State of New Jersey
DEPARTMENT OF THE TREASURY
DIVISION OF STATE LOTTERY
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Michellene Davis
Acting State Treasurer

October 29, 2007

Dear Acting Treasurer Davis,

Christiansen Capital Advisors, LLC (CCA) has prepared an analysis of the New Jersey gaming environment, as it currently exists today, and the anticipated effect of the introduction of video lottery terminals (VLT) on Atlantic City casinos and New Jersey Lottery revenues. The CCA report is being delivered to you under separate cover from the Office of Public Finance. In order to put the results of that study into the proper context, I am writing this letter to advise you of the costs of a VLT operation and the effect of those costs on the expected net proceeds of a VLT operation.

Summary:

The installation of VLTs at the Meadowlands presents the potential to generate an annual gross "win" (revenue net of prize payouts) of approximately $268.3 million. The net revenue to the State, for the constitutional dedication to Education and Institutions, would be approximately $114 million once the following required or mandatory expenses are addressed:

- $120.7 million for retention of a licensed qualified agent to run the day-to-day VLT facility operations;
- $22.8 million for acquiring and maintaining VLT machines and requisite software;
- $6.7 million for a central monitoring and accounting system for VLT transactions; and,
- $3.9 million for the assumption of State administrative costs.

The above costs do not factor in any of the requisite capital expenditures for facility upgrades or improvements to accommodate VLTs and VLT patrons. These estimates are anticipated to be significant. Additionally, the Christiansen study did not, and was not intended to, opine on the many legal issues which may be surrounding the viability of VLTs in New Jersey. Three chief issues among them are: 1) whether the VLT's centralized number system, which determines the outcome of each wager using a random number generator, would be permitted under New Jersey's Constitution and 2) whether a constitutional amendment would be necessary to dedicate VLT revenues to sources other than Education and Institution purposes, including to the racing industry and 3) whether the establishment of VLT's requires any further analysis under the New Jersey Constitution's provision on permissible gambling within the State.

Report Methodology:

CCA presented three scenarios as required under the Scope of Services in the RFQ for VLT Market Feasibility Consultant issued on March 14, 2007. Scenario A: VLTs at the Meadowlands Racetrack. Scenario B: VLT's at the Meadowlands and Monmouth Racetracks. Scenario C: VLTs at the Meadowlands, Monmouth and Freehold Racetracks. Key in CCA's analysis, was their projection of "Net Machine Win" (defined below) for each scenario:

	Net Machine Win
• Scenario A:	
o 2,100 VLTs – Meadowlands Racetrack	$350
• Scenario B:	
o 2,100 VLTs – Meadowlands Racetrack	$350
o 2,100 VLTs – Monmouth Racetrack	$187
• Scenario C:	
o 2,100 VLTs – Meadowlands Racetrack	$350
o 2,100 VLTs – Monmouth Racetrack	$ 99
o 2,100 VLTs – Freehold Raceway	$116

Atlantic City's casino operations and the State operated New Jersey Lottery provide an important revenue stream to support important dedicated causes (Casinos: Senior Citizen Programs; Lottery: Education and State Institutions). It is essential that the State take the results of CCA's work, which among other things, projects gross gaming revenues from VLT operations in the three (3) scenarios described above, then consider the potential costs of running a VLT operation and insure that the required Lottery contributions to Education and State Institutions are met..

It is important that we identify all of the costs that would be associated with the various scenarios presented by CCA. CCA's "Net Machine Win" projections reflect the gross revenue that would be left behind by the playing public. CCA's projections, however, do not include all of the costs associated with running a successful VLT operation, nor does it include the capital costs necessary to upgrade facilities and purchase and install VLTs. In this letter I will focus on the operating costs of a VLT facility. We are not currently in a position to identify the capital costs associated with any of the three (3) scenarios. It is anticipated that any State Lottery run VLT operation will follow the best practices that are currently being followed in the Lottery industry today. These would include, contracting for a central computer monitoring system and network connectivity of all gaming devices, licensing VLT facility operators and contracting with VLT terminal providers (manufacturers). Currently, in VLT operations existing in other states, the contractors and licensees are compensated for their efforts by a percent of the revenue generated from VLT operations. These costs must be identified and incorporated into any revenue analysis in order to assess the profitability of the proposed VLT operation.

