



April 2008 (Revised)

Report No. 08-19

Lottery Profits Continue to Increase; Options Available to Enhance Transfers to Education

at a glance

In Fiscal Year 2006-07, the Lottery continued to increase ticket sales and transfers to the Educational Enhancement Trust Fund. However, current sales and forecasts indicate a slowing of revenue growth and transfers. To address this challenge, the Lottery is planning to expand its retail network and expand its multi-priced on-line games. In addition, it should carefully evaluate the benefits and disadvantages of adding a super jackpot game and joining a multi-state game and provide the results of its assessment to the Legislature.

The Lottery's operating expense rate is among the lowest in the nation. The Lottery could realize additional efficiencies by ensuring that contract terms represent the best value for the state, and reduce costs for leasing office space. The Lottery should develop its vendor performance monitoring system to ensure accountability and to help identify further operational efficiencies. The Lottery should also develop a comprehensive marketing plan and expand its evaluation of marketing outcomes.

Scope

The Joint Legislative Auditing Committee directed OPPAGA to examine the Department of the Lottery and identify options to enhance its earning capability and improve its efficiency as required in s. 24.123, *Florida Statutes*.¹ Our

¹ Section 24.123, *F.S.*, requires an annual financial audit to include recommendations to enhance the earning capability of the state lottery and to improve the efficiency of department operations.

report also tracks the Lottery's implementation of prior OPPAGA recommendations.²

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 and also to enable the people of the state to play the best lottery games available. The Lottery is headquartered in Tallahassee with nine district offices (Exhibit 3 shows the location of the district offices). The Lottery generates revenue from the sale of both on-line and scratch-off (otherwise referred to as instant) tickets. The Lottery is self-supporting and receives no general revenue. For Fiscal Year 2007-08, the Legislature appropriated \$159.9 million and authorized 440 positions for Lottery operations.

Since its inception, the Lottery's core functions to produce, advertise, and sell tickets have been outsourced to private vendors and retailers. The vendors operating under contract with the Lottery are responsible for advertising the

² *Lottery Scratch-Off Sales Increase; Options Available to Enhance Transfers to Education*, Report No. [07-09](#), February 2007; *Florida's Lottery Responding to Revenue, Efficiency, and Minority Retailer Challenges*, Report No. [06-04](#), January 2006; *Lottery Faces Challenges Meeting Future Revenue Demands, Continues Work to Improve Efficiency*, 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.

Lottery's products; producing on-line games including supplying computer systems, terminals and technical support; and printing and distributing scratch-off games. Retailers, such as supermarkets, convenience stores, gas stations, and newsstands sell the Lottery's various products to the public. In Fiscal Year 2007-08, over 73% of the Lottery's appropriation was allocated to pay vendors for providing advertising, and on-line and scratch-off games. Retailer commissions are paid directly from sales revenues, and do not appear in the department's appropriation.

The Lottery contracts with three primary vendors to provide its core functions. In March 2006, the department renewed its major advertising contract with Cooper & Hayes through June 2008.³ Beginning in January 2005, the Lottery entered a six-year contract with its on-line gaming system vendor, GTECH, to provide computer systems, retailer terminals, software, and telecommunications along with technical support services. The Lottery contracts with Scientific Games to print and distribute all scratch-off game tickets (through September 2008).

³ The department has a separate contract with Zubi Advertising Services for Spanish language advertising and related services.

