State-ownership. The effect of the adjustment is to increase the cost of equity for SA Lotteries to 9.3% and for SATAB to 13.2%; and
- (c) although gaming taxes are not currently levied on the Businesses, our analysis incorporates pro-forma gaming taxes levied at the same tax rates applied under the privatisation scenario, in order to draw a valid comparison between the privatisation and retention scenarios. The projected gaming tax revenue has been discounted at a rate of 7.5%, consistent with the privatisation scenario.

We have calculated the minimum sale proceeds or "benchmark price" which would be required for the State to be better off by privatising the Businesses as follows:

$$\text{Minimum Sale Proceeds} = \text{Retention Value} - \text{Value of Tax Stream under Privatisation}$$

This analysis represents a preliminary basis for comparing the value to the State under a retention scenario to the estimated sale proceeds in a privatisation. Factors not taken into account by the

analysis include:

- (a) in our view, the Businesses are likely to underperform while in State ownership, due to their reduced ability to respond to commercial issues and changes in the marketplace; and
- (b) the cost of equity estimate used to value earnings distributions to the State under the retention scenario does not take into account the additional risks faced by the Businesses under State ownership. The potential impact of these risks on the Businesses' distributions to the State and on their value is considered in Section 3.

One of the critical areas of sensitivity in our analysis is the discount rate used to determine a present value of the gaming tax receipts. The discount rate has a material impact on the aggregate valuations and therefore any differential used in gaming tax discount rates across different businesses will have an impact on relative valuations of the sell/retain options for Government. As it is not a focus of this paper to analyse the relative risk factors on gaming tax revenues from each business (nor is it an analysis which CSFB could undertake in the time available), we have chosen a constant discount rate for gaming tax across the Businesses. We continue to believe that it is appropriate to use a lower discount rate for gaming tax cash flows than for equity cash flows, as the risks associated with a tax on product profits are less than for taxes on equity profits. It is important to note that this outcome leads to higher absolute values but does not impact relative values of the different sell/retain options for Government.

### **2.3 Merger Synergies**

In our analysis of a merger and trade sale of all three gambling businesses (SATAB, SA Lotteries and the Adelaide Casino) set out in the Feasibility Study, we incorporated annual cost reductions of around \$22 million and annual revenue synergies amounting to 1.5% of projected turnover. These cost reductions were largely driven by head office savings at SA Lotteries and by head office and call centre savings at SATAB, achieved through a merger of SATAB with SA Lotteries followed by a sale to an industry buyer with existing Australian operations.

Excluding the Adelaide Casino from the merged entity would only impact the cost reductions expected to be achieved to the extent that those cost savings relate directly to the Casino (ie. by \$0.5 million per annum). The effect of excluding the Casino on the revenue synergies achieved in a merger would be more significant, due to reduced cross-selling opportunities and reduced ability to offer a 'one-stop-shop' internet gambling outlet. We have estimated that the revenue synergies would fall from 1.5% to 0.5% of the merged entity's turnover.

These revised cost reductions and revenue enhancements have been incorporated in the cash flow projections under the privatisation scenario for the merged SATAB/SA Lotteries sale, which are used to calculate the gaming tax accruing to the State and the likely up-front sale proceeds under the privatisation scenario.

Although it may be possible to achieve some of the cost savings and revenue enhancements associated with a merger of the Businesses under State ownership, we believe that it is unlikely that the potential for efficiency gains could be exploited fully (and maintained in the medium to long term). This view is based on our understanding of the performance of the Businesses to date under State ownership and our experience with the privatisation of other State-owned businesses. Furthermore, a significant proportion of the cost savings incorporated under the merger/trade sale scenario relate to the combination of the merged SATAB/SA Lotteries business with the existing operations of the purchaser (in other States). These savings would not be achievable if the Businesses are retained by the State. As a result, we have not incorporated any merger cost reductions or revenue

enhancements in our analysis of the retention scenario.

## 2.4 Results

The results of our analysis are as follows:

### Merger of SATAB/SA Lotteries

(\$ Million)	Present Value	Projected Cash Flow Year Ended 30 June				
		2000	2001	2002	2003	2004
<b>Privatisation Scenario:</b>						
Gaming Tax:						
SA Lotteries (50%)	1,310.4 <sup>(1)</sup>	57.5	60.4	63.4	66.3	68.4
SATAB (15%)	360.7 <sup>(1)</sup>	16.4	17.1	17.7	18.5	19.0
	1,671.2	73.8	77.4	81.2	84.8	87.4
Interest Saving <sup>(2)</sup>	426.6	25.6	25.6	25.6	25.6	25.6
<b>Total Value to State</b>	<b>2,097.7</b>	<b>99.4</b>	<b>103.0</b>	<b>106.8</b>	<b>110.4</b>	<b>113.0</b>
<b>Retention Scenario:</b>						
Pro-forma Gaming Tax						
SA Lotteries (50%)	1,304.2 <sup>(3)</sup>	67.3	60.1	63.1	66.0	68.0
SATAB (15%)	355.3 <sup>(3)</sup>	16.3	17.0	17.6	18.8	18.8
	1,659.5	73.7	77.0	80.7	84.3	86.9
Earnings Distribution						
SA Lotteries	285.3 <sup>(4)</sup>	17.8 <sup>(4)</sup>	18.3	19.9	21.1	21.4
SATAB	48.4 <sup>(5)</sup>	3.8	3.6	4.7	5.5	5.6
	333.7	21.1	21.9	24.6	26.6	27.0
<b>Total Value to State</b>	<b>1,993.2</b>	<b>94.7</b>	<b>98.9</b>	<b>105.3</b>	<b>110.9</b>	<b>113.9</b>
<b>Benefit from Privatisation</b>	<b>104.52</b>					
<b>Minimum Sale Price:</b>						
Retention Value	1,993.2					
Less: Gaming Tax under Privatisation	(1,671.2)					
<b>Minimum Sale Proceeds</b>	<b>322.0</b>					
Trade Sale Proceeds (CSFB Estimate)	426.5					

(1) Based on projected cash flows over ten years discounted at 7.6% and a terminal value calculation.

(2) Based on estimated trade sale proceeds for the merged entity and an estimated interest rate on State debt of 6.0%.

(3) Based on projected cash flows over ten years under retention scenario discounted at a cost of equity of 9.3% and a terminal value calculation.

(4) Assumes that capital expenditure requirements for the SA Lotteries IT system are met through a reduction in cash rather than reduced distributions to the State.

(5) Based on projected cash flows over ten years under retention scenario discounted at a cost of equity of 13.2% and a terminal value calculation.

## SATAB – Separate Trade Sale

(\$ Million)	Present Value	Projected Cash Flow Year Ended 30 June				
		2000	2001	2002	2003	2004
<b>Privatisation Scenario:</b>						
Gaming Tax:						
SATAB (15%)	359.0 <sup>(1)</sup>	16.3	17.0	17.7	18.4	18.9
Interest Saving <sup>(2)</sup>	122.2	7.3	7.3	7.3	7.3	7.3
<b>Total Value to State</b>	<b>481.2</b>	<b>23.7</b>	<b>24.3</b>	<b>25.0</b>	<b>25.7</b>	<b>26.3</b>
<b>Retention Scenario:</b>						
Pro-forma Gaming Tax (15%)	355.3 <sup>(1)</sup>	16.3	17.0	17.6	18.3	18.8
Earnings Distribution	48.4 <sup>(3)</sup>	3.3	8.6	4.7	5.5	5.6
<b>Total Value to State</b>	<b>403.7</b>	<b>19.6</b>	<b>20.5</b>	<b>22.3</b>	<b>23.8</b>	<b>24.5</b>
<b>Benefit from Privatisation</b>	<b>77.5</b>					
<b>Minimum Sale Price:</b>						
Retention Value	403.7					
Less: Gaming Tax under Privatisation	(359.0)					
<b>Minimum Sale Proceeds</b>	<b>44.7</b>					
<b>Trade Sale Proceeds (CSFB Estimate)</b>	<b>122.2</b>					

(1) Based on projected cash flows over ten years discounted at 7.5% and a terminal value calculation.

(2) Based on estimated trade sale proceeds for the merged entity and an estimated interest rate on State debt of 6.0%.

(3) Based on projected cash flows over ten years under retention scenario discounted at a cost of equity of 13.2% and a terminal value calculation.

## SA Lotteries – Separate Trade Sale (50% Lotteries Tax)

(\$ Million)	Present Value	Projected Cash Flow Year Ended 30 June				
		2000	2001	2002	2003	2004
<b>Privatisation Scenario:</b>						
Gaming Tax:						
SA Lotteries (50%)	1,304.2 <sup>(1)</sup>	67.3	60.1	63.1	66.0	68.0
Interest Saving <sup>(2)</sup>	281.4	16.9	16.9	16.9	16.9	16.9
<b>Total Value to State</b>	<b>1,585.6</b>	<b>74.2</b>	<b>77.0</b>	<b>80.0</b>	<b>62.9</b>	<b>84.9</b>
<b>Retention Scenario:</b>						
Pro-forma Gaming Tax (50%)	1,304.2 <sup>(1)</sup>	67.3 <sup>(3)</sup>	60.1	63.1	66.0	68.0
Earnings Distribution	285.3 <sup>(4)</sup>	17.8	18.3	19.9	21.1	21.4
<b>Total Value to State</b>	<b>1,589.5</b>	<b>75.1</b>	<b>78.4</b>	<b>83.0</b>	<b>87.0</b>	<b>89.4</b>
<b>Benefit from Privatisation</b>	<b>(3.85)</b>					
<b>Minimum Sale Price:</b>						
Retention Value	1,589.5					
Less: Gaming Tax under Privatisation	(1,304.2)					
<b>Minimum Sale Proceeds</b>	<b>285.3</b>					
<b>Trade Sale Proceeds (CSFB Estimate)</b>	<b>281.4</b>					

(1) Based on projected cash flows over ten years discounted at 7.5% and a terminal value calculation.

(2) Based on estimated trade sale proceeds for the merged entity and an estimated interest rate on State debt of 6.0%.

(3) Assumes that capital expenditure requirements for the SA Lotteries IT system are met through a reduction in cash rather than reduced distributions to the State.

(4) Based on projected cash flows over ten years under retention scenario discounted at a cost of equity of 9.3% and a terminal value calculation.

## SA Lotteries – Separate Trade Sale (60% Lotteries Tax)

(\$ Million)	Present Value	Projected Cash Flow Year Ended 30 June				
		2000	2001	2002	2003	2004
<b>Privatisation Scenario:</b>						
Gaming Tax:						
SA Lotteries (60%)	1,666.0 <sup>(1)</sup>	68.8	72.1	75.7	79.2	81.6
Interest Saving <sup>(2)</sup>	137.2	8.2	8.2	8.2	8.2	8.2
Total Value to State	1,702.3	77.0	80.3	84.0	87.4	89.9
<b>Retention Scenario:</b>						
Pro-forma Gaming Tax (60%)	1,565.0 <sup>(1)</sup>	68.8 <sup>(3)</sup>	72.1	75.7	79.2	81.6
Earnings Distribution	100.2 <sup>(4)</sup>	7.6	6.2	7.2	7.8	7.7
Total Value to State	1,665.2	76.4	78.3	82.9	87.0	89.4
<b>Benefit from Privatisation</b>	37.1					
<b>Minimum Sale Price:</b>						
Retention Value	1,665.2					
Less: Gaming Tax under Privatisation	(1,565.0)					
Minimum Sale Proceeds	100.2					
Trade Sale Proceeds (CSFB Estimate)	137.2					

- (1) Based on projected cash flows over ten years discounted at 7.6% and a terminal value calculation.  
(2) Based on estimated trade sale proceeds for the merged entity and an estimated interest rate on State debt of 6.0%.  
(3) Assumes that capital expenditure requirements for the SA Lotteries IT system are met through a reduction in cash rather than reduced distributions to the State.  
(4) Based on projected cash flows over ten years under retention scenario discounted at a cost of equity of 9.3% and a terminal value calculation.

