ATTACHMENT

5-Year Risk Analysis Report Recommendations

2018-22 Research and Analysis

Contents

Executive Summary

The California State Lottery (Lottery) presents its quinquennial enterprise-wide assessment of the organization's risk exposures along with a comprehensive analysis to reassess the most appropriate management of its insurable risks. Potential management options for this risk must be filtered through the California State Lottery Act (Lottery Act) framework. The Lottery Act provides structure and direction for conducting the Lottery's business. With this in mind, the Lottery has developed an optimal set of recommendations for the Director and Lottery Commission that will allow the Lottery to most efficiently and effectively manage its insurable risks.

In conducting the analysis, the Lottery contracted with MGK Risk and Insurance Services, Inc. (MGK) to explore all insurable risks of the Lottery. MGK identified nine insurable risk categories for the Lottery and evaluated the probable fiscal exposures and risk needs assessment for each. MGK identified property losses, general liability, automobile liability and physical damages, crime, errors and omissions, professional liability, workers' compensation, cybercrime, and advertising injury as insurable risk exposures of the Lottery.

In addition to the identified insurable risk, the Lottery has identified two provisions within the Lottery Act that govern its approach to risk management. The first discusses the Lottery's maximum allowable administrative expense (13% of sales), and the second prohibits additional funding from other State sources. Capital risk tolerances of the Lottery were also considered and are influenced by the Lottery's inability to retain earnings and the 13 percent administrative expense cap.

The Lottery recommends reasserting its comprehensive risk management policy and a mix of insurance and self-insurance to manage its insurable risk. Specifically, it is recommended that the Lottery 1) obtain insurance to transfer risk for the Lottery's exposure to property losses and automobile exposures and 2) maintain self-insurance for general liability, automobile physical damage, crime, errors and omissions, professional liability, workers' compensation, cybercrime, and advertising injury. This mix of insurance and self-insurance will allow the Lottery to continue operation with the most efficient and effective approach in managing the Lottery's insurable risk without negatively impacting its ability to continue to maximize supplemental funding for public schools and colleges. Details of the recommendation are contained within the following report.

1. Objective

The Lottery's objective was to conduct an enterprise-wide assessment of the organization's risk exposures along with a comprehensive analysis, to determine the most appropriate management of insurable risks.

2. Background

2.1 Overview

The Lottery extensively analyzed the organization's enterprise-wide insurable risk exposures. The research aimed to examine the Lottery's insurable risk, determine the organization's potential exposure to that risk, and develop recommendations to optimize its insurable risk without impeding its mission to raise supplemental funding for public schools and colleges.

Because a critical component of the enterprise risk analysis required the assistance of experts in insurance and insurable risk, the Lottery contracted with MGK. MGK explored all insurable risks of the Lottery, primarily factoring in experience and potential exposure, and provided a detailed report outlining the organization's foreseeable loss across the spectrum of insurable risks. In conjunction with the MGK report, the Lottery explored the details of the Lottery Act to document the relevant components that guide decisions applicable to insurable risk management. Finally, the tolerances of the Lottery to absorb expenses associated with actualized losses, as opposed to transferring all or some risks to a commercial insurance carrier, were examined.

2.2 Insurance Definitions

Insurable risk is a type of risk an insurance provider could charge a large enough fee to cover expected risk expenses and the insurance provider's expenses. This risk must be definable and financially measurable. The risk cannot be so great the associated insurance fees are so high they make insuring unfeasible. Finally, to be insurable, the risk must be actualized from chance. The risk is considered uninsurable if any of these conditions are not met.

2.2.1 Insurance

With insurance, the Lottery would pay a fee to transfer specific risks to an insurance provider. The insurance provider charges a premium high enough to cover projected Lottery insurance claims, but also the operating expenses of the insurer.

2.2.2 Self-Insurance

With self-insurance, the organization will analyze risk and budget funds to compensate for potential expenses associated with actualized risk. Any insurable risk could be self-insured. Self-insurance can benefit the organization because the added cost from an insurance provider would not be incurred. It is rare for an entity to be exclusively self-insured; typically, predictable losses from insurable risks are self-insured, with commercial insurance covering risk above a set self-insurance limit.

3. Methodology

The Lottery and MGK conducted qualitative and quantitative research, utilizing data analysis, interviews, and document review. All documents provided are listed in Appendix A.

4. Findings

4.1 Insurable Risk of the California State Lottery

4.1.1 Property Losses

The Lottery owns nine district offices, a headquarters building, two distribution centers, and an emergency backup facility. With Lottery offices located throughout the State, it is not likely a catastrophic event would impact each location equally. There is a low probability a loss would be close to $2 million per event for the aggregate of Lottery properties. Potential losses to the Lottery for owned properties are the highest among all insurable risks, with an estimated probable maximum loss of $38.5 million. MGK ranked the risk needs assessment as high for this category.

4.1.2 General Liability Exposures

General liability exposures are negligent acts on the part of the Lottery, resulting in injury to third parties. The Tort Claims Act, outlined in sections 810-996.6 of the California Government Code, governs those exposures of the Lottery. The estimated probable maximum loss from this type of exposure is $14.6 million. Due to its substantial volume of cash transactions from retail product sales, the Lottery faces elevated financial risks that exceed those of a conventional public entity. As a specialized enterprise, the Lottery's risk exposures—especially those related to cash transactions—are inherently more complex and lie outside the standard risk profiles associated with traditional public entities. Actualized losses from cash transactions remain less than 1% of revenues, and MGK identified this as an insignificant cost of doing business. MGK ranked the risk needs assessment as low for this category.

4.1.3 Automobile Liability and Physical Damage Exposures

The Lottery has a current fleet of 361 automobiles. Auto liability coverage protects third parties against negligent operators of vehicles. The Lottery currently contracts for insurance with the California Department of General Services (DGS). Automobile liability risks are presently transferred to DGS via a contract and under the authority of Government Code. (Physical damage is not included in this contract.) DGS is cost-effective and offers better coverage than in the private sector. The estimated probable maximum loss from this type of exposure is $300,000.