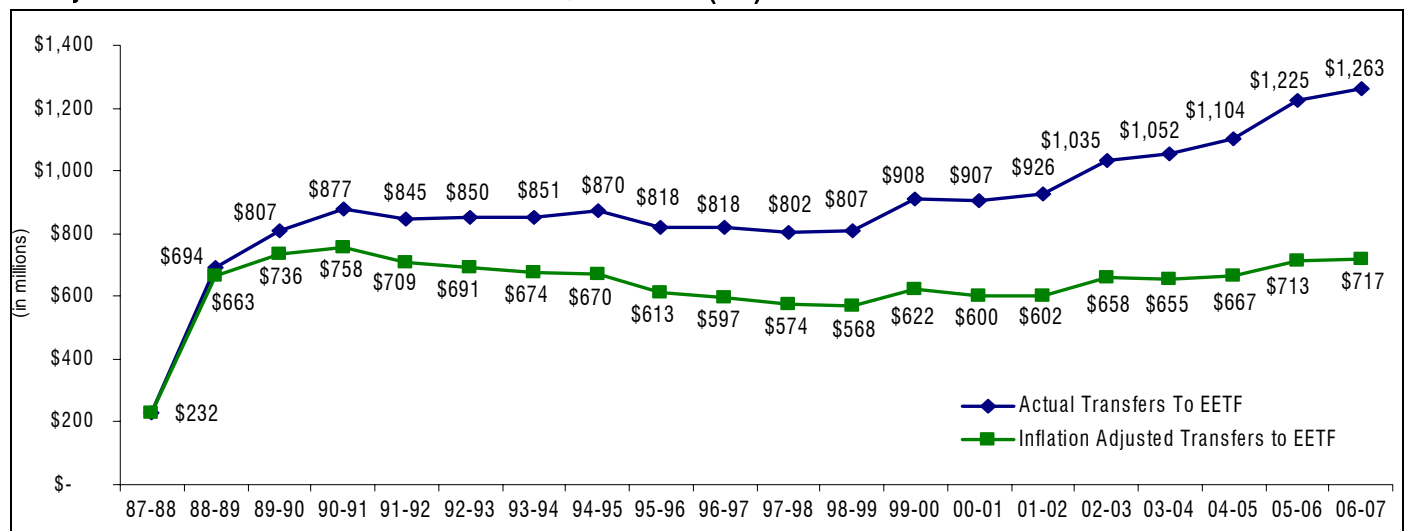
Lottery Transfer Performance

In Fiscal Year 2006-07, the Lottery transferred \$1.26 billion to the Educational Enhancement Trust Fund, \$39 million more than in Fiscal Year 2005-06. As shown in Exhibit 1, transfers to education have been rising over the last six years, and are approaching the level of the Lottery's peak year for inflation-adjusted transfers, Fiscal Year 1990-91.

While the Lottery has been successful and has established an ambitious goal to increase annual transfers to education to \$1.5 billion by Fiscal Year 2010-11, it faces the ongoing challenge of maintaining and growing sales. New game sales tend to level off over time, and the Lottery faces competition from other forms of entertainment and gambling. The April 2008 Lottery Revenue Estimating Conference estimates Lottery transfers to education will not reach the agency's Fiscal Year 2010-11 goals due to the economic downturn and increasing fuel prices. As shown by Exhibit 2, the Lottery is projected to transfer \$1.37 billion in Fiscal Year 2010-11 which is less than its goal of \$1.5 billion.⁴

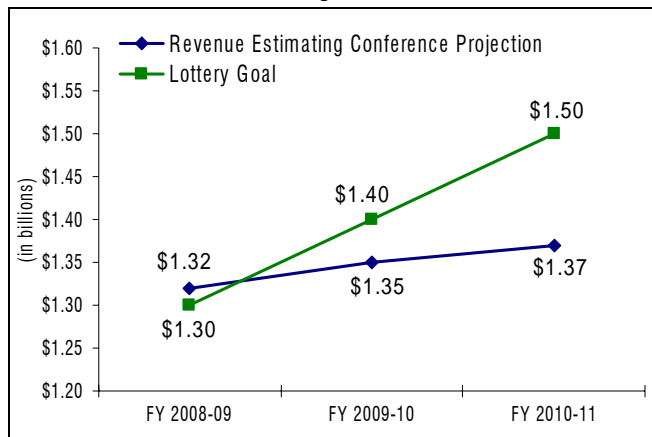
⁴ In its Long Range Program Plan, the Lottery reported its annual transfer to education target will be \$1.3 billion in Fiscal Year 2008-09, \$1.4 billion in Fiscal Year 2009-10, and \$1.5 billion in Fiscal Year 2010-11. The April 2008 Revenue Estimating Conference projects Lottery transfers to education during this same period to be \$1.32 billion in Fiscal Year 2008-09, \$1.35 billion in Fiscal Year 2009-10, and \$1.37 billion in Fiscal Year 2010-11.

