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Justification Review

Sale of Lottery Products Program
Department of the Lottery

Report No. 02-11 February 2002



*Office of Program Policy Analysis
and Government Accountability*

an office of the Florida Legislature

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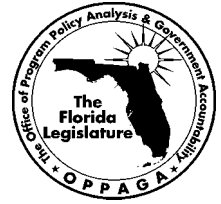
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John W. Turcotte, OPPAGA Director*



The Florida Legislature

OFFICE OF PROGRAM POLICY ANALYSIS AND GOVERNMENT ACCOUNTABILITY



John W. Turcotte, Director

February 2002

The President of the Senate,
the Speaker of the House of Representatives,
and the Joint Legislative Auditing Committee

I directed our office to examine the *Sale of Lottery Products Program* administered by the Department of the Lottery. OPPAGA reports findings and recommendations as required by the Government Performance and Accountability Act of 1994. Mark Frederick and John Hughes conducted the examination under the supervision of Jane Fletcher.

We wish to express our appreciation to the staff of the Department of the Lottery for its cooperation and the many courtesies shown us during the course of the examination.

Sincerely,

John W. Turcotte
Director

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Executive Summary

Justification Review of the Sale of Lottery Products Program

Purpose

This report presents the results of OPPAGA's program evaluation and justification review of the Department of the Lottery's Sale of Lottery Products Program. State law directs OPPAGA to complete a justification review of each state agency during its second year operating under a performance-based program budget. The Department of the Lottery, which organizes all of its services under the Sale of Lottery Products Program, began operating under a performance-based program budget in Fiscal Year 1999-00. Thus, OPPAGA conducted this review to assess agency performance measures, evaluate program performance, and identify policy alternative for improving services and reducing costs.

Background

In November 1986, Florida voters approved a constitutional amendment authorizing the state to operate a lottery. In 1987, the Legislature enacted Ch. 87-65, *Laws of Florida* (Ch. 24, *Florida Statutes*) known as the Florida Public Education Lottery Act creating the Department of the Lottery. Now, 13 years old, the Florida Lottery is among the mature lotteries operating in the United States.

The purpose of the Florida Lottery is to generate significant additional money for education in a manner consonant with the dignity of the state and welfare of its citizens and also enable the people of the state to play the best lottery games available. The Lottery generates significant revenue with both on-line and scratch-off (otherwise referred to as instant) games.

The Department of the Lottery is headquartered in Tallahassee and contracts with three vendors to provide its advertising, on-line, and scratch-off games. Its 11 district offices sell lottery products and redeem winning lottery tickets worth up to \$250,000. District offices also house marketing and sales representatives and other field staff who serve as the primary contacts between the department and its retailer network. As part of this function district staff recruit new retailers and maintain the retailer network. Over 11,000 retailers such as gas stations and convenience stores sell lottery products and redeem winning lottery tickets worth up to \$600.

The Florida Lottery is self-supporting and receives no general revenue. Florida law requires the lottery to pay, as nearly as practical, 50% of its gross revenues in prizes and transfer at least 38% of all gross revenues to the Education Enhancement Trust Fund (EETF). The Lottery can use the remaining 12% for expenses, but it must transfer any monies not needed for expenses by the end of the year to the EETF. Since being appointed in 1999, Secretary David Griffin implemented organizational changes resulting in operational savings and staff reductions. In Fiscal Year 2001-02, the Lottery's budget was \$126,567,616, down 8.5% (\$11.8 million) since 1999-00. The Lottery was authorized 513 positions in fiscal Year 2001-02, down 28% (202 positions) since 1999-00.

Program Benefit, Placement, and Performance

The program is meeting its purpose and should be continued

The Florida Lottery meets its purpose, generating substantial revenues for education, and should be continued. While not an essential government service, the Florida Lottery provides the state with significant revenues used to support educational programs. Abolishing the Lottery would reduce the state's total general and trust revenues by about \$900 million (2%) annually. While the Florida Lottery generates substantial revenue for education, it does create some social costs. As a form of gambling, lotteries can contribute to problem and pathological gambling, and underage gambling. However, when compared to other forms of gambling, lotteries are less addictive and less attractive to underage players. In addition, various options for expanding the Lottery may be regressive or provide support for the expansion of legalized gambling, particularly casinos operated by Indian tribes.

The program is appropriately placed within the Department of the Lottery

We find no compelling reasons to transfer the Florida Lottery to another state agency or consolidate its remaining functions with another agency. The potential for long-term savings as a result of a merger is nominal, as few positions would be eliminated because of the unique nature of most of the lotteries functions. We also found no compelling reason to establish a corporation to operate the lottery. The Florida Lottery is already exempt from some state regulations, such as the fact that all employees of the department are exempt from the Career Service System, which establishes employee occupational groups and corresponding salary ranges. Further, while lottery corporations are designed to be less bureaucratic, they have not clearly demonstrated that they are more cost-effective than the Florida Lottery.

The Lottery performs well meeting Legislative standards and ranking high among peers

Using performance-based program budgeting (PB²) measures and other relevant performance information, we determined that the Florida Lottery has met or exceeded its legislative goals to raise funds for education and reduce its operating expenses. After several years of declining sales, Lottery revenues have grown over the past four years and

totaled \$2.298 billion in 2000-01, an increase of \$31 million from the prior year. The Florida Lottery ranks first in the nation, based on four key performance measures that reflect the Lottery's efficiency and effectiveness: total transfers to the state (net income), transfers as a percentage of all revenue, per capita transfers to the state, and expenses as a percentage of total transfers.

Inflation threatens the value of transfers to education

Despite its strong current position, over time the effect of inflation significantly lowers the value of the Lottery's transfers to education. After adjusting for inflation the Lottery's transfers to education peaked in 1991-92. Subsequently, sales and revenues declined until 1999-00 when the Lottery revised its flagship Lotto game and reintroduced the Mega Money game. But even the record growth of 1999-00 did not bring the value of Lottery transfers back to the level of 1991-92. Moreover, during this same time period, the average per capita sales generated by peer states out paced that of Florida. Given the natural tendency for inflation to erode the value of its revenues, the Florida Lottery must act aggressively to maintain its value to the state.

Options for Improvement

The Florida Lottery is generally meeting legislative goals, but improvements are needed to enhance program performance. In recent years, the Lottery has introduced several changes in its games that have successfully increased sales. However, we found the Florida Lottery has the potential to significantly increase sales and transfers to education. We recommend that the Lottery consider the options below.

- Introduce new games, such as a super-jackpot game. The various possible new games that the Lottery could offer vary in both their potential revenue and social costs.
- Enhance its current games, such as increasing drawings for daily games.
- Reduce the percentage of scratch-off revenue transferred to education, while increasing the percentage transferred from on-line games. This would enable the Lottery to increase payouts for scratch-off games. However, the Lottery would have to change the prize structure for the on-line games so that they payout less.
- Increase the distribution of its games, making the games more readily available. The more opportunities players have to buy lottery tickets, the more the Lottery will sell.

To help the Florida Lottery maximize revenues and increase transfers to education, we recommend that the Legislature consider the options below.

- The Legislature could authorize the Lottery to offer video lottery or keno games. The amount of potential revenue would be dependent on several factors, some of which would be determined by the

Executive Summary

Legislature. However, while these games have the potential for raising significant revenues, they also have potential disadvantages.

- The Legislature could change the law to reduce or exempt the 38% transfer requirement for scratch-off games. If the Lottery had transferred 34% of scratch-off revenues in 2000-01, it would have increased total transfers by about \$12 million.
- Alternatively, the Legislature could permit the Lottery to gradually reduce the transfer percentage for scratch-off games as long as the Lottery continues to increase transfers.
- The Legislature could designate another source of funds to be used in conjunction with unclaimed prize money. If the Legislature had authorized the Lottery to use the unencumbered balance in its administrative trust fund to raise payouts it would have increased transfers by about \$15 million for 2000-01.
- The Legislature could remove the 38% transfer requirement for all games. In its place the Legislature could mandate a specific dollar value of the transfer, thus ensuring the Lottery maintains its value.

Options could reduce procurement costs

Bid protests hinder the Lottery's ability to operate efficiently due to costs incurred in defending its position. All of the Lottery's contract award decisions have prevailed in their bid protests before the Division of Administrative Hearings and District Court of Appeal. To reduce procurement costs, the Legislature should consider several options.

- Raise bond requirements to file bid protests and allow the Lottery to recover all costs, including attorney fees.
- Limit the scope of protests by raising the standard of review from capricious to arbitrary, illegal, dishonest, or fraudulent.
- Establish a new bid protest process, exempting the Lottery from the hearing requirements of s. 120.57, *Florida Statutes*.

Changes could reduce prize payment costs

The Florida Lottery incurs high costs to redeem winning tickets relative to the volume of transactions processed at 11 district offices. The vast majority of tickets redeemed at district offices are for prizes worth less than \$600 that could otherwise be redeemed at one of over 11,000 retailers across the state who sell similar tickets. To reduce administrative expenses associated with payout out prizes, we recommend that the Florida Lottery discontinue redeeming prizes at its district offices. Instead, the Florida Lottery should direct all winners of prizes worth less than \$600 to retailer locations to redeem their winning tickets. For prizes in excess of \$600, the Lottery should either centralize this activity or assess whether third parties could process these claims at less cost. Based on available data, implementing these recommendations could save approximately \$1.6 million annually in administrative costs.

Outsourcing functions could reduce costs

The Florida Lottery performs several functions in-house that have the potential to be cost-effectively outsourced, such as its field support operations at an annual savings of approximately \$1.1 million. In conjunction with considering discontinuing its prize payout function at its

district offices, we recommend that the Florida Lottery consider outsourcing the remaining field support operation, while allowing current state workers to bid against vendors to maintain these functions in-house. Further, the Florida Lottery should maintain comparable data and periodically re-evaluate the functions it out sources to determine whether outsourcing continues to be cost-effective. The Florida Lottery should also periodically evaluate the potential to outsource functions performed in-house.

*Options exist to
reduce facility costs*

The Florida Lottery substantially reduced its need for office and warehouse space through substantial staff reductions and outsourcing, but has not commensurately reduced the amount of space it leases. Depending on decisions made regarding whether to continue its district operations as currently performed, we recommend that the Florida Lottery, at a minimum, make efficient use of the space it currently leases. The Florida Lottery should consolidate district offices, such as its Fort Lauderdale office with West Palm Beach and Miami district offices, and the Tallahassee district office should be relocated back to the headquarters location. The Florida Lottery should also lease no more space than necessary in the remaining district office locations. The Florida Lottery should also sublet extra space at its headquarters location to other suitable tenants.

Agency Response

The Secretary of the Department of the Lottery provided a written response to our preliminary and tentative findings and recommendations. (See Appendix C, page 80.)

Introduction

Purpose

This report presents the results of OPPAGA's program evaluation and justification review of the Sale of Lottery Products Program administered by the Department of the Lottery. The 1994 Government Performance and Accountability Act directs OPPAGA to conduct justification reviews of each program during its second year of operation under a performance-based budget. Justification reviews assess agency performance measures, evaluate program performance, and identify policy alternatives for improving services and reducing costs. Appendix A summarizes our conclusions regarding the nine issue areas the law requires OPPAGA to consider in a justification review.

Background

Florida Lottery authorized in 1986

In November 1986, Florida voters approved a constitutional amendment authorizing the state to operate a lottery.¹ In 1987, the Legislature enacted Ch. 87-65, *Laws of Florida* (Ch. 24, *Florida Statutes*), known as the Florida Public Education Lottery Act. The act created the Department of the Lottery to operate as much like a business as possible to generate significant additional money for education in a manner consonant with the dignity of the state and welfare of its citizens and also enable the people of the state to play the best lottery games available.² Now, 13 years old, the Florida Lottery is among the mature lotteries operating in the United States.³

Florida has two basic types of lottery games

The Lottery generates significant revenues with both on-line and scratch-off games

The Lottery generates significant revenue with both on-line and scratch-off (otherwise referred to as instant) games.⁴ In 2000-01, the Florida Lottery had total ticket sales of \$2.275 billion. As shown in Exhibit 1, on-line games produced 72% of all sales. Lotto generated more sales than any other game, accounting for 37% of total sales.

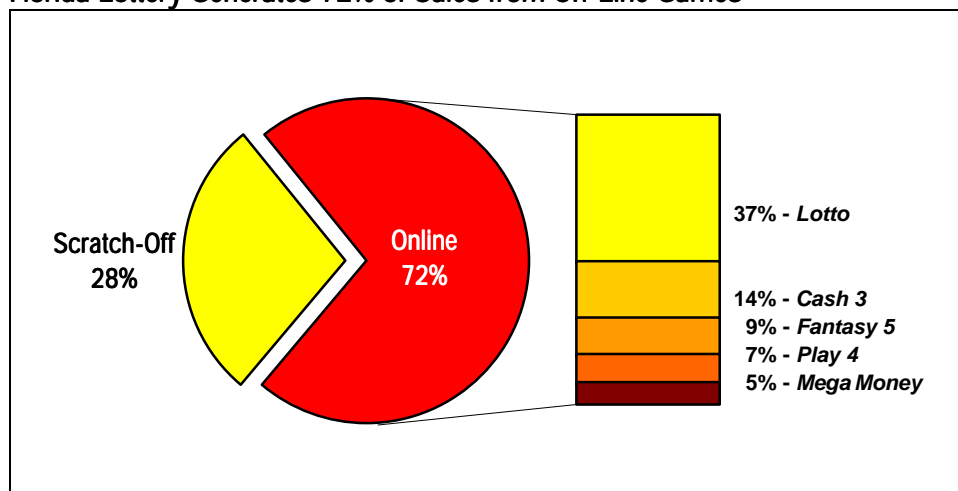
¹ Article X, Section 15, Florida Constitution.

² Sections 20.317, 24.102, and 24.104, *F.S.*

³ The Florida Lottery is the twelfth most recent among the nation's 38 state-operated lotteries and the District of Columbia. New Hampshire established the first in 1964, and South Carolina the most recent in 2001.

⁴ "Revenue" means sales from game tickets before payment of any operation costs or expenses.

Exhibit 1
Florida Lottery Generates 72% of Sales from On-Line Games



Source: Department of the Lottery.

As of September 2001, the Florida Lottery offered five different on-line games: Lotto, Mega Money, Fantasy 5, Play 4, and Cash 3. Players purchase on-line game tickets from retailers who print them using terminals connected to a central computer by telecommunication lines.⁵ Players choose a set of numbers, which retailers enter into a computer terminal that prints a lottery ticket containing those numbers and then electronically communicates the sale to the Lottery. Players win if they match some or all of the numbers drawn in the official statewide drawing for the date played.

Scratch-off games are preprinted tickets with latex covering the play area. Players scratch the covering off and determine immediately if they have won a prize or entry into preliminary grand prize drawings. The Lottery introduces two new scratch-off games every other Tuesday, and offers over 50 new scratch-off games per year, each with its own theme and play style. The Lottery prints a fixed number of tickets for each game and typically sells out within four to six months after which the Lottery discontinues or renews the game.

The Lottery Internet website provides complete information about all games including rules, current and previous winning numbers, and prize payouts.⁶

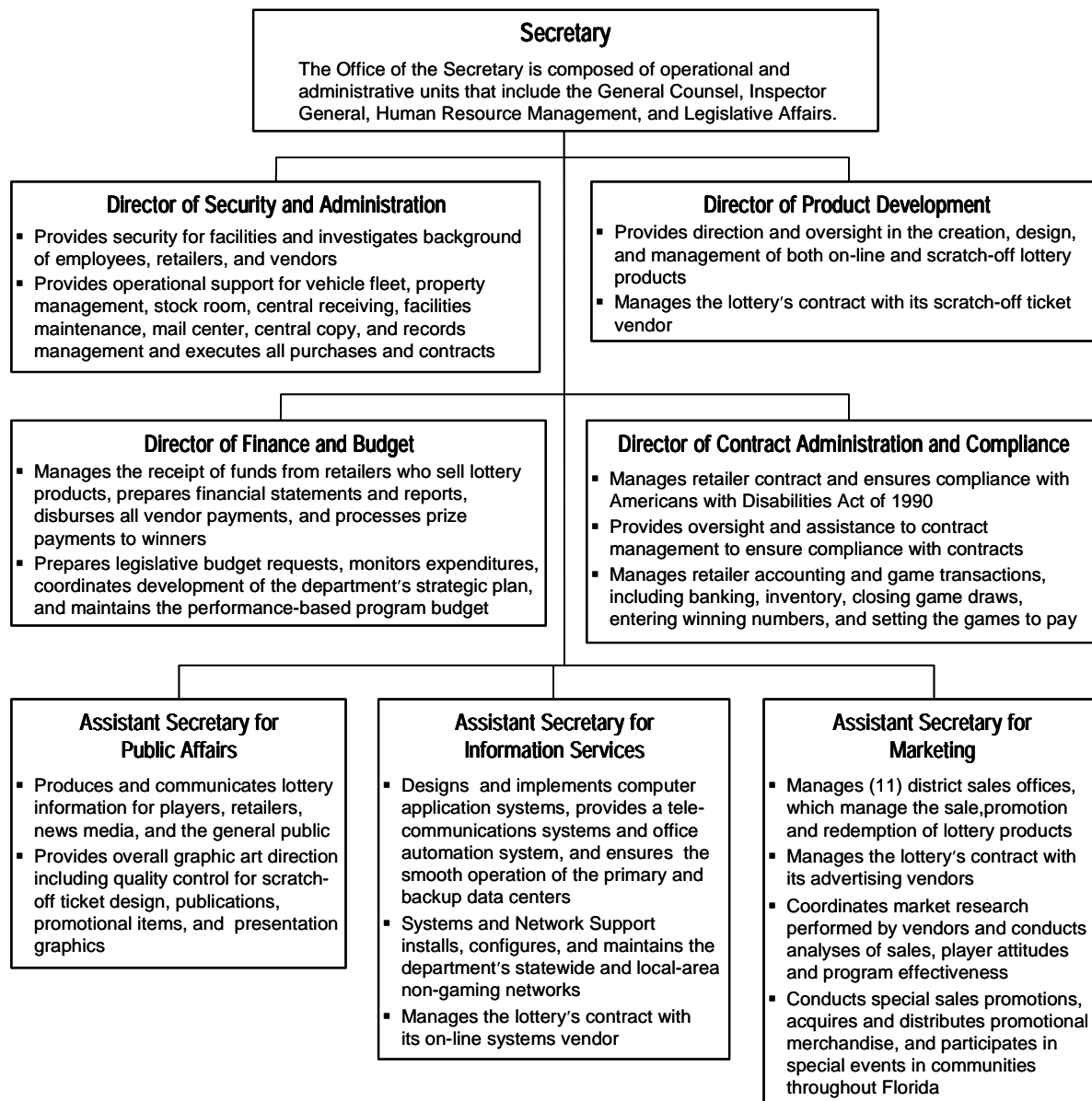
⁵ Various state and federal laws prohibit the sale of lottery tickets via the Internet, the mails, or fax.

⁶ The Florida Lottery's website is www.flalottery.com.

The Department of the Lottery is headquartered in Tallahassee with 11 district offices

A Secretary appointed by the Governor heads the Department of the Lottery, which is headquartered in Tallahassee. David Griffin has served as Secretary of the Department of the Lottery since June 1999. As shown in Exhibit 2, several offices report directly to the Secretary. The Secretary has three assistant secretaries in charge of information services, marketing, and public affairs. Other major functions of the department include finance and budget, games administration, product development, and security.

Exhibit 2
Organizational and Functional Chart of the Department of the Lottery



Source: Department of the Lottery.

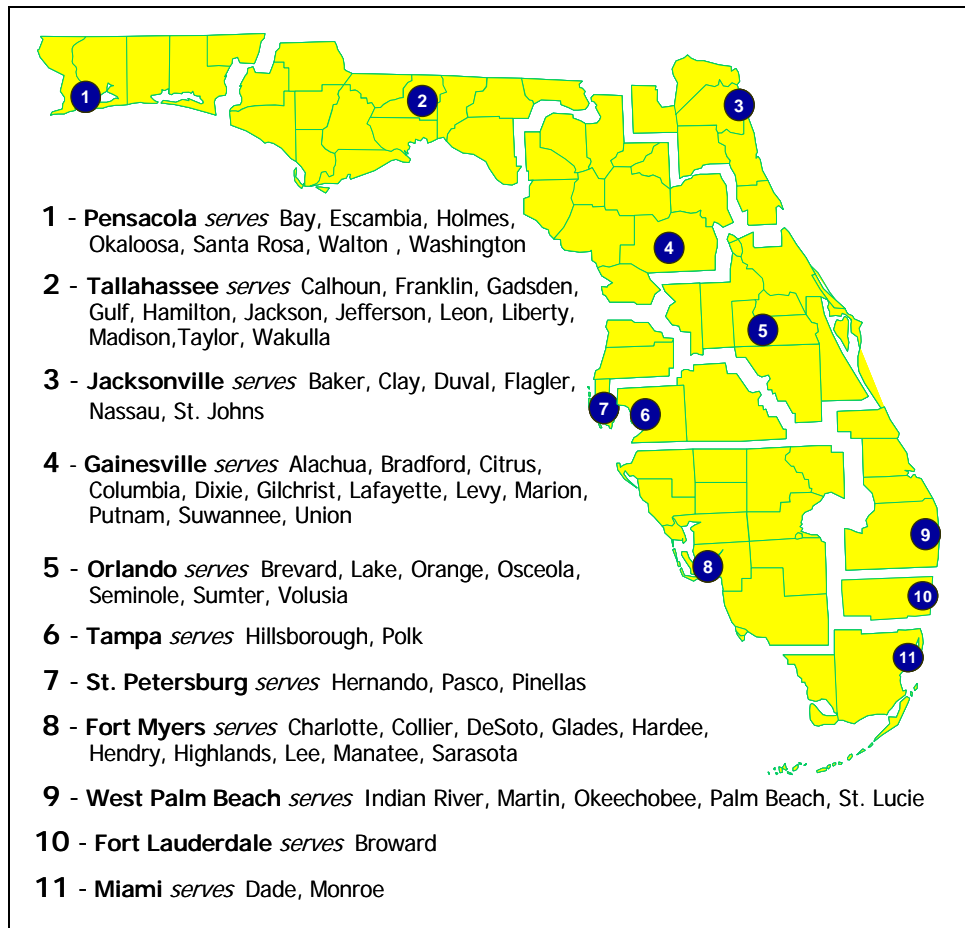
Introduction

District offices provide services to both the public and retailers

The Florida Lottery has 11 district offices (see Exhibit 3). The district offices serve two functions. First, players can redeem winning lottery tickets with values of up to \$250,000 through the regional offices (larger prizes must be redeemed at the Lottery headquarters in Tallahassee). Second, district offices house marketing and sales representatives and other field staff who serve as the primary contacts between the department and its retailer network. As part of this function district staff recruit new retailers and maintain the retailer network.

Exhibit 3

The Florida Lottery Operates 11 District Office Locations



Source: Department of the Lottery.

Retailers sell lottery products to the public

Retailers, such as supermarkets, convenience stores, gas stations, and newsstands sell the Lottery's various tickets. Some retailers sell only scratch-off products. Retailers must apply with the Lottery to sell scratch-off and on-line products, and they generally must sell only scratch-off tickets for a time before they are considered to be eligible for an on-line

terminal.⁷ The Florida Lottery pays retailers a 5% commission on all tickets sold and a 1% commission for redeeming winning tickets (retailers may redeem winning tickets with a value of less than \$600). The Lottery also offers retailers occasional incentives to achieve specific sales goals.

Vendors perform major functions for the Florida Lottery

The Florida Lottery contracts with three vendors to provide its advertising, on-line, and scratch-off games. HMS/McFarland & Drier and Sanchez & Levitan provide advertising and related services for the Lottery and were paid \$33.7 million for advertising campaigns in 2000-01. Automated Wagering provides computer systems, retailer terminals, software, and telecommunications along with technical support services. This company receives a 1.85% commission on all on-line sales plus incentive payments, and was paid \$31 million in 2000-01. The third vendor, Scientific Games, prints and distributes all scratch-off game tickets and is paid on a commission basis, receiving 2.4375% of all scratch-off sales. In 2001 Scientific Games received \$16 million from the Florida Lottery.

Program Resources

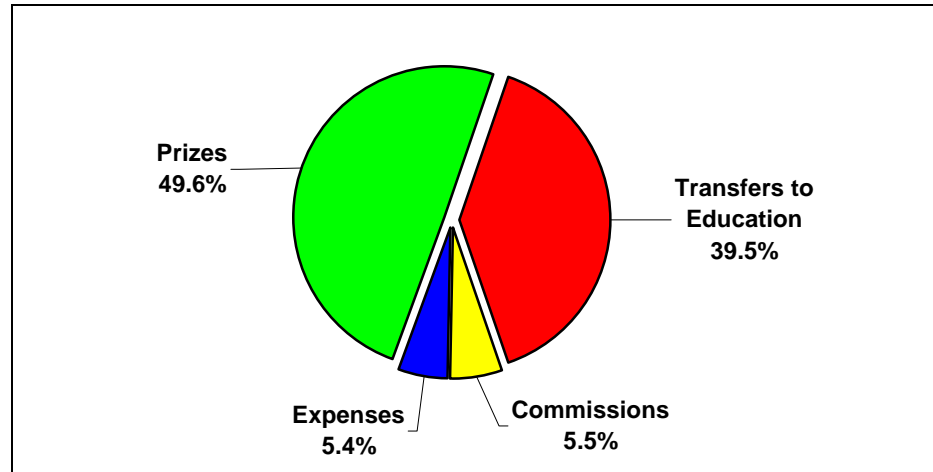
The Florida Lottery is self-supporting and receives no general revenue. Florida law governs the use of Lottery revenues. The Lottery must, as nearly as practical, pay 50% of its gross revenues from the sale of lottery tickets in prizes. The law further directs the Lottery to transfer at least 38% of all gross revenues from the sale of lottery tickets as well as other earned revenue to the Education Enhancement Trust Fund (EETF). The Lottery can use the remaining 12% for expenses, but it must transfer any monies not needed for expenses by the end of the year to the EETF.⁸ Exhibit 4 shows the actual expenditures and amount transferred to education in 2000-01.⁹

⁷ As of June 2001, the Florida Lottery contracted with 11,409 retailers. Of these, 1,903 sold only scratch-off games while 9,506 sold both on-line and scratch-off games.

