

# Little Hoover Commission

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Governor of California

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

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

The Honorable Kenneth L. Maddy  
Senate Minority Floor Leader

The Honorable Ross Johnson  
Assembly Minority Floor Leader

Dear Governor and Members of the Legislature:

In January 1987, the Little Hoover Commission released a report on the organization, operation and performance of the California State Lottery (Lottery). The Commission concluded that the Lottery "had accomplished a great deal in a relatively short time and should be commended for the hard work of its staff. However, the Commission also found that the Lottery's rapid growth and meteoric sales have placed tremendous demands on the Lottery's staff in conducting its business. As a result, the Lottery has failed to establish certain business systems and controls necessary in an enterprise of its size."

To improve the organization, operation and performance of the Lottery, the Little Hoover Commission's 1987 report resulted in 12 recommendations focusing on three major areas:

- Procurement procedures and practices;
- Existing relationships with contractors; and
- Financial accountability and control.

The primary purpose of this follow-up investigation was to determine whether the Little Hoover Commission's 1987 recommendations have been fully implemented by the Lottery and whether new issues have arisen that may impede the Lottery's ability to operate

efficiently and maximize funding for education. Appendix I summarizes the status of each of the 12 recommendations which, for the most part, have been or are in the process of being implemented. However, there continue to be two areas of concern to our Commission:

- (1) The lack of external budgetary oversight; and
- (2) The Lottery's system for monitoring contract performance.

In addition, during our most recent investigation which included a public hearing in Sacramento on September 15, 1989, the Little Hoover Commission identified new areas of concern that should be addressed:

- (1) The Lottery does not have the ability to obtain project research and development services in a competitive manner; and
- (2) The Lottery does not have a comprehensive system for evaluating the effectiveness of advertising and promotional expenditures.

The Lottery has grown from a State Department with an operating budget of \$70 million and sales of \$2 billion in 1986/87, to a Department with an operating budget of \$384 million and sales soaring to \$2.8 billion projected in the 1989/90 fiscal year. Since the Lottery is continuing to grow rapidly, sound business practices indicative of a mature organization must be fully implemented.

### FINDINGS

FINDING #1: The Lottery is exempt from external budgetary oversight.

The California State Lottery occupies a unique and unprecedented position as a State agency. Under the provisions of the Lottery Act, the Lottery is exempt from normal budgetary review by either the Legislature or any State control agency. Various sections of the Lottery Act specifically prohibit certain State control agencies from overseeing Lottery budgets and operations, including the Department of Finance, the Department of General Services, and the Office of Administrative Law. Because the Lottery's budget is not subject to legislative review the Legislative Analysts' Office does not perform routine budgetary oversight of the Lottery as it does for most other State agencies. Thus, the Lottery is responsible for developing, recommending and approving its own budget without the normal government controls.

The only State agency which does have responsibility for oversight of Lottery operations is the State Controller's Office. Various provisions of the Lottery Act require the State Controller's Office to establish a Lottery Education Fund and to make disbursements from that fund to the various educational entities within the State. In addition, Section 8880.67 of the Government

Code specifies the other responsibilities and authority of the State Controller. This section states:

"The State Controller shall conduct quarterly and annual post audits of all accounts and transactions of the Commission and other special post audits as the State Controller deems necessary. The Controller or his agents conducting audits under this chapter shall have access and authority to examine any and all records of the Commission, its distributing agencies, Lottery contractors, and Lottery game retailers."

In spite of this authorization, there have been some reservations expressed by individual staff members of the California State Lottery regarding the role and authority of the State Controller's Office in conducting studies and operational audits of the Lottery. Questions have been raised by the Lottery staff regarding the appropriateness of costs associated with the State Controller's Office review of their operations and the method whereby such funds are charged to the Lottery. Although, the Lottery believes that the State Controller's role is clearly defined in the Lottery Act, and that no policy issue regarding access to data exists, the State Controller's Office audit staff has indicated that constant harassment by the Lottery Internal Audit Staff, including the denial of requests for information and the requirement that the Controller submit formal engagement letters detailing the specific scope of inquiry prior to the release of information, has delayed the Controller's review of the Lottery. Furthermore, representatives from the State Controller's office have indicated that these procedural delays have resulted in cost increases, thus diverting funds from education.

