



Watch Your Assets

Exposing the misuse and abuse of the public commons

March 26, 2008

Texas Hold ‘Em:

Privatizing the Lottery Raises Gambling Stakes

Last year Governor Rick Perry proposed leasing or selling the Texas Lottery to collect a quick payout of somewhere between \$14 billion and \$20 billion. In promoting this idea, the governor has not showed all of his cards to the public. Projections that the gambling industry privately submitted to the governor’s office make clear that the state cannot raise a purse of this size unless it resigns itself to the proliferation of more gambling in potentially more-addictive forms. If Texans oppose such a gambling expansion, then these documents suggest that what they should play with the Texas Lottery games is Texas Hold ‘Em.

The Texas Lottery currently generates a little more than \$1 billion a year in state funds earmarked for public education. When Perry proposed auctioning off the lottery in February 2007, he estimated that it would generate an immediate windfall of at least \$14 billion. Perry proposed spending this money on cancer research, expanding health-insurance coverage and on continued funding for public education (Perry’s proposal would reduce the lottery’s contribution to education funding by \$250 million a year).¹

The governor did not say that such a massive payout almost certainly would require a politically sensitive expansion of state-sponsored gambling. Nevertheless, lawmakers greeted his plan coolly. The cold reception may have reflected the governor’s timing. Perry’s pitch came on the heels of privatization scandals involving Texas toll roads, [prisons](#) and [human services](#). Whatever the reason, when Rep. Dennis Bonnen (R-Angleton) introduced legislation last year proposing the long-term lease of the lottery, his bill never got so much as a committee hearing.²

Today, more than a dozen states are studying lottery privatization. California Governor Arnold Schwarzenegger said last year that his state’s lottery could be auctioned off for as much as \$37 billion. Yet the Associated Press reported this February that seven Wall Street banks privately priced the deal for Schwarzenegger, who publicly touted the most “wildly optimistic” quote.³ Significantly, to reach its highest valuations, Wall Street said that the state would have to “allow a significant expansion of gambling in California.”

Lottery privatization is not dead in Austin, either. Lieutenant Governor David Dewhurst has directed two interim Senate committees to assess the merits of lottery privatization.⁴ Meanwhile, gambling interests continue to ply Governor Perry with lottery-privatization schemes.

As in California, many of the documents that the Texas governor's office has released thus far to Watch Your Assets suggest that the payout that Governor Perry has touted is unrealistic unless Texas aggressively expands into new games and widens the venues in which gambling occurs. Texas Attorney General Greg Abbott has issued non-binding opinions indicating that many of the new kinds of games that the gambling industry is pushing require a constitutional amendment. Yet the Dallas company Aces Wired now openly operates electronic gaming machines in selected Texas markets that already cross some legal lines drawn by the Attorney General. Aces Wired, which spearheads a business consortium interested in running the Texas Lottery, has flooded the governor's office with advice on how to go about making this happen.

Privatization Proposals

Current Texas Secretary of State Phil Wilson told the *New York Times* that he first discussed privatizing the Texas Lottery when he was Governor Perry's top economic-development aide in 2006. Wilson said the idea came up in a conversation he had with Phil Gramm, vice chair of investment bank UBS. Gramm's ideas carry considerable weight with the Perry administration.⁵ Not only did Phil Wilson serve as Gramm's aide when the latter served in the U.S. Senate,⁶ but—shortly before he left the Senate in 2002—Gramm transferred a stunning \$610,000 from his campaign account to that of Rick Perry.⁷ Four years later, in September 2006, UBS, the bank that employs the largest same-day donor of Rick Perry's career, submitted the first lottery-privatization proposal to Governor Perry's office.⁸