We note that the CSFB estimate of sale proceeds set out in the tables above is based on the discounted cash flow valuation analysis set out in the Feasibility Study. In that analysis, we included only limited revenue enhancements resulting from a merger and/or trade sale. Trade sale buyers may have more aggressive views in relation to the potential for increased revenues and, as a result, there may be additional upside to the CSFB estimate of sale proceeds.

## 2.5 Conclusions

The value to the State of the alternative scenarios are set out in the table below. Based on our analysis, the value accruing to the State from a merger and trade sale of SA Lotteries and SATAB would exceed the value of retaining SA Lotteries and selling SATAB separately. However, we note that the difference between the merger/sale outcome and the sell SATAB/retain SA Lotteries outcome is 1.3% of the total value to the State. Therefore any decision to pursue a merger and sale of both Businesses, although justified on financial grounds, needs to be supported by a Government view in respect of the risk profile of the Businesses in State ownership (refer Section 4). We also note that the difference between the merge/sale outcome and the sell SATAB/retain SA Lotteries scenario increases if a higher gaming tax rate is levied on SA Lotteries.

## Comparison of Value Outcomes

	Total Value to State (\$ Million)	
	50% Tax on SA Lotteries	60% Tax on SA Lotteries
Sell Merged SATAB and SA Lotteries	2,098	2,245
Retain SA Lotteries, sell SATAB	2,071	2,146
Retain SATAB and SA Lotteries	1,993	2,069
Retain SATAB, sell SA Lotteries	1,989	2,106

### 2.6 Comparison to Budget Estimates

For completeness, a comparison of the cash flows accruing to the State under privatisation and retention scenarios to the budget estimates is set out below. However, as the budget estimates are based on different analytical parameters, they do not provide a valid comparison for evaluating the different scenarios from an economic perspective.

(\$ Million)	Year Ending 30 June			
	2000	2001	2002	2003
<b>Merged SATAB/SA Lotteries</b>				
Budget Estimate	109.2	109.7	112.9	116.7
CSFB Privatisation Estimate	99.4	103.0	106.8	110.4
CSFB Retention Estimate	94.7	98.9	105.3	110.9
<b>SA Lotteries (50% Tax)</b>				
Budget Estimate	86.9	86.1	87.8	90.4
CSFB Privatisation Estimate	74.2	77.0	80.0	82.9
CSFB Retention Estimate	75.1	78.4	83.0	87.0
<b>SATAB</b>				
Budget Estimate	22.3	23.5	25.1	26.3
CSFB Privatisation Estimate	23.7	24.3	25.0	25.7
CSFB Retention Estimate	19.6	20.5	22.3	23.8

## 3. Business Risks

### 3.1 Overview

As discussed in Section 3, the Businesses face significant risks under continued State-ownership. The major additional risks we have identified and their estimated impact on the distributions to the State and the value of the Businesses is set out below. We note that some of the risks identified, particularly in relation to product supply arrangements with SARI and pooling arrangements with TABCorp, will need to be resolved prior to a privatisation of the Businesses. Nevertheless, the State is likely to be better positioned to deal with these issues in the context of a privatisation of the Businesses.

### 3.2 SATAB Business Risks

Scenario	Basis	Potential Impact (\$Million)		
		Profit Reduction <sup>(1)</sup>	Gaming Tax Receipts Reduction <sup>(2)</sup>	Value Reduction <sup>(3)</sup>
<b>High Probability</b>				
<u>Increased SuperTAB Fees</u>	• 50% cost ↑	2.1	-	20.8
- SuperTAB is operated by TABCorp and has already imposed negative settlement fees on SATAB. Negotiating leverage lies with TABCorp.				
<u>SKY Chances Increase</u>	• 50% cost ↑	0.9	-	7.7
- SKY is owned by TAB Limited and has exclusive rights to the racing pictures narrowcast to SATAB agencies.				
<u>Pressure on Operating Costs</u>	• 10% total cost ↑	5.5	-	48.3
- As gaming product competition increases, SATAB will be required to invest more in product development, point of sale presentation, communications, advertising etc, to maintain market position.				
<b>Medium Probability</b>				
<u>Pressure on Turnover</u>	• 10% turnover ↓	3.5	1.8	69.2
- May result from competition by new gaming products (as occurred with the introduction of gaming machines) and new distribution channels (internet) facilitating competition from interstate TABs.				
<b>Low Probability</b>				
<u>Exclusion from SuperTAB pool</u>	• 40% turnover ↓ • No pooling fee	11.6	6.4	188.6
- TABCorp could seek to exclude TAB Limited from the pool in to attract South Australian customers to its own betting product.				
<u>Loss of Victorian racing</u>	• 35% turnover ↓	12.4	6.6	171.0
- SATAB relies on SARI to provide interstate racing information. This arrangement is not formalised. There is a trend in sports business for the product generator (ie. VRC) to sell their products directly rather than through agencies/intermediaries/aggregators.				
<u>Loss of South Australian racing</u>	• 19% turnover ↓	6.7	3.1	116.0
- SATAB relies on SARI to provide local racing information. This arrangement is not formalised and is subject to the same risk as Victorian racing information.				

(1) Based on change in earnings before interest and tax for the year ended 30 June 2000.

(2) Based on change in notional gaming tax receipts for the year ended 30 June 2000.

(3) Based on total change in present value of notional gaming tax and earnings distributions received by the State.

### 3.3 SA Lotteries Business Risks

Scenario	Basis	Potential Impact (\$Million)		
		Profit Reduction <sup>(1)</sup>	Gaming Tax Receipts Reduction <sup>(2)</sup>	Value Reduction <sup>(3)</sup>
<b>High Probability</b>				
<u>Pressure on Operating Costs</u>	• 10% cost ↑	2.0	-	31.0
- Increased gaming product competition will require SA Lotteries to invest in maintaining market position through product development, distribution channel upgrades, advertising and promotion.				
<u>Pressure on Turnover</u>	• 10% turnover ↓	3.0	5.7	178.1
- May result from introduction of new competing gambling products (as occurred when gaming machines were introduced) or new distribution channels (Internet).				
<b>Medium Probability</b>				
<u>Internet competition</u>	• 50% turnover ↓ for Powerball and Saturday Lotto	8.0	14.6	429.1
- The impact of Internet-based lotteries is likely to be felt most in relation to those products which rely on jackpots to attract customers.				
<u>New games introduced by competitor</u>	• 50% turnover ↓ for Keno	3.3	7.4	191.4
- SATAB could introduce a competing Keno-like game in PubTAB outlets which may be achievable under the licence.				
<u>New games introduced by competitor</u>	• 50% turnover ↓ for Instant Scratchies	1.4	2.5	67.5
- Although SA Lotteries' licence conditions will afford some protection, it can be expected that new games/products will be introduced at the margin.				
<b>Low Probability</b>				
<u>Excluded from National Lotto Bloc</u>	• 50% turnover ↓ for all Lotto Bloc products	9.2	16.8	502.1
- SA Lotteries relies upon the National Lotto Bloc for pooling arrangements to increase the size of prizes and attract customers. These arrangements are not formalised				

(1) Based on change in earnings before interest and tax for the year ended 30 June 2000.

(2) Based on change in notional gaming tax receipts for the year ended 30 June 2000.

(3) Based on total change in present value of notional gaming tax and earnings distributions received by the State.

#### 4. Alternative Gaming Tax Rates

Increasing the gaming taxes levied on the Businesses post-privatisation would increase the State's share of the Businesses' future cash flows and the State's exposure to the risks faced by the Businesses, while reducing the upfront sale proceeds achieved (and therefore the ongoing interest savings). The impact of alternative gaming tax rates on the value of each Business to the State is set out in the Table below.

#### Value Impact of Alternative Tax Rates

(\$Million)	Present Value of Tax Stream <sup>(1)</sup>	Sale Proceeds	Total Value to State
<b>SA Lotteries:</b>			
40%	1,043.4	421.0	1,464.4
50%	1,304.2	281.4	1,585.6
60%	1,565.0	137.2	1,702.3
<b>SATAB: <sup>(2)</sup></b>			
15%	359.0	122.2	481.2
20%	477.5	77.4	554.8
26% (VIC, NSW)	671.7	11.9	683.6

- (1) Based on the privatisation scenario for the businesses on a stand-alone trade sale basis. Projected tax revenue has been discounted at 7.5% for both SA Lotteries and SATAB.
- (2) Assumes tax on sport betting remains constant at 20%.

**Confidential**

# **South Australian Gambling Industry**

## **Review of Gaming Machine Options**



**July 1999**

**CREDIT SUISSE** | **FIRST BOSTON**

## Important Notice

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This report contains extensive commercially sensitive information regarding options available to the Government of South Australia (the "Government") with respect to arrangements for the licensing of gaming machines in the State. Disclosure of this information to third parties will be prejudicial to the commercial interests of the State of South Australia (the "State") and the gambling businesses owned by the State, including the Lotteries Commission of South Australia ("SA Lotteries"), the South Australian Totalizator Agency Board ("SATAB") and the Adelaide Casino (together, the "Businesses").

In the event that this report, either in whole or in part or any summary thereof, is released into the public domain, then access to this commercially valuable information may have severe ramifications, including a possible reduction in the value the State can achieve through gaming machine alternatives, the enterprise value of the Businesses and serious impairment of the Government's policy and commercial interests.

In preparing this report, Credit Suisse First Boston Australia Limited and its affiliates ("CSFB") have relied upon confidential information supplied in the first instance by the Office for Government Enterprises Asset Sales Unit (Gaming) and by the Businesses. Further information was gathered through meetings with Government representatives and agencies, including the Liquor and Gaming Commissioner. Neither the information from the Businesses nor that from the Government and its agencies has been independently verified by CSFB insofar as completeness, accuracy or currency is concerned. As such, the statements and opinions contained in this report are based upon the belief that such information is not false or misleading and that there has been no omission of material information which may have a material effect on such statements and opinions.

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# 1. Executive Summary

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## 1.1 Introduction

Credit Suisse First Boston Australia Limited ("CSFB") was engaged by the Government of South Australia (Asset Sales Unit - Gaming) in June 1999 to undertake a Feasibility Study of the options available to the Government for privatising the gambling businesses which it owns. These businesses include SA Lotteries, SATAB and the Adelaide Casino (together, the "Businesses").

Following completion of the Feasibility Study, we have been asked to provide further analysis of the Government's options for implementing a change in gaming machine policy involving a net reduction in the number of gaming machines in the State. Gaming machine policy is clearly a politically and socially sensitive subject throughout Australia at the present time and, in South Australia, it seems that even greater sensitivity prevails. Our advice has been developed within the constraints posed by Government policy considerations, and, therefore, may not necessarily represent the optimal solution from an economic or commercial perspective, or the solution which maximises the State's gaming machine tax revenue in the long term.

Based on discussions with Government officers and the Asset Sales Unit (Gaming), we understand that the Government's objectives in seeking further analysis of gaming machine options are to identify:

- (a) a 'workable' model that the Government could consider for implementation;
- (b) the full range of commercial issues that need to be considered in connection with a policy change;
- (c) the implementation issues that would need to be addressed, together with strategies for key implementation issues; and
- (d) identification of difficult issues that the Government would confront, and need to address, in effecting a policy change.

We also note that the Productivity Commission has recently released a draft report on Australia's gambling industries. Within the time available to conduct our analysis, we have not had an opportunity to conduct an extensive review of the implications that the draft findings of the Productivity Commission may have for the Government's gaming machine policy options. Furthermore, we note that the Productivity Commission's report is not due to be finalised until November 1999.