The following set of definitions will provide an explanation of the key terms that will itemize the associated costs of VLT operations:

- **Net Machine Win** – the Gaming industry uses this term to determine the net credits played at each device. This term represents the end of day scenario after all prizes have been paid. The VLT best practice is to provide a prize award rate of ninety two percent (92%) of the "credits in" or gross handle for the machine. Many of the prizes awarded ("credits out") are returned in the form of additional play ("credits in").

- **Central System Vendor Fees** – The State must perform its due diligence and ensure the accountability of all VLT transactions processed at each terminal. To that end, the industry best practice is to contract with a qualified gaming vendor who will provide the necessary central monitoring computer system and network connectivity to ensure that all transactions are accounted for and monitored. The State of Rhode Island recently completed a procurement process for the continuation of their VLT operation for these services. The contractor selected by Rhode Island currently provides these services for 2.5% of the Net Machine Win. New Jersey will utilize this rate as a benchmark in our analysis.

- **VLT Facility Operations** - The State will need to license a qualified agent (operator) to run the day-to-day operations at the VLT facility. The operator will be responsible for all infrastructure, on-site personnel, and facility maintenance necessary to support the daily gaming environment. Current best practices within the VLT industry provide for a range of compensation, usually tied to the potential volume of gaming activity. Compensation rates to operators are based on percentage of Net Machine Win. The following is a sample of current operator rates in the VLT industry:
  - New York - 30% average base on a sliding scale of activity (NY facility operators are soliciting a rate increase from the NY legislature of 36% to 42%. *Source; Mid-Hudson News, June 2007*).
  - Rhode Island – 26% average[1]
  - Delaware – 47.6% average
  - West Virginia 47% average

  The State of New Jersey is estimating an average operator compensation rate of 45% of Net Machine Win and is subject to change.

- **Terminal Suppliers** – The State will need to contract with qualified vendors who will design, manufacture, and provide maintenance to the machines at the gaming facility. The terminal supplier must ensure software compatibility to the central monitoring system. The State of Rhode Island recently completed the procurement process for the continuation of VLT operation for these services. The multiple contractors selected by Rhode Island currently provide these services for 8.5% of the Net Machine Win. New Jersey will utilize this rate as a benchmark in our analysis.

[1] Rhode Island VLT operations are located in smaller dog track facilities. It is assumed that the operating overhead for these facilities is much less than those at Horse Racing facilities resulting in a lower facility operator fee.

- **State Administrative Costs** - To ensure that the responsible State department can perform its due diligence in the oversight of VLT operations, the state will assume various administrative costs to ensure security, integrity and accountability. It is anticipated that a 24 / 7 State security presence will be needed at each VLT facility to provide on site monitoring of operations. It is also anticipated that effective sales and marketing support will be necessary in order to ensure a successful program of customer awareness is maintained in the marketplace. These costs will be a fixed annual fee based upon the number of state employees dedicated to the VLT program and the associated marketing and administrative support. The preliminary personnel requirements (FTE) necessary to support just one facility are as follows:

	FTE
o Direct Product Administration	
▪ Deputy Director VLT Operations	1
▪ Administrative Assistant	1
▪ Brand Manager	1
▪ Administrative Analyst	1
o Product Support	
▪ Accounting	1
▪ Clerical	1
▪ Tech 2	1
▪ Principle Tech MIS	1
o Sales	
▪ Chain Store Specialist Sales Rep.	1
o Security	
▪ Senior Security Rep VLT Operations	1
▪ On-Site Lottery Security (1 per shift)	8
Total FTE	18

The following revenue analysis, Exhibit L.1, will utilize CCA's projection as presented in scenario "A" where the State would install 2,100 VLTs at the Meadowlands racetrack. CCA has projected the "net win per machine" per day to be $350. We have also presented for, comparative purposes; the surplus proceeds (if any) from VLT operations for various "net win per machine levels."