There is a continuing need for strong, independent oversight of the Lottery in order to maintain public confidence in the integrity of its operations. Independent review of the Lottery's budget and operations provide two major advantages. First, because the Lottery is administered by a part-time commission, such oversight would allow for an intensive review and evaluation of the Lottery's day-to-day operations. Second, because every dollar saved in Lottery administrative costs represents an additional dollar provided for the State's educational system, independent review of the Lottery's budget and operations would ensure that the Lottery is operating in the most economical manner and the amount of funding being generated for education is maximized.

FINDING #2: The California State Lottery does not have the operational flexibility necessary to effectively deal with future project development issues.

At the Little Hoover Commission's September 15, 1989 public hearing on the operations of the Lottery, the Executive Director of the California State Lottery, Mr. Chon Gutierrez, expressed his concern that the Lottery is having difficulty procuring technical research and development services. This is particularly crucial in the development and implementation of new computer-driven on-line game systems. The Lottery has indicated that it is precluded from contracting for independent research and development (R&D) activities because current state procurement

rules only allow payment to a contractor upon the receipt of a deliverable. Further, the Lottery states that current state regulations do not allow a contractor to retain rights to products or services developed for a state agency. This will often preclude otherwise qualified companies from bidding on Lottery contracts that have major R&D components because the product or service developed may not be retained as a proprietary right by the contractor for use elsewhere. These difficulties may preclude the speedy development of such items as interactive on-line games, wagering done through automated teller machines (ATMs), and payment processing through automatic fund transfer to Lottery game winners.

The federal government has encountered similar problems in contracting for R&D in the last several years. These problems have been met by developing contract specifications and criteria for federal agencies that allow these agencies to contract for basic R&D either with other federal agencies, universities or private companies. Federal research and development contracts currently exist for computer software and hardware as well as for operations studies. A primary example of this is the R&D work done by the National Science Foundation on behalf of several federal agencies through contracts with various public and private universities. The U.S. Department of Energy also has several contracts, both through the National Science Foundation and directly with public and private universities to do research and development for computer applications to non-defense programs. Federal regulations and procedures have been developed that enable a contract to be drawn and executed that does not necessarily require the production of a deliverable as a term of the contract.

In recognition of this dilemma at the State level, in 1988 legislation was passed that allows the Office of Information Technology of the Department of Finance to oversee State agencies' participation with private industry and federal, state and local governments in either demonstrating or developing advanced information technologies that may offer efficiencies and reductions in the cost of specified state operations. Sections 11701(g) and 11734 of the Government Code authorize agencies to undertake what are known as advanced technology projects, based upon specified criteria. Monitoring and approval of these projects is undertaken by the Office of Information Technology, located within the Department of Finance. Advanced technology projects must demonstrate information technology not readily available in the marketplace; must address problems shared by several state agencies; must respond to a clearly defined problem; must require a greater resource contribution by outside participants than the affected state agency; and must not require State agency purchase, lease or continued use of the developed technology beyond the project's duration.

The Department of Finance holds no jurisdiction over the Lottery's operations, however, and several of the project requirements, including multi-agency applicability, may not be needed by the Lottery. Therefore, this particular process may not be directly applicable, but can be used as a model.

There is a need for the California State Lottery to have greater flexibility to contract for research and development activities. Without this flexibility the Lottery will not be able to attract qualified

companies when research and development is a requirement of the Request for Proposal. Thus, the Lottery's primary objective to maximize revenue for education will not be achievable.

FINDING #3: The California State Lottery does not currently have an adequate system for evaluating the effectiveness of its advertising and promotional expenditures.

The California State Lottery has based its five-year growth plan on the operational assumption that it can attract new players through advertising and promotion to various Lottery products. The business plan assumes that advertising and promotion would be accomplished in the most efficient and cost-effective manner possible, yet the Lottery does not currently have a comprehensive method for determining the cost-effectiveness of its advertising and promotional expenses. Thus, funds may be used unwisely and revenue goals may not be achieved.