MGK recommends continuing the self-insurance program for automobile physical damage exposure. The program does not provide physical damage coverage to state-owned vehicles. The average premium per commercial vehicle for insurance with $1,000,000 limits of liability coverage range from $1,100 to $1,400 per vehicle with a $1,000 deductible for comprehensive and collision coverage. MGK ranked the risk needs assessment as low for this category.

The following provides more detail about the regulatory framework that governs these insurance arrangements, with specific Government Code sections that apply:

Government Code § 16378

"The State Motor Vehicle Insurance Fund is hereby created as a special account of the general fund."

Government Code § 16379

"Amounts collected by the Department of General Services pursuant to subdivision (a) of Section 11290 shall be deposited in the account and such amounts are continuously appropriated for the purposes set forth in subdivision (a) of section 11290."

Government Code § 11290

"The Department of General Services may fix the cost or pro rata share, or in its discretion an amount it considers equivalent to the cost or pro rata share, and collect from each state agency in advance or upon any other basis that it may determine:

(a) The cost of insuring motor vehicles belonging to the state agency against liability for damages resulting from the ownership or operation of motor vehicles and arising under Article 1 (commencing with Section 17000) of Chapter 1 of Division 9 of the Vehicle Code or an amount to be expended by the Department of General Services in accordance with law in paying claims under that article and for their investigation, adjustment, defense and administration…"

4.1.4 Crime Exposure including Exposures to Third Party and Employee Theft

With approximately 23,000 retailers serving millions of Lottery consumers daily, MGK has identified the potential for criminal activity by vendors, third parties, and employees as an area of vulnerability; this is an area of opportunity for cybercriminals and employee collaboration in theft. Expanded games and increasing price points create the potential for losses to escalate. Though the loss rate compared to revenues is minuscule, the sheer amount of the Lottery's annual revenues poses some vulnerability[1]. The estimated probable maximum loss from this exposure type is $20 million. MGK ranked the risk needs assessment as a medium for this category.

4.1.5 Directors, Officers, and Public Officials Errors & Omissions Exposures

Lottery Directors, Officers, and Public Officials are afforded governmental immunities and coverage against third parties for liability claims arising from conduct within the course and scope of their employment by the Tort Claims Act under Government Code Section § 800 et seq. To date, the Lottery has not experienced an instance of a Lottery Director, Officer, or Public Official alleged to have violated their duties resulting in exposure to the agency. The estimated probable maximum loss from this exposure type is $5 million. MGK ranked the risk needs assessment as low for this category.

---

[1] Due to the fact that becoming a Lottery retailer requires submitting bank account information to allow for the Lottery to collect for the cost of tickets, the loss rate is extremely low.

4.1.6 Professional Liability Exposures: Law Enforcement and Security

The sole area of professional liability identified as an exposure for the Lottery is the Security and Law Enforcement Division (SLED). MGK's assessment noted the Lottery maintains a high level of vetting and training for our officers within SLED. The estimated probable maximum loss from this exposure type is $5 million. MGK ranked the risk needs assessment as low for this category.

4.1.7 Workers' Compensation Exposures

Workers' compensation benefits are provided to employees injured while working within the course and scope of employment with the Lottery; this occurs whether an employee is working from home or on-site. These regulated programs are defined to provide indemnity and medical and vocational assistance, in severe cases, to workers injured within the course and scope of employment. California Labor Code Section 3700 mandates that every employer be insured for workers' compensation or must obtain a certificate of self-insurance from the Director of Industrial Relations. The Lottery currently self-insures the program which the State Compensation Insurance Fund (SCIF) administers.

It is noted estimated exposure for the past three years ending FY 2021-22 totals more than $6.4 million, with two COVID-19 cases consuming nearly $2.9 million, or 44.9%, of the total exposure. The Lottery does not anticipate the COVID exposure to increase, and telework data is emerging from employers reflecting far less exposure from employees working remotely.

MGK notes a majority of annually accepted workers' compensation claims involved back sprain/strain type injuries, with the Lottery having in-house programs such as ergonomic evaluations to address those cumulative trauma injuries/illnesses. Given the payout patterns for these types of claims, the recommendation is a self-insured program remains in place. The estimated probable maximum loss from this type of exposure is estimated to be $1.2 million. MGK rates this as a low to medium area of concern for the Lottery.

4.1.8 Cybercrime Exposure

The Lottery is potentially exposed to cybercrime in two ways: by an organizational breach (first-party damages), or a breach caused by the Lottery resulting in damages to a third party. For instance, liability would exist if a Lottery system malfunctions, causing the network at another location to become corrupt, inoperable, or compromised. In that instance, the Lottery would have potential exposure for the breach to the vendor, merchant, or even another state agency.

Careful consideration for the coverage grants to a cyber liability policy should include:

1. Cyber Terrorism.

2. Breach of Privacy coverage, including damages resulting from alleged violations of the Health Insurance Portability and Accountability Act and state and federal privacy laws and regulations.

3. Coverage for acts of a rogue employee causing damage to the Lottery's computer network.

4. Cyber extortion reimbursement for a credible threat to induce malicious code, harm, and phish customer systems to corrupt, damage, or destroy the computer system.

If the Lottery's existing commercial insurance policy through American International Group Inc. (AIG) cannot address those considerations, MGK recommends pursuing third-party coverage through AIG or another broker. Further, MGK indicates the first-party coverage of $5 million in the Lottery's current policy is not enough. The estimated probable maximum loss from this type of exposure is estimated between $10 million and $25 million. MGK ranked the risk needs assessment as high for this category.

