



Little Hoover Commission

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Executive Director

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Governor of California

The Honorable David A. Roberti
President pro Tempore of the Senate

The Honorable Willie L. Brown, Jr.
Speaker of the Assembly

The Honorable Kenneth L. Maddy
Senate Minority Floor Leader

The Honorable Ross Johnson
Assembly Minority Floor Leader

Members of the Senate

Members of the Assembly

May 3, 1989

Dear Governor and Members of the Legislature:

In its Review of the Organization Operation and Performance of the California State Lottery (January, 1987), the Commission on California State Government Organization and Economy (Little Hoover Commission) found that the Lottery needed to improve its financial accountability and control in order to better justify its expenditures and realize the expressed purpose of the California State Lottery Act of 1984. That purpose is to raise funds for the benefit of public education in the State by transferring the balance of revenues from the sale of lottery tickets, after allocating 50% to pay prizes and no more than 16% to administer the games, to a State Lottery Education Fund.

One Finding of the Commission's Review specifically criticized the Lottery for not having a system to identify or recover unclaimed low-tier (\$2, \$5, and \$10) prizes for instant games. Instant game tickets are sold in packets of 500 to lottery retailers who buy them at a discount to compensate for the retailer's commissions and the cost of prize payouts made by the retailer. Each packet contains a

guaranteed number of low-tier winning tickets to be redeemed by the retailer selling the ticket. Retailers retain unclaimed prizes as an added incentive. The Lottery justified this retention by reference to Section 8880.32 of the State Lottery Statute, which mandates that only those unclaimed prizes "directly payable by the Lottery Commission" must revert to the Lottery's Education Fund. Since the retailer pays winners of low-tier instant game prizes from the monies the retailer has already received from selling the tickets, the Lottery reasoned, those prizes are not "directly payable" by the Lottery, which therefore has no obligation to account for these unclaimed prizes or allocate them to the Education Fund.

The Little Hoover Commission found that as of December, 1986, the unaccounted for monies from low-tier unclaimed prizes totalled potentially between \$13.8 million and \$34.6 million and recommended that the Lottery contract for an independent study to determine if it was economically practical to recapture from retailers lost revenues from unclaimed low-tier instant game prizes. Our recommendation was not based on a position that the Lottery had a legal obligation to do so but that it was certainly authorized to do so, and as a matter of sound fiscal policy, it should determine how much of an extra incentive the Lottery was actually providing to retailers and if it made economic sense to continue to do so or transfer unclaimed low-tier prizes to the Education Fund.

Since the release of our Commission's Review, the Lottery Commission has authorized the playing of Lotto games to supplement instant ticket games and has amended its rules to allow the diversion of unclaimed low-tier Lotto prizes away from the Education Fund and into the prize fund. The purpose of this letter is to present the Commission's findings and recommendations of this new aspect of the issue.

BACKGROUND

In November, 1986, after completion of the Little Hoover Commission's investigation, the Lottery Commission began offering Lotto as an alternative to instant games. For Lotto games which ran from November, 1986 until April 1, 1988, it was the Lottery's policy to transfer all unclaimed "3 of 6" Lotto game prizes, which require the player to match 3 of 6 numbers drawn in order to win a fixed prize of \$5, to the Education Fund. This policy was codified in a Rule the Lottery promulgated just prior to the first drawing. Rule 7(a) provided that ". . . [i]f a valid claim is not made for the prize within the period specified, the unclaimed prize money shall revert to the California State Lottery Education Fund."

For Lotto games beginning April, 1988, however, the Lottery changed its practice abruptly. Instead of transferring low-tier unclaimed "3 of 6" Lotto prizes to the Education Fund, as it had been doing, a portion of unclaimed prize money accumulated during the fourth quarter of 1987-88 was diverted to an instant game prize fund.

