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700 North Tenth Street
Sacramento, CA 95811

calottery

February 6, 2020

Elaine M. Howle
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, California 95814

Re: California State Lottery Response to Draft Audit Report 2019-112

Dear Ms. Howle,

The California State Lottery (Lottery) offers the following responses regarding the recently concluded audit conducted by the California State Auditor (CSA). The audit scope was focused on the Lottery's performance and compliance with the Lottery Act (Government Code section 8880 et. seq.). We thank you for the opportunity to provide feedback on this report, which specifically examined our revenue allocations to education, and our operational and procurement practices.

We are pleased that CSA found no issues with the Lottery's operational and administrative spending levels, its staffing levels, and investigative approaches for awarding prize claims. The Lottery works hard to ensure that its administrative expenses are well within the statutory limit, resulting in an efficient organization that will effectively achieve its mission of maximizing supplemental funding for California public education. The Lottery also assigns a high level of scrutiny and control in awarding Lottery prizes, which is critical to ensuring public trust in the Lottery's operations.

The Lottery agrees with certain findings and recommendations included in this report. The findings that address ways to strengthen and improve the Lottery's internal controls and documentation practices will be adopted, where appropriate and consistent with the Lottery's mission.

The Lottery *strongly disagrees* with CSA's findings that it owes $69 million to education because compliance with a year-over-year proportionality requirement would be inconsistent with the Lottery's mission to maximize funding for education. These findings arise from a fundamental difference of opinion over interpretation of the California State Lottery Act, and Chapter 13 of 2010 (AB 142, Hayashi), which amended the Act in 2010. Because it is not clear what the Legislature intended by "Lottery net revenues" in subdivision (d) of Government Code section 8880.4.5, and because a direct proportionality requirement between Lottery revenues and contributions to education would require the

Lottery to artificially reduce its contribution to education in some years, the Lottery has continued to focus on the intent of subdivision (d) and the Lottery's core mission of maximizing *funding* for education. Since subdivision (d) has gone into effect, the Lottery has continued to grow the amount of *absolute dollars* contributed to public education, meeting the purpose of AB 142 (Government Code §§ 8880.4; 8880.4.5; 8880.63; and 8880.64) and operating in accordance with the California State Lottery Act.

Consistent with the Lottery's Statement of Revenues, Expenses, and Changes in Net Position set forth in its financial statements, which are audited by an external independent certified public accounting firm pursuant to the Lottery Act, the Lottery determines its annual contribution to public education by the total sales revenue, less prize expenses and administrative expenses, plus interest earnings and unclaimed prizes.

During the four fiscal years that the proportionality requirement has been in effect, the Lottery provided $6.7 billion to education, which is an increase of more than $1.3 billion from the previous four fiscal years and more than $2.2 billion from the four fiscal years prior to the first full year of changes under AB 142.

We appreciate the opportunity to respond to the draft report. The enclosed document sets forth the Lottery's detailed response to CSA's audit report findings and recommendations.

Should you have any questions, please feel free to contact our Chief Internal Auditor Roberto Zavala at (916) 822-8358 or by email rzavala@calottery.com.

Sincerely,

Alva V. Johnson
Director

Encl. California State Lottery Management Response to CSA Audit Number 2019-112; Appendix

BACKGROUND

The Lottery takes its mission to provide supplemental funding to education very seriously and is committed to continuing a culture of transparency. In addition to the CSA's audit, the Lottery frequently undergoes audits by its Internal Audits Office, submits mandated financial reporting to the Legislature and Lottery Commission, and is subject to Government Code (GC) section 8880.46.6, which authorizes the State Controller's Office (SCO) to conduct quarterly and annual audits of all accounts and transactions, as well as special audits as it deems necessary. Past SCO audits have focused on a broad array of issues, including procurement and contract practices, prize validation, financial management practices, internal and administrative controls, review of the Lottery's budget process, and audits on administrative operating expenses. On average, the Lottery undergoes 17 audits per fiscal year.

It is important to note the unique nature of the California State Lottery. Unlike other state departments, the Lottery does not utilize General Fund money; its revenue is derived solely from the sale of Lottery products. Thus, the Lottery must continually incentivize and persuade California adults to voluntarily purchase Lottery tickets in order to meet the mandate to maximize supplemental funding for public education. Unlike other state agencies, the public is not required to interact with the Lottery for necessary government services. Instead, the Lottery competes with other consumer goods and entertainment options for discretionary spending. To motivate consumers to purchase Lottery tickets, we must continually invest in a variety of marketing strategies and tactics that engage consumers and our retailer partners.

A report prepared by the Legislative Analyst's Office (LAO), dated August 21, 2019, summarized factors that could influence revenue generated for education. The LAO specifically stated, "The prize structure and prize amounts offered similarly appeal to different demographics of customers. Customers' willingness to purchase specific products depends how attractive they find the potential prize."

The Legislature recognized this lottery industry nuance when it approved amendments to the Lottery Act in 2010 via AB 142 (GC §§ 8880.4; 8880.4.5; 8880.63; 8880.64), which provide added flexibility in prize payouts to maximize supplemental funding for public education. Among other changes, the amended language struck the fixed 50 percent requirement for prizes, and instead specified that not less than 87 percent of the total annual revenues from the sale of Lottery tickets shall be returned to the public in the form of prizes and net revenues to benefit public education. With the prize flexibility granted by AB 142, the Lottery is able to incentivize players to higher priced tickets, which increases sales and results in increased dollars to education.

Prize payout flexibility has been critical to the success of Scratchers® sales in California. Unlike most Draw Games (e.g., Super Lotto Plus®, Powerball®, and Mega Millions®) the prize structure and payout for Scratchers can be controlled to drive consumer participation. This heavily impacts the Lottery's sales revenues and ongoing contributions to education. Over the last eight years, Scratchers sales have grown over 205 percent and currently generate approximately 73 percent of the Lottery's annual revenue. On the other hand, prize payouts for Draw Games are unpredictable because player participation is dependent on the size of the jackpot.

