

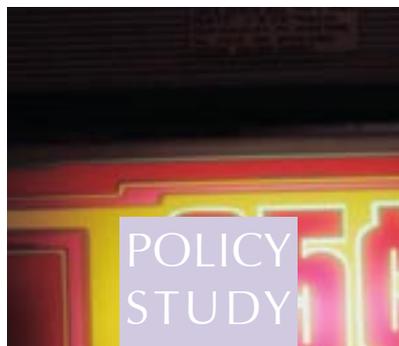


Reason

October 2004

EXPANDING SLOT GAMING IN CALIFORNIA: A BUSINESS ANALYSIS

By Jeffrey C. Hooke and Thomas A. Firey
Project Director: Adrian T. Moore, Ph.D



POLICY
STUDY
326



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Expanding Slot Gaming in California

A Business Analysis

By Jeffrey C. Hooke and Thomas A. Firey
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Executive Summary

California's severe financial situation has prompted state leaders to consider expanding casino-style slot machine gaming. Governor Schwarzenegger and his administration, in particular, are counting on slots revenue to help plug the state's massive budgetary hole. Several options available have fueled controversy within the state regarding revenue and other concerns. To aid leaders in comparing the options, this report examines several possible market designs that California could adopt to expand casino-style slot machine gaming and enhance state revenue. Specifically, this report projects what revenue California would receive under each market design, and what other advantages and drawbacks are implicit in the designs.

Our findings indicate that, if the state elects to expand casino-style slot machine gaming, it would maximize state revenue by auctioning off a small number of operating licenses via a "Reverse Auction" whereby potential operators (including state horse tracks and Indian tribes) vie for the licenses by offering to retain the smallest portion of the win. Under that design, our modeling shows the state would receive \$3.5 billion annually from slot gaming at 15 non-urban locations, with the present value over 20 years equaling \$32 billion. If the games were placed in prime urban locations, the present value of state revenue from the machines increases to \$37 billion.

The state could also receive substantial revenue by auctioning the licenses for cash up front. For 15 non-urban licenses, we project that the state would receive \$15.9 billion initially, followed by smaller annual payments of \$468 million, for a total present value of \$20 billion.

By comparison, the Indian gaming compacts recently negotiated by Governor Schwarzenegger's administration, if enacted with all casino-operating tribes, would provide the state with \$9 billion in present value revenue. Alternatively, Proposition 68, which would give slot machine monopolies to horse tracks and card rooms near prime urban areas, would provide California with gaming tax revenue of a present value of

\$17 billion. Proposition 70, which would place an 8.8 percent state income tax on Indian gaming operations while maintaining their monopoly position, would provide tax revenue of a present value of less than \$3 billion to the state.

Table 1 provides a summary of our modeling results of the various California slot machine market designs.

Table 1: Financial Summary Of Casino-Style Slot Gaming Expansions (In Millions)				
Design	Location of New Facilities	Up-front State Revenue	Annual State Revenue at Maturity, Before Inflation	Present Value to State Over 20 Years at 10% Discount Rate
<p>1A. Reverse Auction (Urban locations) Prospective operators would “bid” on what percentage of the win the state would receive.</p>	Prime Urban Sites	\$0	\$3,942	\$36,541
<p>1B. Reverse Auction (Non-urban locations) Prospective operators would “bid” on what percentage of the win the state would receive.</p>	Secondary Commercial Areas	\$0	\$3,500	\$32,440
<p>2. Cash Auction Prospective operators would bid cash up front for the licenses; the state would also receive an annual fee of \$12,000–\$25,000 per machine.</p>	Secondary Commercial Areas	\$15,900	\$468	\$19,905
<p>3. New Compacts Indian tribes would receive more machines in exchange for paying the state up to 25% of the profits from them and other operating concessions.</p>	Tribal Lands	\$5,000	\$468	\$9,005
<p>4. Proposition 68 Selected racetracks and card rooms would operate up to 30,000 slot machines in exchange for paying an annual 33% gaming tax.</p>	Racetracks and Card Rooms in Prime Urban Locations	\$0	\$1,807	\$16,748
<p>5. Proposition 70 Indian tribes would receive unlimited slots and continued monopoly power in exchange for an 8.8% income tax on slots earnings.</p>	Tribal Lands	\$0	\$281	\$2,604

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Part 1

Introduction

The question of whether to expand casino-style slot machine gaming in California is a controversial issue in 2004. But state leaders are willing to consider the idea because of the state's severe financial situation. Governor Schwarzenegger and his administration, in particular are counting on slots revenue to help plug the state's massive budgetary hole.

This report examines the financial returns to the state of various options that could be used to award the legal right to conduct slots gaming in California. Some options that we consider would use competitive bidding to determine the operators, while others—typically favored by state political leaders and interest groups—would award those rights through political decisions. Below is a brief summary of each market design:

Design #1: Competitive Bidding via Reverse Auction

California would invite potential gaming operators to bid against each other on a limited number of slots parlor operating licenses. Each of the 15 licenses we envision would allow the holder to operate a 2,000-machine facility within a specified geographical area. The operators would bid on what percentage of the win (i.e., the highest tax) they would take in exchange for the license, with the lowest bidder receiving the license and the state of California receiving the rest of the slots revenue.