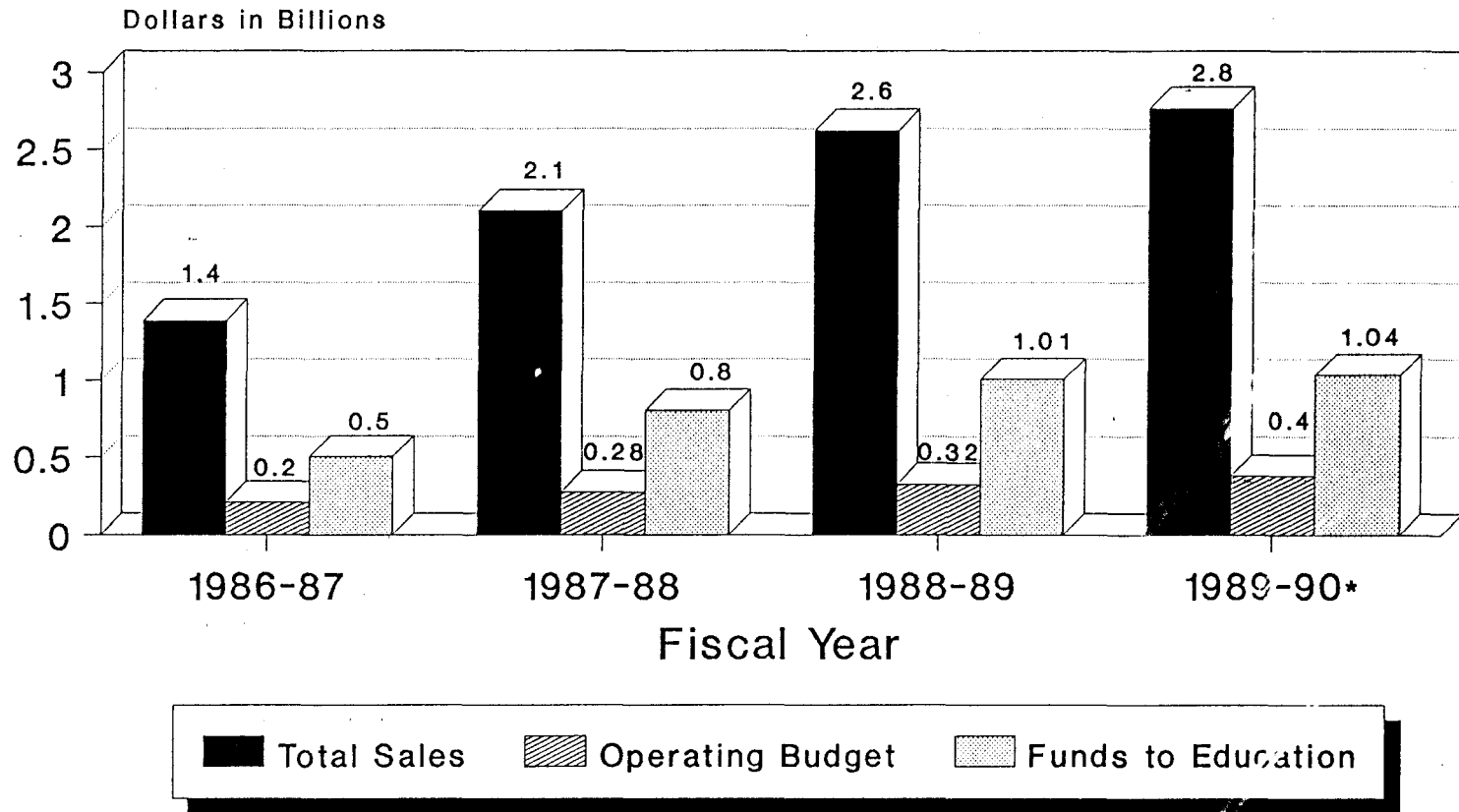
Since its inception in 1985 the California State Lottery has grown rapidly. Exhibit I shows that from fiscal year 1986/87 to 1989/90 the Lottery operating budget increased from \$209 million to \$382 million while total sales increased from \$1.4 billion to \$2.8 billion. The advertising and promotional budget constitutes a substantial part of Lottery operational costs. In the Lottery's FY 1989-90 budget, approximately \$64 million of the \$382 million, or approximately 17 percent, was budgeted for advertising and promotion. In developing its 1989/90 Annual Business Plan the Lottery has proposed to maintain its revenue base in four ways:

- Introduce new games within the next 18 months that will attract new players to the Lottery. These new games will include multiple instant ticket games run concurrently as well as new features to the current LOTTO game;
- Develop new computerized games within the next three years which will appeal to both current and new game players;
- Increase the amount of money spent on promoting and advertising Lottery products; and
- Gradually take over the operation of key components of the current computerized game management and operations systems, now being operated under contract to the Lottery by a private company.