Records released by the governor's office reveal that at least three other investment banks have submitted proposals to lease or sell the Texas Lottery (Lehman Brothers, Merrill Lynch and Goldman Sachs), as has Aces Wired. (The governor's office has withheld many other documents, citing Texas Public Information Act exceptions governing proprietary information.) Significantly, these proposals all suggest that the only way that Texas can generate the kind of revenue that Governor Perry touted is to introduce new games or otherwise expand gambling. This is because the Texas Lottery—where per capita sales⁹ currently drop approximately 1 percent a year—can only command a huge price on the auction block if it can project expanding sales numbers.¹⁰

UBS, for example, estimated that the Texas Lottery could be worth between \$10 billion and \$16 billion if per capita sales increased 2 percent a year. With 7 percent annual growth, UBS estimated that the lottery could yield from \$15 billion to \$24 billion. Based on similar growth estimates, Lehman Brothers projected that the Texas Lottery could be worth \$22 billion. These projections assume that Texas could match the per capita sales rates of lotteries in Maryland, Georgia, and Virginia.



Texas Lottery Ticket.

Yet part of what drives higher sales in those states are games now prohibited in Texas. Notably, the Georgia and Maryland lotteries offer keno, an almost instantaneous number game. The UBS proposal also suggests that the Texas Lottery could boost sales by moving into interactive television and the Internet.

In short, the Wall Street consensus is that maximizing the value of the Texas Lottery requires an expansion of gambling into new games and new venues, which might even extend into virtually ubiquitous cyberspace. This is the point of impact where the assumptions of Wall Street spreadsheets slam into political realities on the ground in Austin. Governor Perry has yet to convince the legislature—much less the public—that lottery privatization is a goose that can lay a golden egg. And this sales job only gets tougher when the public finds out about the need to expand gambling to gild that egg.

Further complicating this political equation is Texas Attorney General Greg Abbott, whose non-binding legal opinions suggest that many of the very gambling expansions cited as ways to maximize a lottery-privatization payout are currently illegal in Texas (Texas courts must make any final decision on this matter). Abbott argues that such games would require a constitutional amendment, which must pass a super majority in the legislature and then be approved by Texas voters.

Such a volatile legal and political landscape gives Wall Street conniption fits. Sub-prime mortgages notwithstanding, these financial wizards go to great lengths to convince themselves and others that they control their risks. If Wall Street were to bet billions of dollars on the Texas Lottery, it would seek to elicit reassurances from a variety of state officials that its investment would perform as expected. It also would want to consult with veteran gambling entrepreneurs who have been testing Texas gaming laws in the courts and on the streets. Before betting billions of dollars on the Texas Lottery, in other words, smart money would want to confer with someone like Aces Wired Chairman Gordon Graves of Austin.

Old Dog, New Tricks

A member of the Lottery Industry Hall of Fame, Gordon Graves once headed a precursor of Gtech—the contractor that has operated the Texas Lottery since its inception. In 2003 Graves retired as CEO of Multimedia Games, a major manufacturer of video lottery terminals. Graves then launched Aces Wired, which quietly began operating hybrid “eight-liner” gambling machines in Texas in late 2005. As the arc of Graves’ career suggests, technology is erasing traditional barriers between different gambling games. Computer software can now simulate virtually any game of chance. As such, computerized machines make the ideal medium for playing cat and mouse with gambling laws and exploiting a fluid regulatory environment.



Example of eight-liner video display machines.

One of Aces Wired’s main plays to date has been its operation of so-called eight-liner video display games. The games look a lot like slot machines and typically offer players eight different ways to win through a tic-tac-toe pattern. State and local authorities regularly raid illegal eight-liner machines across the state. But the lucrative nature of this business, combined with the challenges of convicting violators, ensures that they constantly resurface.

The gist of Texas court rulings on these machines has been that eight-liners can award cheap novelties but not payout anything valuable such as cash. Entrepreneurs continually seek ways around this restriction. In a 2003 decision written by now-Chief Justice Wallace Jefferson, the Texas Supreme Court ruled against one such hybrid: eight-liners that award gift certificates to retail stores.