Design #2: Competitive Bidding via Cash Auction

In this design, California would stipulate an annual gaming tax that would be paid by operators at each of 15 sites. (For this analysis, we assumed the annual tax would be \$12,000 to \$25,000 per slot machine, depending on the size of the casino, following the new Indian slot gaming compacts negotiated by the Schwarzenegger administration.) Prospective operators would then bid against each other over how much up-front cash they would pay California for one of 15 licenses to operate a 2,000-machine slots parlor.

Design #3: New Compacts

In June 2004, Governor Schwarzenegger and five casino-operating Indian tribes agreed to new compacts concerning the tribes' slots operations. Under the terms of the new compacts, which still must be approved by the California legislature and federal government, the five tribes would pay the state a total of \$1 billion in cash initially. Thereafter, each tribe would pay the state an annual fee on any slot machine that it would operate in excess of 2,000 machines per tribe. The tribes would also agree to operate their casinos in a more

transparent and commercial manner for the 30-year duration of the compact. In exchange, the tribes would retain their valuable monopoly on slots gaming in California.

The compacts will likely serve as a template for other casino-operating tribes in the state.¹ Assuming the other tribes enter into similar compacts, the initial cash payments to the state would total \$5 billion.²

Furthermore, for a few tribes without major existing gaming operations, Governor Schwarzenegger has negotiated pacts that would provide the state a predetermined portion of the tribes' future gaming revenue, ranging from 10 percent to 25 percent, as long as the tribes' respective gaming monopolies are preserved. No up-front payments are required for those tribes.

Design #4: Tracks and Card Rooms

As set forth in Proposition 68 that will appear on this November's California ballot, this design would break the Indian monopoly on slot machine gambling unless the gaming tribes—all sovereign governments—agree to pay 25 percent of their win to the state. In the very likely event that the tribes do not agree to that, five California racetracks and 11 California card rooms would be permitted to install up to 30,000 slot machines. One-third of the win from those new machines would be dedicated to local public safety agencies. The remaining two-thirds would go to the slots operators. Future state or local gaming tax increases would be prohibited under Proposition 68, as would be expansions in tribal gaming activity. Proposition 68 would allow slots parlors to be closer to downtown city cores than the other designs.

Design #5: Unlimited Slots at Indian Casinos

As set forth in Proposition 70 that will also appear on this November's California ballot, this design would extend the Indian tribe compacts to 99 years and allow the tribes an unlimited number of slot machines, other gaming positions, and new locations for slots gaming on tribal lands. In exchange, the tribes would pay an 8.8 percent corporate tax on their net profits. If California were to later legalize non-Indian casino-style gaming, the tribes would become exempt from the 8.8 percent tax.

The politically produced designs 3, 4, and 5 do have some merit, but none is the result of careful economic analysis of different casino-style gaming market designs. Such an analysis could determine the revenue potential for the state under various designs as well as other benefits and drawbacks. This report provides that analysis.

Our purpose is to determine the present value of the state's gaming taxes under several different market designs. As part of that analysis, we did not examine (i) the social costs of casino-style gaming, or (ii) the costs of slots parlors displacing tax revenue from other entertainment venues such as restaurants. Those omissions should not be interpreted as indicating that we believe those costs do not matter, and other studies have examined those issues. This report also does not examine the question of whether the addition of more casino tax revenue to state coffers is compatible with the ideals of good government, but that is an important question. Rather, the scope of this report is a thorough economic analysis of the revenue impacts of casino-style gaming options available to California under current policies.

Part 2

Analysis of Market Designs and Financial Results

A. Restricted Marketplace

The vast profit potential of slot-machine gaming in California is the result of laws limiting the games in most locations in the state. That barrier to supply, coupled with strong demand from people who enjoy slots, creates a large producer surplus for legal operators. The surplus means tremendous profits for the Indian tribes that currently hold monopoly power over the California slot machine market. If the legal barrier were to be removed and free-market competition allowed, the producer surplus would drop, the effective price of gaming to consumers would fall, and the consumer surplus (which loosely translates to how much “extra enjoyment” consumers receive for their money) would increase.

When government and special interest groups work together to allow gaming at a small number of venues, they create “gaming monopolies” that capture profits differently from how a competitive market would. The government’s ability to establish gaming monopolies and then tax these enormous profits gives it the ability to generate and extract money for state coffers. Game operators eager to receive a portion of the casino revenue usually accept the state’s manipulations because they profit along with the government. Indeed, the only “loser” from the market manipulations is the gaming consumer, who receives lower odds of “winning” and fewer amenities than he would receive in a competitive market.

Advocates for free markets are troubled by state legalization of casino gaming under constrained market conditions and argue that gambling, like any other product, should only be regulated by special taxes or supply restrictions where there is a clear and compelling need to control a market failure. After that, consumers should be free to enjoy the surplus that they would gain from competition. At the same time, the state should avoid manipulating markets to produce benefits for owners or the state itself. Unfortunately, governments often intervene in markets to extract revenue or distribute benefits.

Under the current regulatory regime for gambling in California, an explicit goal is to limit the supply and limit competition among gambling venues. In exchange for those profit-maximizing limits, the state imposes special taxes to capture some of the profits for the public benefit. Given that reality, it is worth undertaking this study in order to determine how California could best manage the monopoly profits from the expansion of casino-style gaming. Specifically, we look at several different market designs and model the financial results for both the state and the facilities’ private operators under each design.

