



January 2006

Report No. 06-04

Florida's Lottery Responding to Revenue, Efficiency, and Minority Retailer Challenges

at a glance

The Florida Lottery increased its transfers to education in Fiscal Year 2004-05 but continues to face challenges in maintaining long-term revenue growth sufficient to meet the funding needs of the programs it supports. Actions taken by the 2005 Legislature to give the Lottery increased flexibility in setting payouts for on-line games and expanded participation by full-service retailers are projected to boost transfers to education in the future. However, the Lottery also faces increased competition from other gaming opportunities such as expanded Native American casinos and introduction of slot machines in Broward County.

The Lottery has taken steps to improve its operational efficiency. However, it could achieve cost savings by reducing excess leased office and warehouse space, continuing to develop its business case proposal to competitively source field support operations, and reducing prize redemption costs.

While the Lottery has met its overall statutory goal for minority retailer participation, it has not met the requirement for participation by categories of minorities. Changes to this statute may be appropriate.

Scope

The Joint Legislative Auditing Committee directed OPPAGA to examine the Department of the Lottery and identify options to improve its efficiency and enhance its earning capability. Our report also tracks the department's implementation of prior OPPAGA recommendations.¹

Background

Following voter approval of a constitutional amendment, the 1987 Legislature enacted the Florida Public Education Lottery Act. The act created the Department of the Lottery to generate funds for education. The Lottery generates 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 vendors to provide its advertising and on-line and scratch-off games. The Lottery is self-supporting and receives no general revenue. For Fiscal Year 2005-06, the

¹ *Lottery Faces Challenges Meeting Future Revenue Demands, Continues Work to Improve Efficiency*, OPPAGA Report No. [04-80](#), January 2004; *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.

Legislature appropriated \$207.8 million and authorized 440 positions for Lottery operations.

Challenges

The Florida Lottery increased its transfers to education in Fiscal Year 2004-05 but continues to face challenges in maintaining long-term revenue growth sufficient to meet the funding needs of the programs it supports. Actions taken by the 2005 Legislature to give the Lottery increased flexibility in setting payouts for on-line games and expanded participation by full-service retailers are projected to boost transfers to education in the future. However, the Lottery also faces increased competition from other gaming opportunities such as expanded Native American casinos and implementation of slot machines in Broward County.

There are several reasons that it is difficult to maintain continual growth in funding for education. All lotteries face a natural life cycle that begins with rapid growth and gradually diminishes over time. In addition, the Lottery's transfers to education have lost value after taking into account the effects of inflation. Further, the Lottery faces increasing competition from other gambling opportunities around Florida that may limit its growth. Together these challenges require that the Lottery make a concerted effort to maintain or increase its transfers or offer a declining value to the state.

In Fiscal Year 2004-05, the Florida Lottery transferred \$1.1 billion to the Educational Enhancement Trust Fund, \$51 million more than in 2003-04 (see Exhibit 1). As shown in Exhibit 1 inflation-adjusted transfers to education are approximately at the same level as they were a decade ago and remain below their peak Fiscal Year 1990-91 level. However, the Lottery has brought up transfers from a 17-year low in Fiscal Year 1998-99. In the six years since that low point, inflation-adjusted transfers have risen 17%.

The Lottery's Long-Range Program Plan states that its challenge in the future is to continually find ways to maintain at least \$1 billion in annual transfers to education. However, steady

growth is needed to continue to support lottery-funded services. The Revenue Estimating Conference projects an average of 1.2% growth in Lottery transfers to education over the coming decade. In contrast, 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, a 7% annual tuition increase would produce a projected 10.6% annual increase in Bright Futures expenditures.

Lottery faces increased competition. This challenge is exacerbated because the Lottery faces growing competition with other gambling opportunities in and around Florida, such as Native American casinos, casino cruises, and slot machines in Broward County pari-mutuel facilities.

- Largely as a result of recently opened Seminole Hard Rock casinos, gambling revenue from Native American gaming facilities in Florida grew 34% from 2003 to 2004, generating \$862 million in 2004 and moving Florida from tenth to sixth in revenue growth among the 30 states with gaming facilities.²
- Casino cruise operations have expanded in Florida in recent years. As of August 2005, we identified at least 11 casino cruise lines operating out of 14 port cities in Florida.³
- The Revenue Estimating Conference projected the Lottery would see a reduction of between \$10 million to \$23 million in education transfers as a result of consumers substituting slot machines for lottery ticket consumption, following implementation of slots in Broward County pari-mutuel facilities.⁴