4.1.9 Miscellaneous Exposures

4.1.9.1 Advertising Injury

The Lottery's business model encompasses devising new games or slogans to market. The Lottery could be vulnerable to exposure if a competing entity claimed a Lottery slogan or phrase is too close to one already marketed by that entity. The merits of these allegations are generally spurious; however, the costs to defend these claims can be costly. The estimated probable maximum loss from this exposure type is $5 million. MGK ranked the risk needs assessment as low to medium for this category. The Lottery notes this risk is further mitigated by its major advertising contracts placing responsibility on the agency to clear slogans and phrases.

4.2 California State Lottery Act

The Lottery Act provides a framework for how the Lottery conducts business. The Lottery has identified two key elements of the Lottery Act that impact insurable risk management. The first element deals with the administrative expenses of the Lottery, which sets the maximum allowable annual administrative expense to 13 percent of sales of Lottery products. The Lottery Act is silent regarding any action should the Lottery ever exceed the 13 percent maximum, but any instance of exceeding the maximum allowable administrative expense would be a matter of public record and would also be discussed in the State Controller's annual audits of Lottery financial statements. In the second element, the Lottery Act further declares the Lottery cannot receive funding from the state beyond the initial loan allowed the Lottery to begin business operations. The Lottery Act is silent on risk management of insurable risk and does not provide for the ability to retain earnings from one fiscal year to another to manage insurable enterprise risk. These limitations are key elements that influenced the recommendations of this report.

The following Government Code sections and subdivisions apply:

> Government Code § 8880.4, subdivision (a)(5)
>
> "No more than 13 percent of the total annual revenues shall be allocated for payment of expenses of the lottery as described in this chapter. To the extent that expenses of the lottery are less than 13 percent of the total annual revenues, any surplus funds also shall be allocated to the benefit of public education, as specified in this section or in Section 8880.5."
>
> Government Code § 8880.3
>
> "No appropriations, loans, or other transfer of State funds shall be made to the California State Lottery Commission except for a temporary line of credit for initial start-up costs as provided in this Act."

4.3 Capital Risk Tolerances of the California State Lottery

The risk tolerances of the Lottery are influenced by not being able to retain earnings and being required to manage an administrative expense that does not exceed 13 percent of sales of Lottery products. The Lottery utilizes unallocated funding within the 13 percent administrative expense cap for each fiscal year to maximize revenues and supplement funding for public schools and colleges. Over the past 37 years, the Lottery has returned to public education more than $1.4 billion in funds that could have been allocated to administrative expenses. This averages to $38 million per year. In essence, this represents the Lottery's average insurable risk tolerance over the 37 years of Lottery existence. Nothing in the Lottery Act would prevent the Lottery from utilizing any unallocated administrative expense funds to manage its insurable risks.

Beyond the unallocated administrative expense, the Lottery also has a capital expenditure capability that allows the organization to manage the highest and least probable type of insurable or non-insurable catastrophic loss without the need to request other State funds. Utilizing funding beyond the unallocated administrative authority would be a violation of the Lottery Act.

5. Recommendations

To appropriately manage the risks of the Lottery, a mix of insurance and self-insurance will allow the Lottery to continue operation with the most efficient and effective means for managing the Lottery's insurable risk. The following recommendations should be considered for continuation and approval.

5.1 Insurance Recommendation

Certain insurable risks are estimated to be at such a probable financial level they expose the Lottery to an unacceptable risk. The Lottery's policy continues to transfer most insurable risk above $15 million to an insurance provider. Potential exposures above this level add unnecessary exposure to potentially exceeding the statutory 13 percent administrative expense cap for a given fiscal year. Therefore, transferring certain risks to an insurance provider is the optimal solution for the Lottery.

Each California employer is statutorily required to maintain insurance for workers' compensation (or be permissibly self-insured by the State's Department of Industrial Relations). The Lottery participates in the SCIF to address this requirement. The Lottery also participates in the State-sponsored auto liability insurance program, which administers claims and provides legal representation for the Lottery in car accident cases. It does not include physical damage coverage.

Based on the foregoing, the Lottery recommends transferring risk to an insurance provider for the insurable risks listed in the following table.

Proposed Lottery Insurance	Probable Exposures
Property Losses	$38.5 million
Automobile Liability	$300 thousand
Workers' Compensation	$1.2 million

5.2 Self-Insurance Recommendation

The Lottery believes maximizing the self-insurance components of its insurable risk is optimal for meeting its mission. For periods when the self-insurance allocations are not utilized as expenditure, the entire amount of an unallocated budget item will go to California public schools and colleges as supplemental funding. Most insurable risks were identified to be below $15 million. Insurable risks below this level constitute risks that could be absorbed by unallocated administrative expenses during most of the Lottery's fiscal years without impacting the mandates of the Lottery Act. To accomplish this, the Lottery recommends maintaining a $5 million reserve in its annual budget to act as a financially responsible buffer for the insurable risks listed in the following table.

Proposed Lottery Self-Insurance	Probable Maximum Exposures	Risk Ratings
General Liability	$14.6 million	Low
Automobile Physical Damage	$1 million	Low
Crime	$20 million	Medium
Directors, Officers, and Public Officials Errors & Omissions	$1 million	Low
Professional Liability	$5 million	Low
Cyber Crime	$10 to $25 million	High
Advertising Injury	$5 million	Low to Medium

It is worth noting the probable exposure amounts listed in the table above have not significantly changed over the last 10 years. The Lottery has maintained a $5 million reserve for insurable risk annually over the same period. The Lottery has spent an average of $387,000 annually compared to the $5 million budgeted to cover fiscal exposures for the self-insured areas of the organization. To strike a balance between insurable risks and the Lottery's mission, the Lottery recommends setting aside a $5 million reserve in its annual budget to buffer the insurable risks as detailed in the table above.

5.3 Additional Recommendations

To continue mitigating risk, the Lottery provides the following further recommendations:

1) The Lottery is currently in the process of obtaining quotes for "cyber perils" under the current AIG property policy by asking the insurance broker to obtain multiple quotes at renewal. As detailed in section 4.1.8 Cybercrime Exposure, the Lottery has multiple exposure points to cybercrime, and MGK ranked the risk needs assessment as high for this category. A Lottery team of, Finance, Information Security & Privacy Office, Information Technology Services Division, and Operations members will analyze the Lottery's current and future risk exposure to aid in determining if the Lottery should insure or self-insure against cybercrime. In making this determination, the Lottery will consider the cost of insurance, exposure amount, and alternatives.

