



Lottery Faces Challenges Meeting Future Revenue Demands, Continues Work to Improve Efficiency

at a glance

The Florida Lottery is among the highest performing state lotteries, ranking first on two indices of performance measures. However, its revenue growth is flattening out, while programs funded by the Lottery are growing. These trends are exacerbated by developments in other gambling industries, and the Lottery faces substantial challenges to maintaining revenue growth. The Lottery has numerous options to create new or enhanced games as well as improve its market penetration and marketing efforts, and it is pursuing some of these options.

The Lottery should continue taking steps to reduce its lease of excess office and warehouse space. Subletting excess warehouse space at its headquarters location has the potential to save \$300,000 annually, while subletting excess office space could save up to \$700,000 annually.

The Lottery should work with the Center for Efficient Government to continue to develop its business case proposal to competitively source its field support operations, and it should consider other in-house functions for competitive sourcing. Currently, the Lottery is recommending a new competitive bid that would prolong its evaluation beyond the 2005-06 fiscal year.

Scope

The Joint Legislative Auditing Committee contracted jointly with OPPAGA and the Auditor General to conduct the annual audit of the

Department of Lottery. In accordance with the contract, this report develops recommendations to enhance the earning capability of the state lottery and to improve the efficiency of department operations. The report also tracks the department's implementation of prior OPPAGA recommendations and recent legislative proviso, and it updates and expands our previous analyses of revenue-enhancement and operational efficiency options.¹

Overall Performance

Lottery is top performer. The Florida Lottery is successful in carrying out its mission of raising funds for education. In Fiscal Year 2003-04, the Florida Lottery transferred \$1.05 billion to the Educational Enhancement Trust Fund. Our analysis showed that the Lottery ranked highest among U.S. lotteries in performance based on four key measures—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. Exhibit 1 shows both each state's overall ranking as well as adjusted rankings that statistically account for factors

¹ *Progress Report: Florida Lottery Makes Progress by Implementing Many Justification Review Recommendations*, OPPAGA Report No. [04-01](#), January 2004; *Justification Review: Sale of Lottery Products Program*, OPPAGA Report No. [02-11](#), February 2002.

beyond lotteries’ control.² By both measures, Florida ranked highest among the states.³

**Exhibit 1
The Florida Lottery Outperformed All Other State Lotteries in 2003 Based on Key Measures**

State	Unadjusted Rank	State	Statistically Adjusted Rank
Florida	1	Florida	1
New York	1	New Jersey	2
California	3	Georgia	3
Pennsylvania	4	S. Carolina	4
Delaware	5	Pennsylvania	5
Georgia	5	Maryland	6
Michigan	5	New York	7
New Jersey	8	Ohio	8
Ohio	9	Virginia	9
Maryland	10	Kentucky	9
Illinois	11	Louisiana	11
Virginia	12	Massachusetts	12
Louisiana	13	Michigan	13
S. Carolina	13	Kansas	14
Texas	13	Missouri	15
Kentucky	16	Wisconsin	16
Connecticut	17	Texas	17
Massachusetts	18	Connecticut	17
Wisconsin	18	Delaware	19
Kansas	20	Illinois	20
Missouri	20	Nebraska	21
Indiana	22	R. Island	21
Nebraska	22	Indiana	23
Colorado	24	New Mexico	24
Arizona	25	California	25
W. Virginia	26	Arizona	26
Maine	27	Maine	26
Iowa	28	Idaho	28
Minnesota	29	D.C.	28
New Mexico	30	Washington	28
N. Hampshire	31	N. Hampshire	31
Idaho	32	Colorado	32
Vermont	33	W. Virginia	32
Montana	34	Iowa	34
R. Island	34	Vermont	35
D.C.	36	Montana	36
Oregon	37	S. Dakota	37
Washington	38	Minnesota	38
S. Dakota	39	Oregon	39

Source: OPPAGA analysis of La Fleur’s, U.S. Census Bureau, and National Association of State and Provincial Lotteries data.

² The factors outside lotteries’ control for which we adjusted were per-capita income, playing age population, percentage of population in prime playing age, and age of the lottery. Using regression analysis, we used the difference between actual and predicted values for the above factors to adjust two of the four lottery performance measures.

³ In our 2002 review of the Lottery, Florida’s adjusted and unadjusted rankings were first and second, respectively.

Lottery has taken steps to improve performance. The Lottery has taken steps in recent years to reduce its administrative costs and improve its business operations. OPPAGA reviewed the Lottery in 2002 and 2004. In response to our recommendations, the Lottery has

- improved its long-range planning;
- consolidated three district offices, saving \$223,000;
- conducted a pilot study of centralized prize redemptions; and
- begun the process of competitively sourcing its field support operations.

In addition, as we recommended, the Legislature has

- provided the Lottery with flexibility to adjust the scratch-off game transfer rate; after adjusting the rate to increase returns to players, and sales of scratch off games grew by 60%, producing an estimated \$27 million gain to education;⁴
- increased the bond requirement for filing bid protests, which should enable the Lottery to more effectively contract for services;⁵ and
- reduced the Lottery’s appropriation by \$1.6 million, which we estimated would have been the impact of centralizing prize redemptions.

