

EXECUTIVE SUMMARY

The Commission on California State Government Organization and Economy, also known as the Little Hoover Commission, initiated a study of the organization, operation, and performance of the California State Lottery (Lottery) in August 1986.

The Lottery has made significant accomplishments in its first year of operations, including generating approximately \$2 billion in lottery revenues and establishing the Lottery's business operations throughout the State. Moreover, the Lottery is now the State's 24th largest department with an authorized staff of more than 1,000 positions and an administrative operating budget of approximately \$70 million per year. However, the Lottery's dramatic growth has placed tremendous demands on its business operations.

The review of the Lottery's activities showed that the Lottery's staff have worked hard to design, establish, and carry out the Lottery's operations. However, the study revealed that the Lottery now needs to take action to fully implement the business systems, procedures and controls that are expected in an enterprise of its magnitude. Specifically, the study identified three major areas that the Lottery needs to address. The study showed that the Lottery needs to make major improvements in the management and operation of its procurement function. It also revealed that the Lottery needs to closely examine its relationship with certain contractors to determine if existing contractual requirements are being adhered to by the contractors.

Finally, the study identified improvements that need to be made in the Lottery's financial accountability and controls.

The Little Hoover Commission's report presents a total of nine findings in the three main chapters of the report. The findings in each of these chapters are referenced and briefly summarized below.

CHAPTER II - THE LOTTERY NEEDS TO IMPROVE ITS PROCUREMENT PROCEDURES AND PRACTICES

Finding #1 - The Lottery Has Relied Too Heavily on the Use of Sole-Source Contracts to Purchase Goods and Services

Since the Lottery began its business activities in early 1985, it has relied extensively on sole-source contracts to purchase goods and services. For example, our review showed that approximately 71 percent of the contracts for goods and services over \$10,000 that the Lottery entered into in the past two fiscal years were sole-source contracts. While this practice may have been justified initially because the Lottery needed to acquire equipment, materials and services and become operational in an extremely short time frame, the Lottery now needs to make greater utilization of the competitive bid process for future contracts to ensure that it procures goods and services at the lowest available cost. This also will ensure that all responsible vendors have an opportunity to bid on potential Lottery contracts.

Finding #2 - The Lottery's Contract Management System Does Not Provide Adequate Controls

The review of the Lottery's current contract management system revealed that certain contracts are not being monitored or tracked, some contract files do not contain sufficient information to monitor performance, and current procedures are inadequate to ensure proper control of contract performance and payments. As a result, in some instances the Lottery has exceeded allowable contract payment limits and received goods or services without valid contracts in effect. Moreover, this undermines the Lottery Commission's ability to exercise control over the Lottery's expenditures.

Finding #3 - The Lottery Needs to Clarify and Improve its Request for Proposal Development and Proposal Evaluation Processes

The Lottery has received considerable criticism from prospective vendors regarding the process it uses to develop Requests for Proposals (RFPs) for the procurement of goods and services and the process it uses to evaluate proposals it receives. The review of these concerns indicated that the Lottery needs to work to further improve its RFP preparation and proposal evaluation processes so that vendors have a better understanding of what the Lottery seeks to procure and how the Lottery intends to evaluate proposals. For example, the review of the RFP for the most recent instant game ticket contract showed that the Lottery did not adequately define the services it wanted, the bid bond or letter of credit requirements, and the scoring methodology to be used in evaluating proposals.

Finding #4 - The Lottery Does Not Use an Independent Review and Appeals Process to Resolve Contract Disputes

Although the Lottery is required by statute to use a formal bid protest procedure for certain types of contracts, the Lottery's current bid protest procedure is administered by the Lottery Director. Since the Lottery Director is also directly involved in making initial procurement decisions, the Lottery's current bid protest procedure does not have the appearance of independence and its objectivity can and has been questioned. Moreover, the process that the Lottery uses to review bid protests and appeals differs considerably from and contradicts the independent review and appeals process used by other state departments.

CHAPTER III - THE LOTTERY NEEDS TO FURTHER REVIEW ITS EXISTING RELATIONSHIP WITH CERTAIN CONTRACTORS

Finding #5 - The Lottery Needs to Further Review the Minority Business Enterprise Subcontract Relationship of the Current Instant Game Ticket Contractor

The vendors that competed for the Lottery's recent multiple-game instant ticket contract have raised concerns regarding the validity of the subcontracting relationship between Scientific Games, Inc., the Lottery's current instant game ticket contractor, and its minority

subcontractor, Security Packaging, Inc. The review of these concerns indicated that there are several questions relating to the management and control of Security Packaging, Inc. and its relationship to Scientific Games, Inc. that need to be more fully investigated by the Lottery's Contract Compliance Office. Specifically, there are questions regarding the employment status of current employees of Security Packaging, Inc. that formerly worked for Scientific Games, Inc. and the degree to which Scientific Games, Inc. controls the operations of Security Packaging, Inc.