Since promotion and advertising is a key component of the Annual Business Plan, the Lottery has conducted several in-house studies dealing with the effect of market targeting and the effect of various jackpot sizes and payouts for both instant ticket and Lotto games. The Lottery's marketing division has also conducted several analyses of comparative gross advertising expenditures and sales revenues from lotteries in other states. This type of comparative analysis has several inherent limitations: other states' lotteries may not operate in the same

# GROWTH OF CALIFORNIA LOTTERY

## SALES, OPERATING BUDGET AND CONTRIBUTION TO ALL LEVELS OF EDUCATION



\* All figures for Fiscal Year 1989-90 are estimates from the California Lottery Commission's annual plan.

fashion or may appeal to different markets; consistent data may not be available; or each lottery may pursue differing operational goals. However, a state-by-state comparative analysis has shown that the California State Lottery operational expenditures for advertising and promotion are in line with the expenses of other state lotteries.

Section 8880.45 of the Government Code mandates that the Lottery after the first full year of sales contract for an independent study of the effectiveness of Lottery communications and advertising. In September 1988, the consulting firm of Arthur D. Little completed a Communications Effectiveness Study of the California Lottery. In this report, the consultants reviewed the marketing and advertising programs of the Lottery as well as the internal studies completed by Lottery staff and certain studies completed by the staffs of other state lotteries regarding cost analyses and effectiveness of advertising. The consultants concluded that the Lottery was starting to develop effective programs for advertising and communicating with the general public, particularly given the short operational period under review. However, they also indicated that the Lottery had not adopted an effective method of assessing funding effectiveness for advertising. Their report stated, "...spending levels for advertising has the highest priority because of the dollars involved and the potential leverage on sales.... (therefore) the Commission needs to adopt a policy in this regard concerning the return it will accept on incremental expenses.... we recommend the commission adopt a return on investment threshold guideline to guide future incremental funding decisions."

In testimony during the Commission's public hearing on September 15, 1989, the State Controller's Office recommended that the Lottery adopt a return on investment threshold guideline in order to help the Lottery make incremental advertising funding decisions and determine its optimum advertising budget. To date, the Lottery has neither adopted such a policy, nor has it produced any comprehensive studies that would guide the Lottery Commission in evaluating the budget or formulating a return on investment policy.

FINDING #4: The Lottery has not adequately monitored contract performance.

In spite of numerous studies and recommendations over the last three years, the California State Lottery continues to have difficulty monitoring contract performance and promptly executing properly prepared contracts and purchase orders. As a result, purchases and programs may be delayed, and contractors may not be performing needed tasks.

In the Little Hoover Commission's January 1987 review of the Lottery operations this Commission found that their contract management system did not provide adequate controls. The review found that certain contracts were not being monitored or tracked, that some contract files did not contain sufficient information to monitor performance, and that current procedures were inadequate to ensure proper control of contract performance and payments. As a result, in some instances the Lottery had exceeded allowable contract payment limits and received goods or services without valid contracts in effect.

Although some improvements have been made during the last two years, the Lottery continues to experience difficulties in this area. A January 1989 audit by the State Controller's Office of the Lottery's procurement system found inadequate separation of duties between those Lottery staff members charged with procuring goods and services and those staff members charged with reviewing procurement and contract administration. The Controller's Office also noted the purchase orders in several instances were prepared after the purchase of certain items. The Lottery responded by indicating that it would clearly define separation of responsibilities and authority and would ensure that its employees were aware of the applicable procedures for the preparation of purchase orders.

In May 1989, the Management Analysis section of the Lottery concluded a study of the contracting process. The purpose of the study, as stated, was to review the contract process and to offer recommendations for improving or streamlining the process. The study made a total of 16 findings regarding contract operations and numerous recommendations for improvements. Some of the Lottery's own internal findings included the following:

- The current contract process has not been formally approved by management, nor has an operating manual been developed to document the contract process;
- The responsibilities of contract management and contract administration have not been clearly defined. The role of the contract administrator, the contract manager, and the Legal, Accounting, and Budget Office need further definition;
- There is no definitive or consistent interpretation of contract compliance within the various programs;
- There are certain tasks currently performed by contract administrators which are inappropriate. These include: (a) determining evaluation criteria; (b) submitting drafts to the contract manager for review; (c) securing contract approvals; and (d) placing ads in designated publication; and
- Instances exist where contract amendments are executed for expired contract. This results in frustration for the contract administrator and legal staff and indicates a lack of long-term planning on the part of the program.