Exhibit 1
Unadjusted Transfers to Education Increased \$39 Million (3%) in Fiscal Year 2006-07



Source: OPPAGA analysis of Lottery data.

**Exhibit 2
Lottery’s Goal to Increase Transfers to Education
Above Revenue Estimating Conference Forecast**



Source: OPPAGA analysis of Revenue Estimating Conference and Lottery Long Range Program Plan data.

Revenue Enhancement Options

The Lottery has taken several steps to maintain and increase the value of Lottery funding to education, including implementing new games and using its authority to modify prize payouts to boost sales as well as expanding retail outlets. The Lottery should further increase sales by continuing to expand the number of retailers who sell its products. While the Legislature could consider authorizing the Lottery to offer expanded gaming options such as video lottery terminals and a keno game, these options would likely substantially increase the negative social costs of gaming and could face a legal challenge related to the Governor’s recent revenue sharing agreement with the Seminole Tribe.

The Lottery has implemented new games to expand sales. The Lottery has launched new Lottery games to increase sales. Notably, it offered two \$20 on-line holiday raffles in 2007; these games have proven to be successful as the first Holiday Millionaire Raffle sold out in 11 days in 2006.

The department also has used its authority to offer variable prize payouts to boost sales. In the past, the Lottery was required to limit prize payouts to 50% of total sales. The Legislature authorized the Lottery to increase the percentage of game revenues offered as prizes, which

increases players’ chances of winning and tends to increase sales. For example, in May 2007, the Lottery used the variable prize payout structure to enhance prizes of its Firecracker Millionaire Raffle. The Lottery used a 55% prize payout structure for this game and reports the promotion yielded a net \$8.3 million in additional transfers to the Educational Enhancement Trust Fund.⁵

Similarly, since March 2006, the Lottery has offered EZmatch on a continual basis, which is an add-on game to Fantasy 5 using a 53% prize payout structure. With the purchase of a Fantasy 5 ticket, players may also purchase a \$1 EZmatch play for a chance to win up to \$500 instantly. The Lottery reports the net return on this investment to education is \$53.7 million since the launch of EZmatch.

The Lottery plans to use the variable prize payout flexibility to enhance its Lotto game. Beginning in March, players will be given the option of buying \$2 and \$3 Lotto tickets as well as continuing to purchase the \$1 play. These new games will not change the odds of winning or the way the Lotto game is played. Those who choose the \$2 play will be attempting to win the standard Florida Lotto jackpot plus a \$10 million prize (30-year annuity value). Those buying a \$3 ticket will be vying for a jackpot equaling the standard Lotto jackpot plus a \$25 million prize. The Lottery will fund these new prizes through sales of the enhanced game, plus unclaimed prize money and payout flexibility as needed.

Increasing retail network could increase revenues. Increasing the number of retailers has the potential to increase revenues by making lottery products more readily available to residents and tourists. Nationwide data on the performance of state lotteries show that there is a significant relationship between per capita sales and the number of residents per retailer. In Fiscal Year 2006-07, the top 12 state lotteries ranked by per capita sales had an average of 1,200 residents per retailer. During this same period, the Florida Lottery averaged 1,400 residents per retailer, and ranked 12th among U.S. lotteries in per capita sales.