B. Methodology

To carry out our analysis, we projected the annual gross revenue per new slot machine for each of the designs. We used data from current slots operations in California and other states, and then adjusted those data in accordance with California demographics and anticipated slots parlor locations.³

Using those numbers and the assumption that the state gaming licenses are for a period of 20 years, along with other assumptions that are standard in a business analysis of this sort, we modeled the financial results of each gaming market design. We identified a preferred design, the Reverse Auction, and an alternate design, the Cash Auction.

The financial analysis presented in this report uses projection techniques that are widely accepted by corporate appraisers, valuation experts, and financiers. The principal assumptions behind the revenue per machine, slots facility operating expenses, and required capital investments are clearly identified in the accompanying tables or in the endnotes.

To carry out this analysis, we made several assumptions about how the casino market is shaping up.

Number of machines. To preserve the value of the monopolies being sold, the state limits the number of machines at each location, and the state guarantees no further expansion of gaming for a specified period. We hypothesized that the 15 locations would each have 2,000 slot machines, for a total of 30,000 new slot machines. We further hypothesized that table games would not be permitted at the new locations.

Win per day per machine (WPD). When we initially undertook this analysis, we assumed that California would only allow slots gaming in locations that are at least 20 miles away from the downtown cores of large cities. That assumption followed the stated desires of the Schwarzenegger administration. However, the administration's recent pact with the Lytton Band of Pomo Indians, who may be allowed to build a slots facility in the city of San Pablo, about 10 miles from San Francisco, suggests that the administration may be more amenable to slots in prime urban commercial areas. We thus elected to model both possibilities.

For the non-prime urban scenario, we assumed that the 15 awarded licenses would go to operators that would experience a broad range of win-per-day (WPD) per machine. We assumed a range of \$300 to \$600 per machine,⁴ based on the experience of casinos and racinos in similar areas. (A racino is a horse-racing track that also includes slot machines, video gambling terminals, or other casino features.) Existing Indian casinos have WPD for slot machines ranging from \$250 to \$800. The exact average is difficult to quantify because of a lack of reliable data, but reasonable estimates provide a \$300 daily average for the 55,000 slot machines in California. The WPD results for the preferred design are slightly higher than the Indian casinos because the locations that likely would be used by slots operators would be closer to California's population centers (but still respecting the Schwarzenegger prohibition on urban locations) than current Indian facilities. By having more convenient locations, the new slots parlors generate more revenue than Indian casinos on a WPD basis. Table 2 summarizes this WPD, with revenue increasing for locations in more convenient locations.

Table 2: Win Per Day Per Slot Machine (Non-Urban Locations)			
Number of Locations	Total Number of Machines	WPD per Machine	Annual Net Revenue (Millions)
5	10,000	\$600	\$2,190
5	10,000	\$450	\$1,643
5	10,000	\$300	\$1,095
			\$4,928

If the Schwarzenegger administration elects to drop its prohibition on urban locations, the aggregate average WPD will be much higher. For our modeling, we assumed that WPD would average \$500 per machine under this scenario.

Time. Obviously, slots parlors do not begin full-capacity operation immediately after the awarding of the slots licenses. We assumed that it would take three years for the 15 gaming sites to be fully operational and serving their expected customers. Table 3 summarizes anticipated revenues as the gaming locations get up to speed.

Table 3: Projected Win for Years 1-3 (In Millions)			
	Year 1	Year 2	Year 3
Net Revenue	\$2,464	\$3,696	\$4,928
% Capacity	50%	75%	100%

Inflation. For this analysis, we assumed that inflation would be 3 percent annually after the slots parlors' third year of operation.

Capital Expenditures. The cost of constructing a slots parlor varies greatly, depending on location, building quality, and amenities. For example, slots parlors at Vernon Raceway (NY) and Dover Downs (Delaware) cost \$8 million and \$40 million, respectively.⁵ A new facility proposed for Aqueduct racetrack (NY) was budgeted at \$100 million.⁶

To be conservative, we assumed that the \$600 WPD facilities cost \$130 million in up-front costs, including \$60 million for the building, \$30 million for land and infrastructure, \$20 million for the machines, \$10 million for parking lots, and \$10 million for start-up costs. We depreciated assets over a 12-year life in accordance with accepted accounting methods. We further assumed that the cost to construct the \$450 WPD and \$300 WPD facilities would be slightly less than \$130 million because those facilities would likely use less expensive fixtures.

Operating Costs. Cash operating costs would be \$75 per day per machine. That number is corroborated by the federal filings of two gaming companies operating slots parlors.⁷

All of the principal assumptions are corroborated by verifiable data obtained from audited filings with the U.S. Securities and Exchange Commission, audited reports from various state gaming commission Web sites, statistics from the U.S. Census Bureau, and selected newspaper and magazine articles. To complement the data, the authors interviewed selected industry participants and analysts.