In an October 1989 memorandum and reply to the Management Analysis section, the Director of Minority Affairs and Contract Services indicated that certain improvements as outlined in the May 1989 report had been instituted. However, the manager also indicated that the unit had experienced a 60 percent staff turnover, including the unit manager, and that further training and reforms would be necessary. It was originally anticipated that necessary reforms and improvements in the contract process could be completed by November 1989, but that "an additional six-month period (November 1989/April 1990) will be necessary for the refinement of the Contract Services Unit processes/procedures and a review of (Lottery) program



roles/responsibilities in the contract area." To date, the work needed to define formally the various roles and responsibilities of Lottery employees has not been completed, and so has delayed or limited implementations of other needed changes in the monitoring of contract performance

This concern is also discussed in a draft audit by the State Controller's Office of the On-line Games Management Unit, which reviews the operations and monitors the contract performance of the Lottery's largest contractor, the GTECH Corporation, in its operation of the LOITO and on-line game systems. The audit found severe deficiencies in information flow and methodology needed to monitor contract performance; inadequate staffing and staff training within the unit; and other inadequacies of contract control. The Lottery is currently responding to this draft report but vigorously states that the operations of the On-line Games Management Unit are, in fact, effective in adequately monitoring the more-than-\$220 million GTECH contract.

### CONCLUSIONS AND RECOMMENDATIONS

The California State Lottery has grown rapidly in its first four years of operation. The Lottery has done an excellent job of marketing its products, as demonstrated by its increasing sales, and funding that is transferred to the State's educational system. The success of the Lottery, however, has caused a considerable strain upon certain aspects of its operation, as well as adding new challenges and issues. The Lottery is entering a long-term "mature" phase with its operations needing only "fine tuning," rather than a major overhaul. However, certain problems should be addressed in order to effectively operate the California State Lottery and maximize funding transferred to education.

RECOMMENDATION #1: The Lottery's budget should be subject to legislative review through the State's normal budget process. The Governor and Legislature should require that all Lottery funds be classified as "special funds" subject to the review of the Department of Finance, contingent upon a direct budget act appropriation. This will ensure an annual budgetary review and analysis by the Legislative Analyst's Office and the State Legislature.

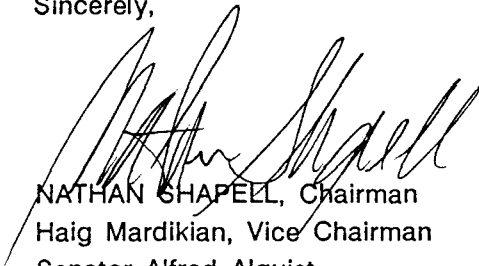
RECOMMENDATION #2: The Governor and the Legislature should enact legislation to allow the California State Lottery to develop and implement a research and development (R&D) function. This can be based upon federal government procurement models, where appropriate, and the current relevant advanced technology project requirements in place for other state agencies.

RECOMMENDATION #3: The California State Lottery should implement a "return on investment" analysis of its advertising and promotional expenditures. By developing and systematically using a return on investment model analysis the Lottery can best determine the effect of expenditures in various advertising and promotional areas, particularly given the role advertising will have in assuring the continued success of the Lottery.

RECOMMENDATION #4: The Lottery should immediately strengthen contract monitoring procedures. This can be done by adopting stringent centralized control measures and ensuring that consistent contract monitoring and administration procedures are used throughout the Lottery. Specifically, the Lottery should strengthen the responsibility of the Contracts Unit for determining parameters of contract compliance, and should centralize and improve contract performance tracking.

The Commission believes that the Governor and Legislature should implement the statutory recommendations outlined in this report and the California State Lottery Commission should adopt the administrative recommendation, thereby ensuring that the California State Lottery operates at peak effectiveness to allow the maximum level of funding to California's public education system.

Sincerely,



NATHAN SHAPELL, Chairman  
Haig Mardikian, Vice Chairman  
Senator Alfred Alquist  
Mary Anne Chalker  
Albert Gersten  
Senator Milton Marks  
Assemblywoman Gwen Moore  
George Paras  
Abraham Spiegel  
Barbara Stone  
Richard Terzian  
Assemblyman Phillip Wyman

## APPENDIX I

### STATUS OF THE 1987 LOTTERY REPORT RECOMMENDATION AND IMPLEMENTATION

1. Recommendation - The Governor and the Legislature should require the CSL to utilize competitive bidding for the purchasing of goods and services of \$10,000 or more.