⁸ Section 24.121, *F.S.*

⁹ Retailer commissions may be over 5% because the commission on ticket sales for scratch-off games is based on total tickets distributed to the players (including free tickets) which, when compared to revenue causes the percentage to be slightly higher than 5%. Additionally, retailers are paid commissions through a 1% cashing bonus on redemption of tickets (including free tickets).

Exhibit 4
The Florida Lottery Transferred 39.5 Cents of Every Dollar Received to Education in 2000-01



Source: OPPAGA analysis of Department of the Lottery data.

Lottery operating budget reduced 8.5% over three years

The Lottery's administrative and operating expenses have declined by \$11.8 million (8.5%) since 1999-00 (see Exhibit 5). To achieve these budget reductions Secretary Griffin initiated a reorganization of the Florida Lottery in 1999. The reorganization reduced salaries and benefits by \$6 million by eliminating 202 positions. In addition, the Lottery

- eliminated instant ticket vending machines, saving \$2.9 million;
- decreased the on-line games contract by \$2 million;
- reduced the advertising budget by \$1.2 million; and
- reduced Lottery expenses by \$1.2 million.¹⁰

¹⁰ Most (11 of 16) budget items decreased, but some (4) increased between 1999-00 and 2001-02, resulting in a net reduction of \$11.8 million.

Exhibit 5
Florida Lottery Budget Has Been Reduced \$11.8 Million (8.5%)
Since 1999-00

Appropriation Funding Categories	Fiscal Year		
	1999-00	2000-01	2001-02
Salaries and Benefits	\$ 30,231,654	\$ 24,496,587	\$ 24,273,533
Other Personal Services	1,548,137	1,499,545	1,073,296
Expenses	14,475,208	14,526,831	13,213,725
Operating Capital Outlay	1,020,010	1,876,571	1,150,000
Motor Vehicles	743,600	332,000	200,000
1-900 Winning Numbers Line Lawsuit Settlement		850,000	850,000
Division of Administrative Hearings	21,599	5,092	13,303
Scratch-Off Ticket Purchases	14,527,500	16,029,188	16,277,813
Paid Advertising	36,240,934	36,240,934	34,994,453
Online Games Contract	33,537,495	31,894,592	31,545,312
Instant Ticket Vending Machines	2,940,000	2,940,000	40,000
Retailer Incentives	2,500,000	2,500,000	2,500,000
Risk Management Insurance	533,749	478,689	410,100
Salary Incentive Payments	19,583	19,583	23,400
Executive Aircraft Pool Subscription	34,179	0	0
Data Processing Services	6,498	2,681	2,681
Total Lottery Budget	\$138,380,146	\$133,692,293	\$126,567,616
Not needed for prizes or expenses (additional transfer to Educational Enhancement Trust Fund) ¹	6,897,505	17,519,955	20,000,000
Total Appropriation	\$145,277,651	\$151,212,248	\$146,567,616

¹ The Legislature requires the unencumbered balance remaining in the Administrative Trust Fund to be transferred at the end of the fiscal year to the Educational Enhancement Trust Fund.

Source: Department of the Lottery.

*Department reduced
staff by 202 positions
since Fiscal Year
1999-00*

The Florida Lottery achieved its recent cuts in salaries and benefits by reducing staff by 202 positions between 1999-00 and 2001-02. The Lottery accomplished these reductions through a combination of process improvements, outsourcing, and the elimination of vacant positions. As shown in Exhibit 6, the largest reduction in the department's workforce included abolishing 115 marketing staff, including 73 district positions. In all, the Lottery reduced its staff from 715 to 513 over a three-year period.

**Exhibit 6
Florida Lottery Reduced Staffing 28% (202 Positions)
Since 1999-00**

Staff Positions	Fiscal Year			Staff Cuts
	1999-00	2000-01	2001-02	1999-00 to 2001-02
Office of the Secretary ¹	246	202	192	54
Public Affairs	34	25	26	8
Information Resources	106	82	81	25
Marketing	69	30	27	42
District Operations	260	186	187	73
Total Authorized Positions (FTE)	<u>715</u>	<u>525</u>	<u>513</u>	<u>202</u>

¹ Includes 13 Americans with Disabilities compliance staff actually located in district offices who were not affected by the Lottery's re-organization.

Source: Department of the Lottery.

Program Benefit and Placement

The Florida Lottery meets its purpose, generating substantial revenues for education, and should be continued. However, the Lottery creates some social costs for the state in terms of compulsive and underage gambling, and is a regressive revenue source. The operation of a state lottery is also used to justify the expansion of Indian gaming.

The Florida Lottery should also be continued in its current organizational structure and governance form. Some Lottery functions could be moved to another agency, but this is not likely to improve services or save money. Similarly, the Lottery could operate under a different governing structure, but our review found no evidence of significant benefits from such a change.

The program is beneficial and should be continued

Abolishing the Florida Lottery could reduce state revenues by 2%

While not an essential government service, the Florida Lottery provides the state with significant revenues used to support educational programs. Abolishing the Lottery would reduce the state's total general and trust revenues by about \$900 million (2%) annually.¹¹

Over \$11 billion transferred to the state since 1987

Revenues generated from the sale of lottery tickets benefit the general public by increasing funds available for education without increasing taxes. For 2000-01, the Florida Lottery paid out \$1.1 billion in prizes and transferred \$907 million to education. Since its inception in 1987, the Florida Lottery has transferred over \$11 billion to the Educational Enhancement Trust Fund administered by the Florida Department of Education while paying out \$14 billion in prizes. Other benefits include the \$126 million retailers received in commissions for 2000-01, totaling \$1.557 billion since 1987.

Lottery-based construction funds have been designated to build 80 new schools

Each year the Legislature determines which education programs will be funded by lottery proceeds and the amount of the funding. In 1997, the Legislature established the Florida Bright Futures Scholarship Program to help pay college tuition for high school students meeting the Legislature's criteria.¹² Lottery proceeds first ensure full funding for Bright Futures Scholarships and then 70% of the remaining funds are distributed to public schools, 15% to community colleges, and 15% to state universities to enhance educational programs. Of the public schools' share,

¹¹ If the Florida Lottery were abolished, funds that had been spent on lottery tickets could be spent on other taxable items that would continue to generate revenues for the state.

¹² The Bright Futures Scholarship Program consists of three awards (Florida Academic Scholars Award, Florida Merit Scholars Award, and Florida Gold Seal Vocational Scholars Award), each award having its own academic eligibility requirements, award amounts, and duration. See www.firn.edu/doe/brfutures for more information.

Program Benefit and Placement

\$180 million is used to pay debt service on the Classrooms First and School Capital Outlay and Bonds, first issued in June 1998. These bonds are intended to make available up to \$2.5 billion for public school construction. As of December 2000, lottery-based construction funds have been designated by school districts to build 80 new schools with 135,000 new student stations. The Legislature intended that the net proceeds of lottery games would be used to support improvements in public education and not be used as a substitute for existing resources for public education.¹³

Lottery revenues fund compulsive gambling treatment referral service

The Legislature has also authorized that a portion of lottery proceeds fund a compulsive gambling program. In 2000-01, the Florida Lottery was authorized to use up to \$2 million of its advertising budget for the purpose of contracting with an established Florida problem gambling organization. The Florida Lottery contracted with the Florida Council of Compulsive Gambling for its referral service. Since lotteries are typically less addictive than other forms of gambling, the help line will primarily benefit players of other types of games.¹⁴ Thus, the Lottery provides funding to help not only lottery players but also people involved in other, more addictive forms of gambling.

If the Lottery were abolished, the revenue loss would require the state to find other funds to pay the remainder of awarded Bright Futures Scholarships or discontinue the scholarships for those students. The state also would need to find additional resources to pay debt service on bonds issued for school construction. Other programs currently funded through the Lottery would be similarly affected, including school recognition, assistance to low-performing schools, and community college and state university enhancement programs. It would also reduce the funds used to disseminate information to help people or others find treatment to recover from a gambling problem.

The Florida Lottery offers a wide variety of entertainment

The Florida Lottery also provides entertainment. Permanent and seasonal residents and tourists alike can enjoy the entertainment of Lottery games and the opportunity to win prizes. The Florida Lottery offers its players a large variety of on-line games such as Lotto and scratch-off games such as Monopoly ranging in cost from \$1 to \$5. Players may win millions of dollars in cash and prizes including Carnival Cruises, Harley-Davidson motorcycles, and Key West vacations. The Florida Lottery continues to update and create new games with new prizes such as the Elvis scratch-off game that offers vacation prizes to Graceland.

¹³ See s. 24.102(2)(a), *F.S.*

¹⁴ Data collected by the National Opinion Research Center for the National Gambling Impact Study Commission shows that lottery players, in general, have the lowest prevalence of pathological and problem gambling (*Gambling Impact and Behavior Study, Report to the National Gambling Impact Study Commission*, 1999, p. 26).

Social costs of the Florida Lottery should be considered

While the Florida Lottery generates substantial revenue for education, it does create some social costs. As a form of gambling, lotteries contribute to problem and pathological gambling, underage gambling, taxing the poor, and providing support for the expansion of legalized gambling, particularly casinos operated by Indian tribes.

Lotteries are less addictive than other forms of gambling

Lottery games can be addictive for some players. Any form of gambling can result in problem or pathological gambling.¹⁵ Pathological gamblers often engage in destructive behaviors such as incurring large debts, resorting to crime to pay off debts, and even suicide.

However, lotteries may be preferable to other forms of gambling. The National Opinion Research Center (NORC), in collaboration with several other groups, produced a report on gambling behaviors in the United States. Their research found that lottery games are typically less addictive than other forms of gambling such as casino, riverboat, pari-mutuel, and private gambling.¹⁶ In addition, states that have lotteries do not have higher rates of problem and pathological gambling. In fact, the data in the NORC study suggests lottery states have fewer problem and pathological gamblers.¹⁷ This produces a counter-intuitive possibility: lotteries may reduce problem and pathological gambling by attracting people away from more addictive gambling venues. Similarly, to the extent that lotteries provide people with an alternative to illegal gambling activities, lotteries may also reduce some of the negative consequences associated with private, unregulated gambling.

Lotteries played by small percentage of youth

Some underage youths do play the Lottery. Aside from the legal concerns, people who begin gambling at a young age appear to have an increased risk of pathological gambling as adults. Because they are widely available, lotteries represent a potential source of underage gambling. For example, instant ticket vending machines were considered to be a risk for the Florida Lottery because of the limited control over underage access.

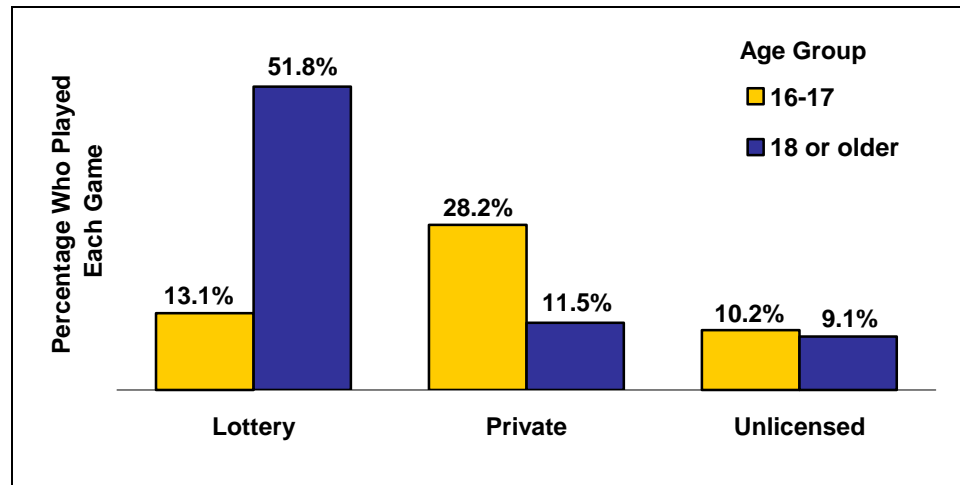
However, lotteries in general are not the primary form of gambling for underage youths. Exhibit 7 shows that private venues, such as card games, represent the most common form of gambling among youths. By contrast, lottery games are the most common form of gambling for those over the age of 18. This exhibit is based on national data, but more information may become available when the Florida Council on Compulsive Gambling completes a study in 2002 that examining gambling problems in Florida including underage gambling and the Lottery.

¹⁵ Pathological gamblers are those meeting five or more criteria defined by the American Psychiatric Association to aid in the diagnosis of mental illnesses. Problem gamblers exhibit three or four of the criteria.

¹⁶ *Gambling Impact and Behavior Study*, p. 26.

¹⁷ *Gambling Impact and Behavior Study*, Table 7, p. 27.

Exhibit 7
Underage Players More Likely to Engage in Private Gambling than Play the Lottery



Source: OPPAGA analysis of National Opinion Research Center data published in the *Gambling Impact and Behavior Study*, p. 62.

Lotteries tend to be regressive

Compared to those with higher incomes, people with lower incomes tend to spend a higher percentage of their income on lottery games. Lotteries are generally regressive and many critics of lotteries argue that they “tax” the poor. While people with higher incomes are more likely to play some form of the lottery, they typically spend less on the lottery as a percentage of their incomes and less per capita. For example, Lottery data from 2001 shows that among the Lottery’s core players those with incomes under \$15,000/year spend an average of \$298, or 2% of their incomes on Lottery products. By contrast, core players with incomes over \$70,000 per year spent an average of \$245, or 0.4% of their income on Lottery games.¹⁸ As a result, lotteries have some regressive effects.

The extent to which individual lotteries are regressive varies based on the product mix and the marketing emphasis. Florida Lottery demographic studies indicate that some products, such as Lotto and Mega Money, are less regressive than other games such as Play 4 and Cash 3. For example, the percentage of income spent on Lotto by lower income players was 3.8 times that of higher income players. For Play 4 the percentage of income spent by lower income players was 18.1 times that of higher income players. Similarly, keno and video lottery terminals may appeal strongest to lower income players. The Florida Lottery does not offer these games at present, which helps limit the regressive effects of the Lottery. However, several marketing and game options discussed in Chapter 4 could make the Lottery more regressive.

¹⁸ To estimate the percentage of income, we took the average spent and divided it by \$15,000 for the lower income group and \$70,000 for the high-income group. This approximation will understate the level of regressivity since those in the upper group average more than \$70,000, while those in the lower group average less than \$15,000.

Florida Lottery may help expand casino-style Indian gambling

Casino opponents fear that expanding the lottery could encourage the expansion of casinos in Florida. Native Americans already operate casinos in Florida.¹⁹ To operate a casino, federal legislation requires tribes to negotiate a compact with their respective states. However, tribes have opened casinos in Florida without a compact, sometimes referred to as “uncompacted” casinos. When the state operates or permits gambling activities, it can provide legal support for permitting and even expanding the number of uncompacted casinos. Consequently, any expansion of the Lottery to include new games such as keno and video lottery terminals could serve as justification to expand gambling in general and casinos in particular.

Administration of Florida Lottery Program functions should remain within the Department of the Lottery

We find no compelling reasons to transfer the Florida Lottery to another state agency or consolidate its remaining functions with another agency. While several other states, including Delaware, Nebraska, New York, Pennsylvania, and Wisconsin, administer lotteries through their revenue or tax departments, the potential for long-term savings as a result of a merger is nominal, as few positions would be eliminated because of the unique nature of most of the lotteries functions. While state initiatives currently exist to consolidate information technology and personnel functions across all state agencies, the Florida Lottery’s remaining functions including marketing and research, finance, sales, security, and technical services should not be consolidated with another state agency. As summarized in Exhibit 8, consolidating part or all of the Florida Lottery with another state agency is more likely to reduce its effectiveness in maximizing revenues to the state as its mission would compete with the other agency’s strategic goals and limited resources.²⁰ An integrated system administered by a single agency is likely to be more effective. For a merger of state agency functions to result in significant benefits, substantial functional similarities must exist.

¹⁹ Since Congress passed the Indian Gaming Regulatory Act (IGRA) in 1988, Indian gambling has expanded to “Class III” gambling (i.e., casino type gambling) in Florida (25 U.S.C.A. s. 2701-2721).

²⁰ The Senate Agriculture Committee concluded the Florida Lottery’s promotion and marketing function is incompatible with that of other agency’s promotion and marketing functions in its report titled *An Evaluation of the Feasibility/Desirability of Merging the Marketing and Promotion Functions in Agencies such as the Departments of Lottery, Commerce, Citrus, Agriculture, or Privatizing These Functions*, January 1996.

Exhibit 8
The Florida Lottery Governance Structure Should Remain Unchanged

Governance	Advantages	Disadvantages
Consolidate the Florida Lottery or its functions into another state agency.	<ul style="list-style-type: none"> ▪ Could marginally reduce staff devoted to a particular lottery function such as finance or accounting 	<ul style="list-style-type: none"> ▪ Lottery goal of maximizing revenue would compete with other agency goals. ▪ The Lottery’s ability to operate effectively may be diminished without specific legislation to allow the Lottery to operate independently.
Establish a public-private corporation to operate the Florida Lottery.	<ul style="list-style-type: none"> ▪ May provide additional flexibility in procurement and personnel functions 	<ul style="list-style-type: none"> ▪ May require constitutional amendment in Florida ▪ Would need to establish an oversight board ▪ No clear performance advantages

Source: OPPAGA analysis of industry related literature and data.

Lottery corporations not as efficient as the Florida Lottery

As shown in Exhibit 8, we also found no compelling reason to establish a corporation to operate the lottery as five other states, Connecticut, Georgia, Kentucky, Louisiana, and New Mexico, have done. These corporations are quasi-governmental entities accountable to the Governor, the Legislature, and the people of the state through a system of audits, reports, legislative oversight, financial disclosure, and supervision by a board of directors.

Corporate lotteries can have two potential advantages over lotteries organized as state agencies. First, corporate lotteries may be exempted from following typical government requirements in terms of bidding and procurement services. This can help them award contracts more quickly, focus more on quality instead of price, and protect them from bid protests (see Chapter 5 for more on procurement). Second, they typically have more leeway to offer salaries that are higher than capped salaries for government employees.

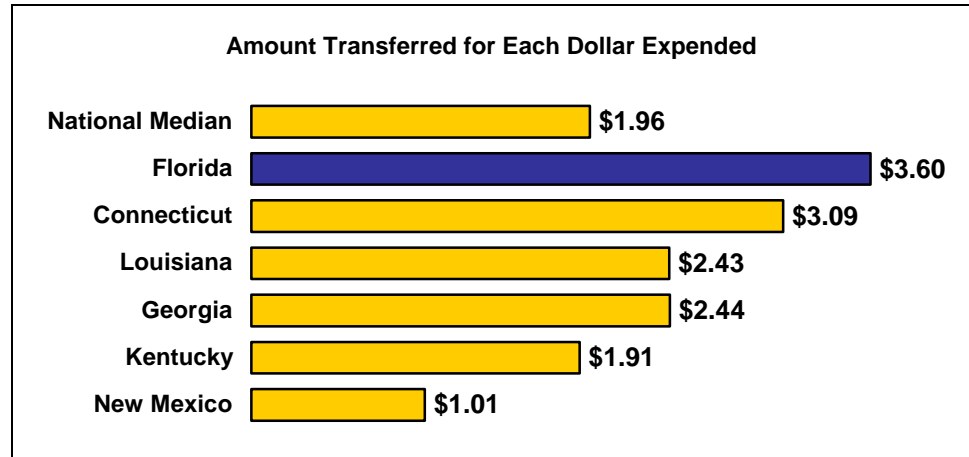
Despite the apparent advantages, several disadvantages limit the potential benefits of converting the Florida Lottery to a public/private corporation. First, the language of the Florida Constitution granting the right for lotteries to be “operated by the state” may preclude a corporate governance model.²¹ Second, a board of directors would need to be established to provide necessary oversight to ensure efficient and effective operations. Third, the Florida Lottery is already exempt from some state regulations, such as the fact that all employees of the department are exempt from the Career Service System, which establishes employee occupational groups and corresponding salary ranges. Finally, while lottery corporations are designed to be less bureaucratic, they have not clearly demonstrated that they are more cost effective.

²¹ Article X, Section 15, Florida Constitution.

Our analysis of performance on key indicators showed that the Florida Lottery has stronger performance than the corporate lotteries. A key indicator of efficiency is the return on investment. In the case of lotteries, the return is the net profit transferred to the state and the investment is the cost of operating the lottery, including retailers' commissions. As shown in Exhibit 9, the return on investment for lotteries operated by corporations is less than the Florida Lottery's.

Exhibit 9

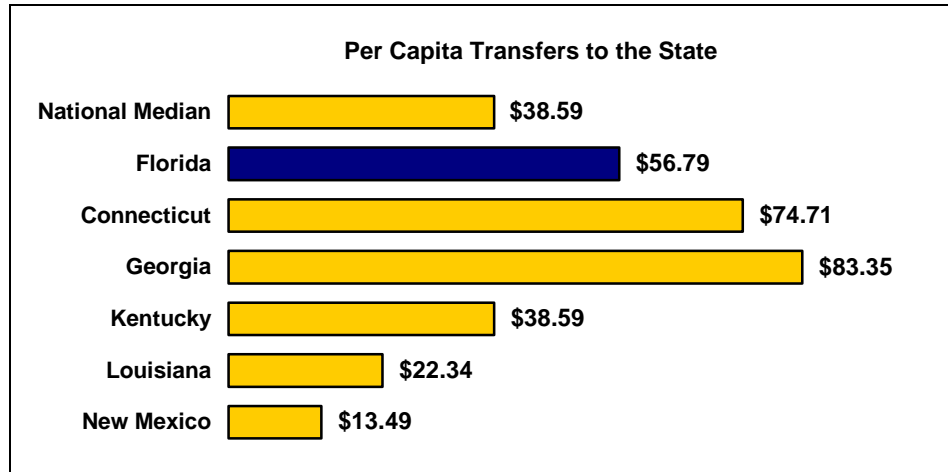
The Florida Lottery Has Greater Return on Investment Than Lotteries Operated by Corporations



Source: OPPAGA analysis of *La Fleur's 2001 World Lottery Almanac* data.

Per capita transfers provide a good measure of effectiveness. Per capita sales equal the net profits transferred to the state divided by the state's resident population. Three of the five lottery corporations per capita net transfers are lower than the Florida Lottery's and are below the national median. As shown in Exhibit 10, only the Connecticut and Georgia lotteries have higher per capita net transfers than the Florida Lottery, most likely due to those lottery's higher prize payouts and higher prize point games, neither of which requires a corporation to implement (see Chapter 4 for options to increase prize payouts).

**Exhibit 10
Lottery Corporation Per Capita Transfer Performance Is Mixed**



Source: OPPAGA analysis of *La Fleur's 2001 World Lottery Almanac* data.

Conclusions and recommendations

While not an essential state function, the Florida Lottery does provide significant additional revenues to the state and should be continued. Moreover, millions of Floridians, seasonal residents, and tourists are provided the opportunity to play a wide variety of games.

There are no compelling reasons to transfer the administration of the Florida Lottery to another state agency or to establish a public corporation to operate the Florida Lottery.

Performance Is Good, But the Lottery Faces Future Challenges

While currently performing well, the Florida Lottery faces future short- and long-term challenges. The Lottery has consistently met the performance standards set by the Legislature such as transferring at least \$0.38 of every dollar to education. In addition, the Lottery ranks first among the 38 state lotteries. However, the Lottery's sales have not kept pace with those of peer states or inflation. Unless the Lottery enhances its current games and adds new games, the value of its contributions to education will continue to decline.

Performance measures are reasonable and used to manage the Lottery

For performance-based program budgeting to work agencies need to develop strong accountability systems that enable managers, the Legislature, and the public to assess program performance. An effective accountability system depends on the development of valid performance measures, a process for validating data reliability, and adequate dissemination and uses of data by program management to modify practices and improve program outcomes.

The Legislature and the Lottery have developed a reasonable set of performance measures and has collected reliable data that can be used to assess the performance of the Sale of Lottery Products Program. The Lottery also regularly reports on program performance, and department managers use performance information to manage the program.

Financial statements provide the primary data sources for the Florida Lottery's performance measures. The Lottery relies on an annual financial audit conducted by an independent CPA firm contracted by the Joint Legislative Auditing Committee to assess the accuracy of data used for the Lottery's performance measures. As part of this audit, the CPA firm performed tests of the Lottery's compliance with provisions of laws, regulations, contracts and grants, and examined the Lottery's internal control over financial reporting. Also, the Florida Lottery's Office of Inspector General assessed the reliability and validity of the legislative measures finding the measures to be both reliable and valid in all material respects, except for the measure—the percentage of respondents who are aware of the Lottery's contribution to education. For this measure, the Lottery contracts with a research vendor to conduct a survey. The

Performance Is Good, But the Lottery Faces Future Challenges

questions are pre-tested to determine bias and whether the responses elicit appropriate information. The results are expected to be correct within +/-5%, 95% of the time.

The Florida Lottery does a good job of reporting program information and using the information to manage its operations. The Lottery reports and program managers use program performance information in several reports including its monthly report of total revenues, prize disbursements and other expenses and monthly executive management reports. These documents are available to the public upon request. The Lottery's website at www.flalottery.com also contains information on program outcomes and revenue distribution. And, the Department of Education has information on the Educational Enhancement Trust Fund at www.firn.edu/doe/bin00047/lottery.pdf.