C. Examining the Designs

Design #1: Reverse Auction (Preferred Design)

Under the Reverse Auction design, California would use market forces to extract the excess profits from slot-machine operators. That is accomplished by inviting many potential gaming operators—including horse tracks, card rooms, Indian tribes, and casino corporations—to bid on a limited number of individually auctioned slots parlor licenses. For the purpose of this study, we assumed that California would license 15 new casino-style gaming facilities. Each license would allow its holder to operate a 2,000-machine slots facility within a specified geographic area. The bids would be in the form of the lowest percentage of the machines' gross revenue (referred to as the “win” in industry parlance) that the operator will take in exchange for the license. From that percentage (which is referred to as the “hold”), the operators would cover their operating expenses, capital costs, and profits.

The chief advantage of the Reverse Auction design is its use of market forces to determine and extract the excess revenue. Participants in the auction would continue to raise their bids in pursuit of a license until the excess profits are all but gone, because the bidders would prefer to have a license that awards a modest profit to having no license at all. Hence, the bidders would reveal to the state exactly how much of the “win” is excess profits.

A second advantage to this design is that it does not require the auction participants to pay any money “up front.” That allows for a variety of firms—from “deep-pocketed” casino entertainment companies and private equity firms to California horse tracks and Indian tribes—to participate in the auction on a near-even footing.

RESULTS: Given those assumptions, we first projected how much in returns slot operators in California would have to make in order for investment in gaming to be attractive. Table 3 shows the percentage of win needed by slots operators to achieve a healthy 20 percent annual rate of return on investment. The higher the operators' WPD per machine, the smaller the percentage needed to obtain the target return. From those figures, we could then project how much various potential slots operators would be willing to bid in order to receive one of the 15 hypothetical California gaming operations licenses.

As indicated in Table 4, in the non-urban scenario, the most productive slots operators (i.e., \$600 WPD) would achieve a 20 percent return on investment by retaining just 25 percent of the slots revenue. A \$450 WPD facility realizes a 20 percent return by retaining 30 percent. The 25 percent and 30 percent retention percentages are in line with New York State racinos (20 percent) and Rhode Island racinos (27 percent).

According to our projections, by the third year of operation of this market design, California would realize \$3.5 billion annually in gaming taxes from the 30,000 slot machines. The present value of that revenue over 20 years is \$32 billion.

If California were to allow urban locations, we estimated the reverse auction would produce a 72 percent gaming tax. That would provide \$37 billion in present value revenue to the state.

Table 4: Estimated State Revenue Under Reverse Auction Design (Non-Urban Locations) (In Millions)			
	\$600 WPD Facilities	\$450 WPD Facilities	\$300 WPD Facilities
Annual Revenue	\$2,190 (100%)	\$1,643 (100%)	\$1,095 (100%)
Likely Betting Tax	<u>\$1,650 (75%)</u>	<u>\$1,157 (70%)</u>	<u>\$692 (63%)</u>
Revenue to Licensees	\$540 (25%)	\$486 (30%)	\$403 (37%)
Cash Operating Costs	<u>\$273</u>	<u>\$273</u>	<u>\$273</u>
EBITDA*	\$267	\$213	\$160
Depreciation	<u>\$50</u>	<u>\$40</u>	<u>\$30</u>
EBIT**	\$217	\$173	\$130
Income Taxes @ 40%	<u>\$87</u>	<u>\$69</u>	<u>\$52</u>
Net Income	<u>\$130</u>	<u>\$104</u>	<u>\$78</u>
Total Investment	\$650	\$520	\$390
Annual Return on Investment	20%	20%	20%
*Earnings Before Interest, Taxes, Depreciation, and Amortization			
** Earnings Before Interest and Taxes			

Design #2: Cash Auction

Under the Cash Auction design, California would award the licenses to the bidders that offer the most up-front cash to the state as a “licensing fee.” Each license would allow its holder to operate a slots facility within a specified geographic area, and the terms of the auction would stipulate that the operators receive 100 percent of the win after paying an annual license fee ranging from \$12,000 to \$25,000 per machine (thus conforming to the economic terms of Governor Schwarzenegger’s slots compacts with several Indian tribes). The bidders would be subject to a rigorous pre-qualification procedure to ensure that they have sufficient cash to finance their bids.

To ensure professionalism, maximize proceeds, and minimize bid-rigging, the auction of each license would be conducted on the state’s behalf by a nationally recognized investment bank.

Experiences Elsewhere. To project the winning bids, we looked at recent sales of semi-monopoly gaming licenses elsewhere in the United States with population statistics comparable to areas in California. Those sales prices are indicative of what potential gaming operators would bid for in a cash auction. We found several good comparisons, which are listed below. Note that slot machines represent about 75 percent of a casino’s profit.

Philadelphia, Pennsylvania (July 2004). Three weeks after the Pennsylvania legislature legalized slot machines at racetracks, Harrah’s Entertainment announced its intention to acquire a 50 percent interest in a local harness racetrack for \$250 million. To be located in suburban Philadelphia, the track was not yet

constructed. If 50 percent of the license is worth \$250 million, then 100 percent of the license is worth \$500 million.