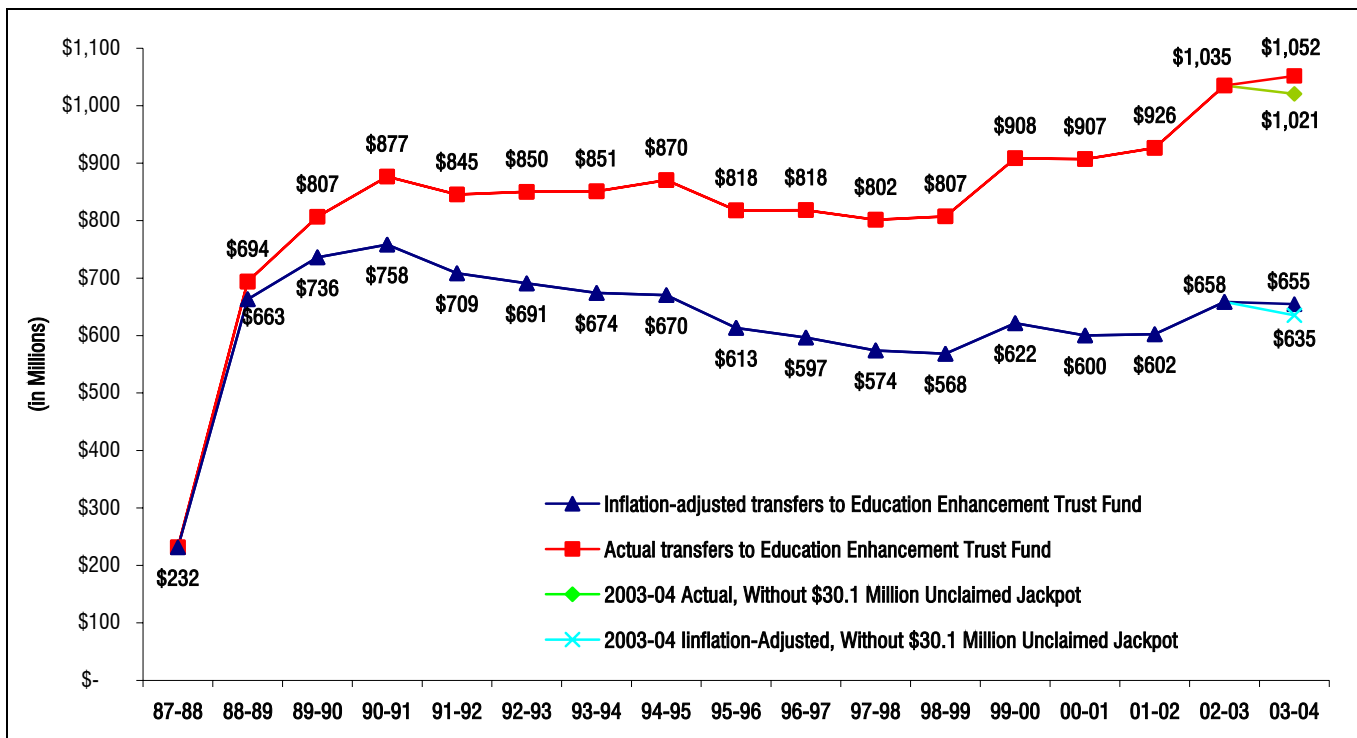
Ongoing challenges. Despite these improvements, Florida faces formidable challenges with regard to Lottery revenue. The Florida Lottery has been operating for over a decade, and, as with other mature lotteries, it struggles to maintain revenue growth. Because of declining on-line game sales, Lottery transfers to education would have declined slightly in Fiscal Year 2003-04 were it not for a large \$30.1 million unclaimed jackpot that was transferred directly in that year. Even with that unclaimed jackpot, Exhibit 2 shows that transfers have not kept pace with inflation. Exhibit 2 also shows that inflation-adjusted transfers to education declined slightly in Fiscal Year 2003-04 and remain below their peak level of Fiscal Year 1990-91.

⁴ Section 1, Ch. 2002-227, *Laws of Florida*.

⁵ Section 12, Ch. 2002-207, *Laws of Florida*.

Exhibit 2

Inflation-Adjusted Transfers to Education Decreased \$3 Million in 2003-04, and Actual Transfers Would Have Declined Absent a Record Unclaimed Lotto Jackpot



Source: OPPAGA analysis of Department of Lottery data.