2) The Lottery should continue to devote resources to research and reporting to limit crime exposure. Scratchers inventory remains the Lottery's most significant exposure point for theft, larceny, and embezzlement. The Lottery currently deploys the Portfolio Risk Management report, identifying inventory saturation amongst Lottery retailers. Further, the Lottery maintains the Retailer Relations Committee, which comprises members from Finance, Security and Law Enforcement Division, Sales & Marketing, and Legal. This committee discusses areas of retailer risk and potential mitigation strategies. Both of these efforts help mitigate fiscal exposure resulting from crime.

6. Appendix – MGK Enterprise Risk Report

California State Lottery Risk Assessment
By: MGK Risk and Insurance Services, Inc.

December 27, 2022

Mr. Tyler Cabral
Manager Financial Analysis and Risk Management
California State Lottery
700 North 10th St.
Sacramento, CA 95811

RE: California State Lottery
Risk Assessment

Dear Mr. Cabral:

Thank you and the staff of the California State Lottery, in particular Andrew Ramirez, for the professionalism displayed in affording my company the opportunity to perform an Enterprise Risk Analysis of operations on your behalf. Essential to our analysis is an evaluation of CSL risk exposures; an examination of risk transfer options and recommendations on alternatives to the programs, both insured and self-insured, currently in place. Our review and analysis were assisted by our prior COPE studies; 2013 CSL Risk Assessment, reports and loss information provided by staff, the 2021 Comprehensive Financial Report and the World Lottery Association Risk Management Assessment Report 2020. This information provides the basis for our conclusions and recommendations.

The CSL has an efficient program for risk retention and loss control, though there exist opportunities to further support the risk decision making process and availability of options. We have identified risk transfer alternatives to the current programs, though they are by no means conclusive of our assessment; rather the start of a process for evaluation and improvement over the years. Indeed, while the organization has three Enterprise Risk Management program structures, employee accidents and remedial measures to create loss prevention is not clearly identified within any. This creates an opportunity for analysis, identification of best practices and program implementation to improve loss performance. This takes place in pro-active business environments and a model utilized by progressive organizations worldwide.

Once again, thank you for the opportunity to serve the CSL and please do not hesitate to contact me directly with any questions or concerns you may have regarding our report.

Very truly yours,

Michael G. Keeley

Michael G. Keeley J.D., ARM
President
MGK Risk and Insurance Services, Inc.

TABLE OF CONTENTS

Subject **Page(s)**

A. Identify and analyze the risks of accidental property, liability, crime and workers' compensation loss to which the Lottery is exposed. This will include:

I Property losses, including boiler and machinery and indirect losses such as increases in operating expenses and loss of income.

The CSL currently has nine district offices, a headquarters building, two warehouses and an emergency room backup facility. The Total Insured Values of the locations total $187M. The properties and contents are insured for **Covered Cause of Loss** which are all loses not otherwise excluded under the policy. Sub-limits include Flood of $15,000,000; Equipment Breakdown (aka Boiler and Machinery) $125M; Business Interruption Coverage (loss of income) is $5,000,000. Electronic Data (termed **Standard Cyber Perils** in the policy) is $5,000,000; Earthquake/Earth Movement is excluded.

A) Other covered cause of loss the Lottery facilities are exposed include the following covered perils, among others:

1. Fire;
2. Lightning;
3. Aircraft;
4. Explosion;
5. Riot;
6. Civil commotion;
7. Smoke;
8. Vehicles;
9. Wind or Hail;
10. Malicious mischief.

B) Indirect losses which result from the direct physical loss from the use of facilities include:

1. Relocation, Temporary Accommodations and Salary Continuation;
2. Business Income (based on loss of revenue and expenditures)

Loss models are developed as follows:

Replacement Cost of the Structures and Contents (includes B&M)

MAXIMUM FORSEEABLE LOSS	PROBABLE MAXIMUM LOSS	NORMAL LOSS EXPECTANACY
$154,369,320	$26,397,154	$2,546,006

Relocation, Temporary Accommodations and Salary Continuation[1]

MAXIMUM FORSEEABLE LOSS	PROBABLE MAXIMUM LOSS	NORMAL LOSS EXPECTANACY
$28,746,041	$4,942,734	$1,268,339

Business Income Loss[2]

MAXIMUM FORSEEABLE LOSS	PROBABLE MAXIMUM LOSS	NORMAL LOSS EXPECTANACY
$48,872,683	$7,201,512	$1,511,526

The CSL headquarters is located at 700 North 10th St. in Sacramento, CA in a LEED Gold certified seven story building. The facility consists of two buildings, one comprising 160,161 square feet in the seven story main building with a 5,300 square foot single story separate Central Utility Plant located within 85 feet of the main site. The property lies within a 500 year flood plane which is considered moderate for exposure by underwriters. This main facility drives property premium pricing and should receive favorable consideration for exposure to the noted risks, other than flood.

The boiler machinery equipment consists of two broilers located in the penthouse which are 1M BTU/hr natural gas fired units. These are high quality units which last many years under extreme conditions. There are also two hot water surge tanks. We assume that regular service and maintenance are taking place which reduce the risk of malfunction to the units.

The CSL also has facilities in Milpitas, Richmond, Fresno, Chatsworth, Rancho Cucamonga, Costa Mesa, Santa Fe Springs and San Diego. Due to the segregation of these exposure units we believe a single catastrophic event is unlikely to affect all equally. Accordingly, these location exposures are grouped for purposes of underwriting and risk, into a single/blanket exposure[3].