Chicago, Illinois (March 2004). Through an auction conducted by New York investment banker Rothschild, Inc., the state of Illinois sold a casino license in metropolitan Chicago for \$518 million to the gaming firm Isle of Capri Casinos.⁸ The license allows only 1,200 slots and 60 table games (vis-à-vis a California license that would allow 2,000 slots but no table games). Illinois permits casinos to hold portions of the win on a graduated basis; on average, the hold ratio for an operator with \$400 million in revenue is approximately 46 percent. In California, the operators' hold rate (i.e., share of the revenues) under the Cash Auction design exceeds 90 percent, which would mean a much higher license value.⁹

Detroit, Michigan (November 2000). Two businessmen, Ted Gatzaros and Dimitrois Papas, sold their 40 percent interest in a Detroit casino license (obtained for free) to the Sault Ste. Marie Chippewa Tribe (which operates five casinos) for \$265 million. If 40 percent is worth \$265 million, a 100 percent interest would therefore be valued at \$663 million. The license permitted 2,200 slots and 100 table games in a state that allows a hold rate of about 70 percent.¹⁰

Lawrenceburg, Indiana (January 2001). In this example, the buyer acquired an operating casino from owners who obtained their operating license for free. The value of the license can thus be determined by subtracting the construction costs of the casino and related improvements from the purchase price that the buyer paid to the sellers. Argosy Gaming bought 42.4 percent of the Lawrenceburg riverboat casino for \$368 million (indicating that 100 percent was worth \$876 million). Assuming a \$70 million cost for the riverboat and \$60 million for the hotel and parking lot, the value of the license was on the order of \$750 million, mainly because of the riverboat's monopoly power in the populated Cincinnati market. The riverboat has 2,246 slots and 95 table games. Indiana has a higher betting tax than what we assumed for California, suggesting a California license is worth more.¹¹

Those four transactions provide a valuation range of \$500 million to \$750 million, solely for the license to operate gaming. In California's case, the Schwarzenegger requirement that slots parlors be distant from downtown cores lowers the license values, but this reduction is far outweighed by the fact that the slots operators pay relatively little in gaming taxes and keep over 90 percent of revenues. Table 5 presents a calculation of the gaming taxes that would result from such a Cash Auction.

Table 5: Gaming Taxes Under Cash Auction Design		
Machines per Parlor	Annual Fee per Machine	Total Fees (In millions)
0-500	\$12,000	\$6.0
500-1,000	\$13,200	\$6.6
1,000-1,500	\$17,000	\$8.5
1,500-2,000	\$20,000	\$10.0
Annual Total for 2,000 Machines		\$31.1
Annual Total for 15 Sites		\$466.5

In addition to considering recent sales of gaming licenses, we estimated what cash buyers would pay for the projected income of the slots monopolies. Gaming stocks trade publicly at 8 to 14 times earnings before interest, taxes, depreciation, and amortization (EBITDA). Gaming firms acquire other gaming properties at 8 to 12 times EBITDA.

To be conservative, we assumed that potential buyers would value California properties at eight times EBITDA. From that amount, we deducted (a) a 25 percent “start-up” discount for risks of the unknown, which is reasonable for such an analysis; (b) a 15 percent discount because full capacity is not attained until the third year and the operator realizes less than full income in years 1 and 2; and (c) the relevant up-front capital costs.

RESULTS: Given those numbers and assumptions, our modeling indicates the 15 California licenses have a total cash value of \$15.9 billion. That calculation is depicted in Table 6. Notice that annual revenues from slots for the state would be much lower than under the Reverse Auction. Because of the up-front cash requirement, fewer bidders would be eligible to bid, which would slightly decrease the auction’s ability to extract excess profits. Also, the state’s demand for up-front payment of the licensing fees (instead of just a tax spread out over the life of the licenses) would increase the risk for the private operators, and that increased risk would result in lower bids. A cash auction should bring approximately \$16 billion in initial cash proceeds to the state of California. By the third year, the state would realize \$468 million annually in gaming taxes.

Table 6: Estimated State Revenue, At Maturity, Under Cash Auction (In Millions)			
	Five \$600 WPD Facilities	Five \$450 WPD Facilities	Five \$300 WPD Facilities
Annual Revenue	\$2,190 (100%)	\$1,643 (100%)	\$1,095 (100%)
Betting Tax	<u>\$156 (7%)</u>	<u>\$156 (9%)</u>	<u>\$156 (14%)</u>
Revenue to Licensees	\$2,034 (93%)	\$1,487 (91%)	\$939 (86%)
Cash Operating Costs	<u>\$273</u>	<u>\$273</u>	<u>\$273</u>
EBITDA ("Cash Flow")	\$1,761	\$1,214	\$666
Bid Calculation			
8x EBITDA	\$14,088	\$9,712	\$5,328
Less: 25% Discount	\$3,522	\$2,428	\$1,332
Less: 15% Discount	\$2,113	\$1,456	\$799
Less: Fixed Assets Cost	<u>\$650</u>	<u>\$520</u>	<u>\$390</u>
Cash Auction Values	\$7,803	\$5,308	\$2,806
Value per License	\$1,561	\$1,062	\$ 561

Drawbacks. Similar to the Reverse Auction, the chief advantage of the Cash Auction is that it would use market forces to extract excess profits from slots operators. However, the Cash Auction has several drawbacks. The most significant problem is that the pool of potential bidders is much smaller than in the Reverse Auction; fewer firms can leverage the capital needed in order to pay the license fees. Moreover, the need for the winning bidders to use money from capital markets to pay the up-front fees cuts into the state’s “take” of the revenue because a portion of the slot profits has to be shared with investors in order to leverage the capital.