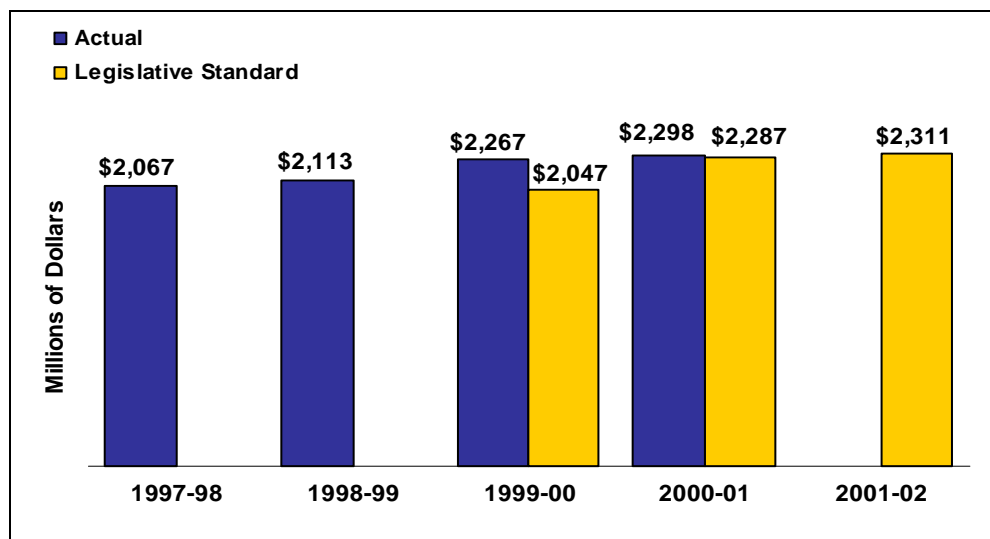
The Lottery has met or exceeded legislative standards

The Lottery has performed well based on its legislative performance measures. Under performance-based program budgeting, the Legislature has established a reasonable set of outcome and output performance standards for the Lottery including those of total revenue, transfers to the Enhancement Trust Fund, and operating expenses as a percentage of total revenues. The Lottery has generally met or exceeded these standards.

The Lottery has met or exceeded revenue standards

Exhibit 11 shows that Lottery revenues have grown over the past four years and exceeded legislative standards for 1999-00 and 2000-01.²² Lottery revenues totaled \$2.298 billion in 2000-01, an increase of \$31 million from the prior year.

Exhibit 11
The Lottery Has Met or Exceeded Revenue Standards



Source: Chapters 99-228, 00-171, and 01-253, *Laws of Florida*, and the Department of the Lottery.

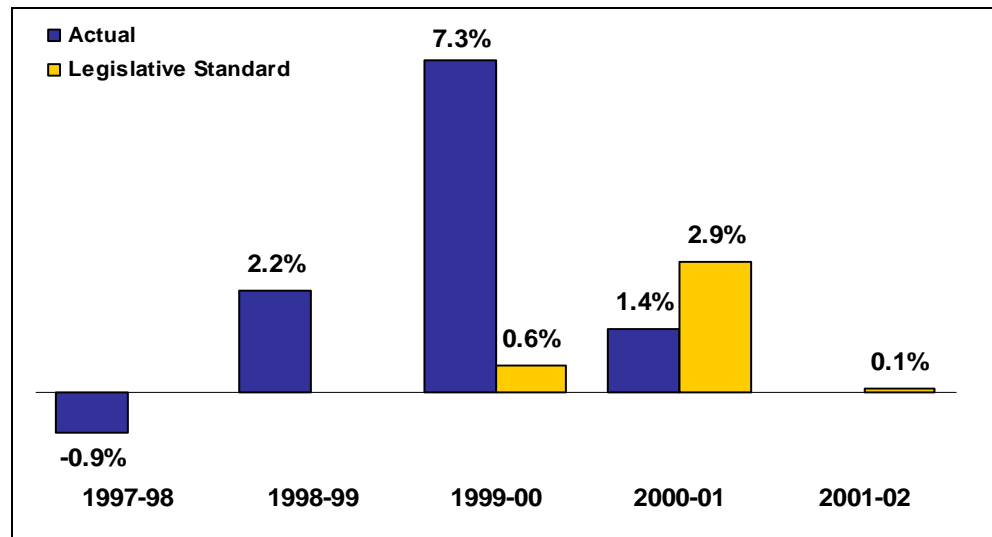
²² "Revenues" for performance measurement purposes means sales from game tickets and other income, such as interest, before payment of any operating costs or expenses.

Performance Is Good, But the Lottery Faces Future Challenges

The Lottery met the standard for revenue growth in 1999-00, but not in 2000-01

Exhibit 12 shows that the Lottery exceeded the legislative standard for growth in revenues in 1999-00, but failed to meet the standard in 2000-01. After declining in 1997-98, revenues grew by 7.3% in 1999-00, largely because Secretary Griffin made substantial design changes to the Lotto game and realized several large jackpots during that year.²³ The Lottery continued to grow the following year but at a much slower pace, in part because the Lottery did not introduce any new games or make changes to current games.

Exhibit 12
The Lottery Exceeded Its Growth Standard in 1999-00, But Failed to Meet It in 2000-01



Source: Chapters 99-228, 00-171, and 01-253, *Laws of Florida*, and the Department of the Lottery.

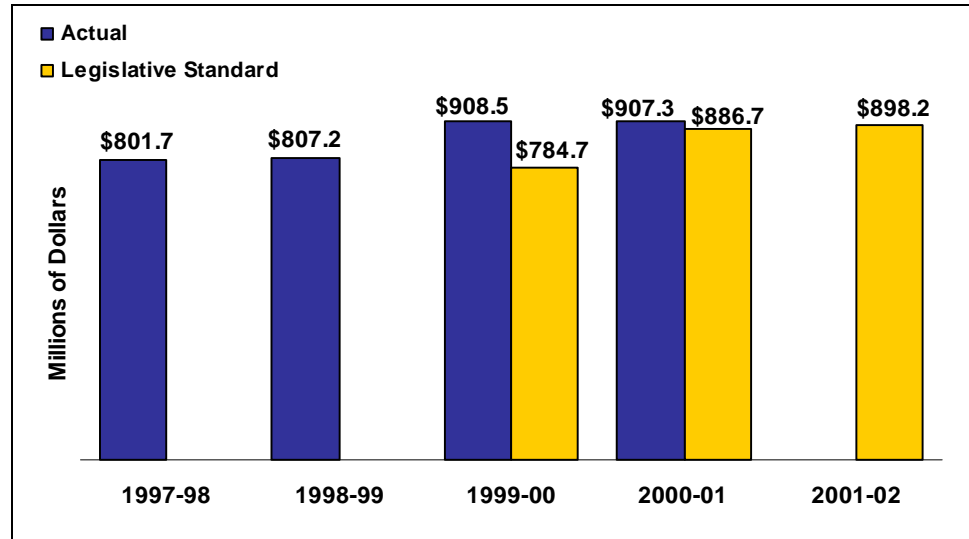
Transfers to education have exceeded legislative standards

Exhibit 13 shows that the Florida Lottery’s transfers to education have exceeded legislative standards for the last two fiscal years. In 1999-00 transfers grew significantly, but declined slightly afterwards.

²³ In October 1999, the Lottery changed the Lotto game to a twice-per-week drawing and added four numbers so that players pick six numbers from 53 choices. This decreased the odds of winning and so increased the likelihood of a rollover and subsequent larger jackpots.

Performance Is Good, But the Lottery Faces Future Challenges

Exhibit 13
Transfers to Education Have Exceeded Standards

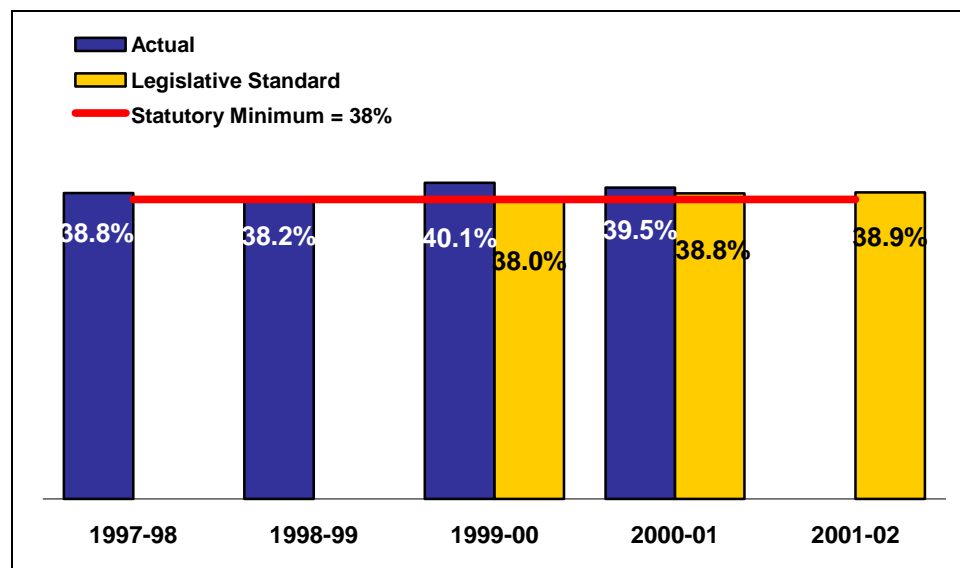


Source: Chapters 99-228, 00-171, and 01-253, *Laws of Florida*, and the Department of the Lottery.

The Lottery transfers more than the required 38% to education

The Lottery is required by law to transfer at least 38% of all revenue to the Education Enhancement Trust Fund. As Exhibit 14 shows, the Lottery has consistently surpassed this statutory requirement. In addition, the Lottery has exceeded the legislative standards for the two most recent fiscal years.

Exhibit 14
Percentage of Lottery Revenues Transferred to Education Has Exceeded Standards

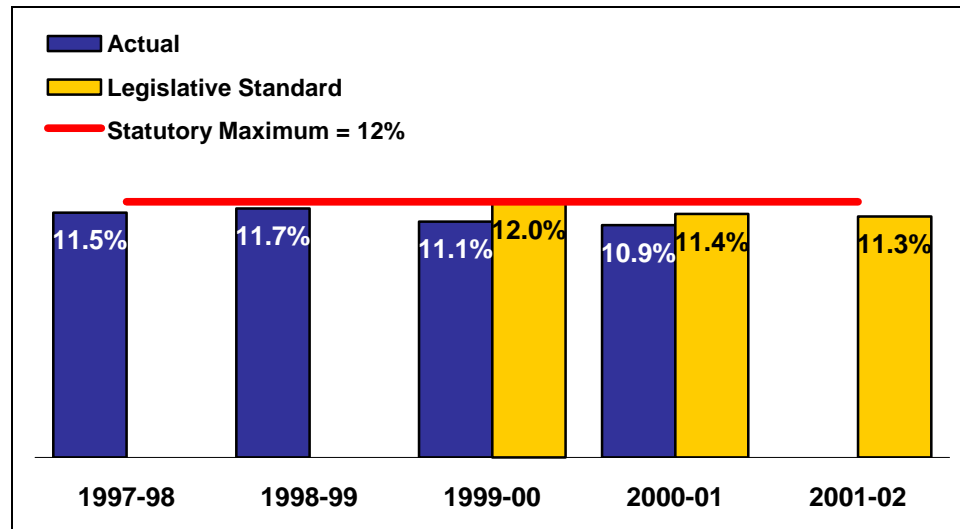


Source: Chapters 99-228, 00-171, and 01-253, *Laws of Florida*, and the Department of the Lottery.

Expenses are lower than the standard and declining

The Lottery's authorizing legislation limits its expenses to approximately 12% of revenue.²⁴ Exhibit 15 shows that the Lottery has kept expenses below 12% for the past four years. Moreover, the Lottery has kept expenses below the legislative standard. Overall Lottery expenses have declined since 1997-98 from 11.5% of revenue to 10.9%.

Exhibit 15
Operating Expenses Are Lower Than Standard and Continuing to Decline



Source: Chapters 99-228, 00-171, and 01-253, *Laws of Florida*, and the Department of the Lottery.

The Lottery has generally met other legislative performance standards

The Lottery has also generally met other legislative performance standards. As shown in Exhibit 16 the Lottery has maintained the percentage of total revenue paid out as prizes close to the legislative standard, and has kept its administrative expenses for retail commissions and operating expenses below the specified levels (these measures were discontinued for 2001-02). Public awareness of the Lottery's contributions to education has remained around the legislative standard of 65%. In addition, the Lottery has kept its administrative and support functions below 9% of its total budget.

²⁴ The authorizing legislation (s. 24.121, *F.S.*) requires the Lottery to transfer 38% of gross revenues from the sale of lottery tickets and other earned revenue to the EETF and to pay as nearly as practical 50% in prizes. So even though the authorizing legislation for the Lottery does not specify a maximum of 12% for administrative expenses that is the effective limit.

Performance Is Good, But the Lottery Faces Future Challenges

Exhibit 16

Program Performance Already Exceeds Standards Established by the Legislature

Florida Lottery Performance Measures	1997-98 Baseline	1999-00 Standard	1999-00 Actual	2000-01 Standard	2000-01 Actual	2001-02 Standard
Percent of total revenue paid as prizes	49.4%	49.7%	48.8%	49.8%	49.6%	Discontinued
Administrative expense paid for retailer commission (millions)	\$113.8	\$112.6	\$125.1	\$129.41	\$126.6	Discontinued
Operating expense (includes retailer commission) (millions)	\$237.4	\$252.8	\$251.2	\$261.8	\$250.7	Discontinued
Survey results of public awareness of the contribution to education by the Lottery—percent of respondents who are aware of the Lottery's contribution to education	65.0%	65.0%	67.3%	65.0%	65.0%	65.0%
Provide executive direction and support services for all lottery operations as measured by percent of total agency budget		No standard		9.0%	6.8%	9.0%

Source: Chapters 99-228, 00-171, and 01-253, *Laws of Florida*, and the Department of the Lottery.

The Lottery ranks first among all state lotteries

Four key performance measures rank the Florida Lottery first in the nation

Based on four key performance measures, the Florida Lottery ranks first in the nation. Using data from 1999-00, we used four measures to rank state lotteries—total transfers to the state (net income), transfers as a percentage of all revenue, expenses as a percentage of total transfers, and per capita transfers to the state.²⁵ We calculated each state's overall ranking, but then statistically adjusted those rankings to account for several factors beyond lotteries' control. Before the statistical adjustment, Florida ranked second among all lotteries in the United States, but ranked first afterwards.

We used data from the La Fleur's almanac to calculate an unadjusted rank for each state. To do this, we first calculated each state's rank on four individual performance measures:

- total transfers to the state;
- transfers to the state as a percentage of lottery revenue;
- per capita transfers; and
- total expenses as a percentage of total transfers.

For example, we ranked each state on total transfers with higher transfers to the state ranking higher. On this measure Florida ranks second in the nation (behind only New York). We then added all the ranks together to form an overall score. In Florida's case its ranks of second, second, fourteenth, and fourth give it an overall score of 22, the second best among all state lotteries (New Jersey ranked first). Exhibit 17 lists the unadjusted ranks for all U.S. lotteries.

²⁵ The data necessary to rank all state lotteries using 2000-01 data were not yet available.

*Statistical adjustment
takes into account
factors affecting
performance*

State lotteries face several constraints on their performance. For example, small states will typically have smaller potential markets for their products as compared to larger states and therefore smaller sales and transfers. Similarly, states with low per capita incomes will typically have smaller sales because their lotteries must compete for a smaller pool of discretionary income when compared to states with high per capita incomes.²⁶ As a result, the unadjusted rankings described above offer distorted comparisons. New York, for example, is both a large state and has a relatively high per capita income. To what extent does size and wealth contribute to New York's success? We addressed this question by using a statistical model to adjust each state's ranking.

Several potential factors beyond the control of individual lotteries can nevertheless influence lottery performance. To account for these factors, we identified four predictors of lottery performance:²⁷

- state per capita income;
- the population of the state over the age of 17;
- the percentage of population between the ages of 25 and 65; and
- the year the given lottery started.

These variables take into account the fact that large states will typically sell more lottery tickets due to their larger population base, particularly the population between the ages of 25 and 65, and that people in states with higher per capita income will have more discretionary income with which to buy tickets.

We used a regression model with these four variables to predict each state's performance on two of the four performance indicators. We selected those performance measures most subject to the influence of state size and wealth. In this case, total transfers to the state and total expenses as a percentage of total transfers. We calculated the difference between actual and predicted performance, called the residual, for each state. The residual provides a measure of how well each lottery performs while taking into account the five factors listed above. For example, the model predicts \$622 million in transfers for Florida. The difference between Florida's actual transfers of \$908 million and what the model predicts is a positive residual of \$286 million. That is the fourth highest among the 38 U.S. lotteries.

*Florida ranks second
before statistical
adjustment, but first
afterwards*

To determine the overall adjusted rankings we used a combination of adjusted and unadjusted ranks. We added each state's adjusted rank for total transfers and total expenses as a percentage of transfers to their unadjusted ranks for transfers as a percentage of total revenues and per capita transfers.²⁸ Florida's ranks, for example, are fourth, second,

²⁶ Per capita income is the income per person in the state.

²⁷ One other potential predictor of performance, the number of tourists visiting a state, could not be used because of a lack of available data.

²⁸ Each state's rank was adjusted by comparing its actual performance against its predicted performance for total transfers and total expenses as a percentage of total revenue. States are ranked

*Performance Is Good, But the Lottery
Faces Future Challenges*

fourteenth, and sixth, for a total score of 26. As shown in Exhibit 17, Florida ranks first among all lotteries in the United States. For more details on the methodology, see Appendix B, Section B-1.

Exhibit 17

Florida's Lottery Ranked First in the Nation for 1999-00 ¹

Statistically Adjusted Rank ²		Unadjusted Rank	
1	Florida	1	New Jersey
2	Georgia	2	Florida
3	New Jersey	3	Pennsylvania
4	Pennsylvania	4	New York
5	Maryland	5	Maryland
5	Wisconsin	6	Illinois
7	New York	7	Georgia
8	District of Columbia	8	Massachusetts
8	Louisiana	9	Wisconsin
10	Michigan	10	California
11	Massachusetts	10	Connecticut
12	Kentucky	10	Michigan
13	Virginia	13	Virginia
14	Ohio	14	District of Columbia
15	Delaware	15	Ohio
15	Illinois	16	Delaware
15	South Dakota	17	Louisiana
18	Missouri	18	Missouri
18	Oregon	18	Texas
20	Indiana	20	Kentucky
21	Kansas	21	Indiana
22	Connecticut	21	Oregon
22	Vermont	23	Rhode Island
24	Rhode Island	24	Nebraska
25	New Mexico	25	South Dakota
26	Arizona	26	Vermont
27	Maine	27	Arizona
28	Texas	27	Kansas
29	Iowa	29	Maine
29	Nebraska	30	Colorado
31	Idaho	31	West Virginia
31	New Hampshire	32	New Hampshire
33	California	33	Minnesota
34	West Virginia	34	Iowa
35	Colorado	35	New Mexico
36	Washington	36	Idaho
37	Minnesota	37	Washington
38	Montana	38	Montana

¹ Duplicate numbers indicate that more than one state had identical rankings.

² The adjusted rank is calculated by ranking each state's actual performance against its predicted performance. Performance is predicted by state per capita income, the population of the state over the age of 17, the presence of video lottery terminals, the percentage of population between the ages of 25 and 65, and the year the given lottery started.

Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

by how much their actual performance exceeds their predicted performance. Performance was predicted by state per capita income, the population of the state over the age of 17, the percentage of population between the ages of 25 and 65, and the year the given lottery started. This recognizes that large states will typically sell more lottery tickets due to their larger population base, particularly the population between the ages of 25 and 65, and that people in states with higher per capita income will have more discretionary income with which to buy tickets.

*Performance Is Good, But the Lottery
Faces Future Challenges*

*Adjusting ranks tends
to affect smaller states
most, but Florida is
consistent*

The statistical adjustment has a slight effect on Florida's rank, improving it by one. However, other states are more strongly affected by the adjustment. In general terms, smaller states and poorer states rise after adjusting the rankings because their sizes and wealth result in lower sales and transfers, but the statistical adjustment takes those factors into account. As a result, smaller states tend to benefit the most from the adjustment. For example, California drops 23 places after the statistical adjustment (from tenth to thirty-third) while New Mexico's rank rises 10 places (from thirty-fifth to twenty-fifth). Florida, by contrast, is a large state that improves its rank after the statistical adjustment.

*Florida performs
consistently well
across each indicator*

Part of the reason for Florida's consistent high ranking is that Florida performs well across all of the indicators used in the ranking. This consistency helps give the Lottery its high overall ranking as shown in Exhibit 18 (for the rankings for all 38 lotteries please see Appendix B, Section B-1).

- Florida ranks fourth (adjusted) in the nation in total net income. Net income is the amount of money the Lottery has left after paying all expenses and represents its transfers to the Education Enhancement Trust Fund.
- Florida ranks second (unadjusted) in transfers to the state as a percentage of total revenues. This measure reflects the ability of the lottery to transfer a high percentage of its sales to the state for use in education. This high ranking is especially impressive given the Lottery's equally high total net income.²⁹
- Florida ranks fourteenth (unadjusted) in per capita transfers to the state. This reflects the Lottery's total transfers to the state on a per-Florida-resident basis and hence has already been adjusted for population. Higher values indicate the lottery earns more money for education on a per person basis.
- Florida has the sixth (adjusted) lowest total expenses as a percentage of total transfers to the state. In the case of expenses, lower is better, and Florida's expenses as a percentage of their transfer to state are among the lowest in the nation. This can be viewed as the Lottery's return on its investment as it reflects how much money the state receives in relation to how much it costs to run the Lottery. Lottery expenses have two sub-components—operational costs and commissions for retailers. The expenses for administration are among the lowest in the nation—seventh. However, with a rank of eighteenth, Florida's commissions are in the middle when compared to other states. Only total expenses are used for the overall ranking.

²⁹ Normally the higher the percentage of revenues transferred to the state the lower the percentage available for prizes. Since prizes drive sales, a lower percentage devoted to prizes tends to reduce sales. Consequently, states with higher transfer percentages often have lower sales.

Performance Is Good, But the Lottery Faces Future Challenges

Exhibit 18

Florida Ranks Highly on Selected Efficiency and Effectiveness Measures

Selected Performance Accountability Measures	Florida (1999-00)	National Average¹	Florida's Unadjusted Rank²	Florida's Adjusted Rank³
Total transfers to the state (millions)	\$907.6	\$155.0	2	4
Transfers to the state as a percentage of total Lottery revenues	40.0%	28.8%	2	N/A
Per capita transfers to the state	\$56.79	\$40.76	14	N/A
Total expenses as a percentage of total transfers to the state	27.8%	50.7%	4*	6*
Administrative expenses	14.0%	23.5%	7*	7*
Commissions to retailers	13.8%	22.5%	2*	18*
Overall National Rank			2	1

* Only the rank for total expenses is used to calculate the overall rank.

¹ The national average is based on the median or middle value, not the mean or numerical average.

² The overall rank is based on sum of the state's rank for each performance measure. For example, Florida's overall adjusted score is 26 or the sum of 4, 2, 14, and 6. A similar score was calculated for the other state lotteries, and each lottery was ranked based on that overall score.

³ The adjusted rank is calculated by ranking each state's actual performance against its predicted performance. Performance is predicted by state per capita income, the population of the state over the age of 17, the percentage of population between the ages of 25 and 65, and the year the given lottery started. The ranks for transfers to the state as a percentage of revenues and per capita transfers are not adjusted because they are only weakly affected by the control variables. The unadjusted ranks for those measures are used to calculate the overall rank.

Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

Florida ranks high for at least three important reasons. First, Florida's Lottery began with an initial growth that far exceeded the norm for state lotteries. Second, as described in Chapter 1, the Lottery has made a concerted effort to reduce expenses and this has resulted in some of the lowest expenses in the nation. Third, Florida changed its games in 1999-00, which resulted in significant growth for that year (see pages 32-33 for more information). That is also the most recent year for which we have comparative data and so Florida's ranking reflected that dramatic increase in sales.

Florida's Lottery faces future challenges to maintain its value

The Florida Lottery faces future challenges as it seeks to maintain transfers to the state. First, all lotteries face a natural life cycle that begins with rapid growth that gradually diminishes over time. The Lottery's sales have declined relative to the national average and to selected peer states. In addition, the Lottery's transfers to education have lost value after taking into account the effects of inflation as explained in the following section. Together these findings indicate that the Lottery must make a concerted effort to maintain or increase its transfers or offer a declining value to the state.

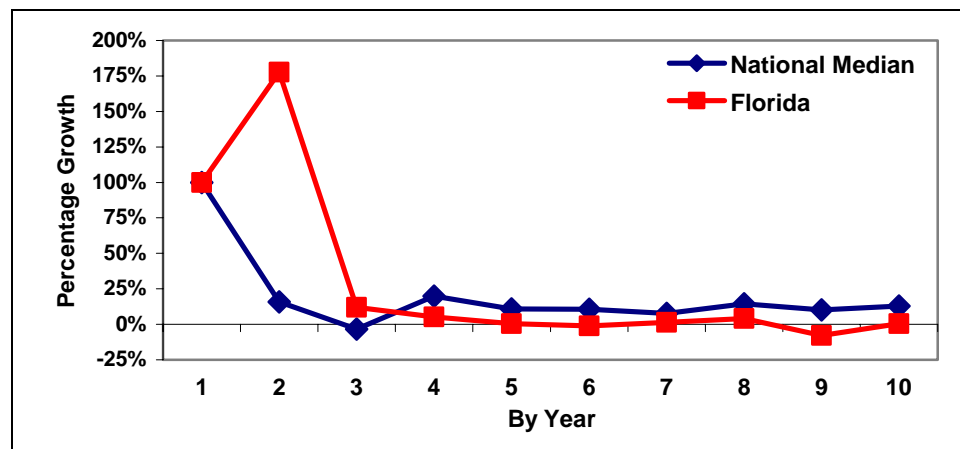
The Florida Lottery faces natural challenges to growth

Lotteries have a natural life cycle of rapid initial growth

Lotteries, like many consumer products, have a natural life cycle of rapid growth followed by modest growth or even decline. Lotteries grow rapidly at first because of the introduction of new games and a certain novelty factor. State lotteries usually begin operations with a modest number of relatively simple games and gradually expand in size and complexity, particularly by adding new games.