In contrast to the slow growth in Lottery transfers to education, the costs of the services the Lottery funds—most notably the Bright Futures Scholarship Program—are projected to increase substantially in the future. For example, appropriations to Bright Futures grew 15% from Fiscal Year 2003-04 to 2004-05. This challenge is exacerbated because the Lottery faces growing competition with other gambling opportunities in and around Florida. For example, Native American casinos continue to expand in Florida. Most recently, two Seminole Hard Rock casinos opened during spring 2004 in Hollywood and Tampa, joining a few other casinos spread through South and Central Florida. Casino cruises sail from large and small Florida ports, with some continued expansion. A new line is expected to open in St. Petersburg in fall 2004. Further, in the 2004 election voters approved a constitutional amendment that authorizes Miami-Dade and Broward counties to hold referenda on whether to authorize slot machines in pari-mutuel facilities. The Financial

Impact Estimating Conference projected that within three years of implementation in both counties, the Lottery would see a reduction of between \$33 million to \$55 million in sales due to consumers substituting slot machines for lottery ticket consumption.

Options to Increase Transfers to Education

There are several steps the state could take to increase Lottery revenues and transfers to education: creating new games to increase revenue; increasing sales of existing games through enhanced marketing; and reducing Lottery administrative costs. The Lottery is pursuing several of these options.

New games could raise Lottery revenue

Creating new games or changing on-line game prize payouts could increase revenue. The Lottery is considering a number of higher-

payout extensions to its on-line games as well as concepts for new on-line games. For example, the Lottery is developing some add-on concepts for on-line games that would allow players to pay an extra dollar to improve odds or payouts or to play a bonus game. The Lottery is also exploring a \$2 on-line game and a limited-time series of higher priced on-line “raffles.”

The agency should test market these concepts prior to implementing them and, in some cases, has some evidence of their success in other states or countries. The test marketing should improve the agency’s ability to forecast earnings from the new or enhanced games. Based on available evidence, the Consensus Estimating Conference on Lottery estimated a \$45.6-million annualized gain in the first year from these on-line game enhancements and a \$61.4-million gain in the second year (the first full year of implementation).

Previously explored game options might raise substantial revenue. Our previous reports explored revenue options from other game options. Based on current data, the estimated revenue to education from a super-jackpot game would range from \$21 million to \$43 million, while a multi-state game would produce between \$47 million and \$68 million. Creating a keno-type game would generate between \$202 million and \$238 million, while video lottery terminals would generate between \$825 million to \$1,849 million. However, some of these games would represent a substantial expansion of legalized gambling in the state.

The Lottery is pursuing revenue-enhancing marketing strategies

Increasing and improving retailers could enhance sales. The agency estimates that by increasing the number of retailers offering Lottery products and improving the quality of retailers’ lottery product marketing could increase education transfers by more than \$50 million annually. The Lottery’s new on-line game contract with GTECH raises the number of retailer terminals to 12,000 (versus 10,000 under the previous contract), and the agency is considering a proposal to further increase to 13,000 terminals. The Lottery also plans to improve placement of terminals and instant ticket bins and expand instant ticket-only

vendors to full-service vendors. Although we could not independently estimate the fiscal impact of these improvements, OPPAGA agrees with and has previously recommended expanding Lottery retail locations to more widely distribute its products.⁶

Increased advertising can raise sales. The Lottery is considering increasing its advertising expenditures, which consultants estimate will yield a \$5 return to education per dollar invested. Although there are few academic studies of the efficacy of lottery advertising, some empirical results show substantial returns to advertising at the margins, and some studies conclude that lotteries in general do not spend enough on advertising. A Pennsylvania Lottery study estimated returns to advertising of a comparable though slightly lower magnitude as that projected by the Florida Lottery.

We believe that effective advertising may boost transfers to education. However, because of the relatively sparse evidence available to evaluate advertising investments prior to making them, we recommend caution in pursuing a significant advertising expansion.

Proposals to transfer unclaimed prize money directly to education assume that total transfers will increase, but transferring unclaimed prizes directly may leave total education transfers unchanged at best

Lottery sales are greatly affected by the size of potential prizes. The Lottery uses unclaimed prize money to increase scratch-off game payouts, which tends to increase sales. Prior to 2002, unclaimed prize money was the only tool the Lottery had available to increase scratch-off game prize payouts. The 2002 Legislature subsequently authorized the Lottery to increase the percentage of ticket proceeds that are used for prize payouts, which has been successful in substantially increasing ticket sales.⁷

The Lottery has current and planned uses of unclaimed prize money in addition to supplementing scratch-off prize payouts. The Lottery contends that it needs at least a portion

⁶ See OPPAGA Report No. [02-11](#), pp. 43-45.

⁷ Section 24.121(1), *F.S.*

of unclaimed prize money to fund initial Lotto and Mega Money jackpots when sales revenue is not sufficient to do so. There were four occurrences of insufficient sales to cover initial Lotto jackpots in Fiscal Year 2002-03, two in 2003-04, and three in the first quarter of 2004-05. The total cash amount supplemented over these 2-1/4 fiscal years was \$1.7 million. The agency also plans to use a portion of unclaimed prize money to finance new or enhanced on-line games.

Both the Lottery and the Legislature have explored the option of transferring at least part of the approximately \$40 million in annual unclaimed prize money directly to education rather than investing it in higher payouts. However, because transfer would reduce lottery prizes and thus sales, it likely would not result in increased net transfers to education.