## 1.2 Discussion of Options

Our analysis has concentrated on the Government restructuring South Australia's gaming machine licensing arrangements in order to implement a cap on the number of machines in the State and reduce the number of approved machines from the current level. This could be achieved by:

- (a) introducing legislation to effect a prohibition on the issuance of new gaming machine licences;
- (b) drafting that legislation to enforce a moratorium on the granting of new licences between the time when the policy change is announced and the time when the legislation takes effect; and
- (c) conducting a buy-back programme to reduce the number of machines approved for installation under the existing gaming machine licences.

Furthermore, the Government could recover the cost of the buy-back programme and extract further value for the State through licence fees and increased tax revenue by:

- (a) re-purchasing more machine licences under the buy-back programme than would be required to achieve the aggregate limit;
- (b) increasing the venue limit (for example, from the current level of 40 to 60); and
- (c) either conducting an auction process to re-sell some of the re-purchased licences to venue owners for a licence fee or allocating these licences to one of the State-owned gambling Businesses, resulting in increased sale proceeds in a privatisation of that Business.

The alternative processes for implementing a buy-back programme are discussed in Section 3 below. A detailed review of the implementation issues and strategies for conducting an auction process for a sale of licences to venue owners and the alternative of allocating a block of licences to one of the State-owned gambling Businesses is provided in Section 4.

### 1.3 CSFB Recommendation

#### *Implementation*

A summary of CSFB's key recommendations and a "blueprint" for implementation of this strategy is set out in Table 1.1. We note that the programme cannot be implemented under existing legislation, hence significant changes to the Gaming Machine Act would be required.

Table 1.1 – Implementation Blueprint

Stage	Steps	Comments
1. Announcement	<ul style="list-style-type: none"> <li>• Prohibition on issuance of new licences, capping number of machines at current level.</li> <li>• Moratorium on licence applications until prohibition becomes effective.</li> <li>• Buy-back programme to be implemented to reduce number of machines.</li> <li>• Venue limit to be raised from 40 to 60.</li> <li>• "Re-issue" programme to be conducted for a proportion of the machine entitlements re-purchased.</li> </ul>	<ul style="list-style-type: none"> <li>• Absolute confidentiality required.</li> <li>• Prevents exploitation of buy-back.</li> <li>• Required to facilitate "re-issue" programme.</li> </ul>
2. Transition Period	<ul style="list-style-type: none"> <li>• Commissioner finalises "in the pipeline" applications.</li> <li>• Approvals to install additional machines under existing licences expire.</li> </ul>	<ul style="list-style-type: none"> <li>• Pre-announcement applications are not penalised.</li> <li>• Prevents exploitation of buy-back and may provide zero cost reduction in approved numbers.</li> </ul>
3. Buy-Back Programme	<ul style="list-style-type: none"> <li>• Re-purchase machine licences (target up to 2,000).</li> <li>• Competitive tender process.</li> <li>• Market clearing price paid to all successful tenderers, ensuring fair treatment.</li> </ul>	<ul style="list-style-type: none"> <li>• Number to be re-purchased should not be disclosed ahead of buy-back process.</li> <li>• Alternatives include fixed price approach.</li> <li>• Alternative would be to re-purchase at actual tendered prices.</li> </ul>
4. Re-Issue Licences	<ul style="list-style-type: none"> <li>• Allocate block of licences to State-owned gambling Business, increasing privatisation proceeds.</li> <li>• Business enters into arrangements with venue owners to install machines.</li> </ul>	<ul style="list-style-type: none"> <li>• Alternative would be to sell licences to venue owners through tender process.</li> </ul>

### *Buy-Back*

We recommend that the buy-back programme should be conducted by way of a competitive tender process managed by the Government. This approach will allow the market to determine the value of the licences, while full Government control of the process and the adoption of a clearing price mechanism will ensure that all participants are treated equally. The Government should retain the flexibility to defer a final decision on the number of licences to be re-purchased until tenders are received.

Once the prohibition on the issuance of new licences is announced, the value of existing licences will increase, reflecting a premium for 'scarcity'. Hence, the State would likely have to pay a premium over the value of the licences based on current cash flows in order to attract sufficient interest to the buy-back programme. In addition, industry lobby groups (such as the Australian Hotels Association), are likely to discourage their constituents from participating in the programme. As a result of these factors, the Government could consider implementing tax reforms (ie. levying a fixed annual charge per machine, while reducing the revenue-based tax rate, thereby making less profitable machines un-economic), in order to attract sufficient interest in the programme at acceptable value. The Government should also take advantage of the opportunity to cancel approvals to install additional machines under existing licences, which could achieve a significant reduction in the approved number of machines at zero cost.

### *Re-Issue*

In respect of the re-issue of machine licences, we believe that a trade buyer participating in a sale of the State-owned gambling Businesses is likely to value a block of gaming machine licences more than the value that could be achieved in an auction of the licences to venue owners. This reflects the ability to achieve higher returns from the machines through optimising their distribution across venues and a lower cost of capital.

However, it is difficult to be prescriptive about the preferred approach to selling the licences, due to a number of factors, particularly timing of implementation and pending clarification of the impact of Federal company tax. If the Government is able to wait for the privatisation of the Businesses to be completed (which could be 15 months) before implementing a re-issue of licences, we believe that the State should pursue granting a block of licences to one of the Businesses.

We also note that, irrespective of the sale method adopted, the buy-back and re-issue programme is likely to be perceived as favouring larger, more profitable venues and their owners. If a block of licences was to be issued to one of the State-owned Businesses (or sold separately to a trade buyer), there would also be greater dissatisfaction among venue owners (and industry groups), as they would not be given an opportunity to purchase the re-issued licences directly, but would need to enter into arrangements with the licence owner. This may exacerbate the difficulties associated with attracting sufficient interest to the buy-back programme.

## 2. Implementation of Aggregate Limit

### 2.1 Current Situation

As set out in Table 2.1, 651 gaming machine licences had been issued to South Australian venues as at 30 June 1999 (including the Adelaide Casino). Under these licences, the Liquor and Gaming Commissioner (the "Commissioner") had approved the installation of 13,664 machines (including the Adelaide Casino's entitlement to install 880 machines). Of the approved number of machines, some 957 had not actually been installed.

**Table 2.1 – Gaming Machine Licences in South Australia  
As at 30 June 1999**

Venues	Number of Licences	Number of Machines		
		Approved	Installed	Not Utilised
Hotels and Clubs	550	12,784 <sup>(1)</sup>	11,944	840
Casino	1	880 <sup>(2)</sup>	763	117
Total	551	13,664	12,707	957

Source: Liquor and Gaming Commissioner.

(1) Number of machines approved by the Commissioner under existing licences.

(2) As discussed in Section 2.2, we have been advised that this may actually represent a minimum number of machines under the draft Approved Licensing Agreement.

Under the existing framework, licences to operate a specified number of gaming machines are issued to venues rather than a separate licence being issued for each machine. Gaming machine licences have, to date, been issued without payment of a licence fee to the State. The licences issued are effectively perpetual in nature, as the licence terms do not incorporate an expiry date, performance requirements (ie. minimum turnover), or provide for termination (except in circumstances related to a breach of the licence terms).

### 2.2 Setting an Aggregate Limit

As set out in Section 2.1, a total of 13,664 gaming machines have been licensed in South Australia (as at 30 June 1999). In addition, the Commissioner has issued further licences since 30 June 1999 and is currently considering eight new licence applications. The total number of approved machines requested by the eight applicants is 241. It should be noted that an influx in licence applications is possible in the coming weeks, as a result of the publicity surrounding the draft Productivity Commission report and anticipation of Government action to impose restrictions. This could lead to a more expensive buy-back programme for the State.

In order to set an aggregate limit on the number of gaming machines in the State which is less than the number of machines currently licensed, the Government could:

- (a) re-purchase entitlements to operate machines under existing licences through a voluntary buy-back programme or compulsory acquisition; and/or
- (b) terminate entitlements to operate machines under existing licences which are not being utilised.

The implementation of these measures is discussed in more detail in Section 3. Whilst the Government may target a certain number of machines in the buy-back programme, it may be difficult to achieve exactly that number at acceptable value under a voluntary buy-back scheme. As a result, it will be difficult for the Government to announce a specific number of machines, below the current level, at which an aggregate limit is to be set. Instead, we believe the Government should announce that the number of gaming machines will be capped at the current level through a prohibition on the issuance of new licences and that the Government will implement a buy-back programme designed to reduce the number of machines below that level. Whilst the Government may set a target for the number of machine reductions to be achieved through the buy-back programme, announcing that target may be prejudicial to the Government's commercial interests in implementing the programme.

We also note that we have been advised that the current draft of the Approved Licensing Agreement applicable to the Adelaide Casino (post-privatisation) provides for 'not less than 880' machines to be installed, rather than a maximum of 880 machines. If this is indeed the case, the draft agreement would require amendment before an effective cap on the number of gaming machines in the State could be implemented.

As the Casino is currently utilising 117 less than the permitted number of machines, there is an opportunity to reduce this number at relatively low (or zero) cost to the State while the Casino remains owned by FundsSA. While this may have implications for the value of the Casino, it could represent an 'easy' start to the reduction process.

## 2.3 Implementation of Prohibition

### *Legislation Required*

In order to impose a cap on the total number of gaming machines in the State and conduct a buy-back programme to reduce the number of gaming machines from the current level, the Government would need to implement a prohibition on the issuance of further licences. This would require the introduction of new legislation. It is crucial that a moratorium on licence applications is implemented between the time of announcement of the planned buy-back and the time when legislation becomes effective, to prevent an influx of licence applications from venue owners who do not intend to install machines, but who are seeking to exploit the buy-back programme. It is also important that absolute confidentiality is maintained ahead of the announcement.

There is no express power in the existing legislation which would allow the Government to stop the licence application and approval process for a period of time. Furthermore, the Commissioner is not able to be directed by the Government in relation to his discretion to refuse licence applications and the Commissioner may take the view that he should wait until amending legislation is passed by Parliament before ceasing to grant new licences. The Commissioner may be able to exercise his discretion to refuse applications made between the time of announcement and legislation taking effect on the grounds that a new licence scheme is about to be introduced. However, a failure to process applications may result in legal challenges on the basis that the Commissioner has failed to exercise his discretion at all.

Hence, the moratorium can only be implemented effectively by drafting the new legislation to terminate without compensation any licences issued by the Commissioner in the period between the date of the Government's announcement and the date of operation of the new legislation. The Government's intention to take this measure would need to be adequately explained in the announcement. There is ample precedent for Governments announcing policy before legislation is introduced and requiring Government bodies to act on the announcement: federal tax changes being announced ahead of legislation to be effective from announcement date.

### *Current Applications*

The Government will need to consider how to deal with venue owners who applied for licences before announcement of the prohibition, but whose applications had not been determined by the Commissioner. To avoid disadvantaging such applicants, the legislation to be introduced by the Government should not nullify licences granted in respect of applications made to the Commissioner before the announcement date.

### *Licences Not Fully Utilised*

The Government will also need to consider how to deal with the 957 machines which are currently permitted under existing licences, but which have not been installed. These relate to 13 venues with a total of 241 approved machines which have not installed any machines and 90 venues which have installed less machines than approved under their licence. Of the 13 venues which have not installed any machines, seven venues have already held the licences for more than six months.

In some cases, venues have received a gaming machine licence, but are still in the process of constructing premises or a gaming area. In other cases, venues have received licences to install a certain number of machines, but have not actually installed the full permitted number. Whilst the Government may not wish to disadvantage venue owners who are genuinely in the process of installing machines, it would arguably be inequitable for the State to re-purchase unutilised entitlements to install machines under licences which were obtained free of charge from the State and the licence holder has not gone to the expense of installing the machines.