Status - Recommendation Implemented - The CSL in early 1987 adopted a formal contract and competitive bidding procedure for purchase of all goods and services of \$5,000 or more. The extensive use of sole-source contracts was greatly limited with these procedures.

2. Recommendation - The Governor and the Legislature should require the CSL 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.

Status - Recommendation Implemented in Part - As a part of the 1987 contracting and procurement procedures instituted by the CSL, a requirement was instituted that the CSL check with the Department of General Services to determine if goods or services were available at competitive prices.

3. Recommendation - The Governor and the Legislature should require the CSL to establish a centrally administered contracts management system.

Status - Recommendation Implemented in Part - In 1987, in response to Commission recommendations, the CSL instituted a new contracts management system. This system provided for central recordkeeping and contracts tracking with contract management responsibility to be handled by designated managers in each of the operational units. The central contracts section is responsible for initial processing of contract bidding award documents, while the individual unit managers are responsible for determining if work is being done to schedule and specification. Current operating difficulties with the system, according to the CSL and the State Controller's Office, are slowly being worked out. The State Controller's Office does have several specific concerns regarding the contract management of the current On-Line Games contract now held by the GTECH Corporation for operation of LOTTO and the main computer systems.

4. Recommendation - The CSL should develop, adopt, use and maintain consistent and comprehensive contracting procedures.

Status - Recommendation Implemented in Part - As a part of the 1987 contracting reforms, the CSL adopted a procedures manual which is used by the units that have contract maintenance responsibility. In some instances, however, such as computer contracts and other on-line computer functioning contracts, the standard contracting procedures may be by-passed.

5. Recommendation - The Governor and the Legislature should require the CSL to follow the guidelines in the State Administrative Manual (SAM) in preparing requests for proposals (RFP).

Status - Recommendation Implemented - As a part of the contracting manual adopted by the CSL, the SAM requirements regarding RFPs was adopted in part by the CSL. The guidelines were modified to take into account the unique and changing operational needs of the CSL.

6. Recommendation - The CSL should clarify and improve its RFP development and proposal evaluation processes.

Status - Recommendation Implemented - In developing its RFP guidelines, the CSL has, to the greatest extent possible, been consistent with the RFP guidelines used in the SAM.

7. Recommendation - The Governor and the Legislature should require the CSL to use an independent review and appeals process to resolve contract disputes.

Status - Recommendation Implemented - As a part of its RFP guidelines, the CSL has separated the appeals process from the selection process. Persons that have any responsibility for, or participate in the evaluation or awarding of, a contract may not participate in the adjudication process for appeals on that contract.

8. Recommendation - The Governor and the Legislature should require the CSL to contract for an independent study to determine the amount of unclaimed low-tier prizes. They should also require the CSL to determine if it is economically feasible and practical to develop a system to recapture lost revenues from unclaimed low-tier prizes in all types of games.

Status - Recommendation Implemented in Part - In 1987, the CSL requested and received an Attorney General's written opinion regarding whether unclaimed low-tier instant ticket prizes need be reclaimed from retailers. The Attorney General's opinion concluded that these unclaimed prizes were not directly payable by the CSL itself, but were a "retailer incentive." The Attorney General therefore concluded that unclaimed low-tier instant ticket prizes need not be refunded to the Lottery Education Fund. Until the adoption of our Commission's May 1989 report on unclaimed low-tier LOTTO prizes, the CSL maintained that the computerized LOTTO low-tier unclaimed prizes were not directly payable by the CSL. With the release of this Commission's report and its recommendation that legislation be enacted to specifically compel the CSL to divert unclaimed low-tier prizes to the Education Fund, the CSL has stated that as a policy they will immediately allocate all unclaimed low-tier LOTTO prizes to the Education Fund. The Commission sponsored Assembly Bill 429 (Moore) which required the CSL to divert all unclaimed low-tier LOTTO prizes to the Lottery Education Fund. This provision was subsequently amended into Senate Bill 906 (Dills), and enacted as Chapter 917, Statutes of 1989.

9. Recommendation - The Governor and the Legislature should require the CSL to provide more timely and complete financial reports.

Status - Recommendation Implemented - The CSL is required to submit quarterly and annual financial reports to the Governor, Legislature, Attorney General, State Controller's Office, and other specified state agencies. Since January 1987, the CSL has met the deadlines for submission of these reports and has developed, in conjunction with the State Controller's Office, a format which provides the necessary financial information needed by each of the reporting agencies.