That being said, we note that casino operator MGM Mirage recently offered to acquire Mandalay Resort Group for \$5 billion.¹² Harrah's Entertainment, another casino operator, has a market value of \$6 billion and a credit line of \$2.5 billion. On July 15, 2004, Harrah's offered to buy Caesar's for \$5.1 billion in cash and stock.¹³ Multiple private equity firms in the United States have pools of capital in excess of \$2 billion, which, when coupled with bank loans, provide the buying power of many billions of dollars. So the prominent gaming-entertainment firms have sufficient access to capital to participate strongly in a California slot machine cash auction.

Design #3: Schwarzenegger's New Compacts

The Schwarzenegger administration has negotiated new slots gaming compacts with five Indian tribes, representing about 20 percent of annual casino revenues.¹⁴ If the remaining tribes sign similar compacts, the state would collect approximately \$5 billion in initial cash payments, followed by annual fees based on the number of new machines installed by the tribes pursuant to the compacts. The tribes are allowed an unlimited number of machines and a continued monopoly on casino gaming.

The annual fees are payable only if a tribe installs more than 2,000 machines, and the fees take effect on a sliding scale, as set forth in Table 7.

Table 7: Gaming Taxes for Additional Slots Under Design #3		
Additional Machines	Annual Fee per Additional Machine	Total Fees (In millions)
2,000-2,500	\$12,000	\$6.0
2,500-3,000	\$13,200	\$6.6
3,000-3,500	\$17,000	\$8.5
3,500-4,000	\$20,000	\$10.0
Annual Total for 2,000 Machines		\$31.1
Annual Total for 15 Sites		\$466.5

Based on the published opinions of industry participants, only 15 Indian casinos have demand in excess of 2,000 slot machines. This report assumes each of those 15 casinos would install 2,000 new machines (for a total of 30,000) over a three-year period. The average WPD per machine is \$350. This WPD is 22 percent lower than the \$450 average in Designs 1 and 2. This reduction reflects the greater distance of the Indian casinos from major population centers, which reduces the number of visits by "convenience gamblers" on a comparative basis.

The \$75 daily cash operating costs of a slot machine and the \$43 average daily gaming tax per machine sum to just \$118, which is substantially below the anticipated cash revenue per machine of \$350 per day. The new machines would thus be very profitable for the tribes. The state's revenue from the new compacts for the first three years is summarized in Table 8.

Table 8: Estimated State Revenue from New Tribe Compacts (In Millions)			
	Year 1	Year 2	Year 3
Initial Payments	\$5,000	\$ ---	\$ ---
Gaming Taxes	\$189	\$317	\$467
Number of Machines	<u>15,000</u>	<u>22,500</u>	<u>30,000</u>
Total Revenue	\$5,189	\$317	\$467

The \$467 million in annual gaming taxes at maturity is constant. It does not increase with inflation.

Design #4: Tracks and Card Rooms

Proposition 68 would break the current Indian gaming oligopoly in California by allowing five racetracks and 11 card rooms in the state to operate a total of 30,000 slot machines. Most of those tracks and card rooms are located in major population centers. According to the proposal, the operators would pay 33 percent of the win to the state in gaming taxes.

RESULTS: This report assumes the 30,000 machines are installed over a three-year period and each machine generates \$500 in WPD per machine. The annual revenue and taxes at maturity are therefore \$5.5 billion and \$1.8 billion, respectively, as set forth in Table 9. Maturity occurs in the third year and inflation would be 3 percent annually thereafter.

Table 9: Estimated State Revenue from Slots at Track and Card Room Locations (in Millions)			
	Year 1	Year 2	Year 3
Slots Revenue	\$2,737	\$4,106	\$5,475
Gaming Taxes (33%)	\$903	\$1,354	\$1,807

Populated areas such as metropolitan Chicago and metropolitan Detroit exhibit average WPD per machine of approximately \$350. Those two areas have about 500 residents per machine. California's population is 36 million, and the 30,000 track and card room machines would be much closer to the population bases than the 55,000 Indian tribe machines. The effective residents-per-capita for the 30,000 new machines would be about 750 and, thus, the \$500 WPD assumption is reasonable.

At maturity, we project that the state would receive \$1.8 billion annually under this design. The present value of the revenue stream over 20 years is \$16.7 billion.

It should be noted that the slots operations would be extremely profitable under this design. We project that a 3,000-machine parlor at Santa Anita racetrack (near Los Angeles) would generate \$548 million in revenue in each year at maturity. After cash operating costs and gaming taxes, the annual operating cash flow would be \$285 million, an incredible 52 percent margin on revenue. That high margin demonstrates the immense profitability of the legal monopoly that Proposition 68 would confer on a small group of wealthy businesses.

At eight times the value, which we previously discussed would be the market value, the 3,000-slot Santa Anita monopoly would trade in the public stock market at a value of \$2.3 billion, boosting the public stock

price of Santa Anita’s owner, Magna Entertainment, from \$6 to approximately \$25. All 15 licenses have a prospective public trading value of approximately \$22 billion. By giving the licenses away for free, Proposition 68, if passed, may be the largest financial giveaway in California’s history.