Hence, we would recommend that, as part of the prohibition on new licences, the Government should announce that the number of machines allowed at any one venue under the venue's existing licence will be reduced to the actual number of machines installed at that venue at some date following the announcement. This would give venue owners who are in the process of installing machines a period of time (for example, three months) to complete their works. Venue owners who have licences with unutilised capacity to install additional machines would lose that unutilised capacity if machines are not installed within the period. This is likely to lead to an increase in the number of gaming machines actually installed. Alternately, the 90 venues could be immediately stripped of their entitlement to install extra machines from the announcement date if they were not already in the process (eg. placed orders for machines with the State Supply Board). This would be our preferred approach.

To avoid disadvantaging venue owners who have genuine reasons for not being able to meet the time limit for installing machines, the new legislation could specify that the Commissioner may grant exemptions from the time limit, provided that certain conditions are met. To prevent manipulation of the buy-back process, the Government will need to allow for the time limit to pass before the buy-back can be carried out. Furthermore, to prevent venues from exploiting the buy-back by first installing additional machines and then selling Machine Entitlements into the buy-back programme, any venue which installs new machines after the announcement should be ineligible to participate in the buy-back.

## **2.4 Other Aspects of Announcement**

Community concerns and publicity arising from the draft Productivity Commission report on the gambling industry represent an opportunity for the Government to initiate reform of the gaming machine sector. It is possible that the publicity surrounding the draft Productivity Commission report and anticipation of Government action lead to an influx in gaming machine licence applications. Hence, if the Government decides to implement its reform programme, we believe it should move quickly. In order to achieve a reduction in the number of machines in the State, the announcement would encompass:

- (a) implementation of a prohibition on the issuance new licences and "withdrawal" of entitlements to install machines under existing licences which remain unutilised within a short period (such as three months). This will have the effect of creating a cap on the number of gaming machines in South Australia;
- (b) implementation of a buy-back programme to reduce the number of gaming machines in the State from the current level,

Other aspects of the announcement required for the successful implementation of the recommended buy-back and re-sale blueprint, as discussed in Sections 3 and 4, include:

- (a) reform of the gaming machine tax regime, with the adoption of a fixed annual charge for each machine allowed under a venue's licence and a reduced revenue-based tax rate;
- (b) an increase in the venue limit from 40 to 60; and
- (c) the re-issue of one new machine licence for every two 'licences' (ie. entitlements to install machines under the existing licences) re-purchased by the Government. This could be subject to a cap on the number of re-issues during the implementation period, if that is desirable from a policy perspective. After the implementation period is completed or a minimum (net) number of machines has been re-purchased, there could be a one-for-one re-issue (which means that machine licences would not be separately tradeable, but the State could profit from any licences forfeited in future).

### 3. Buy-Back Programme

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#### 3.1 Structure of Buy-Back Process

##### *Application of Programme*

As the existing gaming machine licences pertain to venues rather than Individual gaming machines, a buy-back programme to reduce the number of gaming machines would involve paying licensees to reduce the number of machines they are entitled to install under their existing licence ("Machine Entitlement"), rather than re-purchasing the licence itself.

The existing licences allow venues to install up to 40 machines, subject to the Commissioner approving a certain maximum number of machines within that limit. In order to facilitate the buy-back process, the reform legislation introduced by the Government would need to amend the terms of the existing licences to explicitly specify the Machine Entitlement for each venue and enable that Machine Entitlement to be reduced through the buy-back process.

##### *Compulsory vs Voluntary Buy-Back*

A primary consideration for the Government in structuring the licence buy-back is whether the programme is to be conducted on a compulsory or voluntary basis. Whilst we would expect a voluntary buy-back programme to be more costly for the Government, a compulsory acquisition of Machine Entitlements is likely to have significant political implications. Compulsory acquisition (or cancellation) of some of South Australia's gaming Machine Entitlements is likely to be seen as discriminatory by those venue owners whose Machine Entitlements are acquired, whether or not the Government compensates those venue owners, and would meet strong opposition from industry groups. Establishing the level of compensation and determining which Machine Entitlements should be compulsorily acquired would be difficult. Furthermore, a compulsory termination or amendment of existing licensing arrangements by the Government would be seen as a sovereign risk issue which may have implications for future investment in other industries in South Australia. Therefore, we believe that a voluntary scheme is preferable,

##### *Fixed Price Offer*

A voluntary buy-back of Machine Entitlements could be conducted by approaching all licensees with a fixed price offer of compensation for reducing the number of machines allowed at their venue under the terms of their gaming machine licence. Alternatively, the State could offer a formula-based amount per machine, calculated according to net machine revenue and subject to a maximum per machine. The disadvantage of both approaches is that the Government would need to make an assessment of the value of the Machine Entitlements before implementation of the buy-back. Furthermore, the number of Machine Entitlements offered by venue owners at the price set by the Government may vary significantly from the Government's target reduction in the number of machines. If there is insufficient interest in the buy-back programme at the price initially offered, the Government may need to go back to the market at a higher price to acquire additional Machine Entitlements. After going back to the market a second time, licence holders will perceive weakness on the Government's part and hold out for higher prices.

### *Competitive Tender Process*

A voluntary buy-back could also be implemented by way of a competitive tender process which allows the market to determine the value of the Machine Entitlements. There are two alternative mechanisms for setting the price in a competitive tender:

- (a) accepting individual tenders at the price offered from licensees and re-purchasing those Machine Entitlements offered. Tenders would be accepted in ascending order according to the tender price, until the target number of Machine Entitlements is re-purchased. Each successful tenderer would receive a different price; or
- (b) accepting tenders from licensees and setting a "clearing price" at a level which enables the Government to achieve its target reduction in the number of Machine Entitlements (ie, if the Government is seeking to re-purchase 500 Machine Entitlements, the clearing price would be set at the 500th lowest tender price). All successful tenderers would then be compensated at the clearing price, including those tenderers who submitted a tender price below the clearing price.

Whilst the market clearing price mechanism would result in a higher total cost to the Government of re-purchasing its target number of Machine Entitlements, this approach has the advantage of treating all bidders equally and would prevent any perception of unfair or discriminatory treatment of licensees, particularly those who submit ill-informed bids well below the market clearing price.

If there is an element of licensees that have a strong interest in removing gaming machines from their premises, they would be motivated to bid low with a clearing price mechanism to ensure they are bought out at a market price that will be set by others. In some respects, this is similar to the open-priced bookbuild process used in new company floats. However, we do not expect that there would be significant numbers of licensees keen to sell at any price in the new regime where licences become scarce.

The major disadvantage of a clearing price mechanism (apart from a likely higher overall cost to the State) is that it would be difficult to implement without nominating in advance the minimum number of Machine Entitlements to be re-purchased.

If a competitive tender process is adopted, announcing the Government's target number of machine reductions may be advantageous from a political perspective. However, not announcing the target number would allow the Government to retain flexibility to review that target following an assessment of the offers received. In particular, if the Government intends to achieve a significant reduction (such as 2,000 machines which represent around 15% of the total approved number), announcing the Government's target may also lead to an inflation in tender prices due to an increased perception of scarcity.

### *Recommendation*

On balance, we would recommend that the buy-back should be conducted by way of a competitive tender process, using a market clearing price. This approach will allow the market to determine the value of the licences, while ensuring that all participants are treated equally. The Government could also defer a final decision in relation to the number of Machine Entitlements to be re-purchased until tenders have been received, but could indicate a preferred range (eg. 750 – 1,250), with the right to accept a higher number.

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## 3.2 Implementation Issues

### *Value Implications of Moratorium*

As discussed in Section 2.3, it is critical that a moratorium on new licence applications and revocation of unutilised entitlements to install additional machines are implemented before a buy-back programme can commence. Without these measures, the programme would be open to exploitation by venue owners.

At the same time, announcement of the moratorium on licence applications and the associated reforms will add significant "scarcity" value to the existing licences. Even if a venue's gaming machines are not generating a high level of net revenue compared with other venues in the State, the venue owner is likely to perceive a licence to operate gaming machines as a competitive advantage in terms of attracting customers to the venue. Once a moratorium is announced, we would also expect venue owners to take the view that existing gaming machine licences add significantly to the sale value of a venue, as the purchase of a licensed venue would be the only way of obtaining a gaming machine licence once the reforms are implemented. We would expect industry groups (such as the Australian Hotels Association) to communicate these implications of the moratorium to their constituents.

As a result of these factors, smaller venues, in particular, who operate the less profitable gaming machines targeted by the buy-back programme, would require a premium above the intrinsic value of the licence before participating in the buy-back programme.

In Section 3.3 below, we have estimated the intrinsic value of the least profitable gaming machine licences, which would be targeted by the buy-back programme, based on their net machine revenue. As a result of the "scarcity value" brought about by the announcement of the moratorium, it is likely that the State would need to pay a premium over the intrinsic value in order to attract sufficient interest in the buy-back programme. For the purpose of this report, we have assumed a premium of 20-30%. However, this is somewhat subjective and would be difficult to estimate accurately without some market research.

### *Incentives to Participate in Buy-Back*

To offset the impact of "scarcity" on the value of the licences and encourage participation in the buy-back programme, the Government could create an incentive for the targeted venues to participate in the buy-back by making changes to the tax regime applied to gaming machines. The existing tax regime is set out in Table 3.1.

**Table 3.1 - Gaming Machine Tax**

Net Machine Revenue Threshold <sup>(1)</sup>	Tax Rate <sup>(2)</sup>
Less than \$400,000 pa	35.5%
More than \$400,000 pa but less than \$945,000	\$141,645 + 40.5% of revenue above \$400,000
More than \$945,000 pa	\$362,775 + 45.6% of revenue above \$945,000

(1) Total net gaming machine revenue for the licensed venue.

(2) As a percentage of net machine revenue.

The majority of the less profitable machines targeted by the buy-back programme are those installed in venues with a smaller number of gaming machines. These are currently taxed at a rate of 35.5% of net machine revenue. The introduction of a fixed annual charge per machine by the Government, coupled with a reduced percentage of net gaming revenue, would provide an incentive for the owners of less profitable machines to sell their licence entitlements back to the State under the buy-back programme. The fixed annual charge should be set such that only gaming machines below a certain threshold of net revenue incur a higher level of tax than they would under the existing regime. Depending on the variable tax rate applied, the imposition of a fixed charge may lead to an increase in the total amount of gaming tax collected by the Government which may be attractive from a policy perspective, both in terms of reducing the profitability of gaming machines and increasing tax revenue. Alternatively, the tax regime could be restructured such that the total amount of tax collected by the Government remains substantially unchanged.

The move to a fixed/variable tax structure could lead to allegations of favouring the larger venues at the expense of small pubs and clubs, who would be forced out of the gaming machine business. This could be overcome, at least in part, by having a sliding scale of fixed charges so that there is no 'penalty' to venues for, say, the first five machines, but a penalty for more than five machines, thereby providing an incentive for a reduction in the number of machines per venue.

An analysis of detailed revenue and tax data for South Australian gaming machine venues would need to be undertaken in order to determine the optimal levels at which the fixed charge and the reduced revenue-based tax rate should be set. We have not had an opportunity to carry out such analysis as part of this review.

#### *Management of Process*

A buy-back of machine licences by way of a competitive tender process could be conducted directly by the Government. Managing the process directly has the political advantage of the Government being seen to take an active role in reducing the number of gaming machines in the State. As the Government would have full control of the process, it would be in a position to ensure that all venue owners are given the same opportunity to participate.

Alternatively, the Government may wish to consider giving responsibility for management of the process to one of its gambling Businesses, particularly if any new licences issued as part of the reform programme are also issued to that Business (refer Section 4.3). The Government could enter into a contractual arrangement with the Business ahead of the privatisation of that Business, covering the parameters of the buy-back programme.