In a variation on this theme, Aces Wired argues that it has devised a lawful eight-liner that records winnings as credit on an electronic card that can be redeemed for merchandise at participating stores. In March 2007 Attorney General Abbott expressed his non-binding opinion that these machines, which Aces operates around the state, are illegal.¹¹ Abbott’s opinion on Aces’ technology spooked a software company, which sought to stop supplying code for allegedly illegal Aces machines. Abbott’s former Texas Supreme Court colleague Craig Enoch arbitrated the resulting dispute between Aces and its supplier. Contradicting Abbott’s opinion six months earlier, Enoch’s September 2007 arbitration settlement concluded that Aces’ machines are legal. Only Texas courts can settle the matter for good.

Apparently thriving in this contradictory environment, Aces reported in federal securities filing this month that it operates a total of 405 of these machines at six Texas locations, including several state-licensed bingo halls. Significantly, the software in these machines

can be tweaked to run any number of electronic games. Aces reported that it intends to more than double these numbers this fiscal year. Aces also reported that the company is pursuing the purchase of a Corpus Christi dog-racing track to create the state's first "racino" by operating eight-liners there.¹²

The day after Aces filed this optimistic securities report, however, Attorney General Abbott filed a March 14 injunction in federal court to shut down eight-liner machines that the Tigua Indians operated in El Paso. Although Aces previously reported that it was the "joint operator" of a Tigua "gaming amusement center,"¹³ Graves said he severed that relationship a year or so ago when the Tigua gaming facility underwent new management. Nonetheless Abbott's legal actions could affect Aces operations elsewhere.

The undercover state police who built Abbott's case reported that the Tigua gaming center boasted approximately 1,000 "slot style games" such as keno or poker. Most of these machines ran off a pre-paid Visa card that tracks a player's points and winnings. Bolstering Abbott's earlier opinion that such winnings constitute cash, the officers used winnings recorded on one of these Visa cards to buy jeans at a local Wal-Mart. They then returned the pants to the store for cash. This aspect of Abbott's investigation appears to strike at the heart of the Aces business model. If the attorney general loses in court, such lucrative gambling machines would likely cover the state quickly. An Abbott win, on the other hand, could catch Aces with its pants down.

Political Bets

Gaming veterans like Graves know that you have to spend money to make money. Since 2005, when he rolled out his first hybrid eight-liner, Graves has personally contributed \$426,625 to Texas political committees and candidates. The largest recipients of this high-stakes money are Governor Perry, who collected \$102,500 from Graves, and Lieutenant Governor David Dewhurst at \$100,000. The next-largest recipient is Attorney General Abbott, who received \$41,000 of the gambling executive's winnings.

Top Recipients of Graves' Contributions (2005 through 2007)

Amount	Recipient	Office Held/Sought
\$102,500	Rick Perry	Governor
\$100,000	David Dewhurst	Lieutenant Governor
\$41,000	Greg Abbott	Attorney General
\$40,000	Carole Keeton Strayhorn	Governor
\$30,000	Talmadge Heflin	House
\$20,000	Texans to Cure Cancer	NA
\$18,375	Susan Combs	Comptroller
\$12,000	Texas 2020 PAC	NA

Money is not all that Perry has received from Graves. Gordon Graves and Aces Wired have inundated the Governor's Office with memos, emails and presentations about privatizing the lottery. During the 2007 legislative session, Graves made a presentation to gubernatorial aides in which he unveiled an ambitious proposal. Rather than simply

auctioning off the Texas Lottery to a single bidder, Graves proposed that a consortium of gambling and other businesses could collectively operate a slew of electronic games on the state's behalf.

Graves told Watch Your Assets that some of the potential consortium members that he proposed were hypothetical, in that they had not expressed any interest in being part of such an operation. What is clear is that Graves had both business and political reasons for dropping these names at the governor's office. A request to Governor Perry's office for documents involving Gordon Graves or Aces Wired yielded an April 2007 email to gubernatorial Budget and Planning Director Mike Morrissey. That email says that if the consortium involves "large well-respected Texas companies" then "the risk of the legislature changing the law [to prohibit certain kinds of games] goes down considerably."