Design #5: Unlimited Slots at Indian Casinos

Under the terms of Proposition 70, Indian tribes could install an unlimited number of slot machines and table games on tribal lands. In exchange, they would pay an 8.8 percent tax on their “net profits.” Note that this tax would be calculated on net profits after all expenses, whereas the previous gaming taxes were calculated on the “win” revenue from slot machines. An 8.8 percent tax on profits is therefore less than an 8.8 percent tax on win. If California allows non-Indian casino gambling in the future, the requirement for the tribes to pay the 8.8 percent income tax is void, according to Proposition 70.

In line with the opinions of several industry participants, this report assumes the Indian gaming market becomes saturated at 30,000 additional slot machines. The machines would be located at 15 existing sites, each having 2,000 additional machines.

Corresponding to assumptions in Design #3, we project that the new machines would have an average WPD of \$350, producing additional slots revenue for the tribes of \$3.8 billion. We assumed an additional \$400 million in table games revenue. To this \$4.2 billion sum we added the current estimated revenues of \$5.5 billion. Total Indian gaming revenue (at maturity) under this market design would thus be \$9.7 billion, as set forth in Table 10.

Table 10: Projected Annual Indian Gaming Revenue under Proposition 70 (in Millions)	
Existing Revenue	\$5.5
30,000 New Slots	\$3.8
New Table Games	<u>\$0.4</u>
	\$9.7

Net Income. The Indian tribes do not report revenues and profits publicly. Based on available data and discussions with gambling industry participants, we estimate their operating cash flow margin on revenues to be approximately 35 percent (before debt service and revenue sharing with the state). Note that the tribes pay little in gaming taxes or other government levies. However, because many lack capital and gaming expertise, their management fees and leasing fees (which may include the amortization of third-party financial construction costs) are higher than many publicly traded gaming companies.

The estimated income statement for the Indian gaming industry at maturity is set forth in Table 10. The 8.8 percent corporate tax is projected at \$281 million annually, which is a miniscule 3 percent of total revenues. As noted earlier, gaming taxes in other states for non-Indian operations often exceed 50 percent.

Table 11: Estimated Income Statement at Maturity, Indian Gaming Industry (in Millions)	
Total Revenues	\$9,700
Cash Operating Expenses (65%)	<u>\$6,305</u>
Operating Cash Flow (35%)	\$3,395
Depreciation Not Reflected in Cash Operating Expenses	<u>\$200</u>
Net Profits	\$3,195
8.8% California Corporate Income Tax	<u>\$281</u>
Net Profits After Corporate Income Tax	\$2,913

We assume revenues and income taxes increase 3 percent annually. The present value of the income tax stream is \$2.6 billion.

Part 3

Conclusion

The table below shows the revenue value to the state of California for each of the designs analyzed.

Table 12: Financial Summary of Casino-Style Slot Gaming Expansions (In Millions)				
Design	Location of New Facilities	Up-front State Revenue	Annual State Revenue at Maturity, Before Inflation	Present Value to State Over 20 Years at 10% Discount Rate
<p>1A. Reverse Auction (Urban locations) Prospective operators would “bid” on what percentage of the win the state would receive.</p>	Prime Urban Sites	\$0	\$3,942	\$36,541
<p>1B. Reverse Auction (Non-urban locations) Prospective operators would “bid” on what percentage of the win the state would receive.</p>	Secondary Commercial Areas	\$0	\$3,500	\$32,440
<p>2. Cash Auction Prospective operators would bid cash up front for the licenses; the state would also receive an annual fee of \$12,000–\$25,000 per machine.</p>	Secondary Commercial Areas	\$15,900	\$468	\$19,905
<p>3. New Compacts Indian tribes would receive more machines in exchange for paying the state up to 25% of the profits from them and other operating concessions.</p>	Tribal Lands	\$5,000	\$468	\$9,005
<p>4. Proposition 68 Selected racetracks and card rooms would operate up to 30,000 slot machines in exchange for paying an annual 33% gaming tax.</p>	Racetracks and Card Rooms in Prime Urban Locations	\$0	\$1,807	\$16,748
<p>5. Proposition 70 Indian tribes would receive unlimited slots and continued monopoly power in exchange for an 8.8% income tax on slots earnings.</p>	Tribal Lands	\$0	\$281	\$2,604

As our modeling shows, the adoption of additional slot gaming in California would result in \$4 to \$5 billion of incremental gaming activity in the state each year. A large portion of those receipts represents excess profits resulting from the state-imposed legal barrier to the supply of slot gaming. Those large sums of money indicate the need for the state to consider carefully which slot market design it will adopt, or else the state will end up awarding excessive riches to a lucky (or politically well-connected) few.

According to our analysis, the Reverse Auction and the Cash Auction designs are far superior to the other models that have been advanced by state political leaders and interest groups. The auctions harness market forces to reveal and extract the excess profits, and provide a transparent system for awarding the licenses.

The Reverse Auction provides a high present value to the state—\$32 billion if the state goes with non-urban locations, \$37 billion if it goes with urban. This value is \$12 billion to \$17 billion higher than the Cash Auction Design. It is far superior to Designs 3, 4, and 5, which provide free monopolies to Indian tribes, racetracks, and card rooms, but offer relatively little to the state of California in return for protecting the gaming operators' market positions.