However, the Business is unlikely to be able to manage the buy-back more efficiently and commercially than the Government, while the Business is still State-owned. Due to the time required to implement a privatisation of the Businesses, it is unlikely that significant benefits will result from management of the buy-back by one of the Businesses, within the implementation timeframe for the buy-back. Furthermore, giving responsibility for the buy-back to one of the Businesses will inevitably reduce the Government's ability to control the process (irrespective of the contractual arrangements put in place between the Business and the State) and the privatised entity may be seen by venue owners as a competitor. There may also be adverse value implications through corporate tax 'leakage', if it were to occur post-privatisation. Therefore, Government should implement the buy-back programme directly.

### 3.3 Estimated Cost of Buy-Back

The current distribution of gaming machines in South Australia is set out in Table 3.2.

Table 3.2 – Distribution of Gaming Machines in South Australia

Machines at Venue	Number of Venues	% of Venues	Gaming Machines	Cumulative Total	Average NGR <sup>(1)</sup> / Machine/Year
0-5	34	6	145	145	11,987
6-10	151	28	1,222	1,367	15,184
11-16	66	12	838	2,205	18,589
16-20	44	8	806	3,011	21,224
21-25	24	4	555	3,666	24,388
26-30	27	5	765	4,331	28,067
31-35	13	2	420	4,751	27,392
36-40	181	34	7,193	11,944	51,031
	640	100	11,944		

Source: Office of the Liquor and Gaming Commissioner.

(1) Net gaming revenue for the year ended 30 June 1999.

Some 181 venues (or 34% of all venues) have more than 35 machines. Of these, more than 160 venues have installed the maximum number of machines (ie. 40). There is a clear correlation between the number of machines installed at a venue and the net revenue per machine at that venue.

If the Government were to re-purchase 2,000 machine licences on a voluntary basis, the cost of the buy-back would be minimised by purchasing the 2,000 least profitable machine licences, which, as illustrated in Table 3.2, are likely to pertain to those machines in smaller venues (with less than 15 machines per venue). The average annual net machine revenue in venues with less than 15 machines amounts to approximately \$16,300.

We have also been advised that the actual average annual net machine revenue for the 2,000 least profitable gaming machines in South Australia is approximately \$5,800. However, this figure may not be reliable, as it includes machines which have only operated for part of the year. In our analysis of the likely cost of re-purchasing 2,000 licences, we have therefore adopted an estimated annual net machine revenue of \$16,000. We note that, if the machines actually generate significantly lower revenue, the cost to the State of re-purchasing the licences may be reduced.

Assuming a voluntary buy-back programme targeting the 2,000 least profitable gaming machines is implemented, our estimate of the annual net cash flows produced by the machines (on average) and hence the value of the machine licences targeted by the programme, is set out in Table 3.3.

Table 3.3 - Valuation of Machine Licences

Net Machine Revenue	16,000
Less:	
Gaming Tax (35.5%)	5,680
Depreciation <sup>(1)</sup>	2,400
Labour	2,500
Other Operating Costs	<u>2,000</u>
	12,580
Gross Profit	3,420
Company Tax (36%)	1,231
Net Profit After Tax	2,189
Perpetuity Calculation	
Discount Rate	15-20%
Value	10,944 - 14,592
Multiple of NPAT	5.0x - 6.7x
Re-Purchase Premium (20-30%) <sup>(2)</sup>	2,188 - 4,378
Total Value	13,132 - 18,970

(1) Based on machine cost of \$12,000 depreciated over five years.

(2) Reflects scarcity value following announcement of prohibition on licence applications (refer Section 3.2).

The basis of our analysis is as follows:

- (a) we have applied a perpetuity calculation to the estimated earnings generated by the machines in order to calculate the value of the machines. This is consistent with the unlimited life of the existing licences. Our calculation is based on a discount rate of 15-20% after tax, reflecting the relatively high rates of return required by the small business investors who own the existing licences;
- (b) on the basis that the State would be re-purchasing the least profitable machines, which are likely to be located in the smaller venues, we have utilised a 35.5% tax rate (which applies to venues with annual net machine revenue of less than \$0.4 million) in estimating the earnings generated by the machines;
- (c) our earnings estimates reflect a depreciation charge based on a five year machine life and an estimated annual labour charge of \$2,500. The estimated labour cost reflects the low turnover category of the Machine Entitlements being re-purchased. It should be noted that the analysis is quite sensitive to these assumptions, as reductions in fixed costs have a direct impact on the profitability of the machines; and
- (d) we have based our analysis on an average net machine revenue of approximately \$16,000 per annum, based on the current average for venues with less than 15 machines.

Based on the above analysis, it would cost the State around \$13,000-19,000 per machine licence (or \$26-38 million) to re-purchase the 2,000 least profitable gaming machine licences (including a 20-30% scarcity premium). We note that in addition to compensating venue owners for the value of the machine licences, the Government may need to purchase the machines from the licensees in order to generate sufficient interest in the programme.

From its analysis, Bankers Trust ("BT") concluded that some 2,400 licences could be re-purchased at an estimated cost of \$4,000 per licence. We believe that this is overly optimistic and that the State is unlikely to be able to re-purchase 2,000 licences at \$4,000 per licence on a voluntary basis. Key differences in the valuation approach used by BT are a capitalisation of earnings methodology (rather than our discounted cash flow approach), higher tax and depreciation rates and a higher labour cost assumption.

### 3.4 Future Buy-Back Programmes

Once the initial buy-back programme is completed, venue owners will not be able to sell any of their Machine Entitlements, as the existing gaming machine licences are not transferable from one venue to another. The only way for venue owners to crystallise the value of a gaming machine licence would be to sell the venue, with the licence. We believe existing licences should not become transferable between venues, as this would simply add to the value of existing licences and provide a further windfall to licensees.

The Government should consider providing an ongoing buy-back facility to provide venue owners with an opportunity to reduce their Machine Entitlements. This would be important if the gaming machine tax regime is re-structured to include a fixed charge, as this may render some of the machines in a particular venue unprofitable over time. An ongoing buy-back programme could be used to manage the number of licensed machines in the State downwards over time, or to create a pool of licences which can be auctioned by the Government from time to time.

Government could publish prices at which it is prepared to re-purchase Machine Entitlements annually (based on experience gained through the initial buy-back). The difficulty is that, in the future, the prices from prior re-issues of licences will be transparent and selling licensees will hold out for a similar price, rather than enabling the State to profit from the transfer process.

## 4. Sale of Licences

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### 4.1 Overview

The Government could recover the cost of the buy-back programme by issuing new licences in respect of some proportion of the Machine Entitlements re-purchased, in return for a licence fee. For example, a licence for one machine could be issued in respect of every two Machine Entitlements bought under the buy-back programme. This could be subject to a maximum number of machines, if necessary from a Government policy perspective. If an increase in the venue limit is implemented (through the reform legislation), the new licences could be sold to the most profitable gaming venues in the State, which currently have 40 machines, thereby maximising the licence fees received by the State. This re-distribution of machines would also result in an increase in the annual gaming tax generated for the State. Our analysis indicates that an increase in the venue limit from 40 to 60 machines would be sufficient for these measures to generate significant value for the Government.

It should be noted that, whilst these measures would result in a net reduction in the number of gaming machines in the State, they would also result in a re-distribution and concentration of gaming machines which could increase the overall level of player loss in the State and the net gaming revenue accruing to larger venues.

In order to avoid a temporary increase in the number of gaming machines in the State, a sale or 're-issue' of licences cannot commence until after completion of the buy-back programme. The alternative processes for conducting a sale of licences include:

- (a) a competitive tender process. Participation in the tender process can be restricted to venue owners. Alternatively, parties wishing to purchase a block of licences could be allowed to participate;
- (b) issuing a block of licences to one of the State-owned gambling Businesses. The licence value would be extracted through an increase in the sale proceeds upon privatisation of the Business; and
- (c) offering a block of licences for sale. The successful purchaser could use the block of machine licences to establish new venues or enter into arrangements with existing venues for the installation of additional machines.

Each of these alternatives and issues associated with their implementation are reviewed in detail below. The alternative processes for selling the licences can be structured to give venues which currently have less than 40 machines an opportunity to either purchase the licences or enter into an arrangement with the purchaser to place machines at the venue.

It would be possible to specify that linked jackpots are only allowed in respect of the new licences sold. This approach could have several benefits including:

- (a) making the licences more appealing to any party who wishes to purchase them as a block and negotiate with venues to install machines; and
- (b) constituting a tangible reason for the higher value of the licences in the re-issue programme, relative to the buy-back.

However, we understand that there may be political sensitivities with linked jackpots which would need to be taken into account.

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## 4.2 Competitive Tender Process

### 4.2.1 Structure of Tender Process

#### *Participation*

A key consideration for the Government in implementing a competitive tender process for the sale of licences is determining who can participate in the process. Participation could be restricted to venue owners. Alternatively, the Government could allow parties (such as interstate gambling businesses) who seek to purchase a block of the licences to participate. If successful in purchasing licences, these parties could either open new venues (or purchase venues) in which to install the machines, or enter into commercial arrangements with venue owners under which the machines are installed in venues.

Existing licences to operate gaming machines are specific to particular venues and cannot be transferred from one venue to another. These licence conditions would need to be altered for the 're-issued' licences, in order to facilitate ownership of a block of licences by a machine operator who makes arrangements with venues for the placement of machines.

If participation in the tender process is restricted to venue owners, we would expect the majority of the successful purchasers of the 're-issued' licences to be venues that currently have 40 machines (as these are the most profitable venues). However, there is no need to structure the licences specifically as 'above 40' licences, and all venue owners can be given an opportunity to participate.

#### *Pricing Mechanism*

A sale of the licences by way of a competitive tender process would allow the market to determine the value of the licences. As for a buy-back of licences (refer Section 3.1), two alternative pricing mechanisms are available:

- (a) accepting bids in descending order according to the bid price, with each successful bidder paying a different licence fee; or
- (b) determining a 'market clearing price' based on the bids received and selling the licences at the market clearing price to all successful bidders, including those bidders who submitted tenders above the clearing price.

The 'market clearing price' approach does not maximise the value achieved by the Government from the tender process and, in our view, there are no compelling arguments for the adoption of this approach for a sale of licences. A 'market clearing price' approach was used by the Government of NSW in September 1998 to auction licences in respect of 2,300 gaming machines. The licences allowed hotels to increase the number of gaming machines on their premises from 15 to 30. Each licence allowed the installation of one gaming machine and the market clearing price was set at \$50,000 per licence. We understand that the NSW Government received bids which were substantially higher than the market clearing price and that significant value was foregone through the adoption of a clearing price mechanism.

We note however that this is different to the approach recommended for the buy-back. There are no overriding reasons for this, except that we believe that the public will place higher thresholds of fairness and equity in the buy-back than in the re-offer of licences.

#### **4.2.2 Implementation Issues**

##### *Market Power*

Five venue owners together have interests in almost fifty of the most profitable gaming machines venues in South Australia. As a result, there is some risk that these venue owners could collude in bidding for licences in a tender process (given that they are restricted to 20 machines per venue), which may have an impact on the value achieved by the Government. The potential for a sale of the licences to interstate players such as TABCorp and Tattersalls (provided that participation in the tender process was not restricted to venue owners), and a market perception that the tender process represents the last remaining opportunity to acquire licences, would mitigate the effect of market power.

##### *Staggered Auction*

The Government will also have to consider whether to auction all of the available licences at once, or whether to conduct a series of auctions. The latter approach may yield a higher value to the Government, as a benchmark price would be set in the first auction, and bidders who were unsuccessful in the first auction would strive to meet or exceed that benchmark in order to succeed in subsequent auctions. Smaller auctions also create greater scarcity value if there is uncertainty of future auctions proceeding. We favour a staggered approach.