[1]Assumptions:	25,000 square feet @$38 per square foot for 12 months		$11,400,000
	Salaries continued for 60 days;		$16,291,591
	Moving/relocation/return		$477,450
	Temporary equipment		$382,000
	Miscellaneous		$195,000
		Total	**$28,746,041**

[2]Assumptions:	Annual Revenue	$8,400,000,000
	Monthly Revenue	$700,000,000
	½ Month Revenue	$350,000,000
	½ Month Revenue x .113 (administrative expense budget)	$39,550,000

[3]Assumption All locations have under $1,900,000 in combined inventory, contents and EDP equipment

The CSL has transferred risk of exposures to property losses to an admitted commercial insurance carrier, AIG. The deductibles appear reasonable. Those exposures are currently insured at a premium cost of $182,714 associated with real property assets at the Sacramento headquarters and two Southern CA locations. A premium increase of 23% for 2023 was explained based on an increase in property values. As a general rule when increases exceed 10%, more than one quote is desirable; for 20%, no less than three regardless of valuation. In addition and significantly, Cyber, stated herein as "Electronic Data" limits of $5M appear inadequate for both current and ongoing exposures. Accordingly, we recommend the Lottery **strongly consider: 1) securing quotes for "cyber perils" as defined under the current AIG property policy by asking the insurance broker to obtain multiple quotes at renewal[4]**. We would rate this as a **high** level of needs assessment to the CSL.

II General Liability Exposures.

General liability exposures are negligent acts on the part of the CSL which result in injury to third parties. Those exposures of the Lottery are governed by the Tort Claims Act under California Government Code Section 800 et. seq. Over the past three years the Lottery has experienced a total of 23 documented at fault claims. Current tracking is challenging due to a change of method, switching from a vendor to in-house in March, 2022. The primary liability exposure to the CSL historically, however has been retailer sustained losses for the theft and embezzlements of scratchers tickets; though that has resulted in a rather insignificant cost of doing business representing less than 1/1000th of 1% of revenue historically.

The Lottery currently expenses payments made to cover losses from scratcher tickets[5]. Underwriters are cautious about this arrangement and without specific knowledge of how this information is tracked, are reluctant to place a definite premium to undertake that risk. The additional information they will need includes the itemization of **all** CSL scratcher payments due to theft and embezzlements. This, however would not appear to constitute a significant area of exposure to the Lottery.

Public entities generally carry liability coverage with a $100,000 to $1M self-insured retention; a $10,000,000 first layer excess primary limit and up to $15,000,000 second layer; some up to $100M excess limits. Based primarily on the **exposure** base of the CSL I would expect to see a premium in the range of $550,000 to $1.2M annually for this coverage with law enforcement liabilities[6].

[4]Assumption Exclusions to include earthquake and sublimit for flood
[5]Expensing claims refers to payment on an accrual basis for liabilities as they are recognized
[6]Based on municipal entities in CA with similar size work force and MFL liabilities of $47M or less with Self-Insured Retentions from $100,000 to $1M.

General Liability Losses[7]

MAXIMUM FORSEEABLE LOSS	PROBABLE MAXIMUM LOSS	NORMAL LOSS EXPECTANACY
$47,287,500	$14,576,250	$468,00

The CSL's liability losses for the past three years average $1,440,221. This exposure is trending flat. In contrast to public entity exposures, however that are far less frequent in the number of cash transactions, thus the increased **exposure** to losses experienced by the Lottery is far greater. Conversely, however the CSL's law enforcement exposures are far less than those of public entities due to the limited scope of their investigative activities and arrest/detention responsibilities. Based on these factors we rate this as a **low** level of needs assessment to the CSL.

III Automobile Liability and Physical Damage Exposures

Auto liability coverage protects third parties against the negligent operators of vehicles. Physical damage provides protection against the physical loss of the owned auto. The CSL automobile liability, though not physical damage, risks are currently transferred to the State of CA Department of General Services via contract and under the authority of Government Code Sections:

> 16378. The State Motor Vehicle Insurance Fund Account is hereby created as a special account of the general fund;
>
> 16379. Amounts collected by the Department of General Services pursuant to subdivision (a) of Section 11290 shall be deposited in the account and such amounts are continuously appropriated for the purposes set forth in subdivision (a) of section 11290.
>
> 11290. The Department of General Services may fix the cost or pro rata share, or in its discretion an amount it considers equivalent to the cost or pro rata share, and collect from each state agency in advance or upon any other basis that it may determine:

[7]Based on $1M Self-Insured Retention

a) The cost of insuring motor vehicles belonging to the state agency against liability or damages resulting from the ownership or operation of motor vehicles and arising under Article 1 (commencing with Section 17000) of Chapter 1 of Division 9 of the Vehicle Code or an amount to be expended by the Department of General Services in accordance with law in paying claims under that article and for their investigation, adjustment, defense and administration.

The most remarkable and significant aspect of the DGS auto liability insurance program is that it has **no limits** of liability. All commercial policies post limits of from $500,000 to $5,000,000, however these limitations do not exist with the Memorandum of Coverage between the State of CA and its agencies via the DGS.

The CSL has a current fleet of 361 autos. Payments to the DGS over the past three years total $887,621 and are trending downward, declining 51.2% between 2019 and 2022. Further reductions are projected this past term and while we have no specific information pertaining to the reason for this decline specific to the Lottery, industry wide rates are declining due to reduced annual vehicle travel during the COVID era.

Coverage under the DGS program is mandatory for State of California agencies with an auto fleet. The program does not provide physical damage coverage to state owned vehicles and that cost is absorbed by the individual agency. In a standard insurance policy 82% of those costs are generally absorbed by deductibles incurred by the policyholder.

The average premium per commercial vehicle for insurance with $1,000,000 limits of liability coverage range from $1,100 to $1,400 per vehicle with a $1,000 deductible for comprehensive and collision coverage. This coverage would include:

1. Liability
2. Comprehensive
3. Collision
4. Med Pay
5. Towing

Given the positive trend indicators we rate this as a **low** level in the needs assessment to the CSL.