About the Authors

Jeffrey C. Hooke is managing director of Hooke Associates, LLC, an investment bank based in McLean, Virginia. His volunteer work includes being chairman of the Maryland Tax Education Foundation (www.marylandtaxeducation.org). Previously, Hooke was a director of Emerging Markets Partnership (a \$5 billion private equity partnership), a principal investment officer of the World Bank Group, and an investment banker with Lehman Brothers and Schroder Wertheim, respectively, two prominent securities firms based in New York.

Hooke is the author of three books: *The Emerging Markets* (2001), *Security Analysis on Wall Street* (1998), and *M&A: A Practical Guide to Doing the Deal* (1996), published by John Wiley & Sons of New York. His studies on casino-style gaming have led to testimony on the value of gaming licenses and the prospective revenues from state-sanctioned gaming expansion before the legislatures of Maryland, Pennsylvania, and Texas. His views on state-sanctioned gaming expansion have been referenced in numerous publications, including the *New York Times*, *Forbes*, *Washington Post*, *Chicago Sun Times*, *Philadelphia Inquirer*, *Houston Chronicle*, *Baltimore Sun*, *Dallas Morning Post*, *Cleveland Plain Dealer* and *Pittsburgh Post-Gazette*.

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Hooke and Firey co-authored the August 2003 report “Legalizing Video Slot Gaming in Maryland: A Business Analysis,” which was published jointly by the Maryland Tax Education Foundation and The Maryland Public Policy Institute.

Endnotes

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- ¹ See the San Francisco Chronicle, dated June 21, 2004, in an article titled “Deals set on Indian Casinos” by John Hubbell, in which Schwarzenegger spokesman Vince Sollitto is quoted. Also, see press releases from the Governor’s office dated June 21, 2004 and August 19, 2004 in which the governor states a similar goal.
 - ² Interviews with Anne Carr of the California Gaming Commission, Alan Meister of the Analysis Group (and author of the authoritative *Indian Gaming Industry Report*), and Steven Wiegand, *Sacramento Bee* reporter who covers Indian gaming, indicated that the five tribes account for 20 percent of total gaming revenues in California. If the five tribes provide \$1 billion, the total amount if all tribes sign similar agreements should therefore be \$5 billion.
 - ³ To estimate the revenue for existing Indian slot machine operations in California, the authors consulted the three sources listed in endnote 2, as well as Andrew Smith, Director of Research at the American Gaming Association, and Joseph Weinert, editor of the Gaming Observer Newsletter. Data on the “win per day (WPD)” of slot machines in other states is widely available from state gaming board Web sites and other published sources. From this WPD data, the authors examined the productivity of machines in relation to per capita machines in specific areas. The methodology is accepted in the gaming industry and further outlined in “Legalizing Video Slot Gaming in Maryland: A Business Analysis,” by Jeffrey C. Hooke and Thomas A. Firey (MTEF and MPPI 2003).
 - ⁴ See endnote 3 for information on the methodology of projections. The analysis assumes that five locations will be highly productive, five will be very productive and five will be moderately productive in terms of WPD per machine.
 - ⁵ The Vernon Downs construction costs were noted in the track’s Web site in September, 2003. The Dover Downs construction costs are set forth in its audited financial statements as filed with the Securities and Exchange Commission, particularly its information statement dated March 7, 2002.
 - ⁶ Press release of the New York Racing Commission dated April 17, 2003. The Commission announced that it was entering a joint venture to build a 4,500 slots parlor with MGM Mirage for a cost of \$100 million.
 - ⁷ See “Legalizing Video Slot Gaming in Maryland: A Business Analysis” for a detailed review of cash operating costs based on the public filings of gaming companies at the Securities and Exchange Commission.
 - ⁸ The state of Illinois announced the winning Isle of Capri bid on March 15, 2004.
 - ⁹ In Illinois, a gaming business with \$400 million in revenue keeps 46 percent after gaming taxes, or \$184 million to cover operating expense and profit. Under the model being used for California Indian tribes by the Schwarzenegger administration, this same operator in California would retain 92 percent after gaming taxes, or \$368 million. Because annual operating expenses in California would be roughly similar to those in Illinois (i.e., approximately \$120 million), the California business would have \$248

million in operating profits while the Illinois business would only have \$64 million. Therefore the California business is far more valuable than the Illinois business. Thus, the related gaming license in California would be worth more than a similar license in Illinois.

- ¹⁰ See stories by Melvin Claxton and Mark Plus in the *Detroit News* during November 2000. A 2002 interview with Robert Russell, editor of the *Michigan Gaming Law* newsletter, added details regarding the sale.
- ¹¹ See endnote 9, which illustrates that a higher betting tax means a lower hold rate for the operator. A lower hold rate signifies lower profitability for the gaming operator. The related gaming license, therefore, would have a lower value. If California seeks to increase revenues from gaming licenses, it will decrease the value of state gaming licenses.
- ¹² The proposed MGM Mirage/Mandalay merger was announced by the boards of both companies on June 16, 2004 and the terms of the transaction were widely reported in the media.
- ¹³ The proposed Harrah's Entertainment/Caesar's Entertainment merger was announced by the boards of both companies on July 19, 2004 and the terms of the transaction were widely reported in the media.
- ¹⁴ Interview with Steven Wiegand, *Sacramento Bee* reporter who covers Indian gaming, indicated that the five tribes account for 20 percent of total gaming revenues in California.



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