The State of Play in New England Casino Gaming

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I'll give you short odds that Massachusetts Governor Deval Patrick will eventually persuade his state's legislature to legalize high-end, high-stakes casinos—something no other New England governor since Connecticut's Lowell Weicker has done. It has been more a matter of when, not if, Massachusetts and Rhode Island would seek their own pieces of the action, given the spectacular growth of Connecticut's casinos since 1992, and the eager patronage of Foxwoods and Mohegan Sun by citizens of those two states. In Rhode Island, international casino developers are betting $655 million that they can dress up the old Lincoln Park dog track into a flashy destination "racino" (re-dubbed Twin River). And the Great and General Court (that is, legislature) of Massachusetts is performing its usual kabuki ritual before taking up the governor's proposal to put out bids for three large casinos spread strategically around the Bay State.

If and when Governor Patrick succeeds, it will signal a new era in the New England market for high-stakes casino gaming. Till now, Connecticut has reaped most of the net benefits—jobs and tax revenues on the upside, perhaps congestion and problem gambling on the down—from its monopoly in the southern New England market. Three Massachusetts casinos, added to Twin River and New York's new casino in the Catskills, would profoundly change that market. What if anything can, or should, Connecticut do in response?

Steady habits are not the only possible course. Passively accepting the inevitable could tip the region's casino market against Connecticut. But revamping our state's policies towards high-stakes gaming—in essence, fighting fire with fire—could, well, backfire unless the revenues from new casino development more than replaced those the State now realizes from its crown-monopoly deal with Mohegan Sun and Foxwoods on the slots "win" (total "handle" less payments).

A DISTINCTION WITH A DIFFERENCE

A key point for Connecticut readers to note is that, unlike Foxwoods and Mohegan Sun, none of the proposed Massachusetts casinos would be owned and operated by Indian tribes, on tribal lands, under the aegis of the Indian Gaming and Regulatory Act (IGRA) of 1988. True, Governor Patrick's proposed law would give preference to joint bids involving Massachusetts Indian tribes. And the Narragansetts were expressly named as casino participants in the failed Rhode Island constitutional amendment on gaming in November 2006. But in both cases any tribal role would be simply that of a business partner.

History records that Connecticut was different. In the early 1990s, the State lost a court battle to block the construction of Foxwoods by the Mashantucket Pequots on their reservation land, under IGRA. But the original casino buildings had no areas for lucrative slot machines, because Connecticut did not permit anyone to run them in the state. Had things ended there, Foxwoods would likely have been a far smaller, less noteworthy attraction than it has become, and Mohegan Sun might never have been built, at least not in all its current and growing splendor. And the State of Connecticut would have received little additional revenue, along with modest amounts of added congestion and problem gambling.

The tribe and Governor Weicker, however, not wanting to leave money on the table, struck a deal permitting Foxwoods—alone—to install slot machines; in return, the State would get a quarter of the slots' win. In 1996, Foxwoods allowed Mohegan Sun to run slots, too, but under the same terms with the State. With the addition of slot machines, Connecticut's casino industry took off, and with it the State's special revenues from its 25 percent skim, which rose from $30 million in fiscal 1993 to $435 million in fiscal 2007.

The Foxwoods-Weicker deal has proved to be a classic barrier to entry. In the mid-1990s, it effectively deterred Las Vegas interests from opening so-called commercial (non-Indian) casinos in Bridgeport, Hartford and Waterbury, because the State of Connecticut demanded a large sum up front to compensate for the loss of its share of the slots win at Foxwoods and Mohegan Sun if slot machines were permitted elsewhere in the state.

The threatened competition from Massachusetts, Rhode Island and New York again poses a choice for Connecticut, one that may be framed by the answers to two questions: How much will the new entrants erode slots revenues (hence also the State's share of the slots win) at Mohegan Sun and Foxwoods? And how much could Connecticut reap in replacement revenues if it reneged on the deal with the two tribes and allowed its own new commercial casinos? Also at stake, of course, are state jobs, incomes, and regulatory costs.

The answers to those questions turn on the quality of the new entrants' products and whether the region's market for high-stakes gaming can absorb all the new capacity without cutting into profitability.

MEDIEVAL CASTLES REVISITED

Once upon a time, in the Grand Duchy of Connecticut, there were two fairy-tale castles that for 15 years enjoyed security conferred by the duke and enabled by the timorousness of the adjacent Nearly-As-Grand Duchies of Rhode Island, Massachusetts, and New York. Bit by bit, though, envy of the two Connecticut castles' prosperity overcame the other dukes' trepidations, and so they decided to build their own castles from which they could mount raids on the fairy-tale castles and assert control over the flow of custom between their fiefdoms and Connecticut.