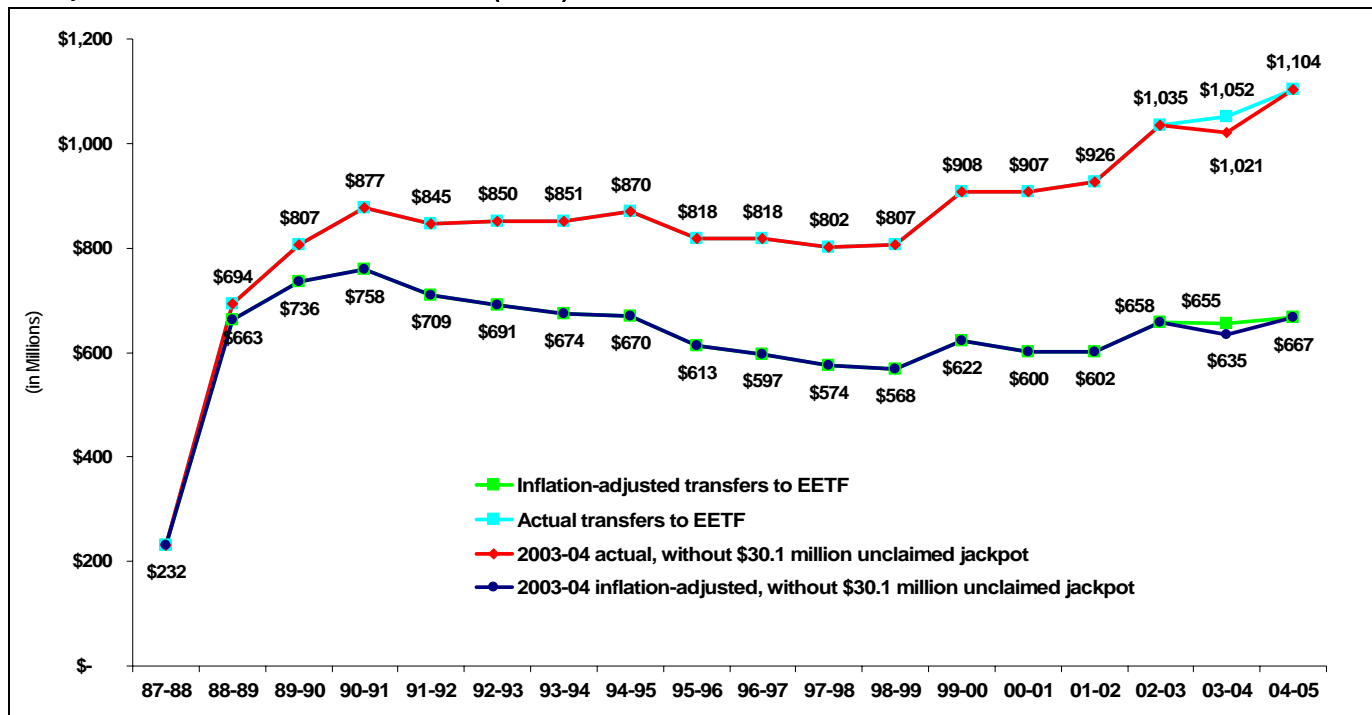
² In addition, though small in magnitude, non-gaming revenue growth (from food, hotel, retail, and entertainment) at these facilities grew 266% to \$77 million, which may suggest a broader tourist appeal of those facilities beyond gambling.

³ We do not have data from which to estimate the size of this segment of the gambling industry in Florida.

⁴ Impact estimates vary depending on assumptions about taxation and licensing.

Exhibit 1

Inflation-Adjusted Transfers to Education Increased \$12 Million (1.9%) in 2004-05, and Unadjusted Transfers Rose \$52 Million (4.9%)¹



¹The inflation-adjusted and unadjusted growth was calculated including the unclaimed prize transfer in 2003-04.

Source: OPPAGA analysis of Department of Lottery data.

Revenue Options

To maintain the value of lottery funding to education, the Lottery will need to implement new strategies to increase revenue. Some options that could help increase revenues are presented below.

New or augmented games could raise Lottery revenue

2005 Legislation gave the Lottery a new tool that may raise on-line game receipts. The 2005 Legislature amended the law to change how the Lottery deals with unclaimed prize money and authorized additional flexibility for on-line games. This additional flexibility may allow the Lottery to increase prize payouts and boost sales, resulting in increased dollars for education.

Previously, all unclaimed prize money remained with the Lottery to be used to augment instant game prize payouts, fund game promotions, and

supplement initial jackpots when sales were low. However, Ch. 2005-84, *Laws of Florida*, required that as of July 2005 the Lottery will transfer 80% of unclaimed prize money, an estimated \$44.8 million in Fiscal Year 2005-06, directly to the Education Enhancement Trust Fund. The unclaimed prize transfer will not adversely affect ticket sales.