##### *Transferability of Licences*

The Government should also consider whether the re-issued licences should be transferable from one venue to another. Whilst transferability would increase the value of the licences and the licence fees the State would expect to achieve through the sale process, this would further reduce the effectiveness of an ongoing buy-back programme (discussed in Section 3.4).

##### *Management of Auction Process*

Management of the auction process could be conducted directly by the Government. This process would require careful management, advice and execution. Alternatively, the Government may wish to consider entering into a contractual arrangement with one of the Businesses, under which that Business would manage the process within the parameters defined in the contract. Once privatised, the Business is likely to be able to manage the auction process more efficiently and commercially than the Government could, as principal. However, this is unlikely to be the case prior to a sale of the Business and may not, therefore, be achievable from a timing perspective. There may also be adverse value implications through corporate tax leakage, if the process were to occur after privatisation.

Furthermore, if the auction process was managed by one of the Businesses under a contractual arrangement with the Government, the Government would not have full control of the process and investors may have a perception of a lack of independence and integrity. This would be of particular concern if the Business managing the process was the Adelaide Casino, which itself has a significant number of gaming machines and effectively competes with venue owners who may participate in the auction.

### 4.2.3 Estimated Value of Licences

We would expect the value of the licences to venue owners to decrease, at the margin, as more licences are made available through the auction process. That is, if a higher number of licences is sold by the Government, some of those licences will be purchased by less profitable venues who are achieving a lower average revenue per machine. As a result, these venues will place a lower value on the licences, which will be reflected by their bid in the tender process.

If the State were to increase the venue limit from 40 to 60 machines and re-sell 500 machine licences through a competitive tender process, we would expect the 25 most profitable operators (who each have 40 machines) to be in the best position to compete, increasing the number of machines at those venues to 60. Similarly, if the State were to re-sell 1,000 machine licences, the operators best placed to succeed in the auction process are likely to be the 50 most profitable venues.

A profile of the average net revenue (per machine) generated by the most profitable gaming machine venues in the State is set out in Table 4.1.

**Table 4.1 – Profile of Average Net Machine Revenue**

Venues <sup>(1)</sup>	Number of Venues With 40 Machines	Average Net Machine Revenue <sup>(2)</sup> (per Machine)
Top 25	25	91,631
Top 50	50	80,530
Top 75	74	72,150
Top 100	86	65,611

Source: Liquor and Gaming Commissioner

(1) Ranked according to profitability as measured by the average net machine revenue for the venue.

(2) For the year ended 30 June 1999.

Our analysis of the value of the licences to the venue owners is based on an estimate of the average net revenue the machines are likely to earn. In light of the profile of the average net machine revenues for the 100 most profitable gaming venues described above, we have based our analysis on an average net machine revenue of \$80,000 if 500 machine licences are sold, \$65,000 if 1,000 machine licences are sold and \$51,000 if 2,000 machine licences are sold. These figures are below the actual average net machine revenue achieved by the most profitable venues, as set out in Table 4.1, representing a prudent conservative margin given the uncertainty of forecasts against historical figures, the lack of knowledge of any major physical constraints which face the venues and the likely profit margin sought by venue operators. We note however, that there could be some upside potential in our indicative valuations in a competitive licence sale process.

Our estimate of the value of the licences under each scenario, based on the estimated earnings generated by the machines, is set out in Table 4.2.

Table 4.2 – Estimated Licence Value

	Number of Licences Issued		
	500	1,000	2,000
Estimated Net Machine Revenue (Average)	80,000	65,000	51,000
Less:			
Gaming Tax (45.6%)	35,400	29,575	23,205
Depreciation	2,400	2,400	2,400
Facilities/Building Depreciation	600	500	500
Labour	4,000	4,000	4,000
Other Opex	2,000	2,000	2,000
	<u>46,300</u>	<u>38,476</u>	<u>32,105</u>
Gross Profit	34,700	26,525	18,895
Company Tax (36%)	12,492	9,549	6,802
Net Profit After Tax	22,208	16,976	12,093
10-Year Annuity Calculation			
Discount Rate	16.0%	17.6%	20.0%
Value per Machine Licence	<u>111,457</u>	<u>77,667</u>	<u>50,699</u>
Multiple of Net Profit After Tax	6.0x	4.6x	4.2x
<b>Total Value (\$m)</b>	<b>55.7</b>	<b>77.7</b>	<b>101.4</b>

In addition to the estimated net machine revenue described above, our analysis is based on:

- (a) a ten-year annuity calculation, reflecting an assumption that the licences will have a ten year life. Even if the licences were issued on a perpetual basis, we believe that it is unlikely that investors would value them in perpetuity, given the risks associated with the emergence of competing products (such as Internet-based gambling) or a future change in Government policy. Our analysis incorporates an after tax discount rate ranging from 15-20%, reflecting the higher rate of return required by smaller/less profitable venues (at the margin) as more licences are made available to the market;
- (b) a gaming tax rate of 45.5%, as the operators who are best placed to succeed in an auction of the licences are the larger venues earning net revenues above \$945,000; and
- (c) a depreciation charge reflecting a machine life of five years and an estimated labour cost of \$4,000 per annum, reflecting the higher turnover/maintenance requirements for the machines (relative to those under the buy-back program in Section 3 above). We have also incorporated an additional depreciation charge, reflecting the estimated cost of expanding existing facilities/buildings to house the additional machines.

As set out in Table 4.2 above, we would expect the value of the licences (at the margin) to reduce if more licences are issued. If only 500 licences are issued, we would expect each licence to be valued at around \$111,000, yielding approximately \$56 million for the State in total. If 2,000 licences were to be issued, we would expect each licence to be valued at around \$51,000, yielding approximately \$101 million for the State in total. As our analysis is based on average net machine revenues below those currently being achieved in South Australia, there is potentially some upside to these figures.

We note that, if the Government were prepared to allow extremely large venues, it is likely that the value of each licence would be far greater per machine, due to the greater economies of scale and strategic value achievable. We have not however evaluated this option, as we understand it is not considered by Government to be equitable to existing venue owners.

Previous analysis carried out by BT differs from our analysis by adopting a capitalisation of earnings approach rather than discounting estimated cashflows, using a lower average net machine revenue, adopting a higher depreciation rate and not taking into account the cost of expanding existing facilities.

#### 4.2.4 Additional Gaming Tax Revenue

Our estimate of the additional gaming tax revenue accruing to the State under each scenario discussed in Section 4.2.3 above, net of the reduction in gaming tax due to the buy-back in Section 3 above, is set out in Table 4.3.

Table 4.3 - Net Impact on Gaming Tax Revenue

	Number of Licences Issued		
	500	1,000	2,000
<u>Licences Bought Back:</u>			
Number of Licences	2,000	2,000	2,000
Average NMR per annum	16,000	16,000	16,000
Tax Rate	35.5%	35.5%	35.5%
Tax per machine per annum	5,680	5,680	5,680
Total Tax (\$m)	11.4	11.4	11.4
<u>New Licences Issued:</u>			
Number of Licences	500	1,000	2,000
Average NMR per annum	80,000	65,000	60,000
Tax Rate	45.5%	45.5%	46.5%
Tax per machine per annum	36,400	29,576	22,750
Total Additional Tax (\$m)	18.2	29.6	45.5
<u>Net Increase in Annual Tax Revenue (\$m)</u>	6.8	18.2	34.1
Present Value <sup>(1)</sup>	47	125	234

(1) Based on a ten-year annuity at a discount rate of 7.5% (as used in the Feasibility Study), reflecting the assumed ten-year licence term.

### 4.3 Issuing Block of Licences to Existing Business

#### 4.3.1 Overview

The Government could issue a block of licences to one of its gambling Businesses in respect of a proportion of the Machine Entitlements acquired through the buy-back programme. The value of these licences would then be extracted through an increase in the sale value of the Business upon privatisation.

#### 4.3.2 Implementation Issues

##### Selecting Business

A key issue for the Government in implementing an allocation of the licences to one of the existing Businesses is determining which Business would gain the most value from the addition of a gaming machine franchise.

The Adelaide Casino may appear to be better placed to operate a gaming machine franchise than the other Businesses, because of its existing gaming machine operation and associated systems. However, we believe that the cost savings that could be achieved as a result of the Casino's existing operations are limited. If the gaming machines are placed in venues under agreements between the Business and the venue, the venue owner would incur the majority of the operating costs (labour, the cost of maintaining premises, etc.).

Whilst it may be possible to expand the Casino's existing IT system infrastructure to provide monitoring and linked jackpots for the machines, SA Lotteries also has an IT system which, according to management, can be augmented to provide these functions cost-effectively. Furthermore, SATAB (and, to some extent, SA Lotteries) have existing communications lines to PubTAB venues around South Australia, some of which may also be gaming machine venues. This may provide some scope for limited cost savings if SATAB and/or Lotteries were to provide a monitoring service.

#### *Arrangements between Machine Operator and Venue Owner*

The Business could use the block of licences to establish its own gaming venues (with the number of machines at each venue being subject to the venue limit). Alternatively, the Business could enter into arrangements with venue owners under which machines are installed in venues. This would be similar to the Victorian regime, where two machine operators (TABCorp and Tattersalls) place machines in venues and share the revenue with the venue owners (refer Section A1.4 in Appendix 1).

Under the Victorian regime, the share of net machine revenue between the machine operator and the venue owner (and the Government, in the form of tax) is stipulated in legislation. There are also some legislative requirements related to the distribution of machines between metropolitan and country areas and between hotels and clubs.

Another important issue pertaining to the arrangements between a machine operator and a venue owner is how the operator would prevent the venue owner from attempting to direct more turnover through the venue-owned machines (eg. through advantageous location of the machines). This problem does not arise under the Victorian regime, where all the machines in a venue are owned by one operator. Rather than labelling the machines as 'venue-owned' or 'operator-owned', this issue could be resolved by calculating the amount of revenue remitted to the machine operator as a proportion of the net revenue generated by all the machines installed at the venue.

If the Government were to issue a block of licences to one of the Businesses, it would need to consider whether to stipulate any requirements in relation to the arrangements between the Business and venue owners (including revenue sharing) in the licence terms or reform legislation. We would advise the Government to minimise any such restrictions, allowing the Business and venue owners to find the best commercial solution to these issues post-privatisation.

#### *Licence Terms*

In order to facilitate an arrangement whereby a machine operator installs gaming machines in a number of venues, the terms of the licences to be issued would need to facilitate the relocation of machines from one venue to another.

If the licences are issued as a block to one of the Businesses, the Government could also increase the value of those licences by allowing the Business to operate linked jackpots. Linked jackpots are expressly prohibited under the current regime (except for the Adelaide Casino). We would expect linked jackpots to be particularly popular in country areas, where they would give patrons an opportunity to participate in larger prize pools.

### 4.3.3 Estimated Value of Licences

If a block of machine licences is allocated to one of the Businesses, and that Business makes arrangements with venue owners for the placement of the machines, we would still expect the machines to be placed in the most profitable gambling venues. Hence, we would expect the machines to generate the same levels of net machine revenue and net profit after tax as described in Section 4.2.3 for the competitive auction scenario. We note that there is potential for the machine operator to increase revenue beyond these levels through optimisation of the distribution of the machines across venues and through linked jackpots (also refer Section 4.3.4). The after tax cash flows accruing to the machine operator would be reduced to the extent that a proportion of the net machine revenue is retained by the venue owner.

In our view, the machine operator (ie. the Business and the purchasers of the Business in a privatisation) would apply a lower discount rate to the after tax cash flows accruing to the operator, compared with the 15-20% discount rate which we have used in respect of venue owners (refer Sections 3.3 and 4.2.3). This reflects the likely lower cost of capital for the machine operator and lower risk due to the operator's ability to optimise the portfolio of gaming machines and has the effect of increasing the value of the cash flows retained by the venue operator.