⁵ This estimate reflects net transfers to education adjusted for higher prize payouts, retailer incentives, and marketing efforts, and excludes sales shifts from other games.

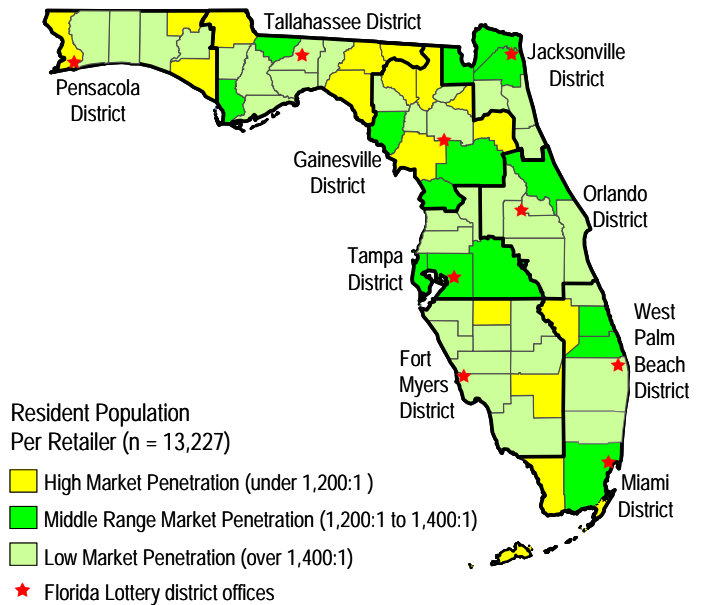
To meet the top-performing states' average market penetration, the Lottery would need to expand its retail network from 13,500 to 15,000 retailers.⁶ Since 2004, the Lottery has increased its retail network from approximately 12,000 to over 13,000 retailers. The Lottery estimates that these new retailers generated increased sales that resulted in an additional \$24 million in transfers to education in Fiscal Year 2006-07. OPPAGA estimates that adding 1,500 additional retailers beyond the current level would generate about \$37 million annually in additional transfers to the Educational Enhancement Trust Fund.⁷ Further, as the state's population grows and new communities are established, the number of lottery retailers should increase to keep pace with population growth.

As shown in Exhibit 3, the current market penetration of Lottery retailers varies substantially across the state. In 16 counties, there were fewer than 1,200 residents per retailer, while 36 counties had more than 1,400 residents per retailer (the remaining counties fell in the middle of this range). The Lottery's on-line game contract provides for potential expansion of the retailer network to 20,000 terminals, and the department currently solicits retailers by pursuing leads developed through trade organizations and gaming system vendors, and accessing state agency data on businesses operating in the state.

Lottery vending machines could enhance revenues. Since 1996, the Lottery has been authorized to sell scratch-off tickets through instant ticket vending machines.⁸ The Lottery previously contracted for these machines, but determined that they were cost-effective in only certain locations. As its contract did not provide for a reduction in the number of leased machines, the department did not renew the contract in 2001.

Since that time, instant ticket vending machine technology has improved, making the machines

Exhibit 3
Florida Retailer Market Penetration Varies Across the State



Source: OPPAGA analysis of Lottery data.

more cost-effective. Further, the Lottery officials report they lost a prospective corporate account with multiple retailer outlets because that business would only distribute Lottery products through vending machines. To address this issue and enhance its retail network, the Lottery has proposed leasing 1,000 instant ticket vending machines. In July 2007, the Revenue Estimating Impact Conference found instant vending machines would have a positive net impact on transfers to education but that the amount is indeterminate.

⁶ Currently, the Lottery has the spending authority to operate up to 13,500 sales terminals.

⁷ This updated estimate assumes all 1,500 terminals are active, that each new terminal would generate at least the Lottery's average weekly net sales per new retailer for 2007, and that there would be 20% lost sales by other retailers as a result of adding new terminals. It also assumes that the transfer rate is the current blended on-line and scratch-off ticket transfer rate of 29.6%.