Also in Ch. 2005-84, *Laws of Florida*, the Legislature gave the Lottery an alternative tool for raising on-line game prize payouts to increase the overall value of transfers to education from those games. In place of the unclaimed prize dollars, the Legislature authorized flexibility in the percentage of on-line game revenue the Lottery agency transfers to the Education Enhancement Trust Fund. Previously, the law required that 50% of on-line ticket sales be paid out in prizes and 39% transferred to education. As of July 2005, the

Lottery may reduce that transfer rate in an effort to boost overall sales.

This is similar in concept to the flexibility the Legislature authorized in 2002 with regard to the instant game transfer rate. However, the way in which the Lottery uses the on-line payout flexibility may differ in practice from its approach with instant games. The flexibility for on-line games likely will be used to create supplemental or add-on games to the existing on-line games, rather than simply to increase jackpots.⁵

The October 2005 Lottery Estimating Conference projected that the prize payout flexibility for on-line games would generate an additional \$8 million in transfers to education during Fiscal Year 2005-06. The conference expects this amount to rise to \$27.1 million in 2006-07, the first full year in which the Lottery will use that flexibility.

The Lottery is pursuing enhanced on-line games. The Lottery has begun to develop and test market higher-payout extensions and other innovations to its on-line games. It also has implemented game packaging efforts (e.g., Grouper) aimed at raising on-line game sales. One example is the November 2005 launch of a holiday season on-line promotion called "Cash for the Holidays." In this promotion, customers buying \$5 or more of Fantasy 5, Mega Money, or Lotto tickets at one time can win instant cash prizes and entries in a New Year's Eve million-dollar drawing. Also, in February 2006 the Lottery plans to release a \$1 "extra" instant-win game as an extension to the Fantasy 5 game.

Previously explored game options might raise substantial revenue. New games that attract new players have the greatest potential to substantially increase revenues to the Florida Lottery and transfers to education. However, some of these options such as keno and video

lottery terminals tend to be more addictive than traditional lottery games and may increase problem or pathological gambling.⁶

Based on current data, the estimated revenue to education from a super-jackpot game would range from \$22 million to \$44 million, while a multi-state game would produce between \$44 million and \$66 million. Creating a keno-type game would generate between \$197 million and \$276 million, while video lottery terminals would generate from \$968 million to \$3.1 billion.⁷

Additional sales terminals. Prior to entering into its current on-line game contract with GTECH, the Lottery had approximately 10,000 retail locations (terminals) statewide. The Lottery's current contract, which went into effect in January 2005, requires GTECH to support 12,000 sales terminals, and the agency has a strategic goal of reaching 15,000 terminals by 2006-07. As part of this expansion, the Lottery is seeking to shift from retailers who sell only instant ticket games to full-service retailers who sell both instant ticket and on-line games. Also, the Lottery is seeking to expand into new types of retail outlets such as videos stores, and it is testing other options including providing additional ticket sales locations in grocery stores and operating instant ticket vending machines.

As of October 2005, the Lottery and GTECH had expanded participation to 12,536 full-service retailers statewide, after receiving legislative approval to support up to 13,000 sales terminals. The shift to full-service retailers is projected to generate \$29 million in additional transfers to education, while the addition of over 1,100 new sales terminals is estimated to generate \$25 million in additional annualized transfers to education.

⁵ The Legislature authorized instant game flexibility in 2002, and the higher-payout instant games have been a significant source of revenue growth for the Lottery in the last few years, allowing the agency to develop \$10 and \$20 scratch-off tickets that have been big sellers. Those games have payout rates of 74% and 75%, respectively, compared with payout rates of 58% and 68% for \$1 and \$5 games, respectively.

⁶ 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.

⁷ These estimates are based on a potentially inaccurate assumption about the transfer rate. Our estimates assume that 39% of sales are transferred to education. However, in 2005 the Legislature gave the Lottery the authority to vary the on-line game transfer rate as an additional tool to raise overall education transfers.