IV Crime Exposure including Exposures to Employees and Third Party Theft

The CSL has been effective in self-insuring these losses by expensing claims against the agency. The trending of crime losses, while favorable to the Lottery, need constant monitoring and education among law enforcement. This is an area of opportunity to **cyber** criminals and crosses over into that area of exposure much more than conventional criminal theft activity such as assault and battery, larceny and burglary. Expanded games and operations create the potential for losses to increase. Employee collaboration in theft enterprises have arisen in the course of lottery businesses as well. Nationwide these schemes have been reported and are well documented. While these business risks may be considered acceptable losses in the normal course of business an assessment of the potential to transfer of catastrophic loss potential is nonetheless necessary. Our marketing research indicates that coverage for employee, vendor and third party theft may be purchased for up to $20,000,000 at a cost of $350,000 to $500,000 annually with a $1M self-insured retention/deductible. Coverage provided under a crime policy generally includes the following grants:

1. Employee Theft Coverage
2. Premises Coverage
3. In Transit Coverage
4. Forgery Coverage
5. Computer Fraud Coverage
6. Funds Transfer Fraud Coverage
7. Money Order & Counterfeit Fraud Coverage
8. Credit Card Fraud Coverage (Sublimit to $1M)
9. Client Coverage
10. Social Engineering Fraud
11. Expense coverage

Industry wide documented instances of large employee theft sums recite a pattern of continuing deception prior to detection. Such instances may result in exposure into the millions of dollars once discovered, though the documented instances of employee theft from state lotteries have been contained. Specifically to the CSL losses average $118,816 over the past 30 months against revenue averaging $700M this barely registers. That is the experience, however the exposure base of $700M does warrant an analysis of potential risk transfer options when coupled with the potential cybercrime potential. In the interim, we recommend continuing this as a self-insured Lottery program and rate this as a **medium** level of needs assessment to the CSL.

V Directors and Officers

CSL Directors, Officers and Public Officials are afforded governmental immunities and coverage against third parties for liability claims arising from conduct within the course and scope of their employment by the Tort Claims Act under Government Code Section 800 et. seq. noted previously. Commercial liability coverage is available for this potential area of exposure as well and is generally divided into two parts:

> **Side A Coverage** The insurance carrier pays on behalf of the individual Directors and Officers and/or Public Officials losses which the insured organization (CSL) has not provided indemnification by reason of any Wrongful Act.
>
> **Side B Coverage** The insurance carrier pays on behalf of the Insured Organization (CSL) all sums necessary to indemnify the Directors and Officers and/or Public Officials for losses as required or permitted by applicable law.

We cannot find an instance of a CSL Director, Officer or Public Official is alleged to have violated their duties resulting in monetary exposure to the agency. We rate this as a **low** level of needs assessment to the CSL and estimate an annual premium in the range of $175,000 to $200,000 with a $100,000 self-insured retention and limits of $5,000,000.

VI Professional Liability Exposures such as that arising from Law Enforcement and Security Activities

The sole area of professional liability exposure for the CSL appears as that within the law enforcement division or Security and Law Enforcement Division (SLED). During my meeting in 2013 with representatives of this talented team of professionals I was impressed with the methods employed to recruit, train and execute the duties of SLED team members. We are advised there has not been a change to that process. A POST background and certification, seven panel drug screen, medical and physical examination as well as MMPI for psychological are completed prior to acceptance. Ongoing POST training every six months upon hire is standard and officers average 25 years-experience in law enforcement prior to employment with SLED. Most officers carry weapons, including firearms, for use when appropriate during the course and scope of their employment.

The responsibilities of officers include the confirmation/validation of lottery prize winnings in excess of $599 to validate winners and investigate stolen tickets, secondary investigations of vandalized or burglarized lottery sales locations and of questionable claims. We rate this as a **low** level of needs assessment to the CSL and estimate the annual cost for this coverage at $350,000 to $425,000 with a $100,000 self-insured retention for $5,000,000 in coverage.

VII Employee Telework Exposures

Workers' compensation benefits are provided to employees injured while working within the course and scope of employment; whether this takes place at the workplace or a distant location, including home aka telework or off-site. These regulated programs are defined to provide indemnity, medical and vocational assistance, in severe cases, to workers injured within the course and scope of employment. In California, it is a statutory requirement that each employer maintains insurance for this exposure or are permissibly self-insured by the State's Department of Industrial Relations. Lottery participates in the State Compensation Insurance Fund (SCIF) to address this requirement."

We note incurred liabilities for the past three years ending 7/1/2022 total $6,436,579 with **two COVID 19 cases consuming $2,892,712 or 44.9% of the total exposure.** We would not anticipate the COVID exposures to increase and telework data is emerging from employers reflecting far less exposure from those stay at home employees.

Most employers are evaluating the proper level of returning deployed employees during COVID, to work. The overwhelming majority of those have decided to continue some form of hybrid work environment with metrics in development for job performance. The Lottery has 970 employees and is performing a similar analysis. We note the majority of annually accepted workers' compensation claims involved back sprain/strain type injuries and have recently become aware of in-house programs to address those cumulative trauma injuries/illnesses. These pro-active loss prevention measures should result in a decreased frequency of those types of injuries/illnesses over time.

Given the recent loss history the CSL would expect to incur a premium in the range of $2.25M to $2.5M in workers' compensation premiums for a fully insured program. Given the payout patterns for these types of claims our recommendation is that a self-insured program remain with the caveat of loss prevention noted above. We rate this as a **low** to **medium** area of concern for the Lottery.

VIII Cyber Exposures

The Lottery's exposure to cybercrime has previously been commented on in the **Property** and **Crime** sections of this report. Those, however are examples of first party cyber coverage where the CSL has been damaged by a breach. There also, however exist instances in which the Lottery may cause a breach resulting in damages to a third party. For instance if a CSL system malfunctions and causes the network at another location to become corrupt, inoperable, or compromised liability would exist. In that instance the CSL would have potential exposure for the breach to that vendor, merchant or possibly even another state agency.