Finding #6 - The Lottery Commission Needs to Review the Statements Made By the Current Instant Game Ticket Contractor Regarding its Business Involvement in South Africa

The vendors that competed for the multiple-game instant ticket contract raised concerns regarding whether Scientific Games, Inc., the Lottery's current instant game ticket contractor, or its parent company, Bally Manufacturing, Inc., had business relationships in South Africa. Although two of the three losing vendors competing for the multiple-game instant ticket contract testified before the Little Hoover Commission that they also had business relationships with South Africa, the losing vendors questioned whether Scientific Games, Inc. made misrepresentations regarding its business relationships in South Africa in testimony before the Legislature in an effort to secure a contract with the Lottery. Under California law it is not illegal to do business in South Africa; however, the State recently passed legislation to divest its investments in South Africa.

The review of the statements made by Scientific Games, Inc. to the Legislature and to the Little Hoover Commission in oral and written testimony apparently contradict. For example, Scientific Games, Inc. testified to the Little Hoover Commission that neither it nor its parent company, Bally Manufacturing, Inc., had business relationships in South Africa. However, written documentation submitted by Bally to the Legislature states that from 1983 to 1986 it sold slot machines adapted for South Africa coins to a distributor, David Mercer International, which were destined for South Africa. Thus, there is a question if misrepresentations did occur before the Legislature and the Lottery Commission should determine if any actions are warranted with respect to Scientific Games, Inc.'s current Lottery contract.

CHAPTER IV - THE LOTTERY NEEDS TO IMPROVE ITS FINANCIAL ACCOUNTABILITY AND CONTROL

Finding #7 - The Lottery Does Not Have a System to Identify and Recover Unclaimed Low-Tier Prizes

The California State Lottery Act requires that unclaimed lottery prize money reverts for use to the State's educational system. Presently, the Lottery does not recover unclaimed low-tier prizes from Lottery ticket retailers, nor is the Lottery aware of how much money is being kept by retailers. While no accurate data is available on the extent of unclaimed low-tier prizes, estimates indicate that the Lottery's failure to recover unclaimed low-tier prizes may have resulted in a \$13.8 million to \$34.6 million loss in funds to the State's educational system during the Lottery's first nine instant ticket games.

Finding #8 - The Lottery Has Not Made Timely or Complete Financial Reports Required By Law

The monthly and quarterly financial reports that the Lottery is required by the Government Code to prepare are one of the primary means established to provide public accountability for the Lottery's activities. During its first year of operation, the Lottery has not provided timely and complete monthly financial reports. This has hindered the ability of State oversight agencies and policy makers to monitor the Lottery's performance and accountability.

Finding #9 - The Lottery is Exempt from an Independent Annual Budgetary Review

Unlike most other state agencies, the Lottery is exempt from normal budgetary review by the Legislature and other state oversight agencies. Because the Lottery's expenditures are not reviewed in the State's budgetary process, the Legislature does not have the same level of assurance that it has for other state department's operations that the Lottery is conducting its operations in a most economical manner. In addition, there is not full assurance that the amount of funding being generated by the Lottery for education is being maximized.

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The Commission recommends that 12 specific actions be taken to further improve the business systems and operations of the Lottery. These include:

1. The Governor and the Legislature should require the Lottery to utilize competitive bidding for purchases of goods and services of \$10,000 or more.
2. The Governor and the Legislature should require the Lottery to determine if goods and services are available through the Department of General Services' existing contracts or state price schedules prior to undertaking any procurement of \$10,000 or more.
3. The Governor and the Legislature should require the Lottery to establish a centrally administered contracts management system.
4. The Lottery should develop, adopt, use, and maintain consistent and comprehensive contracting procedures.
5. The Governor and the Legislature should require the Lottery to follow the guidelines in the State Administrative Manual in preparing Requests for Proposals.
6. The Lottery should clarify and improve its Request for Proposal development and proposal evaluation processes.

7. The Governor and the Legislature should require the Lottery to use an independent review and appeals process to resolve contract disputes.
8. The Lottery Commission should review the minority business enterprise subcontract of the current instant game ticket contractor.
9. The Lottery Commission should review Scientific Games, Inc.'s business involvement in South Africa and the statements that Scientific Games, Inc. made regarding its business involvement in South Africa to the Legislature.
10. The Governor and the Legislature should require the Lottery to contract for an independent study to determine of the amount of unclaimed low-tier prizes. They also should require the Lottery Commission to determine if it is economically feasible and practical to develop a system to recapture lost revenues from unclaimed low-tier prizes.
11. The Governor and the Legislature should require the Lottery to provide more timely and complete financial reports.
12. The Governor and the Legislature should require that all Lottery funds be subject to legislative review through the State's normal budget process.