The Lottery defended its action by analogy to its practice in handling low-tier instant game unclaimed prizes, arguing that "3 of 6" Lotto prizes are similarly not "directly payable" by the Lottery because winners claim their \$5 prize from retailers. In December, 1988, some nine months after the Lottery Commission changed its practice, it amended Rule 7(a) to authorize this change retroactively. In March, 1989, however, the Lottery Commission ignored this authorization and its immediate prior practice by allocating unclaimed "3 of 6" Lotto prizes to the Education Fund.

In its Audit of the Lottery for the twelve months ending June 30, 1988, released on April 13, 1989, the State Controller's Office confirmed that as of June 30, 1988, \$5.9 million in unclaimed Lotto prizes had been diverted from the Education Fund to the prize pool. The Audit concluded that this was unlawful because, unlike instant game prizes, Lotto prizes are "directly payable" by the Lottery and the retailer is simply a conduit for the payment. The Controller reasoned that Lotto prize money is not paid in advance to the retailer, but reimbursed to the retailer by the Lottery. Thus, the Lottery maintains complete control and accounting of all unclaimed prizes.

FINDINGS

1. The Purpose of the Act and the Intent of the People Would be Better Served By Mandating the Allocation of Unclaimed Low-Tier Lotto Prizes to the State Education Fund.

The fundamental purpose of the Initiative which is codified in the California State Lottery Act of 1984 is stated in the Act's first section, entitled "Purpose and Intent." It declares that:

The People of the State of California declare that the purpose of this Act is support for preservation of the rights, liberties and welfare of the people by providing additional monies to benefit education . . .

Where an ambiguity in a technical section of the Act, like the "directly payable" language in Section 8880.32, casts doubt on whether a particular unclaimed prize must be allocated to the prize fund, that section should be interpreted to further the primary purpose of the Act.

The flip-flopping of the Lottery Commission on this question confirms that such ambiguity exists and casts doubt on whether this important issue should be left to the Lottery's administrative discretion. In November, 1986, it promulgated Rule 7(a), mandating that all unclaimed Lotto prizes revert to the Education Fund. In practice, however, for the unclaimed low-tier Lotto prizes accumulated from April through June, 1988, the Lottery Commission authorized the diversion of \$5.9 million away from the Education fund in violation of its own Rule. Then, in December, 1988, the Lottery Commission revised Rule 7(a) to authorize the diversion, claiming the change was "declaratory of existing policy." Most recently, in March, 1989, the Lottery changed its practice again in a way which was inconsistent with its newly revised Rule 7(a).

The Little Hoover Commission believes that the correct interpretation of the Lottery Act requires the allocation of all unclaimed Lotto prizes to the Education Fund. The words "directly payable" cannot reasonably be interpreted in a vacuum; nor will a dictionary definition of that term suffice.

The language of the Act was drafted by persons affiliated with the instant game industry. It was put on the ballot as part of the State Lottery Initiative at a time when there were no Lotto games. The words "directly payable" can therefore best be understood in the context of instant ticket games, where low-tier prize money has already been transferred to the retailer as part of his initial pre-payment before tickets are even sold. The Lottery is no longer in possession of the prize money. It is completely out of the loop and it could be burdensome and expensive to recover the money to place in the Education Fund. Put in that context, the law is readily understandable. We agree that the law does not require that unclaimed instant game prizes must be transferred to the Education Fund because the prizes are not "directly payable" by the Lottery. Nothing prohibits it, however, and as our Initial Review recommended, we think it would be prudent business practice to determine exactly how much is being lost and whether it is feasible to recover it.

Low-tier Lotto prizes, however, stand on a completely different footing. While the retailer still pays the prize in the Lotto game context, the retailer is carrying out the Lottery's function. It is the Lottery's agent. The retailer

has no financial interest in unclaimed prizes as it does in the instant game payment and the unclaimed prize remains at all times in the Lottery's possession. None of the administrative difficulties and attendant costs which might make recouping instant game prize monies from retailers infeasible are present in the Lotto context. The conditions and reasons which gave rise to the "directly payable" language in the Lottery Act simply are not present in Lotto games and the Commission finds that it was the intent of the voters to use all Lottery revenues to fund public education unless very good reasons exist to do otherwise.