If unclaimed prize money were transferred directly to education, the Lottery indicates it would need to use sales revenue that otherwise would be transferred to education to fund prize payouts, resulting in no net increase in minimum guaranteed funding to education. This is needed to meet the requirements of bond covenants that require the agency to maintain a certain minimum transfer rate.⁸

A recent accounting change has eliminated a separate fiscal loss that a direct transfer of unclaimed prizes would have caused. Until recently, the Lottery committed estimated unclaimed prizes in advance to pay scratch-off game prizes. This created a liability that would have resulted in a one-time loss to the agency had unclaimed prizes been transferred directly to education. However, the Lottery no longer estimates unclaimed prizes, but rather it uses those prizes as they become available. This change in accounting practices will have erased

⁸ The contracts with purchasers of lottery-funded bonds specify that before the transfer rate may be reduced below current levels, a consultant must provide written certification that the amount transferred for each of the next three years after the percentage reduction will not be less than the amounts projected by the Consensus Revenue Estimating Conference at the present transfer rate. Violating the bond covenant would be a technical default, which could jeopardize the bonds' marketability and interest costs. In monitoring lottery transfers vis-à-vis the bond covenant requirements, the Division of Bond Finance takes a similar approach to the Lottery in that it includes unclaimed prize money transferred in the overall transfer rate calculation.

this liability as of December 31, 2004, and direct transfer of unclaimed prize money will not result in a loss after that date.

The Lottery is taking steps to improve operational efficiency, but more actions could be taken

The Lottery has taken action to implement OPPAGA recommendations and appropriations proviso to evaluate options to outsource its field operations and centralize prize redemption and to reduce its operating costs by working to reduce its leased space. These efforts should be continued and expanded.

The Lottery should continue to work with the Center for Efficient Government to develop its business case proposal to competitively source its field support function. Pursuant to OPPAGA recommendations and proviso in the 2004 General Appropriations Act, the Lottery developed and submitted in September 2004 a draft business case proposal to competitively source its field support operations.⁹ The Lottery also submitted this preliminary business case proposal to the Center for Efficient Government, which was established in March 2004 by Executive Order [04-45](#).¹⁰

The Lottery's proposal evaluated five options:

- use the results of the open and competitive bidding process that selected the new on-line vendor and utilize the winning proposal;
- reengineer current field support operations;
- conduct a new open and competitive bid;
- conduct a separate open and competitive bid with limited vendor participation (excluding Lottery game vendors); and
- maintain the status quo.

⁹ Field support staff (sales representatives and multiple account coordinators) serve as the primary contacts between the Lottery and its retailers. These staff deliver point-of-sale information to retailers, process end of games, communicate upcoming changes to retailers, ensure retailers compliance with contract, and coordinate corporate account information.

¹⁰ The Center for Efficient Government was established to improve the way state agencies deliver services and to provide an effective review of proposed outsourcing projects. The center provides a process for initiating, reviewing and evaluating outsourcing initiatives. This process consists of standards, templates, guidelines, and a reporting mechanism for each stage of the initiative.

The Lottery proposes to use the option of conducting a new open and competitive bid for two reasons. First, the Lottery plans to increase from 12,000 to 15,000 full-service retailers to increase sales, which may warrant a new bid. Second, the Lottery found that other vendors besides its usual contractors could effectively provide field support services at a savings to the state. However, this option would prolong the evaluation and delay potential cost savings beyond the 2005-06 fiscal year.

We recommend the Lottery continue to work with the Center for Efficient Government on its proposal to competitively source its field support function and continue to submit progress reports at least annually to the Governor, Legislature, and OPPAGA.

The Lottery should consider developing business case proposals for other functions currently performed in-house such as product development. Competitive sourcing or privatization, when appropriately managed, can produce substantial benefits for taxpayers, including saving public dollars and improving service quality. While over 80% of the Lottery's functions are already outsourced, there remain several functions performed in-house that other state lotteries contract with the private sector to provide. These services include financial accounting services, product development, and software development. We recommend that the Lottery work with the Center for Efficient Government to initiate and develop business case proposals for other services provided by the private sector that the Lottery currently performs in-house to determine whether it would be more efficient to procure these services at the same level of quality from contracted vendors.

The Lottery should continue to work with the Department of Management Services to consolidate and reduce its leased office and warehouse space at its headquarters location. Pursuant to OPPAGA recommendations and proviso in the 2004 General Appropriations Act, the Lottery consulted with the Department of Management Services to consider options to

consolidate its use of office and warehouse space at its headquarters location.¹¹ The Lottery is still in the planning stages of consolidating its use of leased space.

Thus far, the Lottery reported it is negotiating the sublease of its ground floor, consisting of office and warehouse space. The Lottery currently pays \$15.49 per square foot for about 20,000 square feet of excess air conditioned warehouse space at an annual cost of \$300,000. To sublet this space, the Lottery would likely incur some one-time re-configuration costs to accommodate the needs of a subleasing tenant, but would still realize an annual savings of about \$250,000 the first year and \$300,000 thereafter. Therefore, we recommend the Lottery continue its efforts to sublet its excess warehouse space.