Assembly Bill 142 has unquestionably been successful in growing funds for public education. As a result of this legislation, annual Lottery sales revenues in California have increased by an average of $483 million per year over the nine years following full implementation of AB 142, resulting in a total of $13.2 billion in additional funding for education.

RESPONSE Summary

<u>I. Required Funding to Education</u>

- Application of the Lottery Act's proportionality requirement would undermine the Lottery's sole mission – to maximize supplemental funding for education. Applying a strict proportionality requirement between Lottery revenues and the funding provided to education would require the Lottery to intentionally suppress sales of games with lower profit margins in some years, thereby reducing its overall contributions to education.

- CSA's definition of "net revenues" as "total sales revenue minus the Lottery's administrative and operational expenses" mathematically forces the prize payout percentage to remain at relatively constant levels. This runs counter to the flexibility afforded to the Lottery under AB 142 to increase prize payouts to increase the amount of funding provided to education.

- The Lottery disagrees that it does not prioritize funding to education when setting its budget. Although CSA cites a few years where prize payouts exceed an outside consultant's recommendation from 10 years ago, the Lottery did use updated industry sales and prize payout data similar to what the prior consultant obtained as well as other market research studies to the prize payout for the years questioned in the report. Additionally, those years generated contributions to education that were between $250 and $550 million more than what the consultant's annual projection was using their recommended payout rate.

II. Procurement Practices

- The Lottery believes that its competitive bidding exceptions are not improperly utilized and that the information provided to the CSA demonstrated that use of these exceptions was appropriate. However the Lottery agrees it needs to strengthen contracting controls and procurement practices and improve supporting documentation for use of competitive bidding.
  - The Lottery is currently revising its policies and processes relating to its procurement program; specifically, the rules and documentation requirements for sole source purchasing, use of the emergency contracting exception from competitive bidding, and determining best value when awarding a purchase.
- CSA's analysis of the Lottery's overall procurement activity omitted a significant agreement that was competitively bid. The Lottery's procurement activity chart reflects the omitted figure and shows that 89 percent of its agreements are competitively bid.
- The Lottery agrees that the contracts associated with the retailer trade shows lacked sufficient documentation to support its evaluation of best value for lodging, catering, and event space.
  - While the retailer trade show program had tremendous value, the Lottery previously suspended the program as a result of an internal audit that identified similar issues. While retailer trade shows are not currently being planned by the Lottery, maintaining positive engagement with our retailers remains a priority. Should the program resume, the Lottery will ensure that proper procurement processes are followed and documented.
- The Lottery disagrees with CSA's underlying conclusions on the value of the Fairs and Festivals program. CSA's determination does not factor in the advertising value that outweighs the accrued out-of-pocket expenses associated with the program.
- The Lottery concurs with CSA's recommendation to better measure the intangible benefits of the Fairs and Festivals program.
  - The Lottery is in the process of developing metrics to ascertain these intangible benefits.

<u>III. Other Areas Reviewed</u>

- CSA found that the Lottery's operational and administrative spending limits were justifiable and remained within its operational cost limits.

- CSA contends the Lottery's staffing additions were adequately justified.

- CSA found no issues with the Lottery's procedures in investigating prize claims.

Below are the Lottery's responses to the specific findings and recommendations provided in the audit report dated January 31, 2020. The Lottery will develop a work plan as part of the CSA follow-up process to ensure corrective actions are implemented.

LOTTERY RESPONSE

<u>I. Required Funding to Education</u>

Conclusion 1- Requirement for Education Funding

Recommendation:

The Legislature should require the Lottery to pay to education, from its administrative expenses, the $69 million it should have provided from fiscal years 2015-16 through 2018-19. To ensure the Lottery adheres to the meaning of its 2010 amendments to the Lottery Act, the Legislature should amend the act to specify that increases in its net revenue and increases in its education funding should be directly proportional.

Response:

A. The Lottery Disputes CSA's Application of a Proportionality Requirement to the Lottery's Performance.

Application of GC section 8880.4.5(d) in the manner proposed by CSA would undermine both the Lottery's sole mission – to maximize supplemental funding for education – and the Legislature's purpose in implementing AB 142. Consistent with the Lottery's mission, the purpose of AB 142 was to give the Lottery greater flexibility in its allocation of revenues, allowing it to offer higher prize games to stimulate lagging sales and maximize the overall funding provided to education. As explained below, a practical application of a strict proportionality requirement between Lottery revenues and the funding provided to education, in the manner proposed by CSA, would require the Lottery to intentionally suppress sales of games with lower profit margins in some years, thereby reducing its overall contributions to education. Since this result is inconsistent with the purpose of the Lottery Act, AB 142, and GC section 8880.4.5(d) itself, CSA's interpretation cannot be correct and must not be applied.

When AB 142 was enacted, sales of Scratchers tickets had declined by more than 16 percent over the preceding three years and virtually all of this decline was attributable to small prize payouts. With a statutory limit of prize payouts at 50 percent[1] (limited by the requirement that at least 34 percent of total annual revenues be allocated to education), California lawmakers decided to follow the lead of lotteries from states like New York, which experienced years of substantial revenue growth under revised statutory provisions similar to AB 142. The California Lottery modeled its implementation of AB 142 after the successful programs implemented by these states through increasing prize payouts for its existing $1, $2, and $5 Scratchers games and expanding its Scratchers product line to include higher priced tickets ($10, $20, and $30) with higher prize payouts.

Increased prize payouts drove sales and offered a path to continued growth. However, it was understood that raising prize payouts necessarily reduced profitability and eliminated proportionality between revenues and dollars to education. CSA notes that there is a wide gap between the Lottery's total revenue and the amount it annually provides to education and that some members of the Legislature have questioned this. Similar gaps have occurred in other states, which the Legislature intended the California Lottery to emulate when it enacted AB 142. This is the natural result of increasing prize payouts to allow for deployment of less profitable games, and was the best strategy available to stop the Lottery's sales decline and realize continued growth. This phenomenon is present in all states that have implemented higher prize payouts, and the California Lottery is in close alignment with other state lotteries in this regard.

