

Using an Auction Mechanism To Grant Gaming Licenses

Feasibility Analysis
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Auction: Definition and Benefit

- **Definition:** Essentially, an auction is “...an economic mechanism whose purpose is the allocation of goods and the formation of prices for those goods via a process known as bidding.”
- **Benefit:** Economists typically favor auctions over other methods for allocating licenses to operate in a market. Studies have shown that an auction without a reserve price, as long as it attracts at least one more bidder than a negotiation, raises more expected revenue than any negotiation procedure. Generally, the seller’s revenue goes up with increases in the number of bidders.



Goal, Success and Objective

- **Goal:** To get bidders to reveal their valuation of the item under consideration and raise maximum revenue. The economic theory is that “the parties in the market are much better informed than the government with respect to the economic value of the goods offered.”
- **Success:** The highest bidder is the one that values the item the most.
- **Specific Objective:** To have the State of Florida allocate the right to operate casino gambling in specified markets within the state in a manner that optimizes the revenue to the state.



Environment

- **Environment:** Post-auction, the outcome is a non-competitive market where the “license” operates as an exclusive franchise for that territorial area. For most bidders, the license value is generally related to the future (albeit uncertain) income stream expected from the license, but this will be not the case for the Seminole Tribe of Florida. For them, the future value is also linked to the creation of exclusivity for the other sites they operate.

The primary differentiation among the bidders will be:

- Available financial capital for investment in facility development (effectively a binding budget constraint on individual bidders)
- Perception / evaluation of the future income stream.



Four Forms, Many Variants

Auction Types			
ENGLISH AUCTION (Ascending-Bid, Open or Oral)	DUTCH AUCTION (Descending Bid)	FIRST-PRICE, SEALED-BID AUCTION	SECOND-PRICE, SEALED BID AUCTION
<ul style="list-style-type: none"> * Auctioneer starts with the lowest price he is willing to accept (the reserve price) * Price is raised in incremental amounts by bidders * This continues until no one is willing to bid higher * Auction is closed with the highest bidder winning 	<ul style="list-style-type: none"> * Auctioneer starts with a price that is higher than he thinks the item will get * The price is lowered in incremental amounts by the Auctioneer * This continues until someone is willing to accept that price * Auction is closed with the highest bidder winning 	<ul style="list-style-type: none"> * Each bidder submits a single, sealed bid * No information is shared between bidders * All the bids are opened at one time * Auction is closed with the highest bidder winning 	<ul style="list-style-type: none"> * Each bidder submits a single, sealed bid * No information is shared between bidders * The highest bidder wins the item, but at the price offered by the next highest bidder
<p>KEY ASSUMPTIONS FOR THE DIFFERENT TYPES TO PRODUCE EQUAL RESULTS</p> <ol style="list-style-type: none"> 1. The item being auctioned has an independent, private value to all bidders – no bidder is estimating resale value or a benefit equal to all. 2. All bidders are risk-neutral. 			



Auction Preferences

Auction Type: Of the four general auction classifications, two are more suitable for auctioning gaming licenses than the others:

- **English Auction...** This open forum generally produces the most money for the seller as the interaction among bidders spurs individual pricing to higher levels.
- **First-Price, Sealed-Bid Auction...** The complicated financial projections required in bid development would likely constrain some of the interactive benefit from the English Auction. In addition, the exclusive nature of the award (monopolistic or quasi-monopolistic) could push up bids even though they are sealed (typically, a suppressant). In this case, losing out is virtually a permanent outcome.



(Excluded from initial consideration: Dutch and Second-Price, Sealed-Bid)

Analysis of Potential Return

Key Question...

- What is being bid?

[The amount of granted monopoly power influences the value.]

Assumptions Used In Analysis...

- *A permit or license to operate; otherwise, the casino will be regulated in the same manner as the existing pari-mutuel facilities with slots. A 35% tax rate is also assumed, with the neutrality assumption most recently adopted by the Revenue Estimating Conference (over time, receipts at 35% roughly equal receipts at 50%).*
 - *SCENARIO 1: Casino with slots, table games, and card games*
 - *SCENARIO 2: Casino with slots and limited card games*
- *Under either scenario, the award will grant a quasi-monopoly, with continued competition from the existing and proposed Seminole Tribe casinos and --- to a lesser degree --- from the pari-mutuel facilities in Broward and Miami-Dade. For the purpose of this analysis, the license will be exclusive (i.e. for a single geographic area), likely a county.*

Who can bid?

Key Questions...

- Will there be entry fees?
 - Will there be prequalification of bidders?
[Is there a need for minimum quality conditions? Do concerns about the use of the license exist?]
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Assumptions Used In Analysis...

- *The bidding is open to all interested parties: the Seminole Tribe of Florida, the existing pari-mutuel operators, and entertainment / gaming ventures are all likely bidders.*
- *Entry fees will be sufficient to cover the costs of the auction, but will offer no significant deterrence to potential bidders.*
- *Prequalification of bidders will occur to the extent necessary to assure sufficient capacity to develop and operate a casino at a minimum level of quality, within three years of the award.*

How many sites will there be?