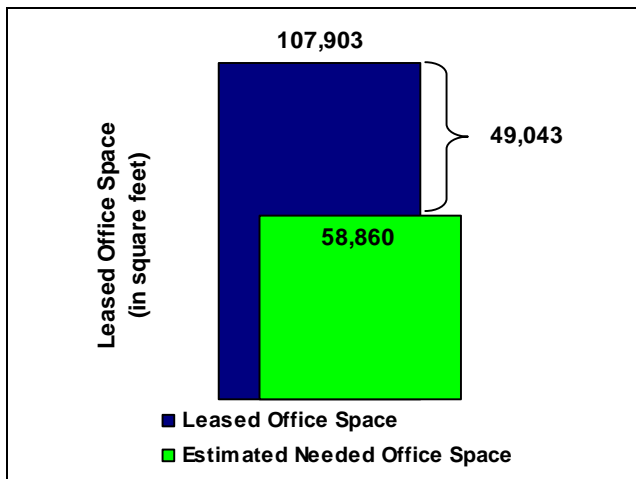
However, even if the ground floor is sublet, the Lottery would still lease a large amount of excess office space. Adjusting for office space already sublet and for the unique needs of the Lottery, it currently leases about 107,903 square feet of office space at its headquarters location.¹² Based on current DMS space allowances of 180 square feet per employee, the Lottery leases about 49,043 square feet of excess office space at this location (approximately one full floor of the building) at an annual expense of \$759,676 (see Exhibit 3).¹³ The Lottery's efforts to sublet its ground floor would involve about 12,500 square feet of office space. This would still leave the Lottery obligated to lease about 36,000 square feet of excess office space.

¹¹ Concurrent with implementation of this recommendation, Executive Order [04-118](#) was established in June 2004 to have the Department of Management Services (DMS) provide leasing agent services to reduce executive agency's private sector space leasing costs, improve work-space quality, or improve delivery of services. The Lottery entered into an interagency agreement with the DMS in July 2004 to implement this executive order.

¹² The Lottery leases a total of 157,653 square feet (129,042 square feet of office space and 28,611 square feet of warehouse space) at its headquarters location. Adjusting the Lottery's office space by deducting space used for its cafeteria, space already sublet to its vendors, extra computer space, extra security surveillance and testing lab space, winner's lounge, and video production space unique to the Lottery operation, it currently leases 107,903 square feet of office space.

¹³ The Lottery's 327 employees located at its headquarters location account for 58,860 square feet at 180 square feet per employee.

**Exhibit 3
The Florida Lottery Leases About
49,043 Square Feet More Than Necessary**



Source: OPPAGA analysis of Lottery data.

It may be difficult for the Lottery to fully meet the DMS standards because it would likely require a major reconfiguration of its existing layout of hard wall offices and hallways at substantial upfront costs. However, the agency may be able to negotiate to have some or all of these costs borne by the building owner.

We recommend that the Lottery continue to work with the DMS to establish and execute a plan to consolidate its lease of office space to current DMS standards where economical and sublet the extra office and warehouse space to suitable tenants. The Lottery should continue to report its progress at least annually to the Governor, Legislature, and OPPAGA.

The Lottery should continue to evaluate and implement options to reduce prize redemption costs. In a prior report, OPPAGA determined that the Lottery’s cost to redeem winning tickets worth less than \$600 at district offices exceeded retailer payments by over \$1 million.¹⁴ OPPAGA also determined that paying a bank a transaction

fee (e.g., \$10 as was paid by the Ohio Lottery) to redeem winning tickets worth between \$600 and \$5,000 would cost about \$300,000 less annually than the Lottery’s district offices. Accordingly, OPPAGA identified several options the Lottery could consider to reduce prize redemption costs and increase customer convenience including centralizing the function or contracting with banks, grocery stores, or tax collectors to redeem prizes over \$600. In response, the Lottery conducted a pilot study in September 2003 on centralizing its prize redemption function. The Lottery reported inconclusive evidence to determine whether the savings outweighed the potential lost sales from closing district offices. The Lottery reports that ongoing evaluation of the remaining options is on hold pending its transition to a new on-line vender in 2005.

Also, as technological advances occur, opportunities arise to reduce administrative expenses and improve customer convenience and satisfaction. One such advance is a ticket checking devise to streamline the prize redemption process. To claim a prize, a lottery ticket must first be checked to see if it is a winning ticket. To reduce retailer labor costs and processing time, an electronic self service terminal could be used by players to verify which tickets to redeem. We recommend that the Lottery continue to evaluate and implement cost-effective prize redemption options as resources and time permit.

Agency Response

In accordance with the provisions of s. 11.51(6), *Florida Statutes*, a draft of our report was submitted to the Secretary of the Department of Lottery for review and response.

The Secretary’s written response is reproduced in its entirety beginning on page 8.