The Lottery's performance under AB 142 was subjected to a "five-year test period." If the Lottery failed to successfully meet certain growth criteria during this time, the statute would be automatically repealed and the previous 34 percent requirement would be reinstated, effectively limiting prize payouts to a fixed 50 percent of revenues. It was the abandonment of that 50 percent prize payout cap that made possible the Lottery's great success in increasing funding to education from $1.129 billion in fiscal year (FY) 2010-11, the first full year of implementation of AB 142 changes, to $1.392 billion in FY 2014-15, the end of the five-year period. In the four fiscal years after the test period (FY 2015-16 through 2018-19), the Lottery has provided approximately $6.7 billion to education, which is an increase of more than $1.3 billion from the previous four fiscal years, and an increase of more than $2.2 billion from the four fiscal years prior to the first full year in which AB 142 was effective.

[1] During this time, the Lottery chose to use a portion of its then 16 percent administrative funding to supplement prize payouts, resulting in an overall prize rate of approximately 52 percent.

It does not make sense to interpret subdivision (d) of GC section 8880.4.5 to impose a strict proportionality requirement immediately after the Lottery successfully completed a test period during which, unimpeded by a proportionality requirement, it had dramatically increased education dollars. Surely, the Legislature could not have intended that this subdivision immediately change the rules that had worked so well during the preceding years in a way that actually undermines the clear intent behind AB 142 – to transfer *more dollars* to education.

The Lottery notes that during the five-year test period, the SCO defined “net revenues” as gross revenues (i.e., the Lottery’s total sales). This is the definition the SCO applied to determine whether or not the Lottery had met the “tests” in each of the first five years of AB 142. The Lottery expected this same definition would therefore apply in the years following AB 142. Knowing it would be impossible for growth in funding for education to be proportional to growth in total sales, the Lottery chose to focus on its primary mission of maximizing supplemental funding - the *dollars* provided - to education, giving no effect to the proportionality requirement.

The requirement for proportionality would defeat the overall intent of AB 142 and the Lottery’s sole mission to maximize funding to education because it would require the Lottery to artificially suppress sales and associated contributions to education during some years. These circumstances are not hypothetical. They have occurred in the past and will occur in the future. The following are examples of years in which a strict proportional requirement would have undermined the Lottery’s overarching mission of maximizing funding to education.

From FY 2016-17 to FY 2017-18, using CSA’s definition of net revenues, the actual year-over-year net revenues increased by 12.4 percent while the year-over-year funding for education increased by 10.1 percent. Consequently, under CSA’s analysis, the growth in net revenues and education funding was not proportional.

The year-over-year increase in sales was primarily driven by the fact that $30 Scratchers games were only introduced half way through FY 2016-17, but were sold during the entire FY 2017-18. Despite the fact that sales for the Lottery’s remaining games (which have a significantly lower prize expense than Scratchers) increased by more than $236 million from FY 2016-17 to FY 2017-18, and that the $30 Scratchers sales contributed an estimated $118 million to education, the lower profit margin on the $30 game caused the funding for education to grow at a lower rate than net revenues.

In order to meet a requirement to have strict proportionality between these two year-over-year growth rates, the Lottery would have needed to bring both growth rates down to 7.9 percent by completely eliminating the $30 Scratchers game for the entire FY 2017-18 and scaling back sales of the $20 Scratchers game. This would have decreased net revenues (as defined by CSA) for FY 2017-18 by an estimated $242 million and decreased prize expense by an estimated $209 million. But most significantly, it would have reduced funding to education by an estimated $33 million from what education actually received from the Lottery that year. Requiring strict proportionality thus flies in the face of the Lottery Act's overarching mission – to maximize funding for education. The table appended to this response details the figures used in this comparison.

This same situation would apply in fiscal years following extremely large jackpots. Because the jackpot games have a lower prize payout and thus, on a per-dollar basis contribute more to education, the Lottery would need to take action to purposely suppress sales, and therefore funding for education, in any fiscal year following extremely large jackpot levels. Although the Lottery cannot predict when this will occur, it is not uncommon.

In FY 2015-16, the Powerball jackpot reached a then-historic $1.5 billion midway through the fiscal year. This resulted in unprecedented Powerball sales. Because FY 2016-17 had only average jackpots in both Powerball and Mega Millions, net revenues (again using the CSA's definition) actually *decreased* from FY 2015-16 to FY 2016-17. Since Powerball has among the lowest prize expense of Lottery games, the funding for education decreased disproportionally from FY 2015-16 to FY 2016-17.

The CSA report indicates that the Lottery would only have met (in fact, surpassed) the proportionality requirement in FY 2015-16 and FY 2018-19. The only reason the Lottery would have met its proportionality requirement in those two fiscal years is because FY 2015-16 had a then-historic $1.5 billion advertised jackpot in Powerball and FY 2018-19 had a record $1.6 billion advertised jackpot in Mega Millions (resulting in an exponential increase in sales in these games). This situation sets the Lottery up to fail the proportionality requirement in the following year as explained above.

CSA apparently assumes that the Lottery can increase year-over-year growth in funding for education upward to match the rising year-over-year growth in net revenues. This is not possible because the only realistic way to achieve strict proportionality is to reduce sales in higher payout Scratchers games or Hot Spot®, the only games over which the Lottery has sufficient control to achieve proportionality, and forgo the additional money that the Lottery would have earned for education. If the Lottery did not artificially limit or reduce revenues, there would be more dollars available for education, but the increased prize expense would exacerbate the disproportionality between net revenues and funding for education.

CSA concluded that: “If the Lottery had adhered to this proportionality requirement, it would have provided education with $69 million more than it actually provided during fiscal years 2015-16 through 2018-19.” This statement ignores the fact that strict adherence to a proportionality requirement would have resulted in losses to education, not gains, because the Lottery would have had to purposely reduce Scratchers sales and, therefore, the funding for education, to maintain a strict proportionality.