Key Questions...

- How many exclusive territories will be awarded?
- Will land use / permitting preemption of local governments be a component?

[If this is not a component, the uncertainty and increased risk will tend to suppress bids, and the non-Indian bidders will be at a competitive disadvantage in the location where the Indians have land.]

Assumptions Used In Analysis...

- *The number of territories is developed within the analysis to maintain revenue neutrality against the proposed Compact.*
- *Unclear, but for the purpose of this analysis, a specific premium for uncertainty is not assumed. Effectively, this means the receiving local governments are willing participants and that suitable land is readily available, with minimal development delays.*

How will the financing work?

Key Questions...

- What is the term or length of the property right?
[Construction investment argues for a longer period of time (20-30 years).]
 - Is the state's payment upfront, over time, or both?
[If payments are made over time, then ability to operate and time to commencement become factors, arguing for limited entry into the auction. In these cases, the "use of the license" becomes important.]
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Assumptions Used In Analysis...

- *Because of the length of time needed for viable debt financing and construction, the license is assumed to be valid for thirty (30) years.*
- *The state's payment for the license award will be up-front. For the purpose of this analysis, no royalties or installment payment plans are assumed.*

What are the Auction's mechanics?

Key Questions...

- What will the auction framework be?
 - Will the territorial auctions be independent or simultaneous with a common end? [There may be complementarities and substitutes.]
 - Are there any future resale possibilities for the successful bidders?
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Assumptions Used In Analysis...

- *For the purpose of this analysis, simultaneous auctions are assumed, with the possibility of package or linked bids. This allows a single bidder to participate in more than one auction – the high bid is determined by adding the high bids excluding the linked bids, and then comparing that total to the linked bids to determine which is the highest across the affected auctions. The linked bids would have to net more dollars to the state (across the package) to become the successful award.*
- *A common, statewide referendum to determine individual results for each county is assumed to occur before the auction, so that there is no uncertainty regarding viable territories (although some uncertainty regarding specific location is factored in).*
- *For the purpose of this analysis, no premium for lock-in is assumed (i.e. a resale is possible outside the confines of the auction).*

Should the Auction be tailored?

Key Questions...

- Will the auction be asymmetric or colored to level the playing field or to provide a specific policy direction?

[To illustrate a potential problem: the previously “sunk costs” in existing land holdings and infrastructure will give any bidder already established in the geographic area a potential competitive advantage. However, “colored” or “asymmetric” auctions are much harder to design, and the risks against a successful outcome are greater.]

Assumptions Used In Analysis...

- *For the purpose of this analysis, no breaks or special opportunities are granted under either scenario. However, future analyses may include the impact of a bid discount*, special set-aside or separate opportunity for casinos developed in conjunction with existing pari-mutuel facilities. Generally, these auctions fail to net as much money.*

**Usually a pre-established discount factor used to deflate qualifying bids. It allows a qualifying winner to pay less than the bid amount.*

Recent Prices for Gambling Licenses

YEAR	STATE	FRAMEWORK	AMOUNT
2008	Illinois	Top offer in auction by sealed bid, with additional requirements.	\$435 million
2004	Pennsylvania	Derived from the acquisition of a 50% interest in a local harness track.	\$500 million
2004	Illinois	Auction setting --- three companies were engaged in the auction for a specific site over a 20-hour period.	\$518 million
2000	Michigan	Derived from the acquisition of a 40% interest in a casino license.	\$663 million
2001	Indiana	Derived from the acquisition of a 42.4% interest in an operating riverboat casino.	\$750 million

Based on the past value of gaming / casino licenses in other states, a viable upper range is somewhere between **\$435 million and \$750 million per license**. However, there are at least four reasons to believe that Florida's auction would generate something less:

- Existing gambling competition in prime geographic areas.
- Fewer tourists in most other locations (especially international tourists).
- Uncertainty surrounding the specific site and development issues / costs.
- Weaker credit market, squeezed profits, and remaining effects of the recession.

Potential Revenue Per License

- SCENARIO 1: Given the potential drags on Florida's auction earnings, a worst-case 50% discount is assumed on the average of the bid range.

SCENARIO 1: Casino with slots, table games, and card games

\$573 MILLION multiplied by 50% = \$286.5 MILLION

- SCENARIO 2: The worst-case 50% discount is assumed on the average of the bid range, and a further 33% discount is assumed for the loss of table games.

SCENARIO 2: Casino with slots and limited card games

\$286.5 MILLION including 33% discount = \$192.1 MILLION



Minimum Number of Licenses

- Using an Index created by ranking counties on density, population, number of seniors, and per capita income, it is reasonable to assume that **eight licenses** dispersed among the higher-ranked counties in Florida would generate sufficient annual tax dollars to exceed the estimates for both SB 788 and the latest Compact offered by the Executive Office of the Governor (see “Gaming Compact: A Financial Comparison” dated November 2, 2009).