Operational Efficiency

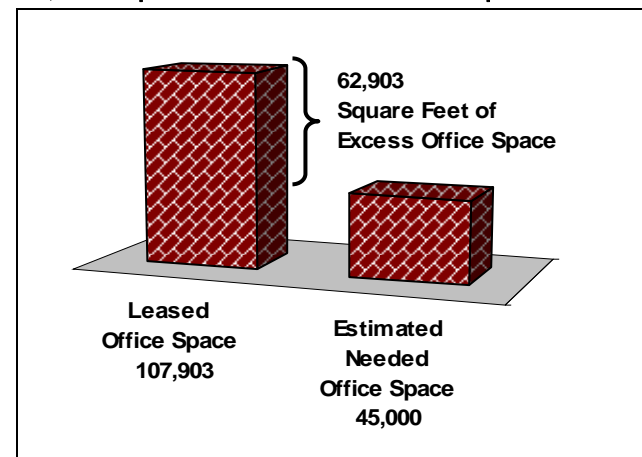
The Lottery should continue to work with the Department of Management Services to consolidate and reduce its leased office and warehouse space at its headquarters location. Pursuant to OPPAGA recommendations and proviso in the 2005 General Appropriations Act, the Lottery established a plan to consolidate its use of leased space at its headquarters location and made this space available for potential tenants to sublease.⁸ The Lottery's plan is to consolidate its business functions and staff on the top three floors of its four-story headquarters building and sublease the bottom floor of the building. The bottom floor consists of both warehouse and office space. However, the Lottery has reported unsuccessful negotiations with five potential subleasing tenants.

The Lottery currently pays \$15.64 per square foot for about 20,000 square feet of excess air conditioned warehouse space at an annual cost of \$312,800. In subleasing this space, the Lottery likely would incur some one-time re-configuration costs to accommodate the needs of a subleasing tenant. However, it would still realize an annual savings of about \$250,000 the first year and about \$300,000 thereafter. Therefore, we believe that the Lottery should continue its efforts to sublease its excess warehouse space.

The Lottery would still lease a large amount of excess office space even if it subleases the ground floor of its headquarters building. Adjusting for office space already subleased and for the unique needs of the Lottery, it currently leases about 107,903 square feet of office space at

its headquarters location.⁹ Based on current DMS space allowances of 180 square feet per employee, the Lottery leases about 62,903 square feet of excess office space at this location (over one full floor of the building) at an annual expense of \$983,803 (see Exhibit 2).¹⁰ The Lottery's plan to sublease its ground floor would involve about 12,500 square feet of office space. This would still leave the Lottery obligated to lease about 50,000 square feet of excess office space.

Exhibit 2
The Florida Lottery Leases About 62,903 Square Feet of Excess Office Space



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.

⁸ 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.

⁹ 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 subleased 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.

¹⁰ The Lottery's 250 employees located at its headquarters location account for 45,000 square feet at 180 square feet per employee.

Accordingly, we believe that the Lottery should continue to work with the DMS to expand its plan to consolidate its lease of office space to current DMS standards where economical and sublease 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 develop its business case proposal to competitively source its field support function. Pursuant to OPPAGA recommendations and proviso in the 2004 General Appropriations Act, in September 2004 the Lottery submitted a draft business case proposal to the Legislature to competitively source its field support operations.¹¹ 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](#).¹²

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.

The Lottery recommended 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. The Lottery reports it was given approval by the Center for Efficient Government to proceed.

Although approved to proceed, the Lottery's preliminary draft business case proposal needs to provide decision makers with more information to properly evaluate the proposed competitive sourcing initiative. Business cases should present a comprehensive description of how the competitive sourcing would save money and/or improve services or quality. However, the Lottery's preliminary business case lacked some short-term program costs. For instance, the Lottery's proposal did not include unemployment compensation costs as a potential consequence of outsourcing field support, which could be a significant non-recurring startup cost. The Lottery's proposal also did not identify penalties for poor vendor performance or lack of performance. To ensure vendor services accountability, establishing clear and enforceable penalties for poor or lack of performance is critical.

We recommend that the Lottery continue to develop 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 continue to evaluate and implement options to reduce prize redemption costs. In our 2002 report, we noted that the Lottery's cost to redeem winning tickets worth less than \$600 at district offices exceeded what it would have cost had retailers redeemed these tickets. Retailers are paid 1% of the value of the prize for redeeming winning tickets. The Lottery could have saved over \$1 million had retailers redeemed all winning tickets worth less than \$600.¹³ We also noted that some other lotteries

¹¹ 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.

¹² 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.

¹³ OPPAGA Report No. [02-11](#). Winners currently may redeem prizes up to \$600 at any participating retailers that sell similar Lottery games, or may redeem them at Lottery district offices or by mailing the winning tickets to the Florida Lottery headquarters. Retailers are paid a commission of 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.

contract with banks for prize redemption at a lower cost than the Lottery's current practice. For example, Ohio pays banks a \$10 fee to redeem winning tickets. The Florida Lottery could save \$300,000 annually if contracted with banks or other vendors to redeem winning tickets. The Lottery conducted a pilot study in September 2003 on centralizing its prize redemption function but reported inconclusive evidence to determine whether the savings outweighed the potential lost sales from closing district offices. Lottery officials report that while other retailer prize redemption options are being considered, they have not acted to implement them.