⁸ Section 4, Ch. 96-341, *Laws of Florida*.

The Lottery is proposing to reinstate vending machines. Currently, the Lottery's authority to distribute Lottery products through vending machines is limited to scratch-off games. In 1996, when the Legislature authorized the Lottery to use vending machines to distribute scratch-off tickets, the technology did not exist to support vending machines to sell on-line games. However, this technology is now available and is currently an option for the Lottery in its on-line contract with GTECH.

If the Legislature chooses to authorize this action, it could consider authorizing the Lottery to use vending machines to sell on-line games as well. Expanding access to Lottery products could increase social costs as discussed below. If the Legislature chose to do so, it should consider actions to limit potential access by minors. Currently, instant ticket vending machines are required by law to be under the supervision and within direct line of sight of the lottery retailer to ensure that the machine is monitored and only operated by persons at least 18 years of age. This provision should be applied to vending machines that sell on-line tickets as well.

Video lottery terminals and keno games have the potential to increase revenues but would raise social costs of gaming. Other states offer some lottery games that are not offered by the Florida Lottery. These games have the potential to attract new players and substantially increase revenues to the Lottery. For example, introducing video lottery terminals could increase transfers to education between \$464 million and \$1.3 billion.⁹ A keno-type game, i.e., a "quick draw" game, could generate between \$41 million and \$309 million.¹⁰

⁹ OPPAGA revenue estimates for keno are based on per capita performance while revenue estimates for video lottery terminals are based on net income per machine. The keno range is based on high and low state per capita sales after excluding the outlier states from the upper and lower quartiles. The video lottery terminal range is based on the Slot revenue Estimating Conference estimates for the Broward County pari-mutuel facility's lowest net income per machine to the highest net income per machine. For keno, the current on-line transfer rate to the Educational Enhancement Trust Fund of 41.18% was used and 50% for video lottery terminal estimates.

¹⁰ Keno is an 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 a central computer. Keno is similar in principle to other on-line games, but it is more frequently

However, authorizing lottery games such as video lottery terminals and keno-type games have associated social negative consequences. Video lottery and keno-type games are considered to be more addictive than traditional lottery games and could contribute to problem and pathological gambling and increased law enforcement needed to combat crime typically associated with gambling. A small percentage of gamblers develop pathological addictions leading to a variety of financial, physical, and emotional problems. Studies indicate that problem and pathological gamblers can suffer financial hardship, bankruptcy, unemployment, and may resort to crimes to support their addictive behavior as well as commit domestic violence, substance abuse, and suicide. Studies have shown that the negative effects associated with problem gambling may take at least three to four years to manifest themselves. As a result, some adverse effects are not immediately apparent when legalized gambling is approved or expanded.

Estimating the costs of problem and pathological gambling is difficult and subject to debate because methods to estimate these costs have not yet been fully developed. However, the National Gambling Impact Study Commission has estimated that the annual average costs of job loss, unemployment benefits, welfare benefits, poor physical and mental health, and problem or pathological gambling treatment to society is approximately \$1,195 per pathological gambler per year and approximately \$715 per problem gambler per year. The magnitude of these negatives effects and their costs in Florida is indeterminate at this time, but available data indicates that concerns are increasing with the recent expansion of casinos and electronic gaming devices in Florida.

(normally every five minutes) and normally played in a social setting such as a bar or restaurant. Video lottery terminals are player activated and can be programmed to play casino-style games such as poker, blackjack, keno, and bingo; or simulate mechanical slot machines or roulette wheels.