Potential Consortium Members Claimed by Gordon Graves

Potential Members	Gaming Link
Austin Race Track	Presumed reference to Austin Jockey Club
Chickasaw Nation	Casinos
Dick Clark Productions	Licenses slot-machine content to IGT (see below)
Exxon-Mobil	Exxon Tigermarkets accept Aces gambling credits
Gaming Capital Group	Gambling-industry investment bank
Graves Management	Gordon Graves' investment company
Harrah's Entertainment	Casinos
IGT (Intern'l Game Technology)	Manufactures gaming machines
Magna Entertainment	Owens Lone Star Park
Maxxam	Sam Houston Race Park
Merv Griffin* & Corpus	Graves owns stock in the Corpus Greyhound Race Track
MGM Mirage	Casinos
AT&T	Unknown
Clear Channel Com.	Unknown
J.C. Penney	Unknown

*The entertainer who died in 2007 had vast interests—including casino properties.

The businesses that Graves listed as potential members of his consortium do, indeed, have "a heavy presence in Texas." As the governor's office would surely realize, one place where this presence is felt is the Austin lobby. Just the gambling interests that Graves listed as potential members of his consortium spent up to \$3.5 million on 60 Texas lobby contracts in 2006 and 2007. The four investment banks that submitted lottery privatization proposals to Governor Perry spent up to \$1.3 million more on 23 additional Texas lobby contracts. These same interests contributed a total of almost \$3.2 million to state PACs and candidates since 2005.

Texas Lobby Contracts Tied To the Lottery Consortium, 2006-2007

Gambling Interest Tied To Graves' Lottery Consortium	Min. Value of Contracts	Max. Value of Contracts	No. of Contracts
Big City Capital, LLC	\$360,000	\$625,000	6
Aces Wired Inc	\$300,000	\$600,000	6
Harrah's Entertainment, Inc.	\$250,000	\$490,000	14
MEC Lone Star LP	\$180,000	\$430,000	13
Chickasaw Nation	\$200,000	\$410,000	5
Southwest Florida Enterprises	\$150,000	\$300,000	3
Sam Houston Race Park, Ltd	\$125,000	\$260,000	6
Hickman Investments	\$100,000	\$200,000	2
International Game Technology	\$50,000	\$100,000	2
Graves Management, Inc.	\$50,000	\$100,000	1
Corpus Christi Greyhound Assn.	\$0	\$10,000	1
Austin Jockey Club	\$0	\$10,000	1
TOTALS:	\$1,765,000	\$3,535,000	60

Texas Lobby Contracts for Lottery Banks, 2006-2007

Bank	Min. Value of Contracts	Max. Value of Contracts	No. of Contracts
Merrill Lynch & Co.	\$375,000	\$560,000	6
Goldman Sachs Group	\$180,000	\$435,000	13
UBS AG	\$100,000	\$200,000	2
Lehman Brothers	\$35,000	\$75,000	2
TOTALS:	\$690,000	\$1,270,000	23

Some of the top lobbyists hired by these interests got on-the-job training working for Governor Perry. Aces Wired lobbyist Dan Shelley is Perry's former legislative director. Ex-Chief of Staff Mike Toomey now jockeys for Sam Houston Race Park and Big City Capital. Harrah's hired Gwyn Shea after she stepped down as the Perry-appointed Secretary of State. Former Press Secretary Ray Sullivan lobbies for Phil Gramm's UBS. Bill Jones, a one-time gubernatorial general counsel, now counsels Merrill Lynch. Former Perry Campaign Director Luis Saenz now lobbies for Lehman Brothers.