¹⁴ OPPAGA Report No. [02-11](#). Winners currently may claim prizes up to \$600 at any of the Florida Lottery’s retailers that sell similar games, at district offices, or simply mail the ticket to the Florida Lottery headquarters. Retailers are paid a commission (1% of the prize amount) for redeeming winning tickets worth less than \$600. Prizes of \$600 to \$250,000 require claim forms be submitted to a district office or Lottery headquarters in Tallahassee. Prizes over \$250,000 must be claimed at Lottery headquarters.



JEB BUSH
Governor

FLORIDA LOTTERY

REBECCA DIRDEN MATTINGLY
Secretary

November 23, 2004

Mr. Gary R. VanLandingham, Interim Director
Office of Program Policy Analysis and
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111 West Madison Street, Room 112
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Tallahassee, Florida 32399-1475

Dear Mr. VanLandingham:

In response to your office's November 2004 draft progress report entitled *Lottery Faces Challenges Meeting Future Revenue Demands, Continues Work to Improve Efficiency*, I would like to thank you and your staff for a thorough review and follow-up evaluation. I am pleased that your review recognizes the Lottery's efforts to reduce its administrative costs and improve its business operations. In the remainder of this letter, I would like to address those findings that are directed to and within the control of the Florida Lottery.

Finding: The Florida Lottery Ranked Highest Among U.S. Lotteries in Performance.

The 2002 Justification Review concluded that “[B]ased on four key performance measures, the Florida Lottery ranks first in the nation.” I am pleased to learn that the Florida Lottery remains the top-performing U.S. lottery in terms of total net transfers to the state, transfers as a percentage of total revenue, expenses as a percentage of total transfers, and per capita transfers to the state.

Finding: Florida Faces Formidable Challenges With Regard to Lottery Revenue.

The report recognizes that inflation-adjusted transfers to the Educational Enhancement Trust Fund declined slightly in Fiscal Year 2003-04 and remain below their peak level reached in Fiscal Year 1990-91. The report concludes that, because of declining on-line game sales, transfers to the Educational Enhancement Trust Fund have not kept pace with inflation. This is not unique to Florida and reflects the downward trend in on-line game sales nationwide. Nevertheless, the Lottery has achieved significant growth in both sales and net government revenue. Fiscal Year 2003-04 was another in a series of record years

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for the Florida Lottery, with total revenues of \$3.086 billion (unaudited) and transfers to the Educational Enhancement Trust Fund of \$1.05 billion (unaudited). Fiscal Year 2003-04 marked the third consecutive year of record transfers and the second consecutive year in which transfers to the Educational Enhancement Trust Fund exceeded \$1.0 billion. It also marked the first time in the history of the Lottery that total sales exceeded \$3.0 billion.

Much of this success is due to the dramatic increase in the sale of scratch-off game tickets since the Legislature authorized the Lottery to increase the prize payout for its scratch-off games. Since Fiscal Year 2001-02, scratch-off game sales have doubled, increasing from \$662 million to \$1.36 billion last fiscal year. The Lottery does not have the same flexibility to vary the prize payout for its on-line games as it does for its scratch-off games. As a result, on-line game sales have increased by less than three percent during this same period. Specific strategies to increase on-line game sales will be discussed in the remainder of this letter.

The Lottery recognizes the potential for other gaming opportunities to impact Lottery sales, and our product development and marketing research efforts, as well as our product launch schedule, are geared to mitigate these impacts. Most recently, the Lottery has been developing strategies to mitigate the impacts of the 2004 hurricane season that, we estimate, has cost the Lottery more than \$40 million in lost sales and more than \$12 million in lost transfers.

Finding: New Games Could Raise Lottery Revenue.

Consistent with the Lottery's long-range program plan, on-line sales growth will be pursued through a combination of increased market penetration, product extensions, redesign of existing games, on-line game promotions, and the exploration of new on-line game concepts that follow conservative and traditional on-line game play styles.

The Lottery must continuously address the fact that Lottery games increasingly compete for discretionary spending with other forms of entertainment. Market research and special studies help gain an understanding of how discretionary spending can be directed to Lottery products and ultimately to the Educational Enhancement Trust Fund. Research and studies are routinely conducted in order to identify needed improvements in the areas of product design, communication and distribution capabilities. It is critical to identify product designs that meet the interests of current and potential players, to maximize the impact and cost-effectiveness of on-line and scratch-off promotions and advertising efforts, and to develop state-of-the-art distribution methods for our products. Consistent with your recommendation, market research and quantitative testing will continue to play a critical role in all of our game development efforts.