Exhibit 19 shows that Florida Lottery sales grew very quickly in its second year when on-line games were initiated. Since then the Lottery's sales growth has been lower than the national average.³⁰ Given the natural tendency for growth to decline or stagnate over time, Florida's Lottery must act aggressively to maintain or increase its sales.

Exhibit 19
Florida Lottery Had Slower Sales Growth After a Rapid Start



Note: Analysis is based on the first 10 years of sales for all Lotteries in existence before 1990-91.

Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

The Lottery has not kept pace with inflation and has fallen behind its peer states

Inflation significantly lowers the value of the Lottery's transfers to education

The effect of inflation significantly lowers the value of the Lottery's sales and ultimately its transfers to education. Since 1991-92 the Lottery's sales per capita have declined by 31% after adjusting for inflation.³¹ During the same period, per capita sales nationwide grew by 10% while sales

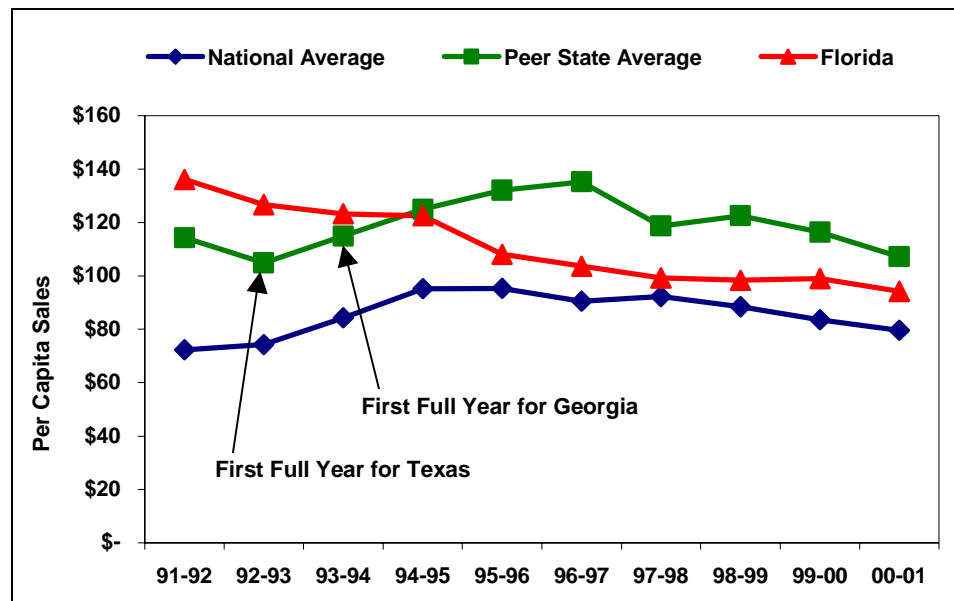
³⁰ The Lottery started in 1988 with its scratch-off game "Millionaire," adding the Florida LOTTO and Cash 3 on-line games within four months. In 1989, the Florida Lottery launched FANTASY 5; Play 4 was introduced in 1991, and Mega Money was introduced in 1999, both on-line games.

³¹ We use per capita sales to compare state lotteries because larger states tend to have higher total sales owing to their larger populations.

Performance Is Good, But the Lottery Faces Future Challenges

among peer states declined 6%.³² Exhibit 20 shows that while Florida's total sales are still higher than the national average, since 1995-96 sales have been below those of peer states. Given that Florida began with very strong sales, it still ranks highly overall even after these declines. But if the Lottery continues to lose ground, it will not be able to offer Floridians the benefits in proportion to what it now provides.

Exhibit 20
The Lottery's Total Sales Per Capita Have Declined After Adjusting for Inflation and in Comparison to Other States



Notes: Includes only states that have operated at least 10 years. Does not include sales for video lottery terminals or keno. Sales data for 2000-01 are unaudited.

Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

After adjusting for inflation on-line sales declined from 1991-92 to 1998-99

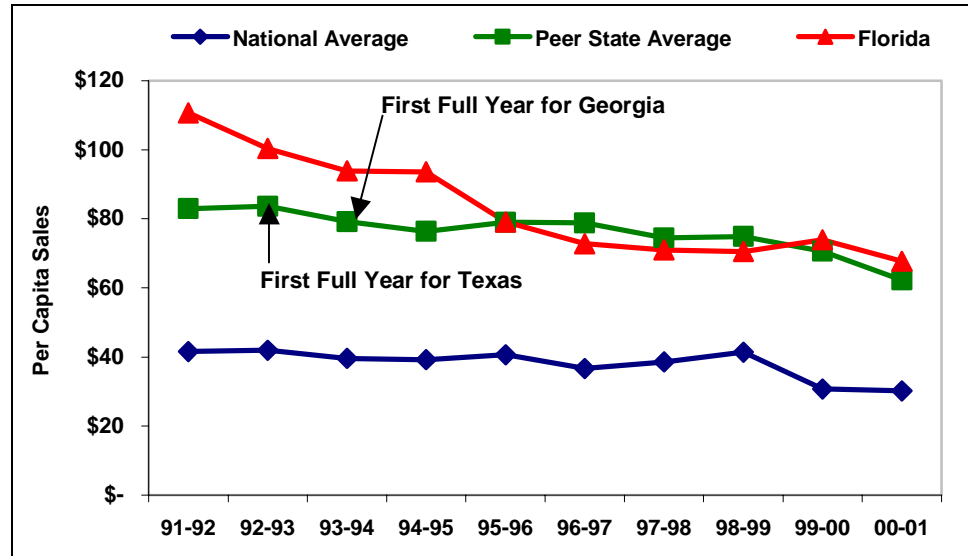
Exhibit 21 shows that after adjusting for inflation Florida's per capita on-line games sales declined from 1991-92 until 1998-99. In 1999-00, on-line sales increased but declined again in 2000-01. Part of the reason the lottery has difficulty keeping pace with inflation is that the price of on-line lottery tickets has remained constant over time. Tickets for the Lotto, Fantasy 5, or Mega Money cost \$1, the same now as at the beginning of each game. However, other states have shown smaller inflation adjusted declines. Florida's on-line sales declined 39% from 1991-92 to 2000-01 as compared to 27% nationally and 25% among Florida's peers.³³

³² Peer states include California, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, and Pennsylvania. Georgia and Texas are also included although those lotteries began in 1992 and 1993. We included their sales data beginning the first full year of operation. When calculating total sales this is the first full year for both on-line and scratch-off games, but when calculating sales for each individual type of game we use the first full year for that type of game.

³³ Without Georgia and Texas, the peer state average still declined 25%.

Exhibit 21

The Lottery's On-Line Games Sales Per Capita Have Declined After Adjusting for Inflation, But Are Still Slightly Higher than Peer States



Notes: Includes only states that have operated at least 10 years. Does not include sales for video lottery terminals or keno. Sales data for 2000-01 are unaudited.

Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

Scratch-off games sales have held their value with respect to inflation, but have fallen behind national averages

Scratch-off games sales have held their value with respect to inflation, but have fallen behind national averages. Exhibit 22 shows that after taking into account inflation, scratch-off sales grew through 1996-97. However, sales did experience a downturn from 1996-97 until 2000-01 when they increased again.

Scratch-off games have kept pace with inflation in part because the Lottery can vary the price of scratch-off tickets. For example, the Florida Lottery currently offers \$1, \$2, and \$5 scratch-off games. Other states have offered \$10 and \$20 tickets as well. The varying price points allow the Lottery to mitigate some of the effects of inflation. However, the Lottery is limited in its ability to offer higher price points because more expensive games need higher prize payouts to attract players.

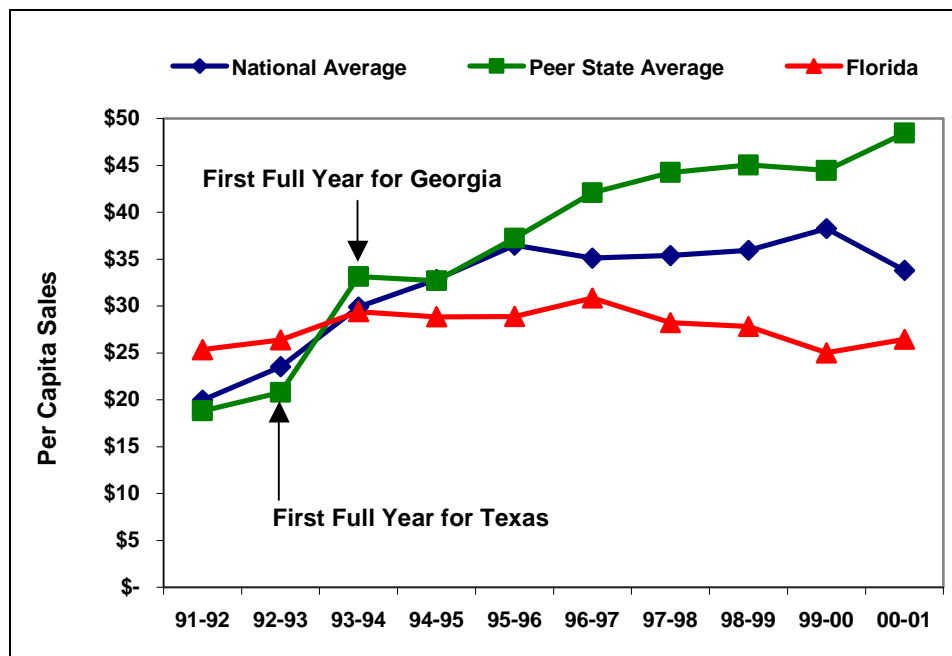
Exhibit 22 also shows that Florida's scratch-off per capita sales have grown less than the national and peer state averages. Since 1991-92, Florida's scratch-off sales grew 4% as compared to 69% nationally and 157% among Florida's peer states.

One reason for Florida's relatively low scratch-off performance is that Florida has a low payout percentage. During 1999-00, Florida paid out an average of 56% on its scratch-off games, the lowest average in the nation. Payouts affect sales because players buy more tickets for games they perceive as paying better or having better odds. In addition, when players win small prizes they sometimes use those prizes to buy more tickets. During 2000-01, the Lottery increased its prize payout percentage to 58.7% and saw a corresponding increase in sales of \$71 million. This

Performance Is Good, But the Lottery Faces Future Challenges

suggests that if the Lottery could sustain higher payouts Florida's scratch-off sales could be considerably higher than the current level (see Chapter 4 for more details).³⁴

Exhibit 22
The Lottery's Scratch-Off Sales Per Capita Have Held Their Value After Adjusting for Inflation, But Lag Significantly Behind Other States



Notes: Includes only states that have operated at least 10 years. Sales data for 2000-01 are unaudited. Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

Sales must grow faster to offset inflation

Inflation will continue to erode the value of the Lottery's transfers to education. To offset this, sales growth must outpace inflation. The Lottery's scratch-off games sales have kept pace with inflation, but not with Florida's peers or the national average. The Lottery and the Legislature should consider the options discussed in Chapter 4 to increase scratch-off sales.

On-line games sales greatly exceed the national average and slightly exceed the average for Florida's peer states. But over the last decade these games have lost significant value after taking into account inflation. Since on-line games represent 72% of all sales, the Lottery needs to offer regular innovations in its on-line games to ensure their continued value to the state.

³⁴ The statutory requirement to transfer 38% of revenues to the EETF limits the Lottery's ability to offer higher prize payouts and would have to be modified to increase payouts.

Conclusions and recommendations

The Florida Lottery performs well, but faces future challenges. The Lottery has consistently met annual performance standards set by the Legislature and in statute, and the Lottery ranks first among the 38 state lotteries in the nation.

However, two concerns remain. First, over time, inflation has eroded the value of the Lottery's contributions to education. Second, the Lottery's scratch-off games do not compare favorably with national and peer state averages.

To maximize revenue for the state and education the Lottery should grow with the goal of at least maintaining, if not increasing, the constant dollar value of its transfers to education. Chapter 4 provides a variety of game options along with the potential revenue benefits. However, improving the Lottery's scratch-off games may require legislative approval to increase prize payouts. This could make the Lottery more competitive with both the national and peer state average. Chapter 4 reviews several games options available to the Lottery as well as the potential for changing the prize payout levels for scratch-off games.

The Florida Lottery Can Substantially Increase Revenues

Over the past decade the Lottery's transfers to education have remained level in actual dollars while declining in real terms. For the next five years, the Lottery has a goal of increasing sales by 2.5% per year. The Lottery could reach this goal and possibly keep pace with inflation, but it will likely have to implement one or more of the options presented here.

We found the Florida Lottery has the potential to significantly increase sales and transfers to education. To maximize revenues, the Florida Lottery could implement several options including

- offering new games,
- increasing prize payouts for scratch-off games,
- enhancing current games, and
- expanding ticket distribution channels.

Lottery has made changes to maintain and improve sales

In recent years, the Lottery has introduced several changes in its games that have successfully increased sales.

- In 1999-00, Secretary Griffin increased drawings for the Lottery's Lotto game to twice per week, changed the matrix from 6 of 49 numbers to 6 of 53 (changing the odds from 1 in 14 million to 1 in 23 million), and increased the lower-tier prizes. As a result, Lotto sales rose by over \$127 million (17%) over the previous year.
- In 1999-00, the Lottery reintroduced its Mega-Money game bringing in \$121 million in sales after a brief trial period during the year before.
- In 1999-00, the Lottery increased the number of new scratch-off games from 35 to 50 introduced each year and developed a regular schedule for their introduction. This has helped retailers know when to expect new games and provides players with more variety and choices. The lottery has also added value to its scratch-off line by increasing co-promotions, such as the launch of Men In Black with Universal Studios Orlando. The Men In Black scratch-off game featured cash prizes up to \$10,000, merchandise prizes, and expense-paid, two-day vacation trips to Universal Studios and Islands of Adventure theme parks in Orlando.

*The Florida Lottery Can
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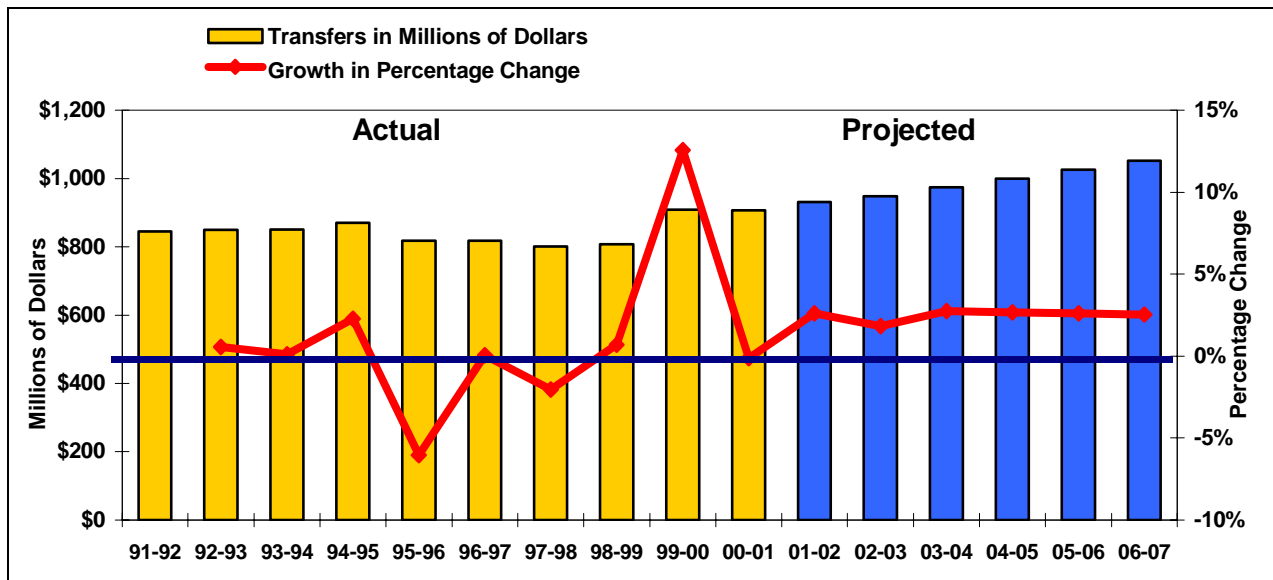
- In July 2001, the Florida Lottery launched a new Fantasy 5 game and increased top prize payouts from \$20,000 to \$100,000, increased the matrix from 5 of 26 numbers to 5 of 36, and provided a jackpot "roll down" feature that increased four-number Fantasy 5 prizes when there is no jackpot winner and added a free ticket prize for a 2 of 5 match. Since the game launch, new Fantasy 5 game sales have been more than 50% higher than the same period during the prior year.

The Lottery currently seeks to increase its rate of growth

To meet its sales goals, the Lottery will have to exceed its growth over the past five years

To meet its sales goals, the Lottery will have to exceed its growth over the past five years. The Lottery's 2002-03 Long Range Program Plan projects a 2.5% annual growth rate in sales for the next five years. That goal is higher than the Lottery's average growth of 2.2% since 1996-97.³⁵ Moreover, as Exhibit 23 shows, virtually all of the Lottery's growth in the last five years occurred in 1999-00 with the change to Lotto and the reintroduction of Mega-Money. The three previous years had little or negative growth and transfers declined slightly in 2000-01. This suggests that the Lottery will need a strategy to sustain its growth.

Exhibit 23
The Florida Lottery Averaged 2.2% Sales Growth Over Last Five Years



Note: Transfer dollars are not adjusted for inflation.
Source: OPPAGA analysis of Lottery data and Long-Range Program Plan.

³⁵ As reported in Chapter 3, the Lottery's past growth has not kept pace with inflation. Whether the projected growth of 2.5% would keep pace will depend on the rate of inflation over the next five years.

The Florida Lottery Can Substantially Increase Revenues

The Lottery has several growth strategies that could help it meet its goal. Some actions currently being considered or implemented by the Lottery include

- adding a new on-line game;
- increasing co-promotions with other popular consumer brands (e.g., NASCAR);
- packaging scratch-off games into smaller book sizes;
- providing more second chance promotions using merchandise prizes;
- sustaining 50-55 scratch-off game launches and ordering fewer tickets for faster sellout rates; and
- cross-promoting scratch-off games with on-line games.

Lottery and the Legislature have many options for increasing sales

The Lottery has several options to increase its revenues, each supporting some of the strategies outlined above. Selecting the best option depends on the amount of revenue desired and balancing the associated social costs. All of these options fall into four basic categories.

- The Lottery could offer new games designed to attract players from new market segments. In general, these have the greatest potential for revenue increases but some would require authorization from the Legislature. The Florida Lottery can also offer new games that are designed to appeal to current lottery players.
- The Legislature could authorize the Lottery to increase prize payouts for scratch-off games. Higher payouts for scratch-off games are likely to increase sales, will provide the Lottery the flexibility to offer higher priced games, and have the potential for moderate increases in transfers to education. This option would require the Legislature to make more money available for prize payouts or change the 38% transfer requirement.
- The Lottery could enhance current games with additional drawings and features, such as the ability to buy extra numbers to increase the odds of winning. These kinds of enhancements tend to have small to moderate potential to increase transfers to the Educational Enhancement Trust Fund.
- The Lottery could increase distribution channels to provide players with greater access to lottery products.

The Lottery can combine options from these categories to reach the level of growth desired, keeping in mind that some options have greater disadvantages than others.

New games could generate over \$1 billion for education

New games have the greatest potential to substantially increase money for education

New games that attract new players have the greatest potential to substantially increase revenues to the Florida Lottery and the Educational Enhancement Trust Fund. Video lottery terminals (VLTs) and keno fall into this category. Both games offer the potential for substantial recurring revenues but both games offer some of the highest social costs of all lottery games. In particular, video lottery terminals could offer games that mimic those available in casinos. Even if the Legislature limited VLTs to pari-mutuel facilities or liquor licensees, this would still represent a significant expansion of gambling in Florida.³⁶ Exhibit 24 lists these and other game options, their advantages and disadvantages, and estimated revenues whenever we were able to develop reasonable estimates.

We caution that all revenue estimates are subject to changing economic conditions, the limitations and effective date set by the authorizing legislation, the status of any ongoing litigation, and the implementation by the Florida Lottery. For example, these estimates are based on projected sales for the entire 2002-03 fiscal year as if the game had been fully implemented. Moreover, video lotteries and keno estimates would be strongly affected by the number and type of locations permitted to offer these games. Estimated revenues could be lower than expected if multiple games were introduced around the same time. Finally, these estimates are based on sales from other states in 2000-01, prior to the September 11 terrorist attack. Please see Appendix B, Section B-2, for additional details on the revenue estimates.

Exhibit 24

New Games Can Raise Over \$1 Billion for Education

Option	Advantages	Disadvantages
<p>Video Lottery Terminals Players use video terminals that can be programmed to play casino-style games such as poker, blackjack, keno, and bingo, or simulate mechanical slot machines or roulette wheels.</p>	<ul style="list-style-type: none"> ▪ Potential recurring transfers to education range from \$641 million to \$1 billion per year. ▪ Play could be limited to pari-mutuel facilities such as racetracks or establishments with liquor licenses. 	<ul style="list-style-type: none"> ▪ Because of its rapid play style, it may be more addictive than other lottery games. ▪ Because of its rapid play style, it could be regressive. ▪ The state's legal position in relation to Native American gaming in Florida might materially change should video lottery be permitted, which might ultimately increase casino style gambling on Native American lands in Florida. ▪ It would represent a substantial change for gambling in Florida by permitting casino-style lottery games. ▪ It would require legislative changes to legalize player-activated terminals in Florida.

³⁶ New York has recently authorized its lottery to offer video lottery terminals. The legislation authorizes VLTs at five racetracks with the option to expand to additional tracks. New York has estimated first full year revenues of \$265 million for the state.

The Florida Lottery Can Substantially Increase Revenues

Option	Advantages	Disadvantages
<p>Keno On-line lottery game in which players choose as many as 10 numbers from a panel of 80 numbers in the hope of matching their choices to those drawn by the central computer at Lottery headquarters. Similar in principle to other on-line games, but it is more frequently (normally every five minutes) and normally played in a social setting such as a bar or restaurant.</p>	<ul style="list-style-type: none"> ▪ Potential recurring transfers to education range from \$138 to \$193 million per year. ▪ It can be limited to existing areas where betting is allowed such as pari-mutuel facilities or social settings such as bars and restaurants. 	<ul style="list-style-type: none"> ▪ Keno is more addictive than traditional lottery games, though not as addictive as video lotteries. ▪ Because of its rapid play style, it could be regressive.
<p>Multi-State, e.g., Powerball Multi-state games such as Powerball often reach very large jackpot sizes because they cover several states.</p>	<ul style="list-style-type: none"> ▪ Potential recurring transfers to education range from \$31 to \$48 million per year. ▪ It offers players greater opportunities for very large jackpots. 	<ul style="list-style-type: none"> ▪ There is a high risk of cannibalizing the Florida Lotto game because drawings are held twice weekly.
<p>Super Jackpot Games Played like Lotto, but offered on a less frequent basis with very large jackpots (over \$100 million). May be offered in conjunction with a special event, such as the new year.</p>	<ul style="list-style-type: none"> ▪ Potential recurring transfers to education range from \$20 to \$40 million per year. ▪ Experience with New York's Millennium Millions shows that annual games can generate a huge jackpot and additional sales. Spain has a similar game, El Gordo. ▪ Super jackpots may provide sufficient incentive for non-residents to travel to Florida, particularly those from nearby states. ▪ Because jackpot drawings will be spaced months apart, there are greater opportunities for impulse sales. Players may wager a larger cumulative amount by making a series of small impulse wagers spread over several months. 	<ul style="list-style-type: none"> ▪ There is some potential to cannibalize the Florida Lotto when the drawing date for the super jackpot approaches. The likelihood increases further if the Lotto jackpot is at the lower levels (\$3 to \$7 million) and the super jackpot is well over \$100 million. ▪ May require the Lottery to buy insurance or set aside funds to guarantee a large jackpot if sales do not meet expectations. ▪ Getting player interest early in the sales cycle may be costly. Players tend to play closer to the draw date.
<p>Pulltabs/Breakopen Tickets Players win instantly by "breaking open" the ticket instead of scratching off the covering. Pulltabs can be sold in sets that have a predetermined number of winning tickets. Retailers order individual sets guaranteeing them of a specific number of winners in each deal.</p>	<ul style="list-style-type: none"> ▪ Potential recurring transfers to education range from \$2 to \$10 million per year. ▪ It may be possible to increase Lottery sales by offering a new product that is typically sold in locations such as bars. 	<ul style="list-style-type: none"> ▪ Pulltab/Breakopen tickets would compete with the same funding source as scratch-off games, which could cause a decrease in sales for scratch-off games due to lower prize payouts. ▪ The Lottery currently pays 50%–60% for instant games. This may not compete well with the Indian casino pulltabs that payout 70%-80%. ▪ It could cause cannibalization of other lottery products, particularly scratch-off games. ▪ Implementation would require lease or purchase of validation equipment.
<p>CD-Rom Interactive Games Players purchase a CD-Rom programmed with a lottery game along with the lottery tickets. The tickets enable the player to play the CD on a home computer. For example, the program may offer players 100 doors and each ticket allows the player to open three doors. If they match the prize behind three doors they win that prize.</p>	<ul style="list-style-type: none"> ▪ Potential recurring transfers to education range from \$4 to \$6 million per year. ▪ The play style offers more intrinsic value than a traditional paper lottery ticket and may be more marketable. ▪ It is attractive to the young adult market (20-34 years). ▪ It can have validation codes to prevent underage gambling and underage players would not be permitted to redeem tickets even if they played the CD. 	<ul style="list-style-type: none"> ▪ It has higher operational costs than other scratch-off style games. ▪ It could lose some entertainment value since gratification is deferred, as players must play the game on a computer, not on the premises. ▪ It may increase underage gambling by appealing to younger market segments.