At the end of the 13th century, England's Edward I ("Longshanks"), having conquered Wales, built a ring of coastal castles to secure his gains. (At one of them, he christened his son the first Prince of Wales.) Taking a leaf from Longshanks' notebook, Rhode Island and Massachusetts appear to be constructing their own ring of castles…, er, casinos, around those of Connecticut. (See map, next page.) New York has built its own mid-level casino in the Catskill Mountains, to tempt residents to stay home, but it may be too far from Connecticut to pose much of an offensive threat. As one proceeds northwest from an imaginary line connecting Newark, New Jersey, and Manchester, New Hampshire,

Everything turns on the quality of the new entrants' products and whether the market can absorb the new capacity.

If you were Connecticut, would you stick with the hand you've been dealt, or ask for more cards?

population density declines rather sharply. (Put differently, some 27 million people live within a 2.5-hour drive of Connecticut's casinos.) Thus, the Rhode Island and Massachusetts casinos sit athwart many of the main travel arteries that underlie the prosperity of the Connecticut casinos. Interstate 95, the artery from the west, of course, suffers from appalling congestion over much of its length.

Fairy tales can come true. As noted earlier, investors headed by Len Wolman and Sol Kerzner, who collaborated with the Mohegans on their Connecticut casino and still retain a 5% royalty interest, have bought the old Lincoln Park racino (an aging dog-track with a slots parlor) in Lincoln, RI, and are glitzing it up to the tune of $220 million and 1,000 additional slot machines. They're hoping to change the composition as well as increase the size of the customer draw, though the lack of table games (still illegal in Rhode Island) may dull the luster for the younger male gamblers driving the current boom in professional poker. MGM Mirage bid unsuccessfully against the Wolman-Kerzner group for Lincoln Park.

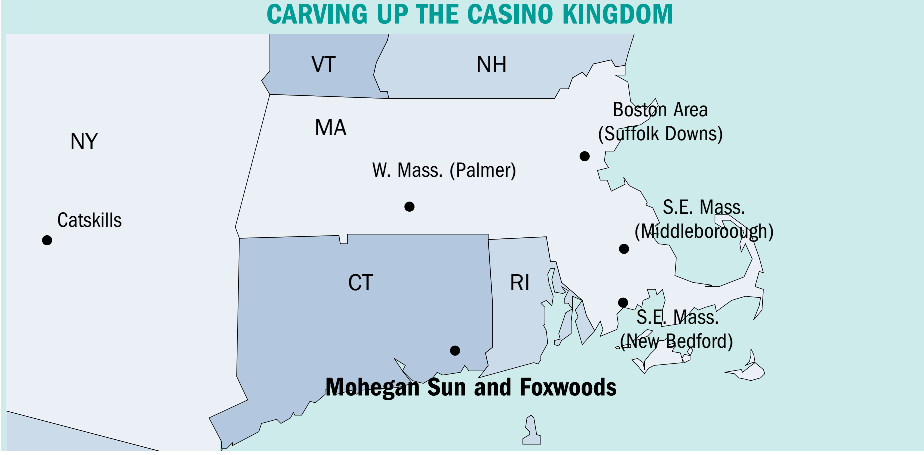
Massachusetts Governor Patrick's proposed casino bill would authorize bids to license up to three "destination resort" casinos, one each in the Boston area and the southeastern and western parts of the state; no investor could participate in more than one casino. The bill would give preference (among other things) to projects having Massachusetts Indian tribe partners, and require bidders to own the land for the casinos. It also stipulates a minimum facilities investment of $1 billion each, an initial fee of $200 million, and yearly license fees of 27% of gross gaming revenues (GGR)—another term for the "win"—but not less than $100 million a year. The licenses would be for 10 years, renewable under procedures TBA; presumably option terms would be included in any bid. Finally, the Patrick bill spells out a host of state trust funds into which the proceeds would be deposited, and provides for extra fees to cover administrative and regulatory costs.

For perspective, Foxwoods and Mohegan Sun are currently finishing up major expansions, adding 2 million and 1.4 million square feet, respectively, and costing a combined $1.4 billion. (Foxwoods bills its expansion, with partner MGM Grand, as "Connecticut's third casino".) The minimum target job creation in the Patrick bill is 5,000 jobs at each casino; current employment at the two Connecticut casinos exceeds 20,000. And while the implied minimum yearly GGR at each Massachusetts casino is $370 million; the comparable figure for Mohegan Sun and Foxwoods combined in 2006 was some $2.5 billion. It is expected, of course, that the Boston-area casino would be the largest, and the one in western Massachusetts the smallest.