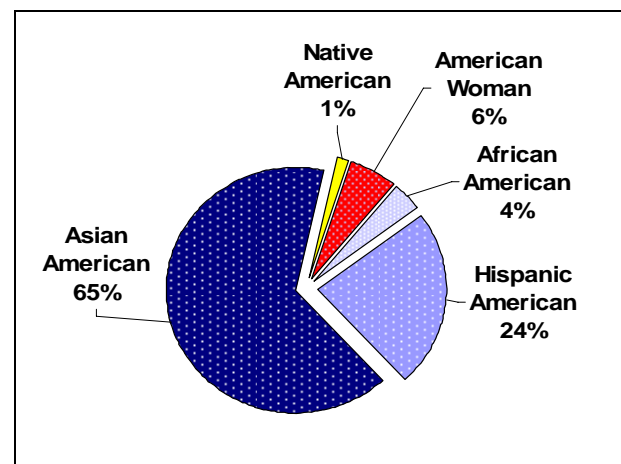
Also, as technological advances occur, opportunities arise to reduce administrative expenses and improve customer convenience and satisfaction. One such advance is a ticket-checking device to streamline the prize redemption process at retailer locations. To claim a prize, a lottery ticket must first 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. Having the customer scan the tickets would save retailers time when redeeming tickets by not having to scan non-winning lottery tickets. We recommend that the Lottery continue to evaluate and implement cost-effective prize redemption options.

Minority Retailer Participation

The Lottery has met the overall statutory requirement for minority retailer participation but has not met the requirement that no more than 35% of minority retailers be of one minority category. Florida statutes require that at least 15% of lottery retailers be minority business enterprises and that no more than 35% of minority retailers be owned by the same type of minority person.¹⁴ The Lottery has met the overall standard, as 36% of its retailers were

minority business enterprises in Fiscal Year 2004-05. However, the Lottery has historically been unable to meet the requirement that no more than 35% of those minority retailers be owned by the same type of minority. As shown by Exhibit 3, retailers reporting themselves as Asian American own 65% of all minority-owned ticket sales outlets in 2004-05.

Exhibit 3
In Fiscal Year 2004-05, Minority Business Enterprises Were 36% of All Lottery Retailers, But Nearly Two-Thirds of Those Minorities Identified Themselves as Asian American



Source: OPPAGA analysis of Lottery data.

Part of the reason the Lottery has difficulty meeting this standard may be due to Florida's definition of minority retailer. Section 288.703(3), *Florida Statutes*, defines "minority person" as a lawful, permanent resident of Florida who is either African American, Hispanic American, Asian American, Native American, or an American woman. Retail outlet owners self-report their minority status and may only choose one of these categories.

This statutory definition and the Lottery's reporting process create inaccurate data as discussed below.

- Florida's statutory definition of minority person does not include the category of Middle Eastern as does the federal definition.¹⁵ The federal definition includes

¹⁴ Section 24.113, *F.S.*

¹⁵ Section 288.703(3), *F.S.*

persons with origin from Central Asia across North Africa. To the extent that retailers of Middle Eastern descent self-report as minority persons despite their absence from the statute, they are most likely to report themselves as Asian American, and perhaps African American to a lesser extent.¹⁶ This can result in an over-representation of Asian American retailers in the Lottery's data and may contribute to the large proportion of Asian Americans as a percentage of all minority retailers.

- Retailers must currently choose to report themselves as only one category of minority person on the Lottery's retailer application form. As a result, retailers who are both Hispanic and African American, or both a woman and an Asian American, must chose only a single reporting category. This can result in inaccurate reporting of the Lottery's retailer participation.

Recommendations

The Lottery should continue to pursue operational efficiency options. 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. It also should continue to develop its business case proposal to competitively source its field support function.

¹⁶ Definitions of the Middle East vary, but often it spans the geographic area from North Africa to Central Asia. For additional detail, see OPPAGA Memorandum to the Joint Legislative Auditing Committee, dated February 23, 2005.

The Lottery should additionally continue to evaluate and implement options to reduce prize redemption costs and include these strategies in its next update of its strategic plan.

The Legislature should consider revising the statute pertaining to minority retailers. To provide a more realistic participation goal for the Lottery, the Legislature could consider removing the 35% statutory cap on the participation of a single type of minority person or redefining "minority person" for the purpose of lottery retail business ownership. This could include adding a category of "Middle Eastern" and possibly other sub-divisions of the "Asian" category, allowing owners to report themselves in multiple ethnic/racial categories such as "Hispanic" and "African American", and/or allowing owners to report their gender and ethnicity/race separately, rather than making "Woman" an exclusive category.