*The Florida Lottery Can
Substantially Increase Revenues*

Option	Advantages	Disadvantages
<p>Probability Games Every scratch-off ticket can win a prize as compared to traditional scratch-off tickets, where winning tickets are pre-determined. For example, a "Lucky Numbers" game could have eight "8's" hidden among 20 scratch-off spots. The player chooses any 8 spots to scratch-off. If the player uncovers 4 or more like numbers, he or she wins the specified prize. Since every ticket has eight "8's" numbers, every ticket is a potential winner depending on what the player chooses to scratch-off.</p>	<ul style="list-style-type: none"> ▪ Probability games offer players three entertaining features -- choice, instant-win opportunities and appealing play styles. ▪ The game offers a product to appeal to a new type of player. 	<ul style="list-style-type: none"> ▪ Cost of implementation would require the purchase or lease of new validation equipment. ▪ Retailer and player training would be extensive since probability games require players to scratch a portion of the ticket and not the entire ticket as they do now with traditional scratch-off games ▪ Payouts for probability games would be estimated based on statistical probability, which would leave the possibility for paying out more than allocated for the game. Insurance would be necessary to protect against these types occurrences.
<p>Two Player Pop-Up Games Two people play the same game together with tickets that actually "pop-open." Some versions permit two players to both win on the same ticket. This type of game has been used successfully with board games like Battleship.</p>	<ul style="list-style-type: none"> ▪ The new game style offers more value to some players. ▪ It may appeal to new market segments. 	<ul style="list-style-type: none"> ▪ It is more expensive to produce than traditional scratch-off games ▪ Retailers may have to install additional dispensers since the tickets will not be the same sizes as current scratch-off tickets.
<p>Extended Play Games Unlike traditional scratch-off games in which winning can be determined in less than a minute, extended play games require 3-5 minutes to play.</p>	<ul style="list-style-type: none"> ▪ The Extended Play ticket provides more entertainment. ▪ Extended Play tickets are several times larger than traditional instant tickets, and have a higher degree of visibility at the point of sale. ▪ Because they allow for play styles not possible on smaller tickets and take longer to play, they may attract new players without diminishing traditional instant ticket sales. 	<ul style="list-style-type: none"> ▪ Extended play games usually have a more complex play style, which could confuse or intimidate some players. ▪ Players could get frustrated since determining whether or not they won could take up to 3-5 minutes per ticket.

Source: OPPAGA analysis of industry literature and the Department of the Lottery. Revenue estimates use data from *La Fleur's 2001 World Lottery Almanac Interim Report* and methodology from the Office of Economic and Demographic Research.

Increasing prize payouts for scratch-off games can increase sales

Increasing prize payouts for scratch-off games is likely to increase transfers to education

Increasing prize payouts for scratch-off games is likely to increase sales and ultimately transfers to education. Prize payouts reflect the percentage of all sales returned to players in the form of prizes. To increase payouts, however, requires putting additional funds into scratch-off prizes. The Lottery currently uses unclaimed prize money to fund higher payouts, producing a net increase of \$36 million for education funding. The Legislature could also provide the Lottery with additional ways to increase prize payouts, such as modifying the required percentage transfer to fund higher payouts. For 2000-01, this could have produced up to \$12 million in additional revenues for education. The Legislature could also permit the Lottery to use any undistributed money

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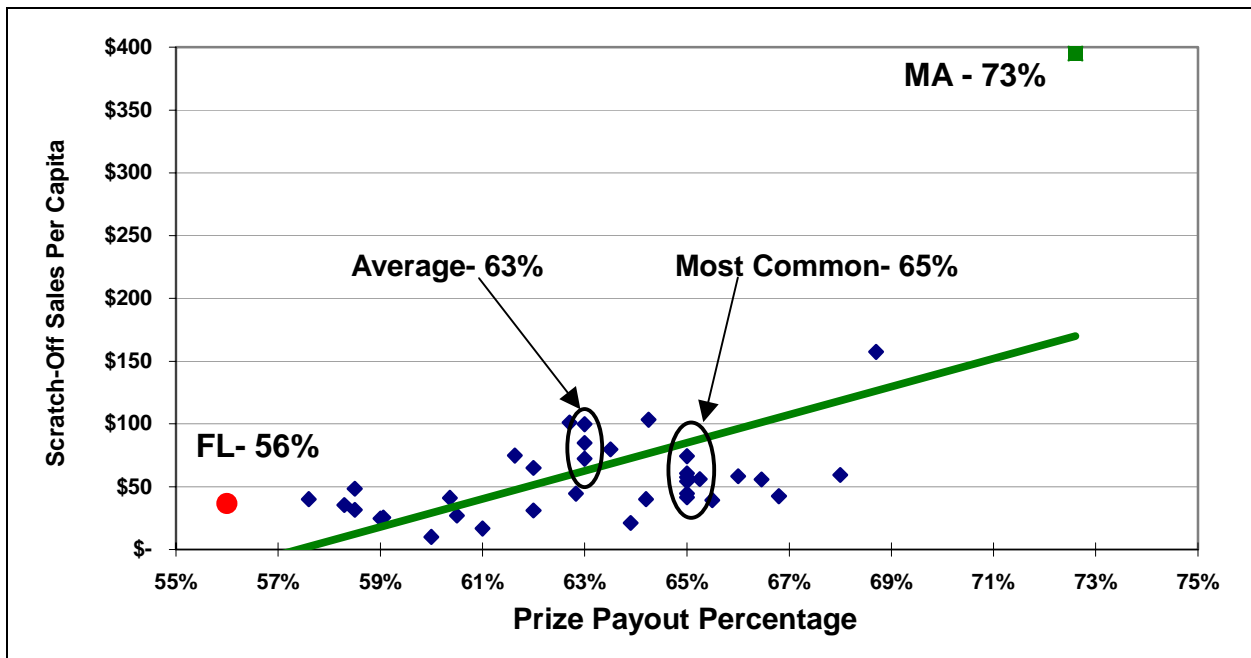
*In 2000, Florida paid
out the lowest
percentage for scratch-
off sales of any lottery
in the nation*

in the Administrative Trust Fund.³⁷ Whatever the source, increasing prize payouts for scratch-off games is likely to increase money for education.

With a 56% prize payout in 1999-00, Florida had the lowest scratch-off payouts in the nation, and which was considerably less than the median national payout of 63%.³⁸ Exhibit 25 shows that, as indicated by the trend-line, states with higher payouts tend to have higher sales per capita.³⁹ While the trend is clearly upward as prize payouts increase, some states perform better or worse than expected. For example, Florida's sales are very high relative to its payouts, as are Massachusetts'.

The relationship between payouts and sales is not perfect. Some states have relatively high payouts but lower sales. This occurs because payouts are just one of several factors that affect ticket sales. The overall pattern, though, shows that sales generally increase when payouts increase.⁴⁰

**Exhibit 25
Higher Payouts Produce Higher Sales of Scratch-Off Tickets**



Source: OPPAGA analysis of National Association of State and Provincial Lotteries data.

³⁷ The Legislature currently requires the unencumbered balance remaining in the Administrative Trust Fund to be transferred at the end of the fiscal year to the Educational Enhancement Trust Fund.

³⁸ Lottery data indicates its prize payouts rose to 58.7% in 2000-01.

³⁹ While all states had prize payouts higher than Florida's Lottery, 28 of 37 other states also had higher per capita sales than Florida.

⁴⁰ *Study of Prize Increases and Scratch-off Tickets, Florida Department of the Lottery*, Report No. 01-119, March 2000, Florida Office of Auditor General, found "that there is reason to believe that a strategy involving prize payment increases could result in increased scratch-off sales." However, the report cautions that increases do not always result in increased sales. Their analysis demonstrated that increased payouts would increase sales *on average*. Sales for individual games depend on several factors, such as game style or marketing, but overall sales for scratch-off games tend to increase with high payouts.

Experiences of other states confirm higher payouts increase sales

The experience of other states also demonstrates a link between payouts and sales. The Texas Legislature required its lottery to reduce prize payouts for its scratch-off games. Sales and transfers to the state both declined and the Texas Legislature directed its Lottery to increase payouts. Since then sales have slowly increased. Colorado and Massachusetts had similar experiences, in each case finding that increasing prize payouts increases profits.

The Lottery now uses unclaimed prize money to increase payouts

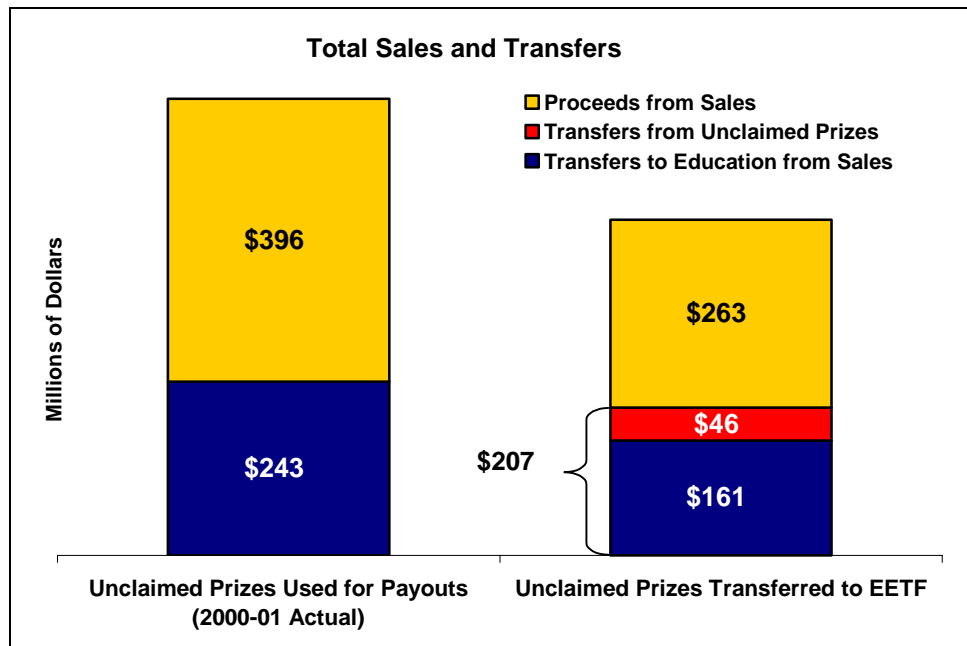
Unclaimed prize money increased transfers to education by about \$36 million

In 2000-01, the Lottery used unclaimed prize money to increase transfers to education by about \$36 million. Unclaimed prize money results from Lottery players with winning tickets not redeeming their prizes. In 2000-01, the Lottery used \$46 million in unclaimed prizes to enhance scratch-off payouts. However, this raises the question of whether education would receive more money if unclaimed prizes were appropriated directly to education.

Based on Florida's experience with changing prize payouts, we estimated the results of appropriating all unclaimed prize money directly to education (see Appendix B, Section B-3 for details).⁴¹ Exhibit 26 shows that appropriating unclaimed prizes to education would have reduced overall sales and transfers. In 2000-01, scratch-off sales produced about \$243 million for education. If unclaimed prizes had been appropriated directly to education, Lottery sales would have declined and transfers would have been about \$161 million. Since education would have received the unclaimed prizes, the total transfers last year would have been about \$207 million or \$36 million less than actually achieved.

⁴¹ This analysis is based on data from scratch-off sales in Florida, not the data presented in Exhibit 25. Data provided by the Lottery indicates that increasing prize payouts by \$1 will generate an average increase of \$4.67 in sales. This translates into \$1.77 of transfers to education for every extra dollar of prizes. These revenue estimates are subject to change based on changing economic conditions and the Lottery's implementation (see Appendix B, Section B-3 for details).

**Exhibit 26
Using Unclaimed Prizes to Increase Payouts Increased Transfers to Education
by an Estimated \$36 Million**



Source: OPPAGA analysis of Lottery sales and data.

Modifying the required percentage transfer for scratch-off games may increase transfers to the Educational Enhancement Trust Fund

Increasing prize payouts could provide \$12 million per year for education

Based on the effects of using unclaimed prize money, the Lottery could increase scratch-off sales if it had additional sources of funding to increase prize payouts. Reducing the percentage of scratch-off revenues transferred to education would provide one source of funds to raise payouts. Currently, the Lottery transfers at least 38% of scratch-off sales to the Education Enhancement Trust Fund. However, as described below, either the Lottery or the Legislature could change this transfer percentage and increase total transfers. For example, if the Legislature had established a scratch-off transfer requirement of 34% for 2000-01, it would have generated about \$12 million more for education.

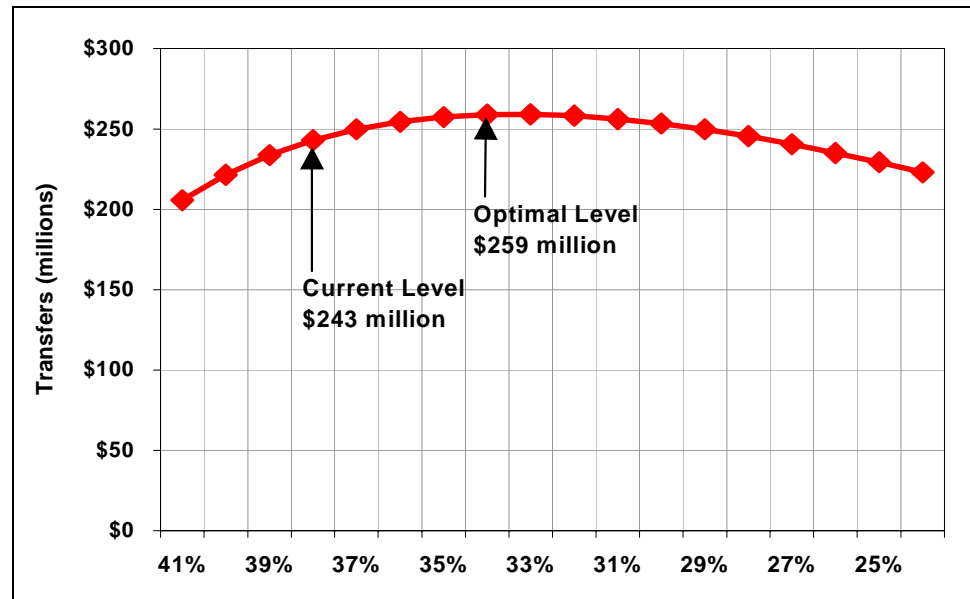
Based on Florida’s experience with prize payouts, we estimated the results of the Legislature exempting scratch-off games from the 38% required transfer to education.⁴² Exhibit 27 shows that a transfer percentage of 34% would produce the largest transfer to education—a net gain of \$12 million (see Appendix B, Section B-3 for details). The far left of the curve shows that if the Lottery increased required transfers to 42% it would have reduced the money for prize payouts which would reduce

⁴² This estimate uses the same data as the unclaimed prize estimates above. However, rather than use the estimated average increase in sales we use the estimate increase in sales for each 1% increase in prize payouts (see Appendix B, Section B-3 for details).

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sales and result in an overall decrease of \$46 million in transfers to education. By contrast, reducing the required transfer percentage to 34% would increase transfers to the state. Any increases beyond this point, however, would produce successively lower transfers because the increase in sales would not be sufficient to cover the money lost to raise the payouts. This indicates that a 34% transfer requirement maximizes benefits to education.⁴³

Exhibit 27
A Transfer Percentage of 34% Maximizes Transfers to Education



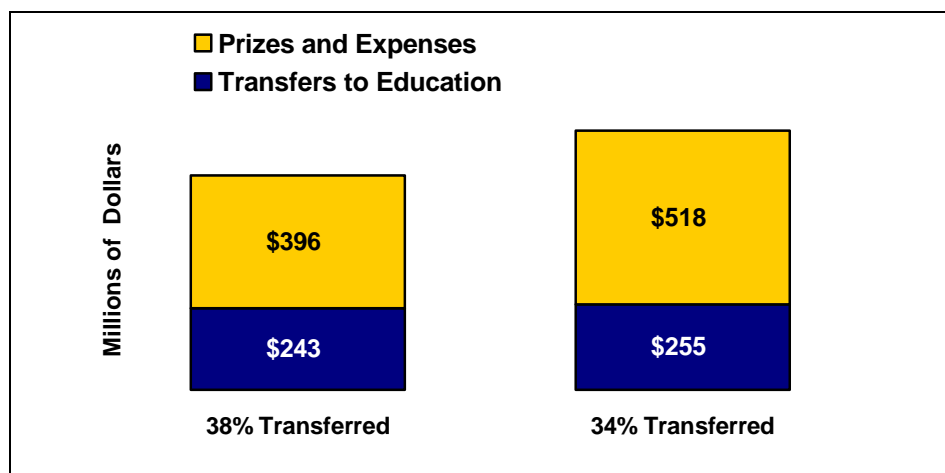
Source: OPPAGA analysis of Lottery data.

Exhibit 28 shows how both sales and transfers for 2000-01 would have changed by lowering 38% requirement to 34%. If the Lottery had transferred 34%, sales would have increased from \$639 million to \$751 million. This, in turn, would have increased transfers to education from \$243 million to \$255 million, \$12 million more for education. Based on current expenses, a 34% transfer requirement would allow the Lottery to increase payouts to about 62% for its scratch-off games.

⁴³ The results of this analysis are based on also using unclaimed prize money to increase payouts.

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**Exhibit 28
Reducing Required Transfers for Scratch-Off Games to 34% Increases
Prize Payouts and Could Increase Overall Transfers to Education**



Source: OPPAGA analysis of Lottery data.

In addition to using unclaimed prize money and lowering the transfer requirement, the Lottery and Legislature have several other options to fund increased prize payouts.

- The Legislature could permit the Lottery to gradually reduce its transfer requirement for scratch-off games while requiring increased sales and transfers.
- The Legislature could designate another source of funds, such as the unencumbered balance in the Administrative Trust Fund, to be used in conjunction with unclaimed prize money to increase prize payouts.
- The Lottery could increase the percentage of revenues transferred to education from its on-line games and then lower the percentage transferred by scratch-off games.
- The Legislature could specify an alternative transfer requirement such as a minimum dollar value.

These options are described more fully in the conclusions and recommendations presented at the end of this chapter.

Enhancements to current games could increase sales

The Lottery could enhance current games and produce small to moderate sales increases. Exhibit 29 lists several potential game enhancements along with their associated advantages and disadvantages.

Exhibit 29

Enhancement Options for Current Games Offer Small to Moderate Sales Increases

Option	Advantages	Disadvantages
<p>Increase Play 4 and Cash 3 Drawings. Currently, PLAY 4 and Cash 3 drawings are held in the evening. This option would add a midday drawing.</p>	<ul style="list-style-type: none"> ▪ There is potential to increase transfers to education. ▪ At least 10 other states play 3 and 4 number games twice per day. ▪ It provides twice as many opportunities to play. ▪ Television may not need to be used for the mid-day drawings if radio or the Internet is used to notify players of drawing results. 	<ul style="list-style-type: none"> ▪ Numbers game players tend to be minorities with lower incomes. ▪ Daytime games may attract more low-income players.
<p>Play Additions to Current Games "Kickers" or "spiels" encourage players to spend more on the given game, but not necessarily buy more tickets. For example, players could pay more for chances to win additional prizes by selecting additional numbers for a Lotto drawing.</p>	<ul style="list-style-type: none"> ▪ They could generate new revenues for current games. For example, Lotto's success could permit a spiel or add-on to work. 	<ul style="list-style-type: none"> ▪ Spiel games have declined in popularity among states because they have not been very successful.

Source: OPPAGA analysis of industry literature and the Department of Lottery.

Expanding product distribution could increase revenues

Many lottery games, particularly scratch-off, are impulse purchases. As such, the more opportunities consumers have to buy a ticket the more the Lottery will sell. Currently, 11,409 licensed retailers across the state sell scratch-off tickets. Over 9,500 retailers have on-line game terminals. As shown in Exhibit 30, over half of the Florida Lottery retailers are combination gas stations and convenience stores.

Exhibit 30

Gas Station Convenience Stores Account for 53% of Florida Lottery Retailers

Type of Retailer	Number of Retailers (As of June 30, 2001)	Percentage
Gas Station/Convenience Stores	6,098	53%
Convenience Stores	2,265	20%
Grocers	1,862	16%
Liquor Stores	413	4%
Merchandise Stores	345	3%
Bars and Restaurants	159	1%
News Stands	115	1%
Drug Stores	102	1%
Other	50	<1%
Total	<u>11,409</u>	<u>100%</u>

Source: Department of the Lottery.

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The Florida Lottery is currently considering or planning three ways to expand its distribution. These enhancements would offer greater player convenience and provide the Lottery with more distribution locations.

- **Selling at grocery store checkout lanes.** This would enable players to buy tickets as they pay for their groceries rather than go to a separate counter. Since many lottery tickets are impulse purchases this would increase their sales.
- **Paying at the pump for scratch-off tickets.** The trend toward paying for gasoline at the pump has likely diminished the walk-in business for gas stations. This would also reduce scratch-off sales for these retailers. The ability to purchase tickets at the pump would increase convenience and thereby enhance sales but it would be difficult to prevent minors from purchasing tickets.
- **Subscription play would allow players to select their favorite lottery games and numbers and sign-up to play them automatically.** Players would subscribe to a particular game for a fixed period of time and would be automatically entered into the drawings.

The Florida Lottery tried to increase the sale of scratch-off tickets through the use of instant ticket vending machines, but determined that the program had not been cost-effective. Exhibit 31 lists the advantages and disadvantages associated with expanding distribution of lottery products through other means.

**Exhibit 31
Florida Department of the Lottery Game Distribution Options**

Option	Advantages	Disadvantages
<p>Selling at Grocery Store Checkout Lanes Grocery stores typically have between 5 and 15 checkout lines that could be used to distribute lottery products.</p>	<ul style="list-style-type: none"> ▪ It may increase product distribution points and make it easier to purchase and redeem lottery products. ▪ It could increase sales because it encourages impulse purchases and is a player convenience. 	<ul style="list-style-type: none"> ▪ It could cause some accounting issues for grocery stores in tracking the sales at every checkout line. ▪ It would require expenditures for dispensers for each grocery store to display/merchandise the product at the point of purchase. ▪ It may be difficult to get supermarkets to participate. ▪ Retailer's accounting systems may be a problem.
<p>Paying at the Pump for Scratch-off Games Paying at the pump for lottery tickets would give another distribution outlet for purchasing lottery tickets. Ideally, the consumer would be able to combine their gas and Lottery purchase.</p>	<ul style="list-style-type: none"> ▪ A "Play at the Pump" option would add player convenience and prevent a sales decline from a decrease in store traffic. 	<ul style="list-style-type: none"> ▪ Most likely it would require the purchase of special dispensing machines like instant ticket vending machines and this technology is in development. ▪ Florida laws require credit card purchases for lottery tickets have \$20 sales of other products. ▪ Florida laws currently do not allow "player activated terminals." ▪ Paying at the pump for gas eliminates the need for many consumers to go inside which will have a direct impact on all product sales inside the store.

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Option	Advantages	Disadvantages
<p>Subscription Play Players can subscribe to on-line game drawings for three months to one year in advance.</p>	<ul style="list-style-type: none"> ▪ Key benefits for the consumers are no missed draws, no waiting in lines, and ease of prize claims. ▪ It provides the ability for people to play who may not be able to otherwise such as visitors, seasonal residents, and physically challenged residents. ▪ Subscription play is offered in about 15 U.S. lotteries. 	<ul style="list-style-type: none"> ▪ Other state lottery officials state using subscription services is manpower intensive due to the manual entry process. ▪ Processing subscriptions takes about three weeks in other states, which may cause player dissatisfaction. ▪ Players may not be able to change their numbers after subscribing. ▪ Some other state's subscription computer systems cannot allow early renewals. ▪ Use of credit cards for lottery purchases without purchase of \$20 in other goods would require law change. ▪ Federal law would restrict subscriptions from out-of-state players unless they have in-state mailing addresses. ▪ Game changes can be problematic, because of the long-lead time requiring communication with players and possibly a replacement ticket. ▪ Because all prize payments will be paid automatically, subscription play will generate no unclaimed prize funds.
<p>Increase product distribution at non-traditional lottery locations (e.g., hotels) Recruitment of nontraditional lottery locations like hotels, restaurants, etc.</p>	<ul style="list-style-type: none"> ▪ It could increase product distribution and awareness. ▪ It could make lottery products more convenient to purchase. ▪ It could potentially reach new players that don't shop where products are currently being sold. 	<ul style="list-style-type: none"> ▪ It could require additional lottery staff to service these new accounts.
<p>Increase product visibility at the point-of-purchase through improved product displays/dispensers. Innovative product displays will catch the eye of consumers and generate impulse purchases.</p>	<ul style="list-style-type: none"> ▪ It could result in improved product visibility. ▪ It likely would increase sales by generating more impulse purchases. 	<ul style="list-style-type: none"> ▪ Additional funding might be necessary to purchase new product displays. ▪ Sales results from changes could vary greatly from location to location and in some cases may not increase sales.
<p>Instant Ticket Vending Machines Vending machines placed in retailer establishments to provide players with convenient access to purchase scratch-off tickets.</p>	<ul style="list-style-type: none"> ▪ It frees retailers from having to spend time selling scratch-off tickets. ▪ Retailers find that ITVM are easy to stock, have good sales, good for inventory purposes, and are a good customer service tool. ▪ It could be cost-effective in some locations or where scratch-off tickets are not being sold, such as in hotels. 	<ul style="list-style-type: none"> ▪ Retailers may lose some impulse sales at the counter. ▪ The Florida Lottery estimates the net increase in scratch-off ticket sales does not cover the instant ticket vending machine program expenses. ▪ Retailers find problems with cutting tickets, tickets jamming in the machine, machines break down often, and have had problems getting service. ▪ ITVM sales are cost-effective in less than 100 locations.

Source: OPPAGA analysis of industry literature and the Department of Lottery.

To meet projected sales goals, the Lottery must balance potential revenues with the likely social costs

In order to increase sales and transfers, the Lottery and the Legislature must balance two conflicting goals. The Legislature directed the Lottery to maximize transfers to education while still maintaining the dignity of the state. As a result, the Lottery has avoided some types of games that would likely substantially increase sales, but could also increase social costs. Some options would have fewer social costs, but would also produce smaller sales increases. In seeking this balance, the Lottery has made generally uncontroversial changes. However, there are a variety of options that would permit the Lottery to maintain or increase its value to the state.