Perry's Ex-Aides Who Lobby for Lottery-Privatization Interests

Lobbyist	Previously Served As Gov. Perry's	Client Tied To Lottery-Privatization Plans	Max. Value of '06-'07 Contracts
Ray Sullivan	Press Secretary	UBS AG	\$200,000
Bill Jones	Gen'l Counsel	Merrill Lynch & Co.	\$400,000
Dan Shelley	Legislative Director	Aces Wired, Inc.	\$100,000
Mike Toomey	Chief of Staff	Big City Capital; Sam Houston Race Park	\$100,000
Luis Saenz	Campaign Director	Lehman Brothers	\$25,000
Gwyn Shea	Secretary of State	Harrah's Entertainment	\$20,000
TOTAL:			\$845,000

Conclusion

Advocates of privatizing the Texas Lottery confront a political conundrum. Lawmakers and voters are growing weary and wary of privatization claims that sound too good to be true. In this climate, nothing short of an eye-popping sales price can excite much interest. Yet the only way to generate such a humongous sales price is to aggressively offer new games to new players in new gambling venues across the state. But straight talk that says that the state can make billions of dollars by opening the floodgates to whole new levels of gambling doesn't make it sound like Texans can get something for nothing.

The billions of dollars that investors would pay to run the Texas Lottery would come out of the pockets of Texas families. While some of the proposals that the governor's office received say that they would target the middle class rather than the poor, the state has repeatedly failed to accomplish such a shift. Last year the Texas Lottery Commission introduced a \$50 scratch-off ticket to attract higher-income players. Subsequent studies by the *Houston Chronicle* and the *San Antonio Express-News* showed that people residing in zip codes with median incomes of \$20,000 or less were 22 percent more likely to buy these tickets than those who lived in zip codes earning more than \$90,000.¹⁴ The bulk of the billions of dollars that Texas would make privatizing the Texas Lottery would come out of the pockets of Texas' poorest families. And these Texans are the ones most likely to require additional public services when their pockets are picked.

¹ "Perry to push sale of lottery," Robert T. Garret and Christy Hoppe, *Dallas Morning News*. Feb. 6, 2007. An earlier version erroneously reported the reduction in public school funds as \$250,000. The correct amount is \$250 million. TJP regrets this error.

² HB 3973

³ The top estimate came from Lehman Brothers. Most of the other banks pegged the price between \$7 billion up to \$29 billion. See "Records show Calif. lottery worth less than stated," Aaron C. Davis, Associated Press. Feb. 19, 2008.

⁴ The Senate Finance Committee and the Senate State Affairs Committee.

⁵ "Some States Consider Leasing Their Lotteries," Nelson D. Schwartz and Ron Nixon, *New York Times*, October 17, 2007.

⁶ Soon after Governor Perry appointed Wilson Secretary of State in July 2007, Friends of Phil Gramm contributed \$5,000 to Wilson's new officeholder account.

⁷ Texans for Rick Perry reported receiving \$300,000 from Friends of Phil Gramm on October 15, 2002. The same day it reported that the Gramm campaign made a \$310,000 media purchase on Perry's behalf.

⁸ The only other donor in this league is the Republican Governor's Association (RGA). Perry's campaign reported receiving two \$500,000 contributions from the RGA (which he now chairs) in 2006. One occurred on October 27, 2006 and the other five days later on November 2, 2006. These contributions arrived soon after Houston homebuilder Bob Perry contributed \$1 million to the RGA.

⁹ The annual amount that the average state resident spends on the lottery.

¹⁰ "Agency Strategic Plan For the Fiscal Years 2007-2011 Period," Texas Lottery Commission. July 7, 2006.

¹¹ Civil charges that the Potter County Attorney brought against Aces for operating these machines in Amarillo are scheduled for trial in September.

¹² United States Securities and Exchange Commission. Form 10-QSB. Filed March 13, 2008.

¹³ United States Securities and Exchange Commission. Form 10-KSB. Filed Feb. 6, 2007.

¹⁴ “Not-So-Rich Buy Lotto's \$50 Ticket; Scratch-off meant to attract more affluent players is drawing those with little disposable income, data shows,” Lisa Sandberg, Chase Davis and Julie Domel, *Houston Chronicle*. Jan. 14, 2008.