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 the Lottery for review and response.

The Secretary's written response is reproduced in its entirety beginning on page 9.



JEB BUSH
Governor

FLORIDA LOTTERY

REBECCA DIRDEN MATTINGLY
Secretary

January 17, 2006

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

Dear Mr. VanLandingham:

In response to your office's December 2005 draft progress report entitled *"Florida's Lottery Responding to Revenue, Efficiency, and Minority Retailer Challenges"*, 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 implement recommendations contained in the February 2002 Justification Review and the December 2004 progress report. 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: "... inflation-adjusted transfers to education are approximately the same level as they were a decade ago and remain below their peak Fiscal Year 1990-91 level. However, the Lottery has brought up transfers from a 17-year low in Fiscal Year 1998-99. In the six years since that low point, inflation-adjusted transfers have risen 17%."

Response: I understand and appreciate the value in historical comparisons, but comparing current inflation-adjusted transfers to the Educational Enhancement Trust Fund to the historical peak fails to tell the whole story. Exhibit 1 in the draft report clearly shows the natural life cycle of a typical lottery, characterized by rapid growth and a gradual decline over time, but this trend exists only through fiscal year 1998-99. Florida Lottery revenues rose sharply from inception to fiscal year 1990-91, at which time inflation-adjusted transfers to the Educational Enhancement Trust Fund reached a historical high of \$758 million. Inflation-adjusted transfers then declined steadily each year for the next eight years, to \$568 million in fiscal year 1998-99, the lowest since start-up.

The draft report recognizes the Lottery's success in reversing this decline over the past six fiscal years. I would like to request the draft report be revised to reflect that, under the leadership of Governor Bush and former Secretary David Griffin, the Lottery initiated a twofold strategy of increasing sales and reducing administrative costs to reverse this declining trend and to maximize net proceeds available to support education. Since fiscal year 1998-99:



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- Actual transfers have increased from \$807 million annually to \$1.1 billion (a 36% increase);
- Inflation-adjusted transfers have increased from \$568 million annually to \$667 million annually (a 17% increase);
- Operating costs, expressed as a percentage of revenue, have decreased consistently each year, from 4.06% to 2.05%; and
- The amount of net profit generated per full-time employee (FTE) has more than doubled, from \$1.1 million to \$2.4 million.

Our long-range planning is designed to continue this upward trend. Although scratch-off ticket sales have increased dramatically (211%) since fiscal year 1998-99, on-line ticket sales have increased only 8.2% during this period. As a result, continued net revenue growth (particularly on-line games) will be pursued through a combination of strategies, including but not limited to:

- Increasing on-line game prize payout percentage;
- Increasing market penetration by increasing the number of Lottery retailers;
- Building strategic alliances with third-party corporate partners;
- Implementing improvements to the on-line gaming system;
- Exploring new on-line game concepts that enhance player satisfaction; and
- Continuing to look for ways to reduce administrative costs.

Finding: "The Lottery would still lease a large amount of excess office space even if it subleases the ground floor of its headquarters building."

Response: Thank you for recognizing our efforts to sublease our excess headquarters office and warehouse space, but the draft report fails to recognize our actual success to date. The relocation of the Tallahassee district office to the Headquarters building and sublease of additional warehouse space to GTECH has resulted in a savings of more than \$120,000 annually.

The plan to consolidate Lottery operations on three floors and sublease the remaining floor is based upon the recommendation of OPPAGA staff following the 2002 Justification Review. Using the Department of Management Services (DMS) standard of 250 square feet per full-time equivalent position, OPPAGA estimated then that the Lottery leased 40,403 square feet more headquarters office space than necessary. Subleasing one full floor (roughly 39,413 gross square feet) would have effectively brought the Lottery into compliance with the DMS standards.

It was a good plan then and it remains a good plan even though it will not ensure compliance with the DMS space standards. Relocation is not a good option. The 2002 Justification Review considered the relocation of the Lottery to a smaller building, but quickly dismissed the idea. At a minimal cost of \$5 million, relocating to another building was deemed to be cost-prohibitive, and breaking the current lease would make the Lottery liable for damages.

Correcting identified building design inefficiencies is not a good option. The 2002 Justification Review recognized that it would be cost-prohibitive to correct certain headquarters building design inefficiencies, such as oversized stairwells and hallways, and that the Lottery's options to

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make more efficient use of its leased headquarters space were limited. This draft report recognizes that it may be difficult for the Lottery to fully meet DMS standards because it would likely require a major reconfiguration of its existing layout of hard wall offices and hallways, at substantial upfront costs. This draft report suggests that the Lottery may be able to negotiate to have some or all of these costs borne by the building owner; however, the building owner has shown no interest in paying for the suggested reconfiguration.