Conclusions and recommendations

The Florida Lottery has the potential for higher sales and transfers to education. This potential is sufficient for the Lottery to reach its goal of increasing sales by 2.5% per year for the next five years. Moreover, the Lottery has the potential to maintain its value, even after adjusting for inflation. But for the Lottery to meet its goal and maintain value, it will require adopting a growth strategy and selecting from the various expansion options.

We recommend that the Lottery establish a long-range calendar for additions and enhancements. It should plan for at least one annual change to its games, either a new game with moderate potential or a significant enhancement to a current game. This regular pace of innovation will help ensure that the Lottery maintains, and possibly increases, its contributions to education.

To maximize its revenues, we recommend the Lottery consider the options described below.

- Introduce new games such as a super-jackpot game. The Florida Lottery has the authority to design and implement new games to maximize revenue in a manner consonant with the dignity of the state and the welfare of its citizens. The various possible new games that the Lottery could offer vary in both their potential revenue and social costs.
- Enhance its current games such as increasing drawings for daily games. The Florida Lottery has demonstrated that changing game designs can increase revenues. The various enhancements that the Lottery could make range from simply increasing the number of draws to substantially changing the way a game is played, its prize structures, and odds of winning.

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- Reduce the percentage of scratch-off revenue transferred to education while increasing the percentage transferred from on-line games. This would enable the Lottery to increase payouts for scratch-off games. The Lottery's authorizing legislation requires it to transfer that 38% of all revenue to the EETF. That means that some games could transfer more and other less, so long as transfers equal at least 38% of all revenues. If the Lottery increased the percentage of revenues transferred by some on-line games the Lottery could then decrease the percentage for scratch-off games and increase prize payouts, in turn increasing sales and transfers. However, to do this the Lottery would have to change the prize structure for the on-line games so that they payout less.⁴⁴ This could be done as part of a larger restructuring of a game or as part of the introduction of a new on-line game.
- Increase the distribution of its games, making the games more readily available. The more opportunities players have to buy lottery tickets, the more the Lottery will sell. Most lottery products are sold in gas stations and convenience stores. However, there are other locations such as hotels that lottery products could be more widely distributed through.

To help the Florida Lottery maximize revenues and increase transfers to education, we recommend that the Legislature consider the following options.

- The Legislature could authorize the Lottery to offer video lottery or keno games. We estimate that video lotteries could produce between \$641 million and \$1 billion annually for education. Keno games could generate between \$164 and \$193 million annually for education. The amount of potential revenue would be dependent on several factors, some of which would be determined by the Legislature. For example, the Legislature would have to determine the number and types of locations for both video lotteries and keno. Video lottery terminals could be limited to existing pari-mutuel facilities while keno might be limited to bars and restaurants.
- The Legislature could change the law to reduce or exempt the 38% transfer requirement for scratch-off games. In essence, the Legislature could require the Lottery to transfer 38% of all revenues from on-line games while permitting the Lottery to transfer a lower percentage of scratch-off games. The Legislature could specify a lower rate, such as 34%. If the Lottery had transferred 34% of scratch-off revenues in 2000-01 we estimate it would have increased total transfers by about \$12 million.

⁴⁴ On-line games such as Lotto are driven more by the size of the jackpot than the overall payout rate and so they would be less affected by a reduction in the payout percentage.

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- Alternatively, the Legislature could permit the Lottery to gradually reduce the transfer percentage for scratch-off games as long as the Lottery continues to increase transfers. Such an incremental approach would permit the Lottery to assess each set of changes and ensure they do in fact benefit education. If higher payouts did not increase transfers to education, payouts could be frozen again at that level. Increasing the transfer percentage, however, could risk a player backlash such as what was seen in Texas. Scratch-off sales for Texas declined dramatically when the Texas Legislature ordered its Lottery to reduce payout percentages. Even after reversing course and increasing payouts, sales have not fully recovered.
- The Legislature could designate another source of funds to be used in conjunction with unclaimed prize money. For example, the Legislature could authorize the Lottery to use the unencumbered balance left in its Administrative Trust Fund (see Chapter 1) to increase payouts. In 2000-01, that would have given the Lottery about \$20 million with which to raise payouts and increased transfers by about \$15 million. Moreover, if the Legislature permitted the Lottery to use the unencumbered balance for prize enhancements it would give the Lottery an additional incentive to minimize expenses.
- The Legislature could remove the 38% transfer requirement for all games. In its place the Legislature could mandate a specific dollar value of the transfer thus ensuring the Lottery maintains its value. This would give the Lottery flexibility as to how it achieves that goal. For example, the Lottery could use the flexibility to increase prize payouts for scratch-off games or it could decide to focus on offering new on-line games. In return for this flexibility, the Legislature could hold the Lottery to higher standards for growth and total overall transfers.

The Florida Lottery's Administrative Costs Could Be Further Reduced

The Florida Lottery has reduced its administrative expenses by \$11.8 million (8.5%) in the last three years, but there are options to reduce them further and still maintain quality services. In relation to other lotteries, the Florida Lottery ranked fourth having relatively small total expenses compared to its net income in 1999-00.⁴⁵ However, when analyzing the administrative expense component of its total expenses, the Florida Lottery falls to seventh, indicating its administrative expenses may have room for further reductions. We found several options have the potential to further reduce the Lottery's administrative expenses that could then be used to boost prize payout amounts as discussed in Chapter 4 on pages 37-42 or directly increase transfers to the Educational Enhancement Trust Fund.

The Florida Lottery reduced administrative expenses

The Florida Lottery cut \$6 million from its staff costs

The Florida Lottery recently implemented organizational changes to improve its operations and reduce its staff costs by \$6 million. Since 1999-00, the Florida Lottery has reorganized using a business model to be more accountable and effective resulting in a flatter organizational structure.⁴⁶ In conjunction, the Florida Lottery conducted process mapping and re-engineering to streamline its work functions resulting in a 28% reduction in staff.

The Florida Lottery initiated other measures to cut administrative costs. In 1999-00, the department found warehouse trucks were not used efficiently and that there were more efficient methods for delivering items. The department outsourced deliveries to the private sector reporting a savings of approximately \$200,000 annually. In addition, the department found instant ticket vending machines (ITVM) were not cost-effective in most locations, with the statewide program operating at a deficit of \$1.1 million, resulting in the ITVM program being discontinued.

⁴⁵ Net income is the amount of money the Lottery has left after all expenses and represents its transfer to the Educational Enhancement Trust Fund.

⁴⁶ *Organizing Around a "Corporate-Style" Strategic Plan*, McKinsey & Company, January 2000.

The Florida Lottery's Administrative Costs Could Be Further Reduced

In addition to changes that have been made already, the Florida Lottery has several options that could further reduce administrative expenditures by

- reducing procurement costs;
- reducing costs associated with making prize payments;
- outsourcing functions to reduce costs; and
- using facility space more efficiently.

Additional changes could reduce procurement costs

The Florida Lottery contracts for the majority of its functions. As part of this process, vendors who are not selected may protest the award of the contract. The Florida Lottery operates in an environment in which some vendors use the bid protest process as a business strategy to win state contracts. Department officials state that unsuccessful bidders protest large as well as some smaller contract awards. A recent large bid protest cost the Florida Lottery over \$10 million.

Grounds for bid protests are largely beyond Lottery control

Regardless of the size of the contract, unsuccessful bidders who protest typically claim that the Florida Lottery was arbitrary in its contract award decision. Florida Lottery managers report that of 148 contracts awarded since 1991-92, 11 (7%) were protested. In each case, the Florida Lottery's bid decisions prevailed before the Division of Administrative Hearings and the District Court of Appeal.

Bid protests cost the Florida Lottery millions

Bid protest costs are significant to the Florida Lottery and hinder its ability to operate efficiently and to generate additional revenues. To defend its bid decisions, the Florida Lottery estimates small procurement protests typically cost \$6,000, medium \$23,000 and large procurement protests may cost over \$100,000. The most protracted bid protest was for the Florida Lottery's on-line system with only two vendors (Automated Wagering, Inc., and GTECH Corporation) vying for the state's business. Some of the costs associated with the bid protest for the Florida Lottery's on-line system contract are noted below.⁴⁷

- In November 1996, the unsuccessful bidder (GTECH) filed a bid protest, which delayed executing the contract until the bid protest was settled in 1999. The delay resulted in several costs to the Florida Lottery.
 - ♦ The Florida Lottery paid \$9,744,079 more to its vendor than the new contract would have required during the protest.
 - ♦ New games were potentially delayed and revenues lost.

⁴⁷ The Florida Lottery has contracted with Automated Wagering, Inc. (AWI), for on-line services since 1988. These services include the provision of computer hardware, software and telecommunications, along with maintenance and other services. In 1995, the Florida Lottery rebid the contract and again chose AWI as its on-line service provider. Shortly thereafter, the unsuccessful bidder protested the award of the contract to AWI; however, the Florida Supreme Court upheld the award of the contract.

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- ♦ The old computer system had to be upgraded to be Y2K compliant costing an additional \$163,683.
- To defend its position, the Florida Lottery paid the State Attorney General \$91,659 and private attorneys \$173,110.
- The Florida Lottery estimates in-house costs for attorneys, staff giving depositions and testimony, and staff providing documents requested by the bidders at \$100,000.⁴⁸

The Florida Lottery follows typical state procurement practices under Chapters 287 and 120, Florida Statutes

Even though the Legislature's intent is for the Florida Lottery to function as much as possible as a business enterprise, the Florida Lottery follows typical state procurement practices.⁴⁹ These procurement practices include Ch. 287 (governing procurement of personal property and services) and Ch. 120 (the Administrative Procedures Act, which provides for bid protests), *Florida Statutes*. Government procurement practices are intended to promote fair and open competition thereby reducing the appearance and opportunity for favoritism, and to inspire public confidence that contracts are awarded equitably and economically through a system of uniform procedures.⁵⁰

To help reduce the costs associated with the Florida Lottery's procurement process, we identified several options to consider. Exhibit 32 lists options and their advantages and disadvantages to help make the Florida Lottery's procurement process more efficient while maintaining accountability for a fair and open process.

⁴⁸ In January 2000, the Second Circuit Court of Leon County, Florida, entered a judgment in favor of the challenger, finding the AWI contract to be null and void and issuing an injunction against proceeding under the contract. In February 2001, the First District Court of Appeal affirmed summary judgment that the amended contract is void. In July 2001, the First District Court of Appeal certified two questions as being of great public importance to the Florida Supreme Court, still pending as of December 2001. Meanwhile, the Florida Lottery is continuing to operate under the amended contract with AWI pursuant to a stay of the court order and will continue operating without interruption until the matter is concluded.

⁴⁹ Sections 24.102(2)(b), 24.105(13), and 24.109, *F.S.* The Florida Lottery has not promulgated alternative rules as permitted by law.

⁵⁰ The Auditor General's report *Single Source and Emergency Procurement*, [Report No. 02-049](#), September 2001, calling for clarification in law and increased review pertain to non-competitive contract awards in contrast to competitive awards discussed above.

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Exhibit 32

Options to Reduce Procurement Costs

Option	Advantages	Disadvantages
<p>Raise bid protest bond requirement and allow the Florida Lottery to recover all costs including attorney fees. Exempt the Florida Lottery from bid protest bond requirements in s. 287.042(2)(c), <i>F.S.</i> Instead, require any person filing a bid protest against a Florida Lottery decision to post a bond that is 1% of the contract or \$5,000 whichever is greater. Also, exempt the Florida Lottery from s. 120.595, <i>F.S.</i> Instead, allow the Florida Lottery to recover reasonable costs and reasonable attorney fees.</p>	<ul style="list-style-type: none"> ▪ It may decrease the number of bid protests filed, as the vendor’s cost to file and consequences of being unsuccessful would be increased. ▪ It may reduce the Florida Lottery’s legal expenses as it may decrease the number of bid protests filed. 	<ul style="list-style-type: none"> ▪ Stakeholders may oppose change as it could limit small business access to bid protest process.
<p>Limit the scope of bid protests by raising standard of review. Exempt the Florida Lottery from s. 120.57(3)(f), <i>F.S.</i> Instead, require the standard of review by an administrative law judge to be whether the Lottery’s intended action is illegal, arbitrary, dishonest, or fraudulent.</p>	<ul style="list-style-type: none"> ▪ It would streamline and expedite recommendations by the Division of Administrative Hearings by limiting the scope of issues challenged. ▪ It would reduce Florida Lottery legal expenses as the number of issues challenged would likely be reduced. ▪ It would maintain accountability by protecting the state and public against fraud and corruption. 	<ul style="list-style-type: none"> ▪ Stakeholders may oppose change due to raised standard of review.
<p>Establish new bid protest process by amending s. 120.80, <i>F.S.</i> Exempt the Florida Lottery from the hearing requirements of s. 120.57, <i>F.S.</i> Instead, the Florida Lottery would be authorized to promulgate rules to allow the Lottery Secretary or designee to review bid protests and make final decisions subject to judicial review by the District Court of Appeals.</p>	<ul style="list-style-type: none"> ▪ It would streamline and expedite final decisions by removing the Division of Administrative Hearings from the Florida Lottery’s bid protest process. ▪ It would reduce Florida Lottery legal expenses. ▪ Accountability would be preserved with final agency decisions subject to judicial review. 	<ul style="list-style-type: none"> ▪ Stakeholders may oppose change, as the agency may be perceived as biased towards decisions in its favor.

Source: OPPAGA analysis of interviews with Department of Management Services and Florida Lottery officials.

Changes could reduce prize payment costs

By modifying the options players have to redeem their winning tickets such as processing more claims through the mail, the Florida Lottery could reduce administrative costs associated with paying out prizes by \$1.6 million annually. See Appendix B, Section B-4, for an explanation of this estimate.

Prizes claimed at retailer, district, and headquarters locations

Winners currently may claim prizes up to \$600 at any of the Florida Lottery’s 11,409 retailers who sell similar games, at district offices, or simply mail the ticket with the requested information to the Florida Lottery headquarters. Retailers are paid a 1% commission of the prize amount for redeeming winning tickets worth less than \$600. Prizes of \$600 to \$250,000 require winner claim forms to be filled out and submitted to one of the Florida Lottery’s 11 district offices or mailed to headquarters.

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Prizes over \$250,000 must be claimed at lottery headquarters in Tallahassee.⁵¹

District prize payment function costs about \$1,910,620 annually

Current costs (estimated at \$1,910,620 annually) to redeem prizes at Florida Lottery district offices appear excessive.⁵² As shown in Exhibit 33, it costs the Florida Lottery about \$1,174,669 to process claims for tickets worth less than \$600 at district offices while retailers could redeem the same tickets at a cost to the Lottery of \$10,971.⁵³ Some winners redeem their tickets worth less than \$600 at district offices for a variety of reasons including having a personal preference to claim their prize at a Florida Lottery location, having multiple winning tickets that include both prizes worth above and below \$600, and a small percentage having trouble validating the ticket at the retailer necessitating that they redeem their ticket at a district location or mail it to headquarters.

Exhibit 33

Paying Out Prizes Under \$600 From District Offices Cost an Estimated \$1,163,698 More Than if Retailers Processed the Same Winning Tickets

Prize Payout Ranges	Estimated Costs FY 2000-01		Prize Payout Amount	Retailer Prize Payment Cost ²
	Claims	Cost ¹		
< \$600	80,933	\$1,174,669	\$ 1,097,071	\$ 10,971
\$600 to \$5,000	18,128	526,223	59,358,939	N/A*
> \$5,000	7,225	209,728	89,976,569	N/A*
Total	<u>106,286</u>	<u>\$1,910,620</u>	<u>\$150,432,579</u>	N/A*

* Retailers are not permitted to redeem prizes over \$600 because of additional work such as checking for state-owed debt and withholding taxes on prizes over \$5,000.

¹ Lottery managers estimate that processing claims at district offices over \$600 cost approximately twice as much time as claims under \$600 because of the additional work associated with checking for state owed debt and collecting taxes. While the average cost to process a claim is \$17.98, processing claims under \$600 cost approximately \$14.51 and claims over \$600 cost approximately \$29.03 each.

² Retailers are paid a 1% commission on the prize payout amount to redeem winning lottery tickets worth up to \$600.

Source: OPPAGA analysis of Florida Lottery data.

We have identified several options to help reduce the costs associated with the Florida Lottery's prize payment cashing services. These options include discontinuing prize payment services at district offices and instead processing all claims under \$600 at retailer locations and the remaining

⁵¹ Florida law requires state owed debt to be deducted from winnings over \$600 (s. 24.115, F.S.) and taxes must be withheld from winnings over \$5,000 (Title 26, Code of Federal Regulations section 31.3402 q).

⁵² Prize payment services performed at district locations cost an estimated \$1,910,620 in 2000-01. This estimate is based on 47 district staff assigned to the prize payment function with salaries and benefits totaling \$1,626,060 and travel and training estimated at \$25,000 and an estimated 25% of facility costs at \$259,560, including lease and utility payments.

⁵³ The large disparity between district office costs to process claims under \$600 and retailer commissions is due to the high labor costs relative to the volume of transactions processed at the Lottery's 11 district offices compared to a 1% commission paid on a small total prize amount to retailers.

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claims processed centrally through the mail or at third party locations for a cost savings of approximately \$1.6 million. Exhibit 34 lists options and their associated advantages and disadvantages to help make the Florida Lottery's prize payment services more efficient (see Appendix B, Section B-4, for an explanation of the potential savings estimate).

**Exhibit 34
Options to Reduce Prize Payment Costs**

Option	Advantages	Disadvantages
<p>Retailers pay all prizes under \$600 and centralize processing of remaining claims.</p> <p>Winners that would have claimed their prizes at a district office would claim their prizes worth less than \$600 at one of the Florida Lottery's retailers or mail their winning ticket into headquarters. Winner claim forms would be submitted by mail or in person to headquarters for winners to redeem prizes over \$600.</p>	<ul style="list-style-type: none"> ▪ Retailers could more efficiently process claims under \$600 at 1% commission rates saving \$1.2 million. ▪ The Florida Lottery could more efficiently process claim forms through a central location saving an additional \$400,000. 	<ul style="list-style-type: none"> ▪ Winners would have to wait to receive their prize payments through the mail, negatively affecting customer convenience and security. ▪ While few tickets would be expected to be lost in the mail, some tickets could be lost in the mail necessitating that winners insure their tickets in the mail at additional cost to the players.
<p>Retailers pay all prizes under \$600 and pay tax collectors to process prize payments over \$600.</p> <p>Prize payments over \$600 would be paid by check in tax collector offices. Winners would claim their prizes worth less than \$600 at one of the Florida Lottery's retailers or mail their winning ticket into headquarters.</p>	<ul style="list-style-type: none"> ▪ Retailers could more efficiently process claims under \$600 at 1% commission rates saving \$1.2 million. ▪ Depending on the terms negotiated, tax collectors may agree to process prize payments at less cost than the Florida Lottery. ▪ Tax collectors have infrastructure and personnel in place to handle funds, security, internal controls, and government requirements. ▪ Customer convenience could be improved as access to redemption centers would likely increase and offices are familiar to the public. 	<ul style="list-style-type: none"> ▪ First year savings may be less depending on computer systems and other infrastructure necessary for tax collectors to assume prize payment function and the actual negotiated compensation. ▪ Wait times at tax collector's offices may increase thus inconveniencing the public. ▪ If winning tickets could be redeemed only at the tax collector's main office, it would be a challenge to communicate the correct location to players. ▪ If winning tickets could be redeemed at all tax collector locations, it would be more costly to train personnel and equip all locations.
<p>Retailers pay all prizes under \$600, banks or grocery stores pay prizes between \$600 and \$5,000, and centrally pay prizes over \$5,000.</p> <p>Prize payments between \$600 and \$5,000 would be paid by check in banks or stores that contract with the Florida Lottery to payout prizes.¹ Winners would claim prizes worth less than \$600 at one of the Florida Lottery's retailers or mail their winning ticket into headquarters. Prize payments over \$5,000 would be processed through the mail or in person at headquarters.</p>	<ul style="list-style-type: none"> ▪ Retailers could more efficiently process claims under \$600 at 1% commission rates saving \$1.2 million. ▪ Banks or grocery stores may bid to process prize payments at less cost than the Florida Lottery. For example, the Ohio Lottery pays banks a \$10 transaction fee to process claims between \$600 and \$5,000. ▪ The Florida Lottery could more efficiently process claims over \$5,000 through a central location. ▪ Customer convenience could be improved as access to redemption centers would likely increase. 	<ul style="list-style-type: none"> ▪ Banks or grocery stores may not be interested in processing prize payments between \$600 and \$5,000, as it would require maintaining knowledgeable clerks at participating locations to check for state owed debt. ▪ Federal law precludes banks from handling gambling matters. Winner would have to have ticket validated and converted to a non-gambling tender by a retailer before a bank could pay the prize. ▪ First year savings may be less depending on computer systems and other infrastructure necessary for banks or grocery stores to assume prize payment function and the actual negotiated compensation.

¹ The Florida Lottery tried to reduce cost and increase customer convenience in 2000 by issuing a Request For Proposal for prize payment cashing services for winning lottery tickets in the range of \$600 to \$5,000 from "qualified public depositories" (i.e., banks). However, no bank responded for a variety of reasons, including that it was only in exchange for advertising, required to be in at least three branches in each district, and the potential disruption caused by lottery customers who could not collect their winnings for a variety of reasons.

Source: OPPAGA analysis of interviews with tax collectors, Florida Lottery officials, and department data.

Outsourcing functions could reduce costs

The Florida Lottery has outsourced the majority of its functions, but it needs to track costs better to demonstrate that the decisions it makes to outsource are efficient and effective. While the Florida Lottery is highly privatized, there exists potential to outsource some of the Lottery's functions currently performed in-house.

At the time of this report, the Florida Lottery was in the process of outsourcing many of its personnel functions. The Florida Lottery is part of the Department of Management Services (DMS) project to outsource many of the State of Florida's human resource, payroll, and benefit services pending review and approval by the Legislature. The Florida Lottery is expected to transfer 15 positions and \$728,093 of its personnel budget to the DMS personnel outsourcing project.

Outsourcing field support operations could potentially reduce administrative costs

The Florida Lottery could potentially reduce administrative expenses if it outsourced its field support operations.⁵⁴ The Florida Lottery's field support operation constitutes the largest portion of in-house costs (i.e., 161 positions and \$9,405,000).⁵⁵ Other states, such as Delaware, Nebraska, Texas, and West Virginia already outsource their field support function. The Florida Lottery's inspector general estimates that outsourcing field support operations could save up to \$1.1 million annually based on an informal request for information issued to get cost information.

Vendors offer and several states have contracts with the private sector for other services currently performed in-house by the Florida Lottery such as financial accounting services, product development, and software development. The Florida Lottery should evaluate the cost benefit of outsourcing functions it currently performs using in-house staff. As a generally accepted good business practice, the Florida Lottery should periodically evaluate the potential of outsourcing functions further to save costs.

Before outsourcing functions, employees should be allowed to compete

When deciding whether to outsource, state workers should be allowed to bid to perform the services. Agencies placed in competitive situations frequently improved performance and were able to underbid vendors. The Governor's "Guidelines for Introducing Competition into Government Services" indicates that current state workers should be able to bid for services. An agency may request bids from private providers and allow state employees to bid on any service they currently provide. Guidelines suggest the effectiveness, quality, timeliness, and thoroughness of private provider delivery must match or exceed an agency's delivery at the same or less cost.

⁵⁴ Field support operations deliver point-of-sale information to retailers, process end of games, communicate upcoming changes to retailers, ensure retailer compliance with contract, and coordinate corporate account information.

⁵⁵ During 2000-01, functions performed in-house accounted for 17% (\$41,167,550 of \$248,855,000) of the Florida Lottery's operating budget.

The Florida Lottery's Administrative Costs Could Be Further Reduced

Improved data would allow for periodic evaluation of outsourcing

The Florida Lottery needs to better maintain information to demonstrate whether its decisions to outsource have been cost-effective.⁵⁶ Within the last several years, the Florida Lottery outsourced several functions including telemarketing and scratch-off ticket distribution. However, due to lack of comparable data over time, the Florida Lottery does not know whether these functions are performed cost-effectively by the private sector.⁵⁷ The Florida Lottery cannot demonstrate whether it received the cost savings expected by outsourcing these functions because comparable unit cost information was not maintained before and after outsourcing these functions. However, Lottery officials indicate that retailers are furnished scratch-off tickets more timely through the direct shipment of tickets from the manufacturer.

Outsourcing is often proposed as a way to improve government functions. Proponents claim that outsourcing can cut government fat, increase employee productivity, and save tax dollars. However, concerns have also been raised that outsourcing government functions can cost more than it saves, can lead to the loss of public control over government services, and may reduce service quality. It is important that the Florida Lottery sufficiently prepare before outsourcing its functions. The Lottery should develop clearly defined tasks to be done, good unit cost data for comparison, and good quality and quantity measures to monitor service delivery.⁵⁸

Options to reduce facility costs

The Florida Lottery has reduced its need for office and warehouse space through substantial staff reductions and outsourcing, but has not commensurately reduced the amount of space it leases. We estimate the Florida Lottery leases approximately \$872,000 more office space than it needs in its headquarters and district office locations annually.

The Florida Lottery pays \$3.3 million annually to lease office and warehouse space

The Florida Lottery spent \$3.3 million in 2000-01 to lease office and warehouse space for its headquarters and district offices. Of this amount, the Florida Lottery paid \$2,345,876, or \$14.88 per square feet of combined office and warehouse space, for its headquarters location. The Florida Lottery's headquarters is leased for a 10-year period with two 5-year extension options, last renewed for a 10-year period in 1998. The Florida Lottery leases 157,653 square feet of space including 129,042 square feet of office space and 28,611 square feet of conditioned warehouse space. The Florida Lottery also leases 70,144 square feet of district space in 11

⁵⁶ During 2000-01, the Florida Lottery contracted with private providers to supply 83% (\$207,698,450 of \$248,866,000) of its functions.