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The most effective way to increase total transfers to the Educational Enhancement Trust Fund over the long-term without expanding gambling is to increase on-line ticket sales. One of the most reliable and proven methods of increasing ticket sales is to stimulate consumer demand by increasing the prize payout percentage. As mentioned previously, the Lottery does not have the same flexibility to vary the prize payout for its on-line games as it does for its scratch-off games. Last session, Senator Clary and Representative Kilmer introduced legislation that would have amended s.24.121 to give the Lottery the same flexibility to vary the prize payout percentage for its on-line games as it does for its scratch-off games. This, we are quite certain, would have generated substantial increases in on-line sales and transfers and, over a period of time, allowed both scratch-off and on-line games to operate at or near the levels necessary to maximize revenues for education, as required by law. Unfortunately, this legislation died in the last week of the session. I am hopeful that similar legislation will be introduced and enacted into law during the upcoming session.

Finding: The Lottery is Pursuing Revenue-Enhancing Marketing Strategies.

I appreciate your support of our efforts to increase market penetration by increasing the number of Lottery retailers. The size of Florida's lottery retailer network has not kept pace with its population growth. With a current network of approximately 12,000 retailers, Florida's ratio of Lottery retailers to population (1:1,521) is below the average for all U.S. lotteries (1:1,418) and badly trails strong-performing lotteries like Massachusetts (1:851), Georgia (1:1,138), New York (1:1,257) and Connecticut (1:1,237). Over the longer term, the Lottery hopes to recruit 3,000 additional full-service retailers (net) statewide, bringing the retailer-to-population ratio down to approximately 1:1,200. If successful, the Lottery will be able to achieve and sustain a competitive level of market penetration necessary to maximize revenues for education, as required by law.

Florida's excellent business climate allows the Lottery to leverage its operations through co-promotions with its corporate partners. The Lottery considers this strategy to be one of its biggest ongoing opportunities. Building strategic alliances with third-party corporate partners will also strengthen the Lottery's product development process and help to generate new promotional strategies that will ultimately add value for the Lottery and its retailers.

Finding: Transferring Unclaimed Prize Money Directly to Education May Leave Total Education Transfers Unchanged At Best.

I agree with your assessment that the direct transfer of unclaimed prize money to the Educational Enhancement Trust Fund is unlikely to generate any additional or "new"

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revenue for education. As discussed below, the direct transfer of all unclaimed prize money to the Educational Enhancement Trust Fund is more likely to reduce the amount of revenue for education. The Lottery has historically committed almost all of the unclaimed prize money to the prize structure of its scratch-off games. This has allowed the Lottery to transfer that much more money from sales to the Educational Enhancement Trust Fund. Taking the unclaimed prize money would mean the Lottery would transfer that much less money from sales. This loss would be offset by the deposit of the unclaimed prize money in to the Educational Enhancement Trust Fund, resulting in no net gain for education.

Two things have happened to reduce the Lottery's dependence on and need for unclaimed prize money. First, the 2002 Legislature passed HB 2011, which authorizes the Lottery to establish variable prize payout percentages for scratch-off games in a manner designed to maximize the amount of funds deposited in the Educational Enhancement Trust Fund. Second, bonds for school and classroom construction are based upon the amount of money that would be available if 38% of gross Lottery sales were transferred to the Educational Enhancement Trust Fund. A September 2003 study shows that, based upon current sales, this level of funding can be sustained if the Lottery maintains a total effective transfer rate of 24%. The total effective transfer rate includes the direct transfer from scratch-off game sales, as well as any unspent administrative funds available and any unclaimed prize money transferred directly to the Educational Enhancement Trust Fund.

Although less dependent on unclaimed prize money, the Lottery still requires the continued occasional use of unclaimed prize money to supplement the jackpot pool for FLORIDA LOTTO and MEGA MONEY. In order to maintain a high level of player confidence in the integrity of the games, the Lottery pays FLORIDA LOTTO and MEGA MONEY jackpots that are at least equal to the estimated jackpot amount posted on billboards and the Lottery's website. In the event the cash available in the FLORIDA LOTTO or MEGA MONEY jackpot pool is insufficient to yield the announced estimated jackpot value, the Lottery may add unclaimed prize money to the jackpot pool to render it sufficient to yield the announced jackpot. This is most likely to occur at start-up jackpot levels (e.g., \$3-\$4 million) when interest rates are comparatively low or when sales are seasonably slow. The Lottery would still need some portion of the unclaimed prize money to cover these occasional expenses. Absent this money, the Lottery would have to estimate FLORIDA LOTTO and MEGA MONEY jackpots more conservatively. Since these games are jackpot driven, more conservative jackpots mean reduced sales and ultimately reduced transfers. The legislation introduced by Senator Clary and Representative Kilmer last session would have allowed the Lottery to retain 20% of the unclaimed prize money for this purpose.

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The report recognizes the Lottery's efforts to revise its accounting practices to eliminate the one-time loss that would occur if unclaimed prize money were transferred directly to the Educational Enhancement Trust Fund. Although the report correctly states that this liability should be erased as of December 31, 2004, the subsequent conclusion that the "direct transfer of unclaimed prize money will not result in a loss after that date" is somewhat misleading. Unless, as discussed above, the Lottery retains a portion of unclaimed money to occasionally supplement the jackpot pool for FLORIDA LOTTO or MEGA MONEY, the direct transfer of all unclaimed prize money will result in a net reduction in transfers to the Educational Enhancement Trust Fund.