Sharing space on the same floor with a non-Lottery tenant is not a good option. In order to ensure the security and integrity of Lottery operations and maintain a high level of public confidence in the Lottery, any sublease of space in the Headquarters building must necessarily recognize the need to restrict access to the Lottery by non-Lottery employees. Subleasing any portion of the Lottery headquarters building to a non-Lottery tenant will likely require construction of a new entrance and internal reconfiguration of the building to restrict access to the Lottery by non-Lottery employees, at a substantial cost. Consolidating Lottery operations on three floors and subleasing the remaining floor would minimize any impact on security and minimize reconfiguration costs.

Finding: "The Lottery should develop a new business case proposal to competitively source its field support function."

Response: Consistent with the 2004 General Appropriations Act, the Lottery completed the business case proposal to privatize field support operations and reported the results to the Governor, President of the Senate, Speaker of the House, and Director of the Office of Program Policy Analysis and Government Accountability on September 1, 2004. A copy was submitted to the Governor's Center for Efficient Government for evaluation by the Oversight Board, consistent with Stage One of the Project Gate Management Process.

The report identifies the need to revise the preliminary business case to outsource Lottery field support operations to include some additional short-term program costs and penalties for poor vendor performance or lack of performance. While I agree that revising the business case as suggested in your report would improve the overall quality and usefulness of the business case, this is the first indication from OPPAGA that there were concerns about the preliminary business case. The Center for Efficient Government reviewed the preliminary business case and authorized the Lottery to proceed to the procurement phase in February 2005. It is our intent to proceed with the procurement phase once the final phases of the online gaming system have been fully implemented.

The process established by the Center for Efficient Government provides for the preliminary business case to be updated at the completion of each stage in its process. In authorizing the Lottery to proceed to the procurement phase, the Center suggested the business case be updated and resubmitted for approval after the competitive procurement has been conducted but prior to drafting or signing a contract with a vendor. As such, it is our intent to update the preliminary business case to address OPPAGA's comments, as well as any other appropriate comments, after the competitive procurement has been conducted but prior to drafting or signing a contract with a vendor.

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Finding: The Lottery should continue to evaluate and implement options to reduce prize redemption costs.

Response: The draft report references a 2002 OPPAGA finding that redemption of all winning tickets less than \$600 by Lottery retailers would save more than \$1 million annually, but fails to mention that the Legislature reduced the Lottery's operating budget by \$1.6 million and 29 positions associated with prize redemption service at district offices in fiscal year 2003-04.

The draft report also states that the Lottery could save \$300,000 annually if it contracted with banks or other vendors to redeem winning tickets. The Lottery has explored the possibility of contracting with banks or other vendors to redeem prizes. Banks and grocery store chains have expressed little or no interest in redeeming prizes of \$600 or greater due to the labor-intensive processes of the statutorily required checks for state-owed debt and federal tax reporting. The failure of a bank or other vendor to adequately and consistently collect and report required taxing information would likely result in the assessment of penalties against the Lottery by the Internal Revenue Service. It may be possible to make the bank or other vendor liable for these penalties as a condition of the contract, but such additional liability is certain to either drive up the cost of the contract or reduce the interest level of any potential bank or other vendor (or both).

We have also looked at available technology that would allow the district prize validation and redemption process to be completely automated. I have seen no evidence to suggest that an automated prize redemption system that provides the same or better level of service to Lottery players is available or could be implemented for less than \$1.6 million annually.

Looking at the elimination of prize redemption at district offices only within the context of reducing administrative costs is narrow and shortsighted. Such a view fails to consider the impacts on our customers, who will experience additional inconvenience, delays and costs when redeeming their winning tickets. Players holding winning tickets up to \$250,000 will no longer be able to walk into a district office with a winning ticket and walk out with their prize. To put this in perspective, during fiscal year 2004-05, district offices redeemed 51,527 prizes between \$600 and \$250,000. The total value of these prizes was \$204.85 million.

Eliminating prize redemption would mean that more than 50,000 winning tickets with prize values ranging from \$600 to \$250,000 would be mailed or redeemed in person, and tens of millions of dollars mailed to winners. Those choosing to mail their winning tickets to Tallahassee will incur additional costs and delays in the form of postage, insurance and processing time. Imagine the public and media reaction to the loss of even a single ticket or check. Those choosing to redeem their winning tickets in person will incur additional costs and delays in the form of travel time and costs. Such a view also fails to consider that any anticipated short-term savings may be offset by the long-term reductions in sales and transfers to the Educational Enhancement Trust Fund. Assuming the \$1.6 million saved each year by eliminating the redemption function will be deposited directly into the Educational Enhancement Trust Fund, it would take only \$5.18 million

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in sales (based upon the current rate of transfer (weighted by sales) of 30.91%) to generate \$1.6 million in transfers to the Educational Enhancement Trust Fund. If the inconvenience, delays and additional costs incurred by players reduce annual sales by just two-tenths of one percent, this well-intentioned effort to save money will have the unintended consequence of REDUCING annual Lottery transfers to the Educational Enhancement Trust Fund.