⁵⁷ OPPAGA found other privatization attempts have not always resulted in expected cost savings. For example, see *Bay and Moore Haven Private Prison contracts Renewed; Bay Costs Increase*, [Report No. 99-46](#), April 2000.

⁵⁸ See OPPAGA's reports *Assessing Privatization in State Agency Programs*, [Report No. 98-64](#), February 1999 and OPPAGA's website for further information on outsourcing and privatization at www.oppaga.state.fl.us/reports/privatization.html.

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locations across the state at a cost of \$946,612 annually (averaging \$13.50 per square foot).

Need for space has decreased over time without a reduction in amount leased

The Florida Lottery's need for space has decreased since its inception as it has reduced its staff by 42% and outsourced warehouse, delivery, and telemarketing functions. As shown in Exhibit 35, the Florida Lottery made the largest reduction in district staff (50%) between 1989-99 and 2001-02. However, the amount of leased space has remained relatively constant.

Exhibit 35

The Florida Lottery Reduced Its Staff by 42% Since 1989-99

Number of Staff	FY 1989-99	FY 2001-02	Percentage Reduced
Headquarters	505	326	35%
District Offices	378	187	50%
Total	<u>883</u>	<u>513</u>	42%

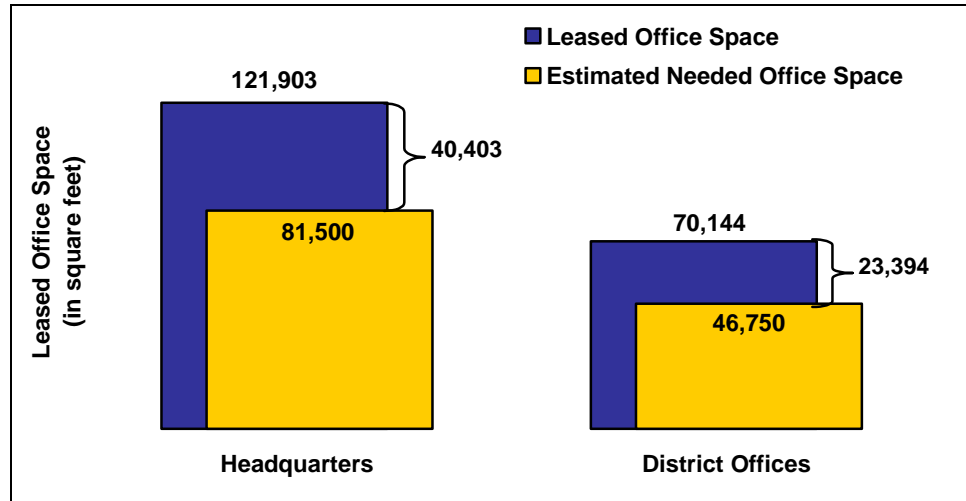
Source: OPPAGA analysis of Florida Lottery data.

Using the Department of Management Services estimated square footage allowance per FTE of 250 square feet, the Florida Lottery should need, at the most, 81,500 square feet of office space in its Tallahassee headquarters location and 46,750 square feet in its district offices.⁵⁹ As shown in Exhibit 36, the Florida Lottery leases 121,903 square feet of headquarters office space (i.e., 129,042 less 7,139 square feet sublet to vendors), 40,403 square feet more than necessary, partially due to an inefficient building design at a cost of \$601,197 per year. Design inefficiencies would likely be cost-prohibitive to correct over sized hallways and stairwells. In addition, the Florida Lottery leases 70,144 square feet of district office space, 23,394 square feet more space than necessary, at a cost of \$315,819 per year.

⁵⁹ Square foot allowance of 250 square feet per FTE/OPS is based on job functions that are primarily administrative and performed in the office and includes circulation space, and a portion of the space used for common conference rooms, mail rooms, break rooms, corridors, file storage, etc. The allowance represents the maximum allocation, not the individual office size. Typically, job functions performed both in the office and the field are allocated 175 square feet and support staff are allocated 90 square feet. However, for this analysis, 250 square feet was used for all positions in the Florida Lottery, as the department was unable to categorize its staff by job function so the actual needed space could be less.

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Exhibit 36
The Florida Lottery Leases About 64,000 Square Feet More than Necessary



Source: OPPAGA analysis of Florida Lottery data.

To help reduce the costs associated with leasing space, we have identified several options to consider. However, the Florida Lottery's options to lease an appropriate amount of space for its operations or make more efficient use of its current leased space are limited. Moving the Florida Lottery's headquarters to an alternative location would be cost prohibitive as the move would cost at least \$5 million and breaking the current lease to move to another privately owned site would make the Lottery liable for damages.⁶⁰ Options that make more efficient use of space it currently leases have the greatest potential to be cost-effectively implemented. Exhibit 37 lists options and their associated advantages and disadvantages to help the Florida Lottery's maximize the use of leased space.

⁶⁰ Damages would be contingent on the landowner's ability to mitigate financial losses due to acquiring a new tenant.

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Exhibit 37
Options to Reduce Facility Costs

Option	Advantages	Disadvantages
Move Tallahassee district office into the headquarters location.	<ul style="list-style-type: none"> ▪ The Lottery could more efficiently use headquarters leased space. ▪ The Lottery could save up to \$73,000 on lease and utilities paid for Tallahassee District Office annually. However, moving costs would offset first year savings. 	<ul style="list-style-type: none"> ▪ Lottery managers report headquarters location is not strategically located for district operations. ▪ Traffic flow between employees and customers could be disruptive.
Consolidate district offices. For example, close Fort Lauderdale district office and re-direct customers and staff to the West Palm Beach and Miami district offices.	<ul style="list-style-type: none"> ▪ The Lottery could more efficiently use district office leased space. ▪ The Lottery could save up to \$105,000 on lease and utilities paid for Fort Lauderdale district office. ▪ Fort Lauderdale district office staff could occupy space previously occupied by telemarketing staff outsourced from West Palm Beach and Miami district offices. 	<ul style="list-style-type: none"> ▪ Customer convenience could be hindered by increased driving time to district offices to redeem winning tickets. ▪ District field support staff would have longer drive time to and from district offices.
Sublet portion of headquarters space to other suitable state agency.	<ul style="list-style-type: none"> ▪ Other state agencies located in Tallahassee typically are in need of space, ranging in September 2001 from 6,000 to 88,000 square feet. ▪ For example, the Department of Revenue needed 12,558 square feet for its child support enforcement function, which if co-located within the Florida Lottery headquarters could reduce the Florida Lottery's lease payments by \$186,863 annually. 	<ul style="list-style-type: none"> ▪ Security distinguishing between Florida Lottery and other state agency personnel would need to be established to limit access to the Florida Lottery by unauthorized persons.

Source: OPPAGA analysis of Department of Management Services data, Florida Lottery data, and interviews with Florida Lottery officials.

Conclusions and recommendations

The Florida Lottery has recently made substantial changes to its organizational structure and processes to significantly reduce its administrative expenses and improve its performance. However, there are still opportunities to reduce its administrative expenses further while maintaining or improving the quality of its services.

The Florida Lottery contracts for the majority of its functions, but it bears substantial costs associated with procuring services due to bid protests largely beyond the Lottery's control to avoid within its current policies and procedures. To minimize the occurrence of bid protests on future Lottery procurements, we recommend that the Legislature consider the following options:

- raise bond requirements to file bid protests;
- limit the scope of bid protests; and
- provide a new bid protest process for the Florida Lottery.

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The Florida Lottery incurs high costs to redeem winning tickets relative to the volume of transactions processed at 11 district offices. The vast majority of the tickets redeemed at district offices are for prize worth less than \$600 that could otherwise be redeemed at one of over 11,000 retailers across the state who sells similar tickets. To reduce administrative expenses associated with paying out prizes, we recommend that the Florida Lottery discontinue redeeming prizes at its district offices. Instead, the Florida Lottery should direct all winners of prizes worth less than \$600 to retailer locations to redeem their winning tickets. For prizes in excess of \$600, the Lottery should either centralize this activity or assess whether third parties could process these claims at less cost. Based on available data, implementing these recommendations could save approximately \$1.6 million annually in administrative costs.

The Florida Lottery performs several functions in-house that have the potential to be cost-effectively outsourced such as its field support operations at an annual savings of approximately \$1.1 million. In conjunction with considering discontinuing its prize payout function at its district offices, we recommend that the Florida Lottery consider outsourcing the remaining field support operation while allowing current state workers to bid against vendors to maintain these functions in-house. Further, the Florida Lottery should maintain comparable data and periodically re-evaluate the functions it outsources to determine whether outsourcing continues to be cost-effective. The Florida Lottery should also periodically evaluate the potential to outsource functions performed in-house.

The Florida Lottery substantially reduced its need for office and warehouse space through substantial staff reductions and outsourcing, but has not commensurately reduced the amount of space it leases. Depending on decisions made regarding whether to continue its district operations as currently performed, we recommend that the Florida Lottery, at a minimum, make efficient use of the space it currently leases. The Florida Lottery should consolidate district offices such as its Fort Lauderdale office with West Palm Beach and Miami district offices and the Tallahassee district office should be relocated back to the headquarters location. The Florida Lottery should also lease no more space than necessary in the remaining district office locations. The Florida Lottery should also sublet extra space at its headquarters location to other suitable tenants.

Statutory Requirements for Program Evaluation and Justification Review

Section 11.513, *Florida Statutes*, provides that OPPAGA program evaluation and justification reviews shall address nine issue areas. Our conclusions on these issues as they relate to the Florida Lottery are summarized in Table A-1.

Table A-1
Summary of Program Evaluation and Justification Review
of the Florida Lottery

Issues	OPPAGA Conclusions
The identifiable cost of each program	The Florida Lottery is a fully self-funded government program. From total ticket sales of \$2.275 billion in 2000-01, the department paid 49.6% in prizes, 39.5% to the Educational Enhancement Trust Fund, 5.5% in commissions to retailers, and 5.4% in administrative expenses. The department's budget decreased by \$11.8 million (8.5%) between 1999-00 and 2001-02.
The specific purpose of each program, as well as the specific public benefit derived therefrom	The purpose of the Florida Lottery is to generate substantial additional revenues for the state's educational programs through the sale of lottery products in a manner that is consonant with the dignity of the state and welfare of its citizens. Further, the Florida Lottery is to enable the people of the state to play the best lottery games available. Since its inception in 1987, the Florida Lottery has transferred over \$11 billion to the Educational Enhancement Trust Fund while paying out \$14 billion in prizes. Other benefits include \$126 million retailers received in commissions for 2000-01, totally \$1.557 billion since 1987. The Florida Lottery offers its players a large variety of on-line games such as Lotto, and scratch-off games such as Monopoly ranging in cost from \$1 to \$5. For more information, see pages 9-10.
Progress toward achieving the outputs and outcomes associated with each program	The Legislature has established outcome and output performance standards for the Lottery including those for total revenue, transfers to the Enhancement Trust Fund, and operating expenses as a percentage of total revenues. The Lottery has generally met or exceeded its legislative performance standards. For more information, see pages 18-22.
An explanation of circumstances contributing to the state agency's ability to achieve, not achieve, or exceed its projected outputs and outcomes, as defined in s. 216.011, <i>F.S.</i> , associated with each program	The Lottery has control over many aspects contributing to its performance as measured by sales. Some of the factors within the Lottery's control include the price of its games, the number of games available, the play styles of the games, and the marketing of its games. However, two important factors affecting the Lottery's performance are largely outside the department's control. First, prize payouts for scratch-off games are limited by the required transfer percentage and this directly affects sales. For more information, see pages 40-42. Second, sales for the Lotto game depend on rollovers that are inherently random. Since the rollovers can be estimated only as probabilities any given fiscal year can have too few rollovers to generate expected sales. Thus, for any given year, Lotto sales can be below (or even above) estimates because of the number of rollovers.

Appendix A

Issues	OPPAGA Conclusions
<p>Alternative courses of action that would result in administering the program more efficiently or effectively</p>	<p>There are several options to increase revenues.</p> <ul style="list-style-type: none"> ▪ The Lottery can offer new games such as video lottery terminals or keno. New games have the largest potential for generating revenue but some have high social costs and some options require statutory changes. For more information, see pages 35-37. ▪ The Lottery can transfer a higher percentage from on-line games so that it can offer higher payouts for scratch-off games. For more information see pages 40-48. ▪ The Legislature can modify the 38% transfer requirement to provide the Lottery with greater flexibility to increase prize payouts for scratch-off games. For more information, see pages 40-42. ▪ The Lottery could enhance some current games to expand their appeal and increase sales. However, these changes would likely generate only small increases in revenues. For more information, see pages 42-43. ▪ The Lottery could expand distribution options to make its games more readily available. For more information, see pages 43-45. <p>The Lottery also has several options to reduce administrative expenses that could then be used to boost prize payout amounts or directly increase transfers to the Educational Enhancement Trust Fund.</p> <p>To minimize the occurrence of bid protests on future Lottery procurements, we recommend that the Legislature consider the following options:</p> <ul style="list-style-type: none"> ▪ raising bond requirements to file bid protests; ▪ limiting the scope of bid protests; and ▪ providing a new bid protest process for the Florida Lottery. <p>For more information, see pages 50-52.</p> <p>To reduce administrative expenses associated with paying out prizes, we recommend the Florida Lottery discontinue redeeming prizes at its district offices. Instead, the Florida Lottery should direct all winners of prizes worth less than \$600 to retailer locations to redeem their winning tickets. For prizes in excess of \$600, the Lottery should either centralize this activity or assess whether third parties could process these claims at less cost. Based on available data, implementing these recommendations could save approximately \$1.6 million annually in administrative costs. For more information, see pages 52-54.</p> <p>The Florida Lottery performs several functions in-house that have the potential to be cost-effectively outsourced such as its field support operations at an annual savings of approximately \$1.1 million. In conjunction with considering discontinuing its prize payout function at its district offices, we recommend that the Florida Lottery consider outsourcing the remaining field support operation while allowing current state workers to bid against vendors to maintain these functions in-house. Further, the Florida Lottery should maintain comparable data and periodically re-evaluate the functions it outsources to determine whether outsourcing continues to be cost-effective. For more information, see pages 55-56.</p> <p>The Florida Lottery substantially reduced its need for office and warehouse space through substantial staff reductions and outsourcing, but has not commensurately reduced the amount of space it leases. Depending on decisions made regarding whether to continue its district operations as currently performed, we recommend that the Florida Lottery should at a minimum make efficient use of the space it currently leases. The Florida Lottery should consolidate district offices such as its Fort Lauderdale office with West Palm Beach and Miami district offices and the Tallahassee district office should be relocated back to the headquarters location. The Florida Lottery should also lease no more space than necessary in the remaining district office locations. The Florida Lottery should also sublet extra space at its headquarters location to other suitable tenants. For more information, see pages 56-59.</p>

Issues	OPPAGA Conclusions
The consequences of discontinuing such program	Abolishing the Florida lottery could reduce the state's available revenues by about \$900 million (2%) annually. If the Florida Lottery were abolished, the revenue loss would require the state to find other funds to continue programs such as the Bright Future Scholarships or discontinue those programs. The state would also need to find additional resources to pay debt service on bonds issued for school construction. For more information, see pages 9-10.
Determination as to public policy, which may include recommendations as to whether it would be sound public policy to continue or discontinue funding the program, either in whole or in part, in the existing manner	The Lottery is funded through the proceeds from sales. This is the appropriate funding mechanism for the Lottery and should be continued. For more information, see pages 5-7.
Whether the information reported pursuant to s. 216.031(5), <i>F.S.</i> , has relevance and utility for the evaluation of each program	The Legislature appropriately discontinued some performance measures and remaining measures are reasonable. The performance measures are largely based on audited financial statement data. For more information, see pages 17-22.
Whether state agency management has established control systems sufficient to ensure that performance data are maintained and supported by state agency records and accurately presented in state agency performance reports	The Florida Lottery is subject to an annual financial audit by an independent certified public accountant. The accountants' report indicates the Florida Lottery's financial statements present fairly, in all material respects, the financial position of the Lottery. The accountants reported that the Lottery maintained an effective internal control system over financial reporting. For more information, see pages 17-18.

Source: Developed by OPPAGA.

Methodology

Appendix B contains the four sections listed below.

- Section B-1: Methodology used to calculate adjusted rank comparing state lottery performance for the 1999-00 fiscal year.
- Section B-2: Methodology used to estimate potential revenues associated with new game options.
- Section B-3: Methodology used to analyze scratch-off prize payouts and modification to the 38% minimum transfer requirement.
- Section B-4: Methodology used to calculate prize redemption costs and estimated savings associated with having retailers redeem all prizes under \$600 and centralizing the remaining prize payment function.

Section B-1: Methodology used to calculate adjusted rank comparing state lottery performance for 1999-00

To provide an accurate comparison of Florida's Lottery with all lotteries in the nation, we created a statistical model to account for performance related factors beyond the lotteries' control. State lotteries are limited to marketing and selling within their individual states. As a result, even effectively managed lotteries may perform poorly because of the unique conditions of that state.

We began with the rankings for each state on four performance measures. We ranked each state based on its actual performance to produce the unadjusted ranks shown in Table B-1. After calculating the rank for each separate performance measure the 4 ranks were added together to produce the total rank points. We then ranked states by their total points with lower scores being better. Table B-1 shows the unadjusted ranks for all four performance measures along with the total rank points and overall unadjusted rank.

Table B-1
State Rankings for Each Performance Measure Prior to Statistical Adjustment

State	Rank for Each Performance Measure				Total Rank Points	Overall Unadjusted Rank
	Total Transfers	Transfers as Percentage of Revenues	Expenses as Percentage of Total Transfers	Total Transfers Per Capita	Sum of All Four Ranks	
New Jersey	5	5	1	7	18	1
Florida	2	2	4	14	22	2
Pennsylvania	7	3	2	15	27	3
New York	1	6	12	12	31	4
Maryland	12	9	3	10	34	5
Illinois	11	7	5	19	42	6
Georgia	6	15	14	8	43	7
Massachusetts	4	29	8	3	44	8
Wisconsin	17	4	6	21	48	9
California	3	10	9	27	49	10
Connecticut	15	16	7	11	49	10
Michigan	9	11	16	13	49	10
Virginia	13	12	10	18	53	13
District of Columbia	16	1	36	5	58	14
Ohio	10	21	13	16	60	15
Delaware	28	13	19	1	61	16
Louisiana	24	8	15	28	75	17
Missouri	20	17	18	25	80	18
Texas	8	25	24	23	80	18
Kentucky	19	22	21	20	82	20
Indiana	18	20	20	26	84	21
Oregon	14	37	27	6	84	21
Rhode Island	21	35	30	2	88	23
Nebraska	29	14	11	37	91	24
South Dakota	23	34	34	4	95	25
Vermont	35	24	17	22	98	26
Arizona	27	19	22	33	101	27
Kansas	31	18	23	29	101	27
Maine	33	23	25	24	105	29
Colorado	25	27	26	30	108	30
West Virginia	30	36	35	9	110	31
New Hampshire	37	28	33	17	115	32
Minnesota	26	31	29	31	117	33
Iowa	32	26	28	32	118	34
New Mexico	34	30	32	35	131	35
Idaho	36	32	31	34	133	36
Washington	22	38	38	36	134	37
Montana	38	33	37	38	146	38

Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

We then adjusted the rankings for two performance measures to take into account, or control for, several factors that would affect a lottery's performance, but are outside their control. These factors are described below.

- **Per capita income.** When people have higher incomes, they have more discretionary money for things like lottery games.
- **Playing age population.** Larger states have more potential buyers.
- **Percentage of population in prime playing age.** While anyone age 18 or older can purchase lottery tickets, people aged 25 to 65 are the prime target audience for lotteries. Having a higher percentage of the population in this playing age will tend to increase sales.
- **Age of the lottery.** Lotteries tend to grow most quickly in their first few years of existence, while older lotteries sometimes stagnate.

We then used these four variables to predict the performance of each state's lottery.⁶¹ That is, we used ordinary least squares regression equations with these four independent variables to predict each lottery's performance two of the four dependent variables. We selected those performance measures most subject to the influence of state size and wealth; in this case, total transfers to the state and total expenses as a percentage of total transfers.⁶²

After predicting each state's performance we used the difference between actual and predicted performance to re-rank each state. More technically, we used the four independent variables listed above to predict each state's performance two selected dependent variables. We saved the residuals (the difference between actual and predict performance) and ranked each state based on how far they have exceeded their predicted performance. This helps adjust for factors such as size that can bias normal performance rankings. For example, a small state will typically have smaller transfers than a larger state.

Our statistical adjustment allows a state whose total transfers far exceed their predicted transfers to rank higher than a state that has larger transfers but whose performance is may also be above predicted but by a smaller amount. For example, Florida's Lottery transferred more money to the state than did Georgia's (\$908 million vs. \$682 million). But Georgia's population is about one-half of Florida's and its predicted transfers are also smaller (\$258 million vs. \$622). While both states exceeded their predicted performance, Georgia did so by \$424 million while Florida transferred \$286 million more than predicted. Thus, although both states far exceeded their predicted transfers, Georgia ranks higher because its residual is higher.

This process was done with both total transfers and expenses as a percentage of total transfers. In both cases the ranks were calculated based on the residuals instead of actual performance. Once that was done, the two

⁶¹ One potential variable, tourism, clearly has a strong theoretical effect on sales (more tourists will produce more sales) but there is no available data for tourism across all 38 lottery states.

⁶² While Chapter 3 reports the separate rankings for administrative expenses and commissions, only total expenses were used to rank the lotteries. This ensures that expenses are not given more weight than the other measures.

unadjusted and two adjusted ranks were added together and the overall rank determined. Table B-2 shows the rankings after adjusting the ranks.

Table B-2
Statistically Adjusted State Rankings for Each Performance Measure

State	Rank for Each Performance Measure				Total Rank Points	Overall Adjusted Rank
	Total Transfers (Adjusted)	Transfers as Percentage of Revenues (Unadjusted)	Expenses as Percentage of Total Transfers (Adjusted)	Total Transfers Per Capita (Unadjusted)	Sum of All Four Ranks	
Florida	4	2	6	14	26	1
Georgia	1	15	5	8	29	2
New Jersey	5	5	15	7	32	3
Pennsylvania	10	3	7	15	35	4
Maryland	17	9	12	10	48	5
Wisconsin	21	4	2	21	48	5
New York	2	6	31	12	51	7
District of Columbia	12	1	35	5	53	8
Louisiana	16	8	1	28	53	8
Michigan	11	11	19	13	54	10
Massachusetts	3	29	20	3	55	11
Kentucky	15	22	3	20	60	12
Virginia	18	12	13	18	61	13
Ohio	13	21	16	16	66	14
Delaware	29	13	24	1	67	15
Illinois	27	7	14	19	67	15
South Dakota	7	34	28	4	73	17
Missouri	24	17	8	25	74	18
Oregon	6	37	25	6	74	18
Indiana	23	20	9	26	78	20
Kansas	22	18	10	29	79	21
Connecticut	32	16	21	11	80	22
Vermont	30	24	4	22	80	22
Rhode Island	20	35	30	2	87	24
New Mexico	8	30	23	35	96	25
Arizona	34	19	11	33	97	26
Maine	33	23	18	24	98	27
Texas	26	25	29	23	103	28
Iowa	25	26	22	32	105	29
Nebraska	37	14	17	37	105	29
Idaho	14	32	26	34	106	31
New Hampshire	28	28	33	17	106	31
California	38	10	34	27	109	33
West Virginia	36	36	36	9	117	34
Colorado	35	27	27	30	119	35
Washington	9	38	38	36	121	36
Minnesota	31	31	32	31	125	37
Montana	19	33	37	38	127	38

Source: OPPAGA analysis of data from *La Fleur's 2001 World Lottery Almanac*.

Section B-2: Methodology used to estimate potential revenues associated with new game options

We developed revenue estimates for six game options: video lottery terminals, keno, multi-state games, super-jackpot games, pulltabs, and CD-Rom based games. We caution that all revenue estimates are subject to changing economic conditions, the limitations and effective date set by the authorizing legislation, the status of any ongoing litigation, and the implementation by the Florida Lottery. For example, these estimates are based on projected sales for the entire 2002-03 fiscal year as if the game had been fully implemented. Moreover, video lotteries and keno estimates would be strongly affected by the number and type of locations permitted to offer these games. Estimated revenues could be lower than expected if multiple games were introduced around the same time. Finally, these estimates are based on sales from other states in 2000-01, prior to the September 11 terrorist attack.

To develop the revenue estimates, we used a methodology provided by the Florida Legislature's Office of Economic and Demographic Research. The basic methodology uses the per capita sales from other state lotteries (and in one case Quebec) to estimate the potential per capita sales for Florida. We then multiply the per capita sales by the state's projected population to yield the estimated total sales for Florida. The transfer to education is 38% of the estimated total sales. Since some sales from each new game would reduce sales for existing games, we also subtract out the estimated revenue loss from other games (cannibalization). This process is outlined in the following equation:

- Revenue = [(Sales Per Capita X Population) X transfer rate] – Cannibalization; where
- Sales per capita = estimated sales based on other states that have the given game;
- Population = the population projected for 2002-03;
- Transfer rate = the required 38% transfer percentage in state law; and
- Cannibalization = the estimated revenue for that game that comes from decreased sales and transfers for other lottery games.

Each game, however, has unique characteristics that affect the resulting revenue estimates. These are discussed in more detail in the methodology section for each game. In general, though, there are two key variations for each game.

First, the estimates for per capita sales have to be calculated differently for each game. In general, the average sales from peer states are likely to be the most reliable estimate of per capita sales. Unfortunately this cannot be done for most games. As a result, we used a variety of ways to calculate the per capita sales for each game. Whenever possible we tried to develop a range of likely sales though the exact process varies by game.

Second, the estimates for cannibalization rates will vary by type of game. The most accurate measure of cannibalization would be the experience of other states. We used this data for multi-state and super-jackpot games but do not have such data for the other four games. Instead, we estimated the cannibalization by looking at the type of game and its similarity to existing games. For multi-state, super-jackpot, pulltabs, and CD-Rom games we estimate a range of cannibalization to provide a more conservative overall estimate of potential revenue. Table B-3 summarizes the source of the sales and cannibalization estimates for each game.