The Commission concludes that the retailer is no more the direct source of payment for low-tier Lotto prizes than the State Controller is for higher tier prizes. Those prizes are also "directly payable" by the Controller's Office, acting on behalf of the Lottery Commission, yet it would obviously be absurd to argue that for this reason those unclaimed prizes can be diverted from the Education Fund.

2. The Lottery Commission's Rule Making Process Does Not Provide Adequate Time for Public Input.

Section 8880.26 of the Lottery Act exempts the Lottery Commission from the long and cumbersome rule making process overseen by the Office of Administrative Law governing most state agencies. The reason for this exemption was a recognition of the Lottery's need to make rapid adjustments in operations in order to maintain profitability and react to changing market conditions.

While the Little Hoover Commission supports this exemption for the reasons stated, it finds that the Lottery Commission used this exemption to promulgate and amend Rule 7(a) with less than a week's notice to the public or opportunity to be heard and that there was no operational need to exclude such input.

RECOMMENDATIONS

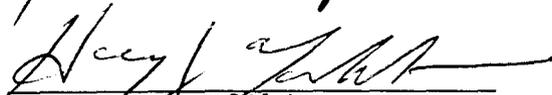
1. Amend the Lottery Act, consistent with its purpose, to clarify that it was not the People's intent in enacting the "directly payable by the Lottery" language in Section 8880.32 to authorize the Lottery Commission to divert any unclaimed prize monies from the California State Education Fund except in the case of low-tier instant ticket games.

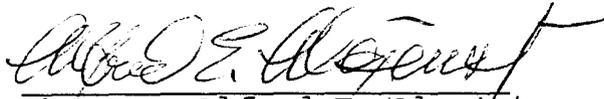
2. Amend the Lottery Act, consistent with its purpose, to require that prior to the promulgation of any rules by the Lottery Commission, which do not concern the operation of Lottery games or the fixing of prizes, the Lottery Commission must provide at least thirty (30) days notice of such action

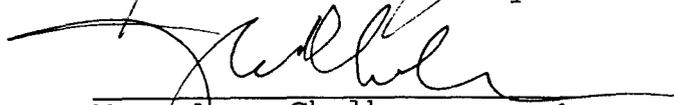
to members of the public requesting such notice and that such individuals be given the opportunity to be heard by the Commission prior to the rule becoming final.

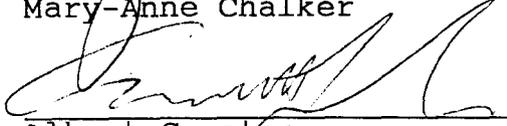
Respectfully Submitted,

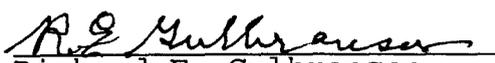

Nathan Shapell, Chairman

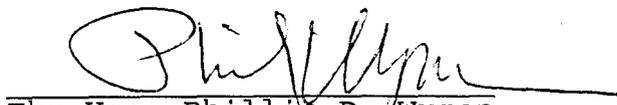

Haig G. Mardikian,
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The Hon. Alfred E. Alquist


Mary-Anne Chalker

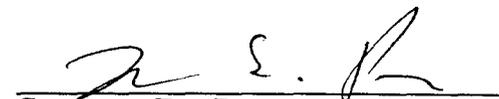

Albert Gersten

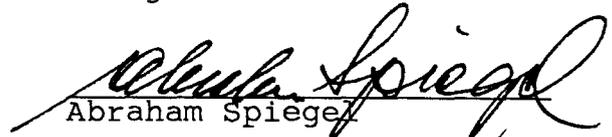

Richard E. Gulbranson

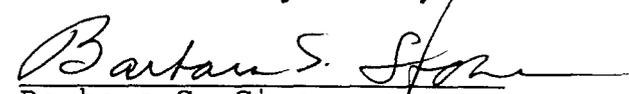

The Hon. Phillip D. Wyman


Milton Marks, Senator


The Hon. Gwen Moore


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