The net impact of these factors is that the machine licences are likely to have a higher value to the machine operator, to the extent that the operator retains revenue generated by the machines and applies a lower discount rate than the venue owner. This analysis is set out in Table 4.4. In addition, we would expect potential purchasers of the Businesses to pay a premium for inclusion of the block of licences in a privatisation of the Business. This premium would reflect a diversification of the Business' operations and the exposure to higher growth parts of the gaming industry.

Table 4.4 – Valuation of Licences  
Issued as a Block to State-Owned Business

	Number of Licences Issued		
	500	1,000	2,000
Net Machine Revenue	80,000	65,000	61,000
Less:			
Gaming Tax (45.5%)	(36,400)	(29,575)	(23,205)
Net Revenue After Tax	43,600	35,425	27,795
Distribution to Venue Owner			
Facilities Depreciation	(600)	(500)	(500)
Labour	(4,000)	(4,000)	(4,000)
Other Operating Costs	(2,000)	(2,000)	(2,000)
	(6,500)	(6,500)	(6,500)
Margin (15%)	(975)	(975)	(975)
Total Distribution	(7,475)	(7,475)	(7,476)
Distribution to Machine Operator	36,125	27,950	20,320
Less: Depreciation <sup>(1)</sup>	(2,400)	(2,400)	(2,400)
Profit Before Tax	33,725	25,560	17,920
Less: Company Tax (36%)	(12,141)	(9,198)	(6,461)
Net Profit After Tax	21,684	16,352	11,469
<u>10-Year Annuity Calculation:</u>			
Discount Rate <sup>(2)</sup>	11.5%	11.5%	11.5%
Total Value to Operator	124,492	94,315	66,149
Total Value for all Machines (\$m)	62.2	94.3	132.3

- (1) Based on a cost of \$12,000 depreciated over a five year machine life. Assumes that the machine operator owns the machine.  
(2) Cost of equity used in the Feasibility Study for the merged entity (including SATAB, SA Lotteries and the Casino).

#### **4.3.4 Additional Gaming Tax Revenue**

As discussed in Section 4.3.3 above, we would generally expect the machines to generate the same level of net revenue, whether the licences are sold directly to venue owners or allocated as a block to one of the Businesses, as they would initially be placed in the same venues. However, if the licences are allocated as a block to one of the Businesses, that Business may be able to re-distribute the machines over time in order to maximise their revenue potential. Allowing the Business to operate linked jackpots may also generate some additional revenue. As a result, the gaming tax revenue accruing to the State may be marginally higher than our estimate of the net impact of the reforms on gaming tax set out in Section 4.2.4.

#### **4.4 Sell Block of Licences**

The Government could sell the licences as a "block" rather than to individual venues, which is similar to allocating the licences to one of the Businesses ahead of privatisation (with similar value). The owner of the licences would then enter arrangements with individual venues, which could range from:

- (a) selling the licences to individual venues;
- (b) installing machines at individual venues, subject to the overall limit of 60 machines per venue.

This would provide the State with a single upfront capital sum and avoid the need to conduct a separate tender process.

If SATAB/SA Lotteries are to be privatised, this type of sale would be preferable post-privatisation, as the purchaser of SATAB/SA Lotteries would be a logical bidder (and the prospect of this occurring may enhance the sale value of SATAB/SA Lotteries through perceived upside potential). However, this would impose timing constraints on the re-issue programme which are not desirable.

#### **4.5 Recommendation**

There are a number of factors which contribute to it being difficult to be prescriptive about the preferred approach. These include: timing of implementation; impact of federal tax on corporates; public policy issues (such as desirability of assigning the licences to one business); and the level of strategic importance a trade buyer would place on the gaming machine licences.

We believe that a trade buyer would value a block of gaming licences at a higher level than the Government could achieve by auctioning them to individual venue owners, due to the higher gaming revenue achievable through portfolio optimisation and lower cost of capital. It is possible, however, that the application of corporate tax to the machine operator could significantly diminish this value difference. This aspect will require further analysis by tax experts.

If the Government is able to wait for the privatisation of the business which is granted the block licences (which could be 15 months) then we believe the State should pursue granting a block of licences to a State gaming business which is to be privatised, rather than auctioning them to individual venue owners.

However, we believe it would be prudent to defer any decision regarding the form of the sale until detailed taxation advice has been obtained.

## Appendix 1. Arrangements in Other States

### A1.1 Distribution of Gaming Machines

A comparison of the number of gaming machines in each State is set out in Table A1.1. NSW has the highest concentration of gaming machines with 19.3 machines (outside casinos) per adult, accounting for 54% of the gaming machines in Australia. The higher penetration of gaming machines in NSW reflects the absence of a limit on the number of machines and the long history of machines in that State, with NSW having licensed gaming machines since 1956, while other states have only introduced gaming machines in the 1990s.

Table A1.1 – Distribution of Gaming Machines<sup>(1)</sup>

	Clubs	Hotels	Casino(s)	Total	No. Machines Outside Casinos per 1,000 Adults
New South Wales	72,429	23,961 <sup>(2)</sup>	1,600	97,890	19.3
Queensland	17,644	9,763	3,121	30,448	9.2
Victoria	13,691	13,613	2,500	29,804	7.7
South Australia	1,446	10,386	716	12,648	10.3
ACT	4,865 <sup>(3)</sup>	60 <sup>(3)</sup>		4,925	19.0
Tasmania	221	1,095	1,041	2,399 <sup>(3)</sup>	3.8
Northern Territory	456	132	607	1,195	4.3
Western Australia			1,125 <sup>(4)</sup>	1,125 <sup>(4)</sup>	-
<b>Total</b>	<b>110,652</b>	<b>59,030</b>	<b>10,610</b>	<b>180,334<sup>(5)</sup></b>	

Source: Australia's Gambling Industries, Draft Report by the Productivity Commission

(1) Most recently available data, but not all for the same date.

(2) Not all are poker machines (includes video draw poker machines).

(3) Total for Tasmania includes 42 machines operated by Admirals Casino Pty Ltd on the *Spirit of Tasmania*.

(4) All electronic video games, not poker machines.

(5) 'Draw card' and 'draw on hold' machines only.

### A1.2 Gaming Machine Restrictions

All Australian states impose some restrictions on the number of gaming machines, including one or more of the following:

- (a) an overall cap on the number of gaming machines in the state or in a region (or both);
- (b) a limit on the number of gaming machines per venue;
- (c) the types of venues in which gaming machines are permitted; and
- (d) the types of machines permitted, processes for approving manufacturers and monitoring arrangements.

Restrictions on the number of gaming machines are summarised in Table A1.2.

Table A1.2 – Global and per Venue Caps on Gaming Machines

	Global Cap?	Casino Cap?	Global Cap on Clubs and Hotels?	Cap on Individual Clubs?	Cap on Individual Hotels?
New South Wales	No	1,500	No	No	30
Victoria	30,000 <sup>(1)</sup>	2,500	27,500 <sup>(1)</sup>	105	105
Queensland	No	No <sup>(2)</sup>	No	280 <sup>(3)</sup>	35 <sup>(3)</sup>
Western Australia	No	No <sup>(3)</sup>			
South Australia	No	No <sup>(3)</sup>	No	40	40
Tasmania	No	No	No	26 <sup>(4)</sup>	15 <sup>(4)</sup>
ACT	5,200 <sup>(5)</sup>		5,200	No <sup>(6)</sup>	13 <sup>(7)</sup>
Northern Territory	No	No	Target of 680 (indicative maximum)	45 <sup>(8)</sup>	6

Source: Australia's Gambling Industries, Draft Report by the Productivity Commission

- (1) While the *Casino (Management Agreement) Act 1993* sets a limit of 45,000 gaming machines throughout Victoria until 2005, a Ministerial Direction limits the number in clubs and hotels to 27,500, and a further 2,500 are permitted in the Casino.
- (2) No formal limit, but any increase requires government approval.
- (3) From 1 July 1999. Scheduled to phase up to a maximum of 300 per club and 45 per hotel from 1 July 2001.
- (4) Until 30 June 2000. Scheduled to phase up to a maximum of 40 per club and 30 per hotel from 1 July 2002.
- (5) Subject to global cap on clubs and hotels.
- (6) Currently applies until 24 June 1999, but continuation is proposed. New licences may still be granted gaming machine licences even if that were to take the total number of gaming machines above 5,200.
- (7) 'Draw card' and 'draw on hold' machines only.
- (8) Not limited by legislation, but set by Gaming Commissioner.

In September 1998 the NSW Government offered for sale licences in respect of 2,300 gaming machines, allowing hotels to install more than 15 and up to 30 machines. NSW specified that only the hotel owners could purchase the gaming machine licences. The price of each licence was set at the market clearing level, with all successful bidders paying the market clearing price, even if this was below their actual bid. The market clearing price was established at \$50,000 per licence (ie. per machine) by way of a competitive tender process.

Other restrictions in relation to gaming machines are set out in Table A1.3.

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Table A1.3 – Machine Gaming in Clubs and Hotels: Some Parameters

	NSW	Vic	Qld	SA	Tas	ACT	NT
Minimum payouts?	85%	87%	85% (max 92%)	85%	85%	85%	88-92% (depends on game)
Gaming machines to be in a designated gaming area?	✓ <sup>(1)</sup>	✓ <sup>(2)</sup>	✓	✓	✓	✓	✓ <sup>(3)</sup>
Note acceptors prohibited?	x	x	x	✓	✓ <sup>(4)</sup>	x	✓
ATMs prohibited from gaming area?	x	✓	x	✓	✓	✓	x <sup>(5)</sup>
Credit by venue prohibited?	✓	✓	✓	✓	✓	✓	✓
Maximum bets?	\$10	x	\$5	\$10	\$10	\$10	\$5
Linked Jackpots in venues?	✓	✓	✓	x	x	✓	✓ <sup>(6)</sup>
Wide area jackpots?	x <sup>(7)</sup>	✓	✓	x	x	✓	x
24-hour monitoring	x <sup>(7)</sup>	✓	✓	✓	✓	x	✓

Source: Australia's Gambling Industries, Draft Report by the Productivity Commission.

- (1) But not applicable to venues of 10 or less gaming machines.
- (2) Except for five gaming machines with \$2 bet maximum which are allowed outside the restricted gaming area.
- (3) Not strictly, but machines need to be in an area under constant supervision.
- (4) But their future use is under consideration.
- (5) Not prohibited, but the Commission prefers ATMs not to be in or near the gaming area. Cash limit of \$200 per day, and no access to funds from credit accounts.
- (6) Jackpots are permitted, although none are operating.
- (7) But moving towards this.

### A1.3 Ownership of Gaming Machines

#### Overview

In all States (where gaming machines are permitted) except for Victoria, venues buy or lease gaming machines and operate the machines. These arrangements are summarised in Table A1.4 and the Victorian arrangements are discussed in more detail below.

**Table A1.4 - Ownership of Gaming Machines**

State	Ownership Arrangements for Clubs and Hotels
NSW, QLD, ACT	Venues buy/lease gaming machines from approved manufacturers or financiers.
SA	Venues buy gaming machines from the State Supply Board.
NT	All gaming machines are owned by the Government.
TAS	Venues lease gaming machines from the Federal Group (the casino licensee).
VIC	Two licensed gaming machine operators (TABCorp and Tattersalls) own and maintain all of the machines and retain one third of net machine revenue.

*Victorian Arrangements*

in Victoria, TABCorp and Tattersalls each have an exclusive licence to own and operate up to half the maximum number of gaming machines permitted in clubs and hotels throughout the state. The operators are required to ensure that a minimum of 20% of gaming machines are installed outside Melbourne and that the machines are distributed evenly between clubs and hotels.