SIGNS OF INTELLIGENT LIFE IN FINANCIAL MARKETS

Every proposal for a new casino outside Las Vegas or Atlantic City seems to elicit the charge that the market is "saturated", raising the spectre that building the new facility will leave behind a wasteland of once-glitzy gaming parlors haunted by the ghosts of problem gamblers. Sooner or later such warnings may prove right. But the astonishing thing about the development of legalized gaming in the U.S. over the last two decades is how few of the ventures, new or old, have failed. Hardly less astonishing is how eager the smart money (like the

CARVING UP THE CASINO KINGDOM



national firms based in Las Vegas, or the Wolman-Kerzner consortium) is to queue up whenever someone so much as hints that another casino might be approved.

Economists are in the habit of looking to financial markets to get a handle on whether markets are "saturated"—in effect, whether there are still so-called super-normal profits to be made from adding capacity. Not that financial markets are prescient or infallible (think sub-prime mortgage debacle). But market participants do try to gather and make sense of market information in order to reduce investment risks to tolerable levels.

In the early 1990s, conventional financial markets knew very little about the prospects for a high-stakes casino on a remote Indian reservation in the backwoods of eastern Connecticut. Thus, when it came time for the Mashantucket Pequots to renovate their former bingo hall, under the terms of IGRA, they had to turn to a Malaysian financier (with prior experience in developing high-stakes casinos) for funds. Once Foxwoods took off, though, the Mohegans were able to arrange for initial financing in more traditional circles. Today, financial markets have grown used to dealing with large business entities operating casinos and are on the lookout for plausible proposals.

Before Massachusetts has even begun moving its casino-authorization bill through the legislative process, interested parties have begun announcing casino plans for one or another of the three bidding sites. Among the parties is Mohegan Sun, which is a partner in a proposal to invest in a casino in Palmer, near an exit on the Mass Pike 15 miles east of I-91—and just 35 miles up Route 32 from the University of Connecticut campus in Storrs.

And all the early interest is before the State of Connecticut has said anything about Massachusetts' plans other than "we expect that the impact is years down the road" (an official in the Office of Policy and Management, quoted in the *New York Times* on October 21, 2007).

FRAMING CONNECTICUT'S CHOICE

If you were the State of Connecticut, what would you do? Stick with the hand you've been dealt? Or ask for more cards—but at the risk of losing the nearly $450 million you now receive in slots royalties?

What's best for the entire state depends on the effect of the Massachusetts casinos on both State revenues and the profitability of Mohegan Sun and Foxwoods, which after all are major employers and generators of income. Let's compare the following simplified strategies.

As the base case, suppose that, if no Massachusetts casino was built, the two casinos' total slots win would remain constant at $1.8 million per year; that would imply constant State slots royalties of $450 million a year.

(A) Now suppose that three casinos, built as proposed in three different regions of Massachusetts, would cause a precipitous initial drop in the Connecticut casinos' slots win, but that it would recover after the novelty wore off to one-half the no-casino level, or $900 million per year. Our State slots royalties would then drop, in the long run, to $225 million a year—a permanent loss, if Connecticut did nothing, of half the current slots royalties, or about 1 percent of total State revenue.

(B) Now suppose that, instead of doing nothing, Connecticut instead authorized two new commercial casinos, and by so doing deterred the two non-Boston Massachusetts casinos from being built. (I strongly doubt that any move by Connecticut could deter a Boston-area casino.) Under the current deal, Connecticut would lose all of its (reduced) slots royalties, but start earning a share of the win at the new commercial casinos. Thus, the State's loss of gaming royalties would not be permanent. This strategy would dominate (A) if the new Connecticut casinos had about the same effect on Foxwoods and Mohegan Sun as the two deterred Massachusetts casinos. It could even be worthwhile for the tribal casinos to seek a new deal with the State of Connecticut over the terms of the new casinos, in exchange for not cutting off the entire current slots royalty payments under the current deal.

The above simple calculations omit a lot of the nitty-gritty details that matter a lot in most political decisions. Nonetheless, they give a pretty fair sense of what may be in store for the State of Connecticut if Governor Patrick persuades the Massachusetts legislature to adopt his proposal. Would it be "the end of easy money", as the *Hartford Courant* editorialized on September 23 last? Not necessarily, though adopting a new high-stakes gaming policy for Connecticut would be anything but easy.

Disclaimer: Mohegan Sun is, and Foxwoods was formerly, a Sustaining Partner of The Connecticut Economy. The author was a consultant to Foxwoods in 1993 and to Mohegan Sun in 1995. Neither business had any role in the writing of this piece.