Because it has the effect of undermining AB 142 and the entire mission of the Lottery, subdivision (d) cannot be interpreted to cause an artificial reduction in education funding to meet an arbitrary, and in some applications, irrational proportionality requirement. This is particularly true because subdivision (d) already included another provision that actually serves the subdivision’s stated purpose – “to ensure continued growth in lottery net revenues allocated to public education.” Such growth is ensured by the portion of subdivision (d) which provides “net revenues allocated to public schools [must be] at least as much as were allocated on average in the prior five fiscal years.” Unlike proportionality, this provision will never require suppression of revenues and loss in education funding to achieve an artificial balance between the two in any given year. It requires a certain amount of growth based on prior years’ performance like the standards in the five-year test period, but it also recognizes that there will be down years due to circumstances beyond the Lottery’s control (poor jackpot levels, the inevitability of slowing sales, colossal natural disaster, faltering economy, etc.) and that, at some point, growth will slow.

CSA states that it is critically important that the Lottery adhere to the proportionality requirement among others “because they are safeguards that ensure that the Lottery’s education funding increases as the Lottery’s revenues increase, is at its highest possible level and does not decline sharply from one year to the next.” As shown above, the proportionality requirement neither ensures that education funding increases as the Lottery’s revenues increase nor ensures that education funding is at its highest possible level.

The Lottery’s interpretation of subdivision (d) is informed by factors that are specifically within its knowledge and expertise, and is entitled to more weight than that of an outside agency. Where an alternative interpretation is offered for a statute that a state agency is charged with implementing, courts have held that the responsible state agency’s interpretation is entitled to great weight unless it is clearly erroneous. (See *Whitcomb Hotel, Inc. v. California Employment Com.* (1944) 24 Cal.2d 753.) The Lottery is responsible for the interpretation and implementation of AB 142. In the Lottery’s opinion, AB 142 must be interpreted in a way that will never have the effect of artificially suppressing growth in education funding. Against this background the Lottery’s interpretation is reasonable and should be accepted.

B. Even if Strict Proportionality were Required, the Lottery Disputes CSA's Conclusion that the Lottery Owes Education $69 Million

1) In Reaching the $69 Million Figure, the CSA Applied a Definition of "Net Revenue" that is Not Supported by Statute or Common Usage.

Government Code section 8880.65 specifies: "The funds remaining in the State Lottery Fund after accrual of all revenues to the State Lottery Fund, and after accrual of all obligations of the Lottery for prizes, expenses, and the repayment of any funds advanced from the temporary line of credit for initial startup costs and interest thereon shall be deemed to be the net revenues of the Lottery." Thus, Lottery net revenues are defined as the funding available for education.

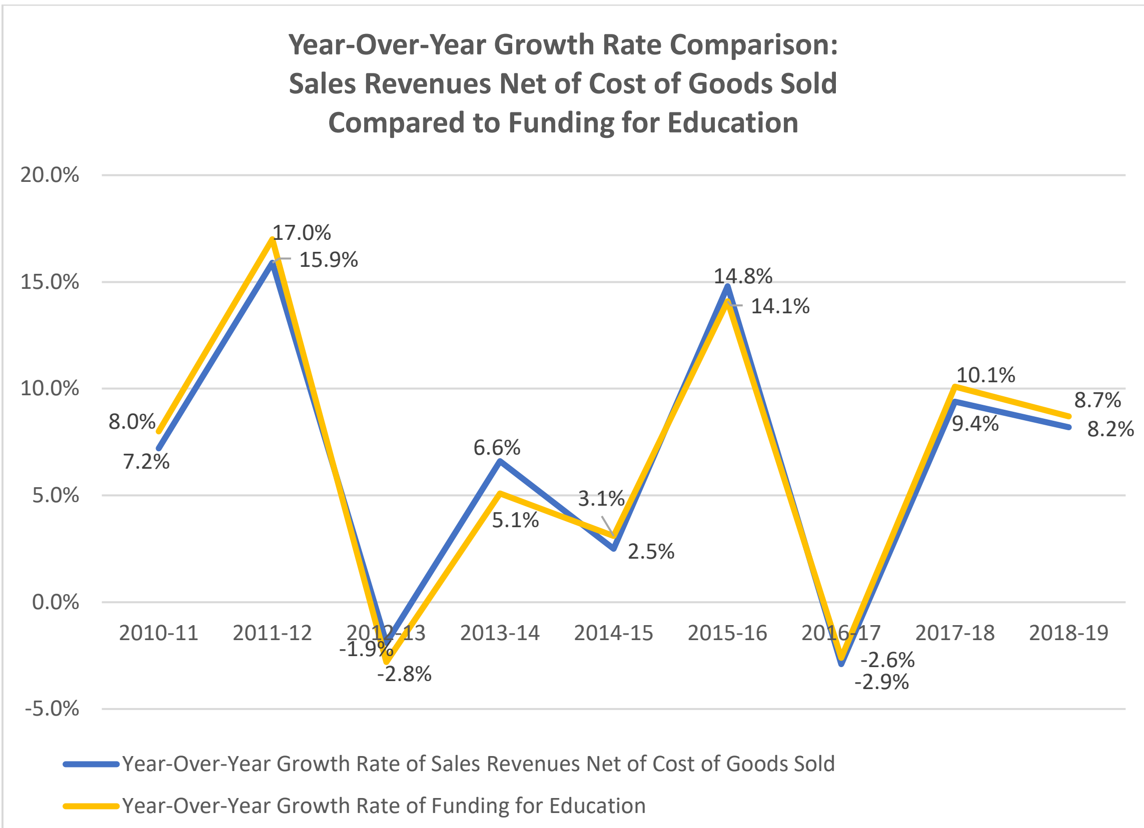
If the definition of the Lottery net revenues from G C section 8880.65 were applied to Subdivision (d) of G C section 8880.4.5, it would require the Lottery to ensure that the funding available for education be increased in proportion to any upward increases in the funding available for education. This makes the proportionality requirement meaningless since it would be impossible to fail. In short, the Legislature's precise intent with respect to this requirement, and specifically the intended meaning of "Lottery net revenues," is unclear.