Table B-3
Summary of Sources for Estimates of Sales Per Capita and Cannibalization

	VLTs	Keno	Multi-State	Super-Jackpot	Pulltabs	CD-Rom
Sales per capita						
Lowest per capita net machine all states	✓					
Mean per capita net machine other states	✓					
Average per capita non-peer keno states		✓				
Average per capita peer states offering the game		✓				
Median per capita all games			✓		✓	
Mean per capita all games			✓		✓	
New York's lowest per capita (no rollovers; first time offered)				✓		
New York's highest per capita (two rollovers; second time offered)				✓		
Quebec's sales per capita						✓
Cannibalization Rates						
Estimated by Office of Economic and Demographic Research (EDR)	✓	✓				
Include lost revenue from reduced pari-mutuel tax receipts	✓	✓				
Observed rates of states with multi-state games			✓			
Based on New York's per capita sales				✓		
Based on scratch-off EDR estimates with arbitrary 50%					✓	
Based on rates for similar non-CD-Rom games with arbitrary 50%						✓

Source: OPPAGA.

Individual game variations

The following section provides a description of the material assumptions used in generating its revenue estimates. Games are presented in potential revenue order.

Video lottery terminals

Video lottery terminals (VLTs) use computer terminals to simulate casino-style games such as poker, blackjack, keno, and bingo. Because of their similarity to casino games the authorization of VLTs would represent a significant change for the state and the Lottery. It would introduce significant casino-style play to the state though states typically confine VLTs to pari-mutuel facilities or establishments with liquor licenses such as bars and restaurants. This is important because the number of facilities

offering VLTs and the number of terminals at each facility will affect the revenues generated.

Per capita sales estimates. Video lottery terminals produce very high sales, but have very high payouts. As a result, it is not possible to transfer 38% of VLT sales to the state, as would be done with other lottery games. Instead, the state’s share comes from the net machine income, which is the income from all machines after excluding prizes. Lotteries must then use as part of the net machine income to pay retailer commissions and expenses. The net machine income after paying expenses and commissions represents the state’s “profit.” Typically expenses and commissions represent 63% of the net machine income so states receive about 37%. For our analysis, we estimated the potential net machine income based on the experience of other states and then calculated 38% of that as Florida’s share. From this we deducted cannibalization and produced the final revenue estimates.

The experience of other states is based on the net machine income reported in the *La Fleur’s 2001 World Lottery Almanac Interim Report*. We calculated the mean per capita net machine income for the four states with VLTs and used this as the high estimate.⁶³ We then used the lowest per capita net machine income (Oregon) to establish the low range.

Cannibalization Estimates. Cannibalization rates were originally estimated by the Florida Legislature’s Office of Economic and Demographic Research (EDR) and include lost revenue from declining sales for Lottery games as well as lost revenue from reduced tax receipts from pari-mutuel games. Table B-4 provides a summary of the sales and cannibalization estimates used in our analysis.

Table B-4
Material Assumptions for Video Lottery Terminal Revenue Estimates

Sales Range	
Lowest per capita net machine among all video lottery states	\$135.09
Mean per capita net machine income for other video lottery states	\$213.80
Estimated Cannibalization	Lottery games – 25% Pari-mutuels – 10%
Revenue Range (millions)	\$640.5M- \$1,013.8M

Source: OPPAGA analysis using data from *La Fleur’s 2001 World Lottery Almanac Interim Report* and methodology from the Office of Economic and Demographic Research.

⁶³ The mean per capita sales average is lower than the median average. Delaware was excluded because its data is reported differently.

New York has recently authorized its Lottery to place VLTs at five race tracks with options for additional tracks. New York's lottery has estimated it will receive \$265 million in transfers during its first full fiscal year. This estimate is much lower than would be expected given the sales of other states and appears to be based on New York planning only 632 terminals per one million residents. Rhode Island currently has the smallest ratio of terminals to people, 1,550 per million while Montana has the most with 21,633 terminals per million people.

Keno

As with video lotteries, keno can also be played on a computer terminal, but the terminal is limited to a single type of game, keno. Often keno is played in a social setting such as a bar or restaurant. Moreover, we should note that the number of establishments offering keno will affect the revenues generated.

Per capita sales estimates. More state lotteries offer keno than video lotteries. This permitted us to compare sales per capita for Florida's peer states and for non-peer states.⁶⁴ We used the peer state sales mean for the high-range estimates and the mean for non-peer states for the low sales estimate.

Cannibalization Estimates. As with video lotteries, cannibalization estimates are based on EDR's estimates and include lost revenue from declining sales for Lottery games as well as lost revenue from a decline in tax receipts from pari-mutuel games. Table B-5 summarizes the main information regarding the revenue estimates for keno.

Table B-5
Material Assumptions for Keno Revenue Estimates

Sales Range	
Average per capita sales among non-peer states offering keno	\$24.21
Average per capita sales among peer states offering keno	\$32.81
Estimated Cannibalization	Lottery games – 10% Pari-mutuels – 8.65%
Revenue Range (millions)	\$138.0M - \$192.9M

Source: OPPAGA analysis using data from *La Fleur's 2001 World Lottery Almanac* and methodology from the Office of Economic and Demographic Research.

Multi-state lotteries

Multi-state lotteries, such as PowerBall, allow people from several states to purchase tickets for a Lotto-style game. The odds are longer than for Lotto, about 1 in 80 million as compared to 1 in 23 million for Florida's Lotto. However, this often results in more rollovers and larger jackpots.

⁶⁴ Peer states for this analysis include California, Georgia, Maryland, Massachusetts, Michigan, and New York. Other peer states such as Texas or Illinois do not offer keno.

Per capita sales estimates. Currently few large states participate in multi-state lotteries. As a result, few Florida peers participate in a multi-state drawing. Instead, we used the mean per capita sales for all states to establish our high range and the median per capita sales for the low range.

Cannibalization estimates. Cannibalization rates are based on the experience of states that have joined multi-state games with the low rate equal to the lowest observed cannibalization and the high rate equal to the highest observed effect. However, even after deducting for cannibalization, a multi-state game in Florida would still generate additional revenues. Table B-6 summarizes the main information regarding the revenue estimates for multi-state lotteries.

Table B-6
Material Assumptions for Multi-State Lottery Estimates

Sales Range	
Median per capita sales among all multi-state games	\$16.22
Mean per capita sales among all multi-state games	\$18.76
Estimated Cannibalization	60% – 70%
Revenue Range (millions)	\$31.41M - \$48.1M

Source: OPPAGA analysis using data from *La Fleur's 2001 World Lottery Almanac* and methodology from the Office of Economic and Demographic Research.

Super-jackpot games

In 1999 and 2000 New York offered two single-drawing super-jackpot games. Played like Lotto but with just a single drawing, New York's Millennium Millions offered initial jackpots of \$62 million and \$90 million. However, in 2000 the jackpot rolled over twice, raising the final jackpot to \$132 million.

Per capita sales estimates. Both sales and cannibalization rates were based on New York's experience. New York's sales varied from the first game to the second, in part because of the rollover. We used the per capita sales from the first drawing to establish our low-range and the sales from the second drawing for our high range.

Cannibalization estimates. The New York lottery used two different methods to estimate its cannibalization, each yielding different results. We used both of them to establish a high and a low range. Table B-7 provides basic information regarding New York's experience with its Millennium Millions.

Table B-7
Material Assumptions for Super-Jackpot Games

Sales Range	
New York's lowest per capita sales (no roll-overs and first time offered)	\$3.29
New York's highest per capita sales (two roll-overs, second offering)	\$6.46
New York's estimated cannibalization	3% – 6%
Revenue Range (millions)	\$19.72M – \$40.21M

Source: OPPAGA analysis using data from the New York state lottery and methodology from the Office of Economic and Demographic Research.

Pulltabs

Pulltabs are offered in at least 10 states. Pulltabs allow players to open tickets instead of scratching off a covering as with traditional tickets.

Per capita sales estimates. As with multi-state games, few of Florida peers offer pulltabs, so we use the average (mean) per capita sales nationwide as our sales estimate. To ensure a conservative estimate, we also use the median per capita sales to provide a low-range for sales.

Cannibalization estimates. Cannibalization estimates are based on the similarity between pulltabs and scratch-offs. Because both are similar we use a relatively high cannibalization rate of 50%. We converted this estimate to a range to reflect the potential uncertainty of the estimate. Table B-8 provides a summary of these estimates.

Table B-8
Material Assumptions for Pulltab Estimates

Sales Range	
Median per capita sales among all states offering pulltabs	\$0.94
Mean per capita sales among all states offering pulltabs	\$2.62
Estimated Cannibalization	40% - 60%
Revenue Range (millions)	\$2.42M - \$10.06M

Source: OPPAGA analysis using data from *La Fleur's 2001 World Lottery Almanac Interim Report* and methodology from the Office of Economic and Demographic Research.

CD-Rom games

CD-Rom games are similar to scratch-off games except that rather than scratch-off a covering the game is played on a computer. Players purchase tickets that reveal potential prizes in the computer game.

Per capita sales estimates. Per capita sales for CD-Rom games were based on the experience of Lotto-Quebec, the only lottery we identified offering CD-Rom based games. To date, Lotto-Quebec has offered four CD-Rom based games.

Cannibalization estimates. The estimate for cannibalization was made by reviewing similar games and using their cannibalization rates. The rationale is that CD-Roms are variations of scratch-off tickets and so are

likely to substantially cannibalize scratch-off sales. In this case, we estimate a cannibalization rate of 50%, the same as used for Pulltabs. We converted this estimate to a range to reflect the potential uncertainty of the estimate. Table B-9 provides a summary of these estimates.

Table B-9
Material Assumptions for CD-Rom Games

Sales Range	
Quebec's sales per capita	\$1.51
Estimated cannibalization	40% - 60%
Revenue Range (millions)	\$3.88M - \$5.82M

Source: OPPAGA analysis using data from *La Fleur's 2001 World Lottery Almanac Interim Report* and methodology from the Office of Economic and Demographic Research.

Section B-3: Methodology used to analyze scratch-off prize payouts and modification to the 38% minimum transfer requirement

Prizes significantly affect sales for lottery games. Lotto sales, for example, rise as the jackpots rise. Similarly, scratch-off players respond in part to the amount of money returned in the form of prizes (the prize payout percentage).⁶⁵ When players have more winning experiences and win more money they tend to play more. This affects scratch-off games in two ways. First, players who win small prizes such as \$1 or \$5 will “churn” some of their winnings by purchasing more tickets for that game. Second, people will be more likely to buy tickets for the scratch-off games they perceive as paying the best. Thus, when Lotteries increase prize payouts for scratch-off games they typically increase sales.

Using unclaimed prizes to enhance scratch-off prize payouts

The Florida Lottery currently uses unclaimed prize money to increase payouts for scratch-off games. While it is logical that the unclaimed prizes increase sales, it is less obvious that they increase sales enough to offset the lost transfers for education. The question for the Legislature is which will produce more money for education: transferring unclaimed prizes to the educational enhancement trust fund or using the unclaimed prizes to enhance prize payouts?

Our analysis found that enhancing scratch-off prize payouts produces more money for education than transferring unclaimed prizes to education. In 2000-01, the Florida Lottery used \$46 million of unclaimed prizes to increase prize payouts for scratch-off games. We estimated the

⁶⁵ Note that while Lotto and scratch-off sales both respond to prizes, the mechanism is different. Lotto players tend to respond to the size of the jackpot while scratch-off players respond in part to percentage or amount of money distributed as prizes. Thus, payout percentages have smaller effects on Lotto and other on-line games than they do with scratch-off games.

effect of transferring that money directly to education using the following equation:

- [(Sales – (unclaimed prizes X sales modifier)) X transfer rate] + unclaimed prizes; where
- Sales = 2000-01 actual sales of \$639.21 million;
- Unclaimed Prizes = \$46.0 million;
- Sales modifier = the estimated increase in sales for each dollar added to prize payouts (\$4.67, see below); and
- Transfer rate = the required 38% transfer percentage.

We reviewed two different models for estimating the sales modifier.

- We reviewed the changes to Florida’s scratch-off payouts for the past five years. During this time each \$1 in prize payouts produced \$5.66 in sales and \$2.15 in transfers.
- We also used data collected by the Florida Lottery. The Florida Lottery used its actual scratch-off sales experiences to estimate the potential to increase sales by raising prize payouts. The Lottery’s data indicate that increasing the prize pool has a variable effect on sales, depending on the prize payout percentage. For example, increasing payouts from 50% to 51% generates about \$7.75 in sales for each \$1 invested in prizes. By contrast, increasing payouts from 69% to 70% produces \$3.24 in sales for each dollar invested. This produces a range of sales modifiers—from \$7.75 at the high end to \$3.24 at the low end. The median of that range is \$4.67, which equates to \$1.77 in transfers for each \$1 invested in prizes. To predict the change in sales we used the median value from the second model as the sales modifier.⁶⁶

We selected this modifier because it has high face validity and is a more conservative estimate than the one produced by our analysis. For example, the first analysis above predicts that raising the prize payouts produces \$5.66 in sales for each \$1 invested in prizes. The second approach predicts a change of somewhere between \$3.24 and \$7.75. However, the predicted change is larger when payouts are low. Since Florida uses unclaimed prizes to increase payouts from 50% to about 58% each \$1 invested would return between \$5.29 and \$7.75 in sales. But the median estimated change for the entire range (\$3.24 - \$7.75) is \$4.67, a more conservative estimate than either of the other estimates.

Table B-10 shows that, based on the median sales modifier, transferring unclaimed prizes directly to education would reduce total transfers to education by an estimated \$35.63 million.

⁶⁶ All revenue estimates based on this model are subject to change based on changing economic conditions and the Lottery’s implementation

Table B-10
Using Unclaimed Prize Money for Scratch-Off Prize Payouts
Increases Money for Education

	Prize Payouts Predicted Using Florida Lottery data
Change in sales and transfers for each \$1 in prizes	\$4.67 in sales \$1.77 in transfers
<i>If unclaimed prizes were directly appropriated to education...</i>	
Effect on Sales (millions)	<u>\$(214.82)M</u>
Effect on Transfers (millions)	<u>\$ (81.63)M</u>
Unclaimed transferred to Education	46.00 M
Net Effect on Transfers to Education (millions)	<u>\$(35.63)M</u>

Source: OPPAGA analysis of data from the Florida Lottery.

Modifying the 38% transfer requirement

The Lottery's authorizing legislation requires that the Lottery transfer at least 38% of sales to the Educational Enhancement Trust Fund. The rest of the money is used to fund prizes and expenses. We estimated that reducing the required transfer percentage for scratch-off games could enable the Lottery increase prize payouts and produce additional transfers to education

Without any enhancements to the prize pool the Lottery pays about 50% (\$320 million) of all sales in prizes. Since the actual sales for 2000-01 were \$639.21 million, increasing the payout percentage by 1% would require putting an additional 1% of sales, or \$6.39 million, in the prize pool. Similarly, to reach a prize payout percentage of 58% requires an additional 8% of sales (\$51.1 million). The Lottery now uses unclaimed prize money to enhance its prize payouts. However, the Lottery would need additional funds for prizes to increase the payout further.

Lowering the required transfer percentage for scratch-off games could provide funds to increase payouts. We estimated the effects reducing the required transfer in order to raise payouts and increase sales. The basic equation is:

- [(Sales + (prize enhancement X sales modifier)) X new transfer rate] – original transfers; where
- Sales = actual 2000-01 sales of \$639.21 million;
- Prize enhancement = [(original transfer rate – new transfer rate) X sales];
- Sales modifier = the predicted change in sales based on the data from the Florida Lottery;
- New transfer rate = the new percentage of sales that would be transferred to education; and

Original transfers = actual 2000-01 transfers of \$242.9 million.

The sales modifier is based on the Lottery's analysis of prize payouts (see model 2, above). The modifier decreases as the payout increases indicating that the marginal return for each \$1 in prizes decreases as the total prize pool increases. This makes intuitive sense—increasing the prize payout when it is already low will have a larger marginal effect than increasing the payout when it is high.

However, even though sales increase, the new transfer is based on the lower transfer rate. Thus, the question is whether the sales increase will offset the decline in the transfer rate. Table B-11 shows that it does; transfers increase until the transfer rate reaches 34% and then decline.

Reading Table B-11 left to right we see that if the scratch-off transfer rate is reduced to 34% it would produce \$25.57 million for prize enhancement. Based on a sales modifier of 4.37, this produces \$111.73 million in new sales. With 34% of this transferred the net gain for education is \$12.42 million. In short, by reducing the required transfer for scratch-off games percentage to 34% and using this money to increase prizes, transfers in 2000-01 would have increased by \$12.42 million.⁶⁷ Beyond that point, the increase in sales does not offset the decrease in the transfer rate.

Table B-11
Decreasing the Required Transfer Percentage Increases Money for Education

A	B	C	D	E	F	G	H
Transfer Rate	2000-01 Sales (millions)	Prize Enhancement (millions)	Sales Modifier	Change in Sales (millions)	New Sales Total (millions)	New Total Transfers (millions)	Change in 2000-01 Transfers (millions)
		$(38\% - A) \times B$	<i>FL Lottery Data</i>	$D \times C$	$B + E$	$F \times A$	$G - \$242.9$
42%	\$639.21	\$(25.57)	\$6.71	\$(171.54)	\$467.67	\$196.42	\$(46.48)
41%	639.21	(19.18)	6.29	(120.62)	518.59	212.62	(30.28)
40%	639.21	(12.78)	5.92	(75.68)	563.53	225.41	(17.49)
39%	639.21	(6.39)	5.59	(35.73)	603.48	235.36	(7.54)
38%	639.21	0.00	5.29	0.00	639.21	242.90	(0.00)
37%	639.21	6.39	5.02	32.09	671.30	248.38	5.48
36%	639.21	12.78	4.78	61.11	700.32	252.11	9.21
35%	639.21	19.18	4.57	87.64	726.85	254.40	11.50
34%	639.21	25.57	4.37	111.73	750.94	255.32	12.42
33%	639.21	31.96	4.18	133.59	772.80	255.03	12.13
32%	639.21	38.35	4.01	153.79	793.00	253.76	10.86
31%	639.21	44.74	3.86	172.71	811.92	251.70	8.80
30%	639.21	51.14	3.72	190.23	829.44	248.83	5.93
29%	639.21	57.53	3.58	205.95	845.16	245.10	2.20
28%	639.21	63.92	3.45	220.53	859.74	240.73	(2.17)
27%	639.21	70.31	3.34	234.85	874.06	236.00	(6.90)
26%	639.21	76.71	3.24	248.52	887.73	230.81	(12.09)

Source: OPPAGA analysis based on Florida Lottery data.

⁶⁷ While Table B-11 yields a 34% optimal level, different models predict different optimums.

Section B-4: Methodology used to calculate prize redemption cost estimates

Under this option, winners that would have claimed their prizes at a district office would claim their prizes worth less than \$600 at one of the Florida Lottery's retailers or mail their winning ticket into headquarters. Winner claim forms would be submitted by mail or in person to headquarters for winners to redeem prizes over \$600. To determine the fiscal impact of this option, we estimated Lottery staff, facilities, retailer commissions, and postage costs.

Staff Costs. The Florida Lottery identified 47 district staff who were assigned to the prize payment function costing \$1,626,060 in salaries and benefits and an estimated \$25,000 in travel and training for 2000-01. The Florida Lottery already processes claims through the mail at headquarters using first class postage on preprinted claim forms, typically for out-of-state winners and winners who have trouble claiming their prize at the retailer or district location. The Florida Lottery estimates that it could process all claims worth more than \$600 through the headquarters with the addition of seven staff costing approximately \$250,000, plus approximately \$4,000 annually for training and travel while maintaining the current level of service.

Facility Costs. The Florida Lottery estimates that 25% of its district facility costs are attributed to its prize redemption function. In 2000-01, 25% of its district facility and utility costs were \$259,560. To process more claims at its headquarters location, the Florida Lottery would not need additional space as it currently has excess capacity and would not incur additional utility costs. The remaining space leased at district offices would need to be reduced to achieve the estimated cost savings.

Retailer Commissions. Currently, the Florida Lottery pays retailers a 1% commission to redeem prizes worth less than \$600. During 2000-01, the Florida Lottery processed 80,933 claims worth less than \$600 at its district office locations that could have been processed at retailer locations. The 80,933 claims worth less than \$600 totaled \$1,097,071. The Lottery would have paid 1% of \$1,097,071 or \$10,971 had retailers processed these claims instead of the Lottery's district offices.

Postage Costs. Processing claims worth more than \$600 would cost approximately \$17,000 in first class postage to send and receive claims. That is, first class postage of \$0.34 each way for 25,353 claims processed in 2000-01 would cost about \$17,000.

Table B-12
The Florida Lottery Could Save About \$1.6 Million Annually Processing
All Claims Under \$600 Through Retailers and Centralizing Claims Over \$600

Categories	Estimated Current Costs	Estimated Costs to Process All Claims Under \$600 at Retailer Locations and Centralize Processing of Claims Over \$600	Estimated Cost Savings
Salaries and Benefits	\$1,626,060	\$250,000	\$1,376,060
Training and Travel	25,000	4,000	21,000
Facilities	259,560	57,000 ¹	202,560
Retailer Commissions	0	10,971	(10,971)
Postage	0	17,000	(17,000)
Total	\$1,910,620	\$338,971	\$1,571,649

¹ The Florida Lottery would not incur additional facility or utility costs to place seven additional staff in its headquarters location to centrally process prize payments. This figure represents an estimated cost reallocation figure for accounting purposes.

Source: OPPAGA analysis of Florida Lottery data.

Response from the Department of the Lottery

In accordance with the provisions of s. 11.51(5), *Florida Statutes*, a draft of our report was submitted to the Secretary of the Department of the Lottery for his review and response.

The Secretary's written response is reprinted herein beginning on page 81.



JEB BUSH
Governor

DAVID GRIFFIN
Secretary

FLORIDA LOTTERY

February 11, 2002

Mr. John W. Turcotte, Director
Office of Program Policy Analysis and
Government Accountability
111 West Madison Street, Room 112
Claude Pepper Building
Tallahassee, Florida 32399-1475

Dear Mr. Turcotte:

In response to your office's recent Justification Review of the Sale of Lottery Products Program, I would like to thank you and your staff for a thorough review and evaluation. I am pleased that your review recognizes the substantial revenues generated by the Lottery for education, as well as our concerted efforts to reduce our administrative costs and meet established performance standards. It is particularly gratifying to read that your office has ranked the Florida Lottery first among the 38 state lotteries in a combination of selected performance measures. In the remainder of this letter, I would like to address those recommendations that are directed to and within the control of the Florida Lottery.

Long-Range Planning

I concur with the recommendation to establish a long-range calendar for product additions and enhancements. The Lottery routinely uses a variety of research and planning tools to track the lifecycle of games and adjust the product lines as needed. Our Marketing Research staff devotes considerable time to understanding customer preferences for Lottery games, evaluating likely player responses to proposed game changes and estimating the sales and revenue impacts of these ideas. All adjustments and enhancements are carefully weighed against the Lottery's statutory mandate to maximize revenues in a manner consonant with the dignity of the state and the welfare of its citizens. An annual product and marketing plan is used to document planned research, product, and marketing strategies. In addition, the Product Development Division is currently developing a long-range product calendar that will identify game additions and enhancements to be researched, and possibly implemented, over the next five years. A full range of products, product enhancements, and distribution technologies will be considered for inclusion. The long-range calendar will be adjusted annually to incorporate market, legislative, and other significant changes.

Revenue Enhancements

The Lottery's long-range program plan, prepared in support of its fiscal year 2002-03 legislative budget request, identifies several business strategies that warrant further evaluation and consideration. Notable among these are increasing the prize payout for instant game tickets and additional (mid-day) draws for daily on-line games because they are specifically recommended in your review. Other strategies that we think warrant consideration include, among others, the development and marketing of break-open instant tickets and enhanced retailer commissions. This is by no means an exhaustive list. The Lottery will continue to evaluate strategies to identify those that we think will best maximize revenues in a manner that is consonant with the dignity of the state and the welfare of its citizens.



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Reduced Administrative Costs

The sale and redemption of tickets by district office staff is part of an overall strategy to put our customers first and foremost in everything we do. The district staff that sell tickets and redeem prizes also resolve customer complaints and respond to questions and requests for assistance. Although discontinuing the practice of redeeming prizes at district offices could further reduce our administrative costs, all operational decisions should, however, consider lowest cost in light of the value added by providing these customer services at the district level. In addition, there is a loyal segment of our customers that prefers to purchase and redeem tickets at district offices. Discontinuing the practice of selling tickets and redeeming prizes at district offices runs the risk of alienating this segment of our customer base, a risk that must be carefully weighed before any such decision is made.

Outsourcing Field Support Activities

Outsourcing is a proven method for reducing costs and, in many cases, providing better service. I concur with your recommendation to consider outsourcing field support activities. As acknowledged in your review, the Lottery has already conducted a preliminary analysis of the cost-effectiveness of outsourcing field support activities. The analysis suggests that these activities could in fact be outsourced at a savings to the State. Any proposed outsourcing would necessarily allow existing field support staff to submit a proposal.

Efficient Use of Space

I concur that reducing the size of the Lottery's work force by 30% has resulted in excess office and warehouse space. The Legislature has established stringent security requirements to ensure honest, secure and exemplary Lottery operations and to maintain a high level of public confidence in the Lottery. Because of the Lottery's stringent security requirements, I think it would be inappropriate to sublease any portion of the Lottery building to another entity; however, the possible consolidation of the Tallahassee district office and Lottery headquarters, as well as the possible consolidation of other district offices, are options that will be evaluated as the expiration dates for the current leases approach.

In closing, please commend your staff for a thorough and accurate justification review. We will monitor progress in implementing the recommendations contained in the review, consistent with the above. If you have any questions, please call me at 487- 7728.

Sincerely,

/s/
David Griffin
Secretary

DG/nd