Florida Counties Ranked

County	Combo Rank
Sarasota County	67
Pinellas County	66
Palm Beach County	65
Lee County	64
Broward County	61
Brevard County	61
Manatee County	61
Collier County	60
Martin County	59
Miami-Dade County	58
Indian River County	57
Pasco County	56
Volusia County	55
Charlotte County	54
Lake County	53
Hillsborough County	52
Polk County	51
Seminole County	49
St. Lucie County	49
Hernando County	48
Duval County	46
Marion County	46
St. Johns County	45
Citrus County	44
Orange County	43
Escambia County	42

Timing Issues

- To be cost-neutral (or beneficial) to the state, an auction must completely offset (or better) the expected gain from a Compact.
- In a viable compact, Florida would receive payments seamlessly from the effective date forward.
- In an auction, the tax receipts will likely be disrupted for four years --- while the State designs and holds the auction, and during any construction, remodeling, or outfitting phase that the successful bidders need to set up operations. [Four years assumes one year for the auction and three years for the winners to become fully operational.]
- Using a very conservative estimate of no tax collections for three years, and only 50% in Year 4, it appears that \$592 million would be needed from the upfront sale of licenses to cover losses under SCENARIO 1 and \$670 million would be needed under SCENARIO 2.
- The sale of eight licenses would generate more than the needed revenues.

SCENARIO 1: Eight Licenses x \$286.5 MILLION = \$2.3 billion

SCENARIO 2: Eight Licenses x \$192.1 MILLION = \$1.5 billion

Projected Cash Flow

- However, the receipts from the auction would not be received until Year 2 (Fiscal Year 2011-12).

Annual Tax Comparison State Impact	FY 2010-11 Cash	FY 2011-12 Cash	Auction Licenses	FY 2012-13 Cash	FY 2013-14 Cash	Summary
<i>Compact: SB 788, As Passed (official REC Estimate)</i>	171.0	171.0	0.0	171.0	171.0	684.0
<i>Compact: Fall EOG Proposal (EDR Estimate: 11/09)</i>	145.5	158.3	0.0	235.9	259.7	799.4
<i>Eight Auctioned Licenses (Scenario 2)</i>	0.0	0.0	1536.8	0.0	129.2	1666.0
<i>Eight Auctioned Licenses (Scenario 1)</i>	0.0	0.0	2292.0	0.0	207.2	2499.2

- By Year 5 (Fiscal Year 2014-15), projected receipts from Scenario 2 approximately equal the receipts from the proposed Compact, and Scenario 1 receipts exceed the proposed Compact.

NOTE: The estimates shown above are based on an assumption that the “banked” funds (\$287.5 million through FY 2009-10) from the Seminole Tribe could be expended by the state, regardless of the Compact status. Therefore, those dollars are not included. Using a different assumption, a gain would still exist under the Auction scenarios relative to the Compact, but the magnitude would be less. The revised Summary numbers for the Compact when the “banked” funds are included are:

<i>Compact: SB 788, As Passed (official REC Estimate)...</i>	<i>\$ 971.5 million</i>
<i>Compact: Fall EOG Proposal (EDR Estimate: 11/09)...</i>	<i>\$1086.9 million</i>

Gambling Capacity

- Preliminary Analysis:
 - Based on a per capita view, Florida (ignoring the draw to tourists) would have capacity for an additional 30 gambling facilities.
 - Based on disposable personal income, Florida would have additional capacity for 23 gambling facilities.
 - Triangulating that information with dense urban areas suggests a maximum of 15 geographic areas;
 - Using international airports suggests no more than 12 geographic areas.
 - Using MSA's suggests a maximum of 9 geographic areas.
- On the supplier side, the 2009-10 Edition of *Casino City's North American Gaming Almanac* lists 178 Casino-Hotels in Nevada and 11 in Atlantic City.
- It is reasonable to have a working assumption that capacity for an eight additional sites exists, even factoring in the current casino sites operated by the Seminole Tribe and the pari-mutuels.

Preliminary Assessment

- Using conservative assumptions:
 - It is feasible for Florida to have an auction for eight facility licenses.
 - It is likely that Florida would generate significantly more state revenues (between auction and tax receipts) than the proposed Compact would generate over the 4-year period FY 2010-11 to 2013-14, even including the “banked” funds.
- Considerations:
 - There would likely be no receipts in the first year (FY 2010-11), compared to the Compact which would generate at least \$145.5 million for state expenditure (\$433 million including the “banked” funds).
 - The number of gambling locations would increase by eight over the proposed Compact (the Seminole Tribe facilities would continue to exist on tribal lands), and the eight new facilities would be sited in other Florida locations. This means an overall increase in gambling.
 - Within an auction setting, any special treatment for the existing pari-mutuel facilities would come with a specific cost.