The report is quick to dismiss the September 2003 prize redemption pilot study as inconclusive, but the study did show that players in the two districts at which prize redemption was suspended expressed a continued need for convenient locations for the redemption of winning tickets. Businesses that give their customers fewer choices, less value and greater inconvenience will not be successful, and the Lottery is no exception to this. Nonetheless, we will continue to look for ways to make prize redemption more cost efficient.

Finding: "The Legislature should consider revising the statute pertaining to minority retailers."

Response: The progress report cites the Lottery's historical inability to meet the statutory requirement contained in s.24.113(1) that the same minority type own no more than 35% of Lottery minority retailers. The report correctly points out that two-thirds of Lottery minority retailers are Asian American.

Compliance with s.24.113(1) may be achieved in any of the following ways. One option would be to increase the number of non-Asian American minority retailers until the "not more than 35%" criterion is achieved. This would mean capping the number of non-minority and Asian American retailers at their current levels and recruiting almost 4000 new non-Asian American minority retailers. This option is not realistic and could not be achieved within a reasonable timeframe.

Another option is to reduce the number of Asian American minority retailers until the "not more than 35%" criterion is achieved. This would mean terminating the contracts of more than 2100 Asian American retailers for reasons that are based solely on race. As an unintended consequence, annual contributions to the Educational Enhancement Trust Fund would be reduced by almost \$200 million. This option is not realistic.

A third option, and what I consider to be the best option, is to amend s.24.113(1) to eliminate the requirement that 15 percent of Lottery retailers be a minority business enterprise with no more than 35 percent of such retailers owned by the same type of minority person. The retailer selection criteria established in s.24.112 have allowed the Lottery to increase opportunity and diversity in retailer contracting without using policies that discriminate or that pit one racial or ethnic group against another. The fact that 36 percent of current Lottery retailers are minority business enterprises attests to this. This practice should be allowed to continue without regard for arbitrary and artificial goals or set-sides. The success of our efforts to increase minority participation as Lottery retailers should be measured by comparing the number of Lottery contracts with minority retailers over a period of time, and not to some arbitrary and artificial goal.

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Finding: "The Lottery should continue to pursue operational efficiency options."

Response: Under performance-based program budgeting, the Legislature has established performance standards for the Florida Lottery. One such standard limits the Lottery's administrative expenses to a specified percentage of total revenue. Lottery revenue not returned to players in the form of prizes and revenue not transferred to the Educational Enhancement Trust Fund is used to pay the Lottery's administrative expenses. These expenses include the day-to-day costs to operate the Lottery, advertising expenses, payments to vendors, and commissions paid to Lottery retailers. For each year since this measure was established, the Lottery's administrative expenses have been below the standard.

This standard may not be the most reliable or accurate indicator of the Lottery's operational efficiency. The Lottery was created to maximize revenue for education, an integral part of which depends on increased sales. Since On-line and Scratch-Off ticket vendors are compensated in the form of a percentage of sales, any increase in sales will necessarily increase payments to the vendors. The same is true for commissions to retailers --- as ticket sales increase, so do commissions paid to Lottery retailers. As a result, any increase in sales will necessarily increase the Lottery's administrative expenses, as this term is currently defined.

For these reasons, it may be more appropriate to exclude payments to vendors and retailer commissions when calculating the Lottery's "true" operating costs. When payments to vendors and retailer commissions are excluded, the Lottery's operating costs (expressed as a percentage of total revenue) have decreased each year since fiscal year 1998-99, from 4.06% to 2.05%.

It is also important to look at per capita contributions to the Educational Enhancement Trust Fund. Since fiscal year 1998-99, the Lottery's contributions have increased while the number of employees has decreased. With 276 (38%) fewer employees, the Lottery generated approximately \$281 million more in actual transfers to the Educational Enhancement Trust Fund than it did six years ago. The amount of net profit generated per full-time employee (FTE) has more than doubled during this period, from \$1.1 million per FTE to \$2.4 million.

Once again, I would like to thank you and your staff for recognizing our efforts to implement recommendations contained in the 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: Governor Jeb Bush
Patricia Levesque

The Florida Legislature

Office of Program Policy Analysis and Government Accountability



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