Careful consideration for the coverage grants to a cyber liability policy should include:

1. Cyber Terrorism;
2. Breach of Privacy coverage including damages resulting from alleged violations of HIPPA, state and federal privacy laws and regulations;
3. Coverage for acts of a rogue employee causing intentional damage to the CSL's computer network;
4. Cyber extortion reimbursement for a credible threat to induce malicious code, harm and phish customer systems to corrupt, damage or destroy the computer system;

These are all considerations and the broker should seek that third party coverage as well as alternative monoline cyber markets should the AIG program not address these issues. While there currently exists a limited form of first party cyber coverage, $5M, that is not nearly enough and you should secure quotes for both first party and third party coverage. Limits should exist at no less than $10M to $25M and the estimated premium I place at $750,000 to $1M annually. We rate this is a **high** area of concern to the CSL's needs assessment.

IX Miscellaneous Exposures

Advertising Injury protection is another area of potential exposure to the organization. The CSL business model likely encompasses devising new games or slogans to market lotto participation. The theory for exposure is that a slogan or phrase is too close to one marketed by competing (gaming) interests or is similar to a previously copywritten song. The merits of these allegations are generally spurious, however the costs to defend actions of this type are very expensive. While the CSL has a favorable arrangement with the Attorney General's office, I would check to make certain they possess the expertise to defend this type of complex litigation[7]. We estimate the cost to secure this coverage at $100,000 to $150,000 annually for $5,000,000 in coverage with a $50,000 self-insured retention.

We rate this as a **low** to **medium** area of needs assessment to the CSL.

Needs Assessment Scale

Low	Medium	High
No need to make changes	Look at alternatives	Urgent adjustment needed

[7]Attorney fees for complex litigation attorneys range from $550 to $750 per hour and often exceed the potential liability exposure of the claim.

California State Lottery Insurable Risk Summary

Type of Coverage	Annual Cost	Limits	Needs Classification	Recommendations/Comments
Property	$182,714	$160,000,000	High	Current schedule includes coverage grant for Cyber. Need to obtain options identified at renewal.
General Liability	$750,000.00 $1,000,000	Self-Funded	Low	Current expensing of payments most cost effective way to fund risk.
Auto Liability	$397,100 to $505,400	Self-Funded	Low	DGS plan and premium most efficient and mandated.
Crime	$725,000 to 800,000	Self-Funded	High	Cyber coverage crosses over Cyber exposures noted in the Property Recommendations.
Directors and Officers	$175,000 to $200,000	Self-Funded	Low	Due to immunities available to D&O's and Tort Claims Act remote esposure relative to cost.
Professional Liability	$350,000 to $425,000	Self-Funded	Low	Loss Experience and scope of duties do not warrant premium cost.
Employee Telework Exposures and Workers' Compensation	$2,225,000 $90,000	Self-Funded	Low to Medium	Significant losses due to COVID claims should not repeat. Establish loss prevention program.
Cyber	750,000 to $1,000,000	Self Funded	High	See previous comments in Property and Crime sections.
Miscellaneous Exposures .	$100,000 to $150,000	Self-Funded	Low	Pertains primarily to Advertising injury exposure.
	*Projected Annual Premium Costs			

B. Evaluate Lottery's ability to Retain risk without insurance.

I. Evaluate Lottery's ability to retain risk and still meet major financial goals.

Since inception in 1984 the Lottery has successfully implemented a primarily self-insured model for operational risk, other than the property risk transfer program which began in 2013. This ability to retain risk and meet annual budget projections would not appear to have impeded the Lottery's ability to meet major financial goals; the most prominent of which is generating revenue for California's public schools. Integration of an active ERM Program to incorporate the loss control measures recommended will further enhance program stability.

II. Evaluate how to best deploy risk retention capacity to reduce and stabilize cost of risk.

The Lottery currently utilizes full risk retention for all areas of operational risk identified other than property. Should expanded commercial insurance options take place the recommended levels of self-insurance should provide the proper level of risk retained to provide optimum premium terms.

C. Assess current insurance programs to:

I. Determine if current policies provide reasonable protection against the risks identified.

The current CSL property policy provides coverage for Real Property, Electronic Data, Equipment Breakdown, Business Interruption and Electronic Data. The policy covers standard perils with a sublimit for flood and exclusion for Earthquake/Earth Movement. The recommended area of improvement lies in an analysis of increasing the Cyber coverage, though this would depend on the contract and indemnification provisions under the IGT Global Solutions Corporation telecommunications and communications scope of work for systems and services. In particular, whether that contract provides protection against spyware and privacy concerns.

II. Identify gaps and overlaps.

The gaps in property coverage are discussed in Sections **I 1.** and **III 1.** above as well as our recommendations for extending the current policy to cover these areas. The auto liability coverage with the DGS does not have first party coverage, however the loss information does not disclose that factor has created a negative impact on the CSL relative to the options available in the commercial marketplace.

III. Determine if coverage is as broad as is generally available.

Coverages in place for the property program are as broad as generally available, however improvement by exploring and evaluating the opportunity to expand coverage grants for cyber is highly recommended.

IV. Identify opportunities for cost reductions.

N/A

V. Evaluate the adequacy of current limits.

One of the primary purposes of the Tort Claims Act is to afford governmental agencies time to investigate and respond to claims prior to formal litigation by third parties. This reduces exposure and lessens uncertainty created by potential vexatious third parties. This has resulted in all California state public agencies self-insuring with losses investigated, resolved and/or litigated by the Department of General Services and the Attorney General's Office. Individual agencies are ultimately responsible for their liabilities with special appropriations from the legislature for large sums in excess of budget constraints. The CSL does not enjoy that privilege based on Government Code Section 8880.3 which reads:

> No appropriations, loans, or other transfer of State funds shall be made to the California State Lottery Commission except for a temporary line of credit for initial start-up costs as provided in this Act.