CSA has defined "net revenues" as "total sales revenue minus the Lottery's administrative and operational expenses." This definition appears to be arbitrary and the Lottery could find no rationale to support it.

CSA concedes that applying their definition of "net revenues" for purposes of meeting the proportionality requirement necessitates that the Lottery's net revenues be equivalent to the sum of the Lottery's education funding and prize payout. There is an inherent flaw in this definition since, mathematically, this forces the prize payout percentage to remain at relatively constant levels. This runs counter to the flexibility that the Legislature intended to add under AB 142.

After exploring the challenges with CSA's definition of "net revenues," the Lottery would propose to define "Lottery net revenues" in the context of AB 142 as sales revenues net of cost of goods sold, which are the expenses the Lottery incurs paying prizes, retailers, and game costs. This alternative definition is appropriate for three reasons: First, it is consistent with the Lottery's Statement of Revenues, Expenses, and Changes in Net Position in its financial statements, which are audited by an external independent certified public accounting firm pursuant to the Lottery Act and display Lottery sales less prizes, retailer costs, and game costs as "income before operating expenses." Second, in the private sector, a company's net sales revenue minus its cost of goods sold is its gross margin, which is used to assess the company's financial health. Third, this is a more meaningful comparison since it better isolates the administrative expenses that the Lottery has more direct control over (i.e., the salaries, wages, and benefits paid to its employees, advertising and marketing expenses, non-gaming contractual services, depreciation, and other general and administrative expenses). In other words, if the Lottery is not mindful of minimizing these operating expenses, the funding it provides for education would clearly be disproportional to its net revenues.

As shown in the graph below, the year-over-year growth pattern of funding for education is very close to the pattern of sales revenues net of cost of goods sold from FY 2015-16 (the first year of the proportionality requirement) through FY 2018-19. This similarity in patterning, as opposed to strict proportionality, is what the Legislature must have had in mind when it used the "in proportion to" language.



2) Regardless of the Definition of Net Revenues, there is no Reasonable Calculation in Which Lottery Underfunded Schools by $69 Million.

a) CSA's Calculation Does Not Take Into Account the Suppression of Funding to Education that Would Have Been Required to Achieve Strict Proportionality in FY2016-17 and FY 2017-18.

CSA's calculation ignores the fact that to achieve proportionality in FY 2016-17 and FY 2017-18, the Lottery would have had to suppress education funding as discussed in detail above. For example, had strict proportionality been required in FY 2017-18, education would not have gained the $53 million as alleged by CSA; it would have instead *lost* $33 million – a swing of $86 million.

b) CSA's Calculation Ignores Aspects of Subdivision (d) that do Not Support its Finding.

Subdivision (d) of G C section 8880.4.5 specifically requires funding for education to increase "…in proportion to any *upward increases* in lottery net revenues" (emphasis added). Because net revenues actually declined from FY 2015-16 to FY 2016-17, there was no "upward increase" in net revenues and the proportionality requirement does not apply. This language alone would remove nearly $16 million from the California State Auditor's $69 million finding.

3) CSA's Analysis Does Not Acknowledge that the Lottery Consistently Spent Less on Administrative Expenses than the 13 Percent Allocation Allows; These Savings Augment Education Funding

The Lottery has authority to allocate up to 13 percent of gross revenues to administrative expenses. Many of those expenses are essentially a fixed percentage of sales revenues (e.g. retailer compensation and gaming costs) and cannot be reduced. These have accounted for approximately 9 percentage points of the 13 percent in each of the last seven fiscal years. Even so, while the remaining 4 percent is an extremely low administrative budget for an organization the size of the Lottery, it has transferred approximately $250 million to education from its administrative allocation in the last four fiscal years. Further, the Lottery has managed to supplement its contribution to education from its administrative allocation almost every year since its inception, totaling over $1 billion since 1985.

Conclusion 2- The Lottery Has Not Prioritized Funding to Education When Setting Its Budgets.

Recommendation:

The Lottery should (1) By August 2020, determine the optimal amount of prize payouts that maximizes the funding for education; (2) By August 2020, establish a policy to annually reconsider the amount of prize payments that maximizes funding for education; and (3) Use this optimal prize amount when setting its budgets, beginning with the budget for fiscal year 2021-22.

Response:

The Lottery disagrees with the finding that it does not prioritize funding to education when setting its budgets. However, the Lottery agrees with the recommendation that the Lottery update the 2010 study referenced by the CSA which established an average optimum prize payout percentage.

One basis for the CSA's assertion is that the Lottery did not responsibly establish the level of prize payout for its games. In support of this allegation, the CSA points to (1) an outside analysis, which projected an optimum prize payout of 62 percent, that has not been updated since 2010 and (2) the Lottery established prize payouts that were $110 million to $248 million in excess of the consultant's recommended rate. The implication is that because prize payouts were higher than needed to sell tickets, profits that fund education were lower than they should have been. The CSA, in essence, concludes that the Lottery could not responsibly establish prize payouts without an updated report from an outside source. This analysis fails to include some key information that demonstrates the Lottery did prioritize funding to education when making these decisions.

First, the Lottery's decision to increase its average prize payout above 62 percent coincided with the introduction of a $30 game and increased sales of its $20 Scratchers product. Both of these efforts required an upward adjustment of the average prize payout, because purchasers of $30 games had to be incentivized to pay a higher price for the ticket, and an increase in the number of $20 tickets distributed added more higher priced tickets to the Lottery's product mix.