"Net Available from VLT Operations" (in yellow) represents the remaining funds available to the State .

Exhibit L.1

	Statutory Breakeven	CCA Estimate Level 1	Level 2	Level 3	Level 4
Gross Handle-(Credits In)	$ 453.22	$ 2,500.00	$ 4,375.00	$ 5,000.00	$ 6,250.00
Prizes @ 92%	$ 416.96	$ 2,300.00	$ 4,025.00	$ 4,600.00	$ 5,750.00
Net Machine Win	$ 36.26	$ 200.00	$ 350.00	$ 400.00	$ 500.00
Number of Machines	2,100	2,100	2,100	2,100	2,100
Operational Days	365	365	365	365	365
Annual Net Win	$ 27,791,171	$ 153,300,000	$ 268,275,000	$ 306,600,000	$ 383,250,000
Central System Vendor Fees	694,779	3,832,500	6,706,875	7,665,000	9,581,250
VLT Facility Operations	12,506,027	68,985,000	120,723,750	137,970,000	172,462,500
Terminal Suppliers	2,362,250	13,030,500	22,803,375	26,061,000	32,576,250
Total Operating Fees	15,563,056	85,848,000	150,234,000	171,696,000	214,620,000
Total Available From VLT Operations	12,228,115	67,452,000	118,041,000	134,904,000	168,630,000
State Administrative Costs	3,890,764	3,890,764	3,890,764	3,890,764	3,890,764
Net Available from VLT Operations	**$ 8,337,351**	**$ 63,561,236**	**$ 114,150,236**	**$ 131,013,236**	**$ 164,739,236**

As presented in the above spreadsheet, a statutory breakeven analysis determines the Net Machine Win sufficient to fund the State's oversight of the operations of a VLT facility AND to meet the statutorily mandated minimum return to the State of 30% (which, if measured based on Net Machine Win, would be $28 million). In this scenario, there are no additional funds for other potential uses and most likely will not sufficiently cover the facility overhead[2]. If the CCA estimated Net Machine Win of $350 per machine materializes, and the estimated costs provided above to operate a VLT facility are accurate, then it appears that there would be $114 million available for the State. Please note that the estimate of $350 Net Machine Win, as compared to Net Machine Win in other states, per CCA's report in Exhibit B.1, is one of the higher amounts of the 8 facilities provided for comparison purposes. For this reason, and to provide context around the possibility that the actual Net Machine Win could be different from the CCA projection, there are several other Net Machine Win amounts provided: including $200 (Level 1), $400 (Level 3) and $500 (Level 4). In the $200 Net Machine Win scenario, $63.5 million surplus proceeds are available, while in the $400 and $500 scenarios, the surpluses are much higher at $131 million and $164.7 million. Please note, that to the extent operating costs exceed those indicated above, the surplus proceeds would be reduced.

To reiterate, I would like to make certain that you are fully aware of both the information developed by CCA in their report as well as what happens downstream, in terms of operating expenditures and statutorily required contributions. It is also important for you to note that CCA indicates that future lottery contributions to the general fund, from traditional product sales, would be modestly impacted by the competition brought on by an introduction of VLTs in the State of New Jersey. The projection by CCA indicates that the future revenue stream of lottery contributions, to the general fund, will be lower than they would have otherwise been by 3.05% or approximately $31.3 million, by fiscal year 2011.

To the extent that you have any questions, please feel free to contact me at your convenience.

Regards,

William Jourdain,
Acting Executive Director
Division of State Lottery

C: Gary Rose, Chief, Office of Economic Growth
Nancy Feldman, Director, Office of Public Finance
Kevin Drennan, Executive Director, Commerce and Economic Growth
Catherine Singer, Office of Public Finance

[2] Facility operators will be contracted at a % of net machine win. In the statutory breakeven scenario level of operation this may not be sufficient to cover the operators fixed expenses i.e.; salaries and operational overhead.