Finding: The Lottery is Taking Steps to Improve Operational Efficiency, But More Actions Could Be Taken.

Thank you for recognizing our efforts to improve our operating efficiency. Consistent with the 2004 General Appropriations Act, the Lottery has completed a preliminary business case proposal to privatize field support operations. This preliminary business case has been submitted to the Governor, President of the Senate, Speaker of the House and to your office. Copies of the preliminary business case proposal have also been submitted to the Governor's Center for Efficient Government (the Center) for evaluation by the Oversight Board, consistent with Stage One of the Project Gate Management Process. As recommended, we will continue to work closely with and rely on the Center to guide the preliminary business case proposal through the Gate Management Process.

On July 9, 2004, the Lottery entered into an agreement with the Department of Management Services (Department) to implement Executive Order 04-118, regarding the Governor's leased space initiative. Under the terms of this agreement, the Lottery and Department have worked closely to identify a suitable tenant or tenants with whom to sublease a portion of the headquarters building.

Consistent with the terms of the Request For Proposals for the on-line gaming system and related services, the Lottery has made available to its new on-line vendor (GTECH) 3,416 square feet of office space. This is a temporary use of space until February 2005, when GTECH is scheduled to assume space occupied by the Lottery's current on-line vendor. The Lottery and GTECH are currently negotiating the sublease of 6,000 square feet of additional warehouse space in the headquarters building. This sublease would run concurrent with GTECH's contract to provide an on-line gaming system and related services, which will run at least through the end of January 2010.

The consolidation of agency statewide mail operations may present an opportunity to sublease a substantial portion of the remaining excess space in the headquarters building. Discussions have begun with representatives from the Department of Management

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Services and Pitney Bowes Management, Inc., (Pitney Bowes) to explore the possibility of subleasing the remaining office and warehouse space on the first floor of the headquarters building (roughly 17,000 square feet of warehouse space and 8,000 square feet of office space). Pitney Bowes has completed its review of floor plans of the building, and has toured the building on more than one occasion. We are optimistic that our available space (which is centrally located, climate controlled, and has 24-hour a day security) will meet their needs.

I appreciate your recognition that full compliance with the Department's space standards will be difficult for the Lottery. As pointed out in the February 2002 Justification Review, the Lottery's options to make more efficient use of its leased headquarters space are limited because of building design inefficiencies, such as oversized stairwells and hallways. Regardless, we will continue to work closely with the Department to make the most efficient use of our leased space.

Although we will continue to explore other opportunities to privatize or outsource functions currently performed in-house, I must respectfully disagree with the recommendation to consider outsourcing product development. I am aware that other state lotteries may do this, but I do not believe it is in the best long-term interests of the Florida Lottery to place primary responsibility for product research and development in the hands of a private vendor. At the present time, the Lottery has only two full-time employees dedicated to product development --- an on-line product manager and an instant product manager. Given such a relatively small investment in product development, I firmly believe the relative long-term economic costs of outsourcing product development will outweigh any nominal cost reductions that might be achieved.

We continue to look for ways to make prize redemption more efficient. Although inconclusive, the September 2003 pilot study did suggest that there is a continued need to provide convenient locations for the purchase and redemption of lottery tickets, and that terminating district office services to players does pose a threat to sales and lottery transfers for education. The Lottery continues to explore available technology that would allow the district prize validation and redemption process to be completely automated. Although banks and grocery store chains have expressed little or no past interest in redeeming prizes of \$600 or greater due to the labor-intensive processes of the statutorily required checks for state owed debt and tax reporting, I am hopeful that, once the new on-line gaming system is in place, we will be able to competitively procure "super retailers" to redeem prizes.

One improvement that was not mentioned in your report that will generate a substantial savings to the State is the implementation of the new on-line gaming system in January. As a result of negotiations with GTECH, the Lottery is acquiring a new gaming system

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that is technologically superior to the current gaming system; that includes 1,500 more full-service terminals than the current system; at a cost that is roughly one-third less than what the State pays the current on-line vendor. Even if on-line sales remain constant at the Fiscal Year 2003-04 level of \$1.7 billion, the State would still save more than \$11.0 million dollars annually in payments to the on-line vendor. The October 2004 forecast by the Lottery Revenue Estimating Conference concluded that the move to the new system with 12,000 full-service terminals would result in a net, annualized gain of \$91.5 million in sales and \$32.5 million in transfers to the Educational Enhancement Trust Fund.

Once again, I would like to thank you and your staff for recognizing our efforts to implement recommendations contained in the February 2002 Justification Review and subsequent progress reports, and for giving us an opportunity to respond to the report. If you have any questions about our response, please call me at 487-7728.

Sincerely,

/s/

Rebecca Dirden Mattingly
Secretary

cc: Patricia Levesque
Chris Flack
Teresa Tinker
Michael Frick
Terry Shoffstall

The Florida Legislature

Office of Program Policy Analysis and Government Accountability



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