CSA speculates that because the Lottery exceeded 62 percent in prize payouts for FY 2015-16 to FY 2018-19, it paid out between about $110 million to $248 million more per year in prizes than it had to, and that this money should have gone to education. However, empirical evidence shows that the addition of these games led to much higher contributions to education than projected by the consultant with the 62 percent optimum prize payout (even allowing for the fact that the consultant used a lower profit margin because of a 13.5 percent figure for administrative expenses). In fact, the Lottery's actual annual contributions in FY 2015-16 through FY 2018-19 exceeded the consultant's annual projection of $1.244 billion with a 62 percent prize payout between $250 million to $550 million per year. This far exceeds the $110 million to $248 million in additional prize expense cited by the CSA.

Second, the consultant's methodology for identifying the optimum prize payout was based on U. S. lottery industry data from FY 1998-99 through FY 2007-08. His analysis could not have taken into account a $30 ticket and its effects on $20 game sales since only 5 jurisdictions had a $30 ticket with 3 of the 5 introducing tickets with that price point in 2007 or 2008.

A report like the one provided by the consultant in 2010 is not the only way to intelligently and responsibly establish prize payouts. Prior to launching the first

$30 Scratchers game in August 2015, the Lottery conducted market research studies to determine consumer interest and potential purchases. Additionally, the prize payout rates used by other states for their $30 tickets were analyzed, resulting in the Lottery adopting a payout rate near the industry average for games with that price point. After sales of the first $30 tickets were completed, the Lottery analyzed the incremental sales and profit generated from adding this product. This study showed the $30 game generated additional dollars for education and the Lottery decided to make this $30 product a part of the Scratchers portfolio introducing a second $30 ticket in January 2017.

The current and historic industry data from the same source used by the consultant is available to the Lottery. So is a wealth of knowledge and experience gleaned by other states who were granted the freedom to increase prize payouts years before California had this opportunity. These are essentially "test laboratories", and the California Lottery has benefitted by learning from their successes and their failures.

In the future, the Lottery's budgets will be informed by an updated report that identifies an average optimum prize payout, but the Lottery will continue to use its internal expertise and industry data to make decisions concerning individual games.

The fact that the Lottery is now zero-basing its operating expenses when developing its budget will help facilitate this requirement. Because zero-basing will result in the Lottery's budgeted operating expenses being lower than as reflected in past budgets, this will help with the proportionality between the budgeted funding for education and the budgeted net revenues, no matter how "net revenues" are defined.

Another area where the CSA is critical of the Lottery's current process involved the manner in which a profit goal of $2 billion was set.

In setting this goal, the Lottery considers trend analysis on growth in profits. However, the CSA believes that the Lottery should set its strategic profit goal by a more formula-driven methodology. This is problematic for several reasons:

> (1) In a business like the Lottery, sales and profits are more difficult to accurately project from a formula three years in advance.
>
> (2) Lottery revenue comes from California adults electing to spend their disposable income on a discretionary product and is somewhat influenced by changing market and consumer trends that are largely outside of the Lottery's control.
>
> (3) The $2 billion profit goal was set during an initial phase of the strategic planning process when specific tactics had not yet been developed. The purpose of setting that target at that point in the process was to have the

Lottery's Divisions develop and propose strategies and tactics to achieve the agreed upon goal.

In contrast to the strategic planning process, during the annual business planning process, specific sales and profit goals are established by product based on the specific tactics and initiatives that will be implemented during the fiscal year. These sales and profit figures are created with significantly more rigor. Additionally, during the development of the annual business plan, each major initiative is reviewed to determine if the proposed expenditure will ultimately benefit the Lottery's contribution to education.

Procurement Practices

The Lottery Entered Noncompetitive Agreements Without Adequate Justification

Recommendation:

To ensure it conducts procurements in a way that preserves all possible funding for education, by August 2020, the Lottery should develop procurement procedures that, at a minimum, do the following:

- *Provide examples of when products are truly available from only one source and examples of when the Lottery should consider whether alternative products also fulfill its needs.*
- *Require its staff to collect and maintain documentation supporting any exception to competitive bidding and provide examples of adequate and inadequate documentation.*
- *Instruct its contracts unit to deny all procurement requests that do not demonstrate adherence to contracting requirements.*

Response:

The Lottery agrees with this finding, to the extent that it identifies appropriate opportunities to strengthen the Lottery's contracting processes. Prior to the start of the CSA's work on this audit, the Lottery likewise identified a need to strengthen contracting controls, further define requirements, and incorporate some of the procurement practices used by other state agencies, in a manner that is consistent with the Lottery's mission of maximizing supplemental funding for public education.

The Lottery believes that its competitive bidding exceptions are not improperly utilized and that the information provided to the CSA demonstrated that the Lottery's use of these exceptions was generally appropriate for the sampled procurements, including the Lottery's financial system upgrade. To the extent that this finding suggests that these procurements were not permitted under

Lottery Regulations, the Lottery disagrees. However, the Lottery agrees that its supporting documentation requirements for use of competitive bidding exceptions should be strengthened and that further guidance should be provided to staff on the use of these exceptions.

The Lottery is currently working on revising its policies, procedures, and processes relating to its procurement program; specifically, the rules and documentation requirements for sole source purchasing, use of the emergency contracting exception from competitive bidding, and determining best value when awarding a purchase.