Our review has disclosed that other state agencies are able to maintain a certain level of risk, depending on the size of the agency, and possibly seek relief from a special appropriation from the legislature or loans for anomalies due to extraordinary circumstances. The CSL is precluded by G.C. 8880.3 from pursuing those options. This would not appear as an area of immediate concern, however as the CSL does not suffer from the variations in financing relative to other state agencies.

Other than Cyber all limits appear adequate.

D. Review the organization, staffing and placement of risk management functions.

I. Provide an evaluation as to whether the current organization and reporting relationships best meet Lottery's risk management needs and goals.

There is an ERM policy statement in effect, though the Chief ERO recently retired. It would appear, however that the DGS is engaged in the actual procurement of the property insurance on behalf of the Lottery, in particular an Associate Risk Analyst. Accordingly, we are uncertain of the lines of communication impacting risk decisions between the two for the purchase of commercial insurance, if any. This is an area of opportunity as the ERM goal incorporates risk analysis across the Lottery enterprise of which the lines of insurance identified create areas of opportunity for engagement.

E. Examine current contracts to determine if risks are appropriately transferred to others.

I. MGK to provide a review of three to five major contracts CSL enters into, including but not limited to sample retail vendor contracts, lease agreements, IT contracts, ad agency agreements and investment manager agreements.

We have had the opportunity to review and analyze selected contracts. Our critique will be limited to the terms related to indemnification and insurance. We offer the **following**:

Haul Away $10,175 (Waste Disposal)

Relevant to the risk transfer of the Lottery, please note the following terms to the agreement:

The Contractor shall indemnify, defend and hold harmless the California State Lottery (Lottery, State of California, its officers, employees, and agents) from and against any and all claims, liabilities, losses, damages, costs, or expenses, including reasonable attorney's fees, which may be incurred, suffered, or required, in whole or in part, as a result of an *actual or alleged act or omission of the **Contractor, subcontractor, or any employees or agents** thereof.*

This language and indemnity provision appear as a Type III as provided in the landmark case of <u>*McDonald and Kruse vs. San Jose Steel*</u> 29 Cal.App.3d 413 (Cal. Ct. App. 1972). This provides risk transfer and protection for the Lottery for the active or passive actions by the Contractor and their employees, however does not provide coverage for the passive negligence of the ***Lottery*** which would close the circle and is a commonly utilized form of risk transfer. Also, a Certificate of Insurance and Additional Named Insured Endorsement should be required for all non-professional service work.

San Bernadino County Sheriff's Department $23,335 (Weapons Range Facilities)

This is a SBCSD drafted agreement by which the CSL provides indemnification to SBC as follows:

"Contractor specifically agrees that this indemnification/defense clause and hold harmless clause is intended to extend to all acts of ***active*** or passive negligence whether sole or concurrent and that Contractor's duty to indemnify, defend and/or hold harmless is intended to be as broad and inclusive as permitted by the law of the State of California…"

This is a classic Type II agreement which provides coverage to the CSL for the negligent acts of the contractor in addition to the ***active*** actions of the Lottery contributing to the loss.

C&C Multicultural LLC $88,600 (Focused Group Based Research)

See **Haul Away** above

Weaver and Tidwell L.L.P., $550,000 (Annual Audits of CSL Financial Statements)

This agreement provides language that is typical of Vendor service agreements and require defense and indemnification for general liability at $1M for liability per person; $2M occurrence and $2M for property damage. Professional Liability (E&O) of $1M is also required as well as workers' compensation. An AM Best A- or better rating. The indemnification provision is Type II and reads as follows:

Contractor shall indemnify and hold harmless, at Contractor's expense, the State of California, the Lottery, the Commission, and all Lottery officers and employees and their respective successors, heirs, representatives, administrators and assigns, from and against any and all responsibilities, suits, judgments, awards, costs, damages, claims, demands, actions, losses, settlements, costs, expenses (including attorneys' fees and expenses), and/or liabilities of every nature threatened or brought against, sustained or incurred by any of them, whether joint, several, or individual (hereafter referred to as "claims") resulting or arising from or in any way connected with (1) any act or omission of Contractor or any of its officers, employees, subcontractors, or agents, whether negligent, unauthorized, intentional, or otherwise; (2) any infringing use of third-party intellectual property; (3) the inaccuracy or breach of any covenants, representations and warranties made by Contractor as they occur; and (4) the breach of a term or condition of the Contract by Contractor. The provisions of this section shall survive the termination or expiration of the Contract.

This is an excellent agreement and would appear to provide the protections needed by the CSL for this professional services agreement. It would appear that for the higher dollar contracts (not certain of the dollar threshold) the CSL does have the proper contractual indemnification to protect their interests.

F. Evaluate the Lottery's risk financing programs. Specifically:

I. Current method for budgeting risk management costs

N/A

II. Need for a system allocating risk costs to operating units.

Prior to consideration of a risk allocation system an operational assessment must take place as to how many positions will remain deployed vs. returning to Lottery brick and mortar facilities. At that point and permanent staffing levels are finalized, in addition to a permanent CERO being hired, further analysis of that risk management technique can take place.

RESOURCE MATERIALS

CSL AIG Property Insurance Binder 2021-2022

CSL AIG Insurance Policy 2021-2022

CSL AIG Binder 2020-2021

CSL AIG Property Insurance Policy 2020-2021

CSL AIG Property Risk Analysis

CSL AIG Renewal Quote 2022

CSL AIG Renewal Quote 2022

CSL Annual Comprehensive Financial Report 2021

CSL Contract C&C Multicultural 2022

CSL Contract Haul Away 2022

CSL DGS Auto Insurance Expense Spreadsheet 2019-2022

CSL San Bernardino County Sheriff's Department 2022

CSL SCIF Loss Runs 2018, 2019, 2020, 2021, 2022 and 2023

CSL Risk Assessment Betty Yee 2020

CSL World Lottery Association RM Assessment 2020