The Victorian arrangements also impose an overall cap of 27,500 on the number of gaming machines permitted in clubs and hotels. As a result, the two operators place gaming machines in venues according to their assessment of likely profitability, in order to optimise the performance of the limited number of machines. Under these arrangements, clubs and hotels cannot control the number of machines located at their venue, as the operators may choose to reduce the number of machines at a venue if returns are deemed to be insufficient. Venue owners who are not successful in contracting with the operators for gaming machines to be installed at their venue are likely to feel disadvantaged relative to venues which do have gaming machines. These arrangements are in contrast to those currently in place in South Australia, where all venues have equal access to machine licences.

**A1.4 Monitoring of Gaming Machines**

All States have implemented measures to monitor the integrity of the gaming machines and to confirm that the correct amounts of gaming tax are being paid. Monitoring arrangements are summarised in Table A1.5.

Table A1.5 – Monitoring of Gaming Machines

State	Monitoring Arrangements
NSW	Gaming machines in clubs and hotels to be connected to a central monitoring system (operated by TAB Limited) by 2001.
VIC	Online monitoring by the two operators, Tattersalls and TABCorp and verified by the VCGA.
OLD	Online monitoring by eight licensed monitoring operators. Venues decide which operator to contract with for monitoring and related services.
WA	Online reporting to Office of Racing, Gaming and Liquor.
SA	Online central monitoring by the Independent Gaming Corporation (jointly operated by the clubs and hotels).
TAS	Online central monitoring by the operator, the Federal Group.
ACT	Venues submit monthly returns to government.
NT	Central monitoring by government for clubs and hotels.

**SATAB / LCSA PROJECT, CONSULTANCY COSTS - PAST AND PROJECTED - as at August 1999**

f f

PAST COSTS - Approximate, based on estimated costs as accrued, not "as paid"

	Dec 1997 to Jan 1998 BZW Desktop Review	March to Aug 1998 TAB/LCSA Scoping, Value-adding (GM's), Preliminary Next steps	Sep to Nov 1998 Principal Consultancy, Key Racee to ASCC, Preliminary Next steps	Dec 1998 to Feb 1999 Principal Consultancy, Follow-up of ASCC requests	March to May 1999 Ingeraon Proposal, franchising, other TAB proposals, RCCG, minimal consultancies	Juh to Aug 1999 Feasibility Study, Value-adding (GM's) Follow-up of Cabinet requests	Total - Dec 1997 to Aug 1999
BZW		BTW MCF MMB JWS	BTW PWC MMB JWS FBS	BTW PWC MMB JWS FBS	PWC FBS	CSFB PWC FBS	
	50,000	393,294	747,011	498,664	36,758	237,200	1,962,927

ESTIMATED FUTURE COSTS - Very preliminary, considered conservative, requires CSFB input once sales strategy confirmed

	Sep to Dec 1999 Merger preps, Reg and Leg issues, HR/IR, SARI, Board structures, etc etc		Jan to Mar 2000 Merger pre-implementation, Business plans, SARI documentation, legislation, etc etc		Apr to May 2000 Parliamentary debate		Jun to Sep 2000 Appoint Board/management, implement merger, vendor due diligence, draft IM, etc etc		Oct to Dec 2000 Trade sale process - issue IM, receive/assess bids, negotiate commercial terms/documentation		Jan 2001 Success fee payment, Pobity Auditor sign-off	Total - Sep 1999 to Jan 2001
	Monthly*	Total	Monthly*	Total	Monthly**	Total	Monthly*	Total	Monthly*	Total	Total	
CSFB	100,000		100,000		75,000		100,000		100,000			
PWC	75,000		75,000		50,000		75,000		15,000			
Legal	100,000		100,000		30,000		75,000		50,000			
FBS	10,000		20,000		20,000		20,000		5,000			
Other	50,000		75,000		10,000		20,000		20,000		50,000	
	368,500	1,474,000	407,000	1,221,000	203,500	407,000	319,000	1,276,000	209,000	627,000	4,700,000	9,705,000
											Success Fee **	5,337,500
											(1.25% x \$427m)	
											Fee Rebate	-700,000
											(7 x \$100K)	4,637,500
												50,000
												4,700,000

\* includes allowance for out-of-pockets

^ assumes some negotiation down of current CSFB proposed fee structure for "pre-legislation" period

\*\* Assumes sale value at mid point of CSFB price range

Est Total Consultancies December 1997 to January 2000 : 11,667,927

**MINUTE forming ENCLOSURE to:**

**ATTACHMENT F**

**TO: MINISTER FOR GOVERNMENT ENTERPRISES**

**RE: SA TAB/LCSA REVIEWS - COMPARISON OF CSFB & BTW FEES**

### **INTRODUCTION**

We have provided preliminary information to you regarding CSFB's interest in an ongoing appointment to the SA TAB/LCSA project.

This paper provides a more detailed analysis of CSFB's proposed fee structure, as requested.

Subject to your views, and to the satisfactory resolution of conflict of interest issues in particular, this paper could form the basis of a recommendation to Cabinet for CSFB's appointment.

A separate paper will be forwarded to you shortly regarding overall project consultancy costs, which could possibly be submitted to Cabinet at the same time, in response to a Cabinet request on 16 August 1999.

### **BACKGROUND**

Following the Feasibility Study, it has been proposed that CSFB's advisory role be extended for the asset preparatory phase of a sale process and that BTW's appointment as Principal Consultant be discontinued.

It has been considered appropriate, however, to resolve the key terms of the CSFB consultancy - including fees, indemnities and conflicts of interest - before BTW's appointment is terminated.

CSFB's preference was to clarify the outcome of Cabinet's deliberations regarding its preferred sales strategy before registering its formal interest in an ongoing role. On the basis of Cabinet's in principle decision of 9 August 1999, CSFB has now formally confirmed its interest in acting as Principal Financial Advisor for a merger and trade sale of SA TAB and LCSA and has submitted a proposed fee structure.

CSFB has indicated informally that it would also be interested in an ongoing role in the IPO-related options that Cabinet has further reviewed recently. However, we have not at this point sounded out CSFB's interest in a sale of either SA TAB or LCSA alone.

It is considered that the terms negotiated with BTW for the SA TAB/LCSA reviews, and for the sale of SA TAB, provide the best benchmark against which to assess CSFB's fee proposals.

## DISCUSSION

Both BTW and CSFB have indicated that the preparation and sale of SA TAB and LCSA could take around 12-18 months, depending on the form of sale, passage of legislation and negotiations with stakeholders, particularly the South Australian Racing Industry.

Attachment 1 shows that for a project timetable of 12 or 18 months, CSFB's proposed consultancy costs (excluding out of pocket expenses) are comparable - if not less than - those negotiated for the BTW consultancy.

In addition, while both consultants' teams for this project have relevant experience, CSFB's proposed team has considerable experience in Government asset sales, has a deep and impressive skills mix and has consistently shown that it can understand and respond to the Government's requirements within tight timeframes.

CSFB has proposed the following fee structure based on the Government proceeding with a merger and trade sale of SA TAB and LCSA:-

- a monthly fixed fee of \$100,000. CSFB has indicated that the monthly fees for the period after sale legislation is passed would be rebateable against the success fee; and
- a success fee of 1.25% of the aggregate sale value of a merged entity with a minimum transaction fee of \$3.5 million.

Based on CSFB's estimates of proceeds from a merger and trade sale of SA TAB and LCSA in the order of \$403 - 450 million, a 1.25% success fee would result in a success fee of around \$5.0 - \$5.6 million (from which post-legislation monthly fees would be deducted).

This SUCCESS fee (prior to rebates) equates to approximately 0.25% of the total present value of SA TAB and LCSA (ie. including tax revenues to the Government), estimated at \$2.1 billion.

In comparison to CSFB's proposed fee structure, the key terms of BTW's fees are:-

- an hourly fee for service (\$375), capped at \$180,000 with no minimum monthly fee; and
- a completion fee of \$925,000 (for SA TAB sale only) - representing approximately:-

- 1.2% of the sale proceeds (based on BTW's SA TAB valuation mid point of approximately \$80 million), and
- 0.35%-0.45% of the (then) overall present value estimated for SA TAB (ie. including tax revenues to the Government).

BTW's fees did not address a possible sale of LCSA as the Government had taken no firm decisions to proceed with privatisation, but it is considered likely that BTW would seek a success fee on a comparable basis to that agreed for SA TAB (ie. around 1.2% of sale proceeds).

Discussions with ERSU at the time indicated that the fee structure agreed with BTW, following extensive negotiations, for its appointment as Principal Consultant was reasonable in comparison to the ETSA arrangements.

It is difficult to make precise comparisons of the two fee structures particularly due to the differing scope of the briefs, the variances in the perceived value of SA TAB and the alternative monthly fee structures (including the CSFB rebate against the success fee).

Nevertheless, CSFB's fees appear reasonable, given the current BTW arrangement, role and resources likely to be required and the quality of CSFB's work.

It is proposed, however, that ASU(G) raise with CSFB the possibility of including the following terms in the agreed fee structure:-

- a lower minimum success fee (currently \$3.5 million) as a guard against the possibility of CSFB's valuations proving to be inflated;
- a possible cap on the success fee for exceptionally high bids; and
- a base retainer fee which would replace the monthly fixed fee in times where the project faced lengthy delays, particularly prior to and during the passage of prerequisite legislation.

The Crown Solicitor's Office is currently considering other key terms relevant to the Consultancy, including indemnities and potential conflicts of interest, to enable the Government's standard consultancy documentation for CSFB's appointment to be finalised, once Cabinet has confirmed its preferred sales strategy and commercial and other issues have been resolved .

## **RECOMMENDATION**

It is recommended that you:-

- note the comparison of CSFB's fee structure to that agreed with BTW for the Principal Consultancy role; and
- subject to Cabinet confirming its preferred sales strategy, approve the Chief Executive of the Department for Administrative and Information Services negotiating final terms, conditions and contractual arrangements with CSFB, in consultation with the Crown Solicitor's Office.

Graham Foreman  
CHIEF EXECUTIVE  
DEPARTMENT FOR ADMINISTRATIVE  
AND INFORMATION SERVICES

August 1999

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**COMPARISON OF CSFB AND BTW FEES**

Scenario 1 - 12 months sale process

	Monthly Fee pre legislation	Effective Monthly Fee post legislation	Success Fee	Total Fee
CSFB	600,000	Nil	5,300,000	5.9 million
BTW	1,080,000	1,080,000	4,300,000	6.5 million

**Assumptions:**

- Merger and sale of SA TAB and LCSA takes 12 months - ie. 6 months prior to legislation being passed and 6 months after legislation is passed.
- Project requirements ensure BTW's capped monthly fee is met each month and that CSFB's fixed \$100,000 monthly fee would apply throughout the period.
- BTW require a success fee for the sale of LCSA on a comparative basis to that agreed for SA TAB - ie a total transaction fee of \$4.3 m for the sale of SA TAB and LCSA .
- Sale of SA TAB and LCSA achieves a sale value of \$427 million (mid point of CSFB's valuation).
- Sale is completed and CSFB's fee is rebateable against the success fee.

Scenario 2 - 18 months sale process

	Monthly Fee pre legislation	Monthly Fee post legislation	Success Fee	Total Fee
CSFB	800,000	Nil	5,300,000	6.1 million
BTW	1,440,000	1,800,000	4,300,000	7.5 million

**Assumptions:**

- Merger and sale of SA TAB and LCSA takes 18 months - ie. 8 months prior to legislation being passed and 10 months after legislation is passed.
- Project requirements ensure BTW's capped monthly fee is met each month and that CSFB's fixed \$100,000 monthly fee would apply throughout the period.
- BTW require a success fee for the sale of LCSA on a comparative basis to that agreed for SA TAB.
- Sale of SA TAB and LCSA achieves a sale value of \$427 million (mid point of CSFB's valuation).
- Sale is completed and CSFB's fee is rebateable against the success fee.