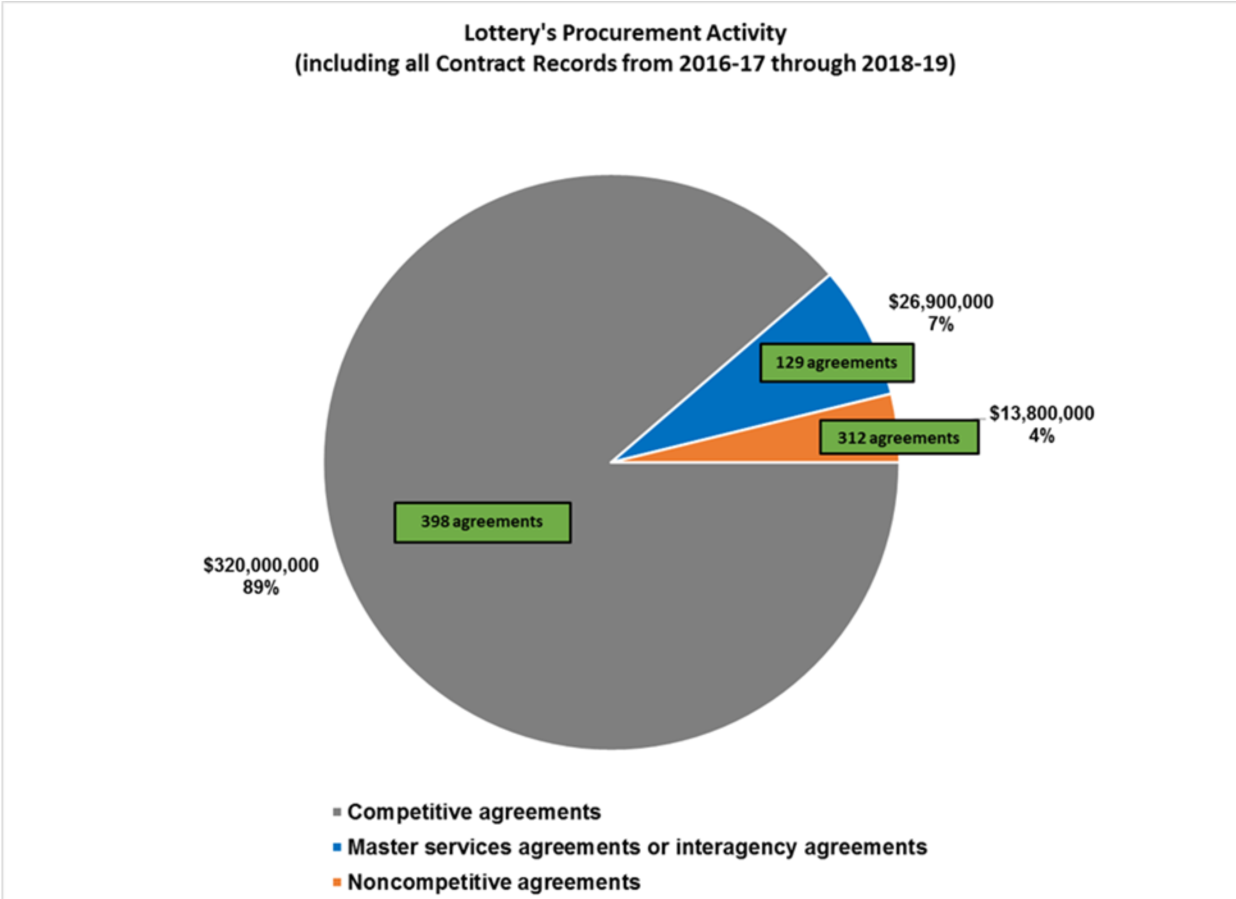
The Lottery plans to implement the changes to its contracting program in 2020. Although the CSA recommends corrective action be completed by August 2020, the Lottery will more likely need until the end of 2020 to properly implement these changes, with assessment of their effectiveness extending into 2021.

A. CSA's Percentages for the Lottery's Overall Procurement Activity Are Misleading

CSA acknowledges in a footnote on page 28 of its report that one contract was excluded from CSA's analysis of overall procurement activity, because the contract amount skewed the data. The omitted procurement was the Lottery's lead advertising agency contract, which was competitively bid and valued at $295 million. While the Lottery acknowledges that a significant portion of its procurements are not competitively bid, presenting them in this fashion is misleading.

Historically, the Lottery's highest dollar value contracts, including its gaming system, Scratchers, and marketing contracts have all been competitively bid, and the vast majority of the Lottery's contract dollars are spent in connection with those contracts. As a result, excluding the Lottery's lead advertising agency contract from an analysis that is specifically based on procurement dollars is misleading at best. Including this information conveys a more accurate picture of the Lottery's overall procurement activity, both during the audit period and as a whole.

When adjusted to include the lead advertising agency contract, the Lottery's actual procurement activity in dollars over the audit period is as follows: 89 percent of the Lottery's procurements are competitively bid; and 11 percent of the Lottery's procurements were not competitively bid (7 percent used leveraged procurement agreements, a noncompetitive option available to all state agencies; 4 percent were procured through another competitive bidding exception available under Lottery Regulations.) This information is depicted in the chart below.



The Lottery did not Minimize Retailer Trade Show expenses and Spent Excessively on Food and Beverages

Recommendation:

To ensure it conducts procurements in a way that preserves all possible funding for education, by August 2020, the Lottery should develop procurement procedures that, at a minimum, do the following:

- *Provide examples of when products are truly available from only one source and examples of when the Lottery should consider whether alternative products also fulfill its needs.*
- *Require its staff to collect and maintain documentation supporting any exception to competitive bidding and provide examples of adequate and inadequate documentation.*
- *Instruct its contracts unit to deny all procurement requests that do not demonstrate adherence to contracting requirements.*

Response:

The Lottery agrees that the contracts associated with its retailer trade shows lacked sufficient documentation to support its evaluation of best value for lodging, food and catering, and event space. While pricing information was not accurately recorded, the Lottery did go through a process to evaluate best value based on available options that met the Lottery's requirements, and overall, the Lottery received significant value from retailer trade shows.

A Lottery internal audit of its Sales Division's Procurement Practices (2019) had identified several issues that the Lottery immediately began to address. This corrective action plan included the hiring of a new Sales Administration Chief focused on administration and operations, enhanced review of the Sales division's procurements and travel, zero-based budgeting for Sales & Marketing division in FY 2019-2020, and adherence to the State Leadership Accountability Act for internal controls.

As CSA reported, retailer trade shows are not currently being planned by the Lottery. However, educating retailers and maintaining positive engagement with them remains a priority. Survey results from each trade show indicated that retailers found value in attending the events with workshops achieving an average of 4.8 out of 5 rating, and 95 percent indicating that they would attend future trade shows. If and when the Lottery resumes a retailer trade show program, the Lottery will continue to execute its corrective action plan, engage in a best value analysis for all contracts and retain thorough documentation to support the contract.

Amending the Lottery Act Would Create Greater Accountability for the Lottery's Procurement Processes

Recommendation:

To ensure that the Lottery is subject to oversight of its procurement practices, the Legislature should amend the Lottery Act to direct the SCO to conduct audits of the Lottery's procurement process at least once every three years.

Response:

The Lottery provides no comment in connection with this recommendation.

The Lottery Does Not Know Whether the Millions It Spends on Its Fairs Program Have Been Effective.

Recommendation:

To ensure that it receives value for the funding it spends on its fairs program, by January 2021, the Lottery should determine whether the program has increased its brand strength, customer loyalty, customer satisfaction, ticket sales, and profits. If the analysis determines that the Lottery has not achieved these benefits, it should terminate the program.

Response:

The Lottery disagrees with CSA's underlying conclusions on the value of the fairs and festivals program. CSA's determination does not factor in the advertising value associated with these marketing events, as part of the Lottery's overall marketing program. This value is reviewed at the onset and is the main factor used to determine if the Lottery will participate in any given event. However, the Lottery concurs with CSA's recommendation to better measure the program's intangible benefits. The Lottery had previously identified opportunities for improvement in the program in its own analyses and has already developed a plan to strengthen the effectiveness of the program.

As part of the zero-based budget development in early 2019, the Lottery performed an in-depth post-analysis of the 2017 Fairs and Festivals program and found that the 25 events generated over $5.5 million dollars in on-site sales. When factoring in the $1.3 to $3.7 million in advertising value, the total value is $6.1 to $9 million, with the net gain and overall value for the Fairs and Festivals program being $1.1 – $3.5 million in combined on-site sales and earned advertising.

A majority of the expenses (approximately $5.4 million) were tied to product sales in the form of retailer commissions and prizing costs as well as the cost of promotional tickets going to players as a "gift with purchase." These promo tickets are used to incentivize trial purchases via a spin the wheel promotion.

The out-of-pocket expenses incurred for the program are 1) sponsorship fees charged by event organizers and 2) travel costs for Lottery staff working the event. These costs are minimal in comparison to the benefits realized from these events. For example, the 25 events held in 2017 cost the Lottery approximately $230,000. The advertising value alone outweighs the accrued out-of-pocket expenses associated with the Fairs and Festivals program.

The Lottery operates the Fair and Festival program based on best practices for event and experiential marketing, which is proven to be an effective marketing strategy that drives sales and significantly improves how consumers feel about and perceive brands. In an annual survey of a wide cross-section of consumers, 85 percent of consumers were likely to purchase after participating in events and experiences, and over 90 percent have more positive feelings about brands after attending. (*EventTrack Event & Experiential Marketing Industry Forecast & Best Practices Study, 2018*).

Additionally, numerous consumer research studies have shown that today's consumers value experiences over possessions and are much more likely to engage with brands that deliver relevant, enriching, entertaining experiences than those that solely rely on traditional advertising in any of its forms. As a result, brands are endorsing this strategy by investing more in experiential marketing with more than a third of chief marketing officers planning to allocate up to half of their budget to experiential marketing efforts over the next three to five years (*Freeman Global Brand Experience Study, 2017*). Again, using 2017 as an example, the Fairs and Festivals Program represented less than one percent of the Lottery's overall marketing budget.

The Lottery concurs with the CSA's recommended program improvements and is in the process of developing its methodology to measure the intangible elements received at fairs and festivals, including awareness, engagement, brand strength, customer loyalty, and customer satisfaction in addition to ticket sales and profits. These metrics will be used to evaluate the efforts during the upcoming festival season that begins in the Spring and continues through the Fall.

Appendix

Year-Over-Year Growth from FY 2016-17 to FY 2017-18

(Dollars in Millions)

	FY 2016-17 Actual	FY 2017-18 Actual	% Diff from 2016-17	FY 2017-18 Scenario	% Diff from 2016-17	$ Diff from 2017-18 Actual
Sales:						
Scratchers	$4,576.0	$5,077.4	11.0%	$4,811.4	5.1%	-$266.0
Jackpot Games	1,041.1	1,234.1	18.5%	1,234.1	18.5%	0.0
Other Draw Games	616.4	654.3	6.2%	654.3	6.2%	0.0
Total, Sales	**$6,233.5**	**$6,965.8**	**11.7%**	**$6,699.8**	**7.5%**	**-$266.0**
Administrative Expenses:						
Retailer & Gaming Costs	$550.0	$608.1	10.6%	$584.6	6.3%	-$23.6
Operating Costs	$225.8	$225.0	-0.3%	$225.0	-0.3%	0.0
Total, Administrative Expenses	**$775.8**	**$833.2**	**7.4%**	**$809.6**	**4.4%**	**-$23.6**
Net Revenues	**$5,457.6**	**$6,132.6**	**12.4%**	**$5,890.2**	**7.9%**	**-$242.4**
Prize Expense:						
Scratchers	$3,121.1	$3,507.3	12.4%	$3,297.7	5.7%	-$209.5
Other Games	842.4	969.3	15.1%	969.3	15.1%	0.0
Total, Prize Expense	**$3,963.5**	**$4,476.6**	**12.9%**	**$4,267.0**	**7.7%**	**-$209.5**
Contribution to Education	$1,494.2	$1,656.1	10.8%	$1,623.2	8.6%	-$32.9
Unclaimed Prizes	46.5	36.0	-22.5%	36.0	-22.5%	0.0
Interest and Other Income	4.8	8.8	83.0%	8.8	83.0%	0.0
Total Available for Education	**$1,545.5**	**$1,700.9**	**10.1%**	**$1,668.1**	**7.9%**	**-$32.9**