In addition, authorizing video lottery terminals could violate a compact made between the Governor and the Seminole Tribe.¹¹ In November 2007, the Governor entered an agreement with the Seminole Tribe providing partial but substantial exclusivity to the tribe to operate casino type games such as slots, high-stakes poker, and blackjack in exchange for sharing a portion of their revenue with the state. While the agreement is being challenged by the Legislature, it provides that revenue sharing will cease if the state authorizes casino style gaming not already authorized at the time of the agreement.¹²

In addition to video lottery and keno-type games there are other games that Florida could implement that would not be as closely associated with the negative effects of gambling. For example, Florida could join a multi-state lotto type game, which tend to have large jackpots (such as Mega Millions), and could produce between \$50 million and \$99 million for education per year.

A super-jackpot game could earn between \$24 million and \$47 million a year.¹³ The department should assess the advantages and disadvantages of these options and their potential to increase sales and transfers to education and submit its findings to the Legislature.

Operational Efficiency Options

The Lottery continues to improve on a key indicator of operational efficiency, its expenses as a percentage of sales. However, it could realize additional efficiencies by ensuring that contract terms represent the best value for the state, and continuing to explore ways to reduce costs for leasing office space. Improved monitoring of vendor performance could help the Lottery identify further operational efficiencies. And, the Lottery should develop a comprehensive marketing plan with specific objectives for its marketing efforts.

The Lottery's administrative expense rate is lower than the legislative standard and has declined over time. Over the past five years, the department has reduced its expenses as a percentage of sales revenue from 10.2% to 9.35%.¹⁴ As shown in Exhibit 4, the Lottery has consistently kept its administrative expense rate below the legislative performance standard. Compared to other state lotteries, the Lottery had the sixth lowest administrative expense rate in Fiscal Year 2005-06.¹⁵

¹¹ In 1987, the U.S. Supreme Court held that tribal governments have the authority to establish gaming operations independent of the state regulation provided that the state permits some form of gaming. To provide the statutory basis for the operation and regulation of gaming by Native American tribes, Congress passed the Indian Gaming Regulator Act in 1988. The act permits states to determine the scope and extent of tribal gaming through tribal-state compacts for Class III gaming and gives the tribes regulator authority over Class I and II gaming. Class I games are under the exclusive jurisdiction of tribes and includes social games and traditional and ceremonial games. Class II excludes house-banked card games but includes bingo, pull tabs, and games similar to bingo, plus non-banking card games (unless prohibited by state law). Class III includes all other types of gambling, including house-banked card games, slot machines, pari-mutuel racing, jai-alai and electronic games of chance.

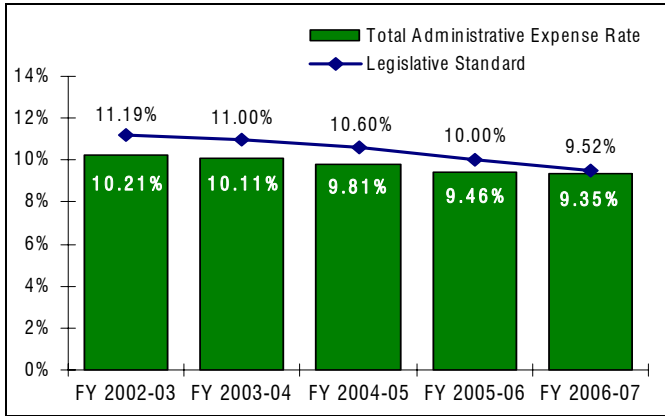
¹² The agreement specifically states "If Class III gaming as defined in this Compact, or other casino-style gambling where the results of such games are determined through the use of a random number generator, that is not presently authorized by or under Florida law is authorized for any location within the State of Florida that is under the jurisdiction of the State, including but not limited to (1) electronically-assisted bingo or pull-tab games or (2) video lottery terminals (VLTs) or any similar games that allow direct operation of the games by customers of the Florida Lottery, any successor entity, and such gambling begins to be offered for public or private use, the Payments due the State pursuant to Parts XI.A and B of this Compact shall cease until such gambling is no longer operated, in which event the Payments due the State pursuant to Parts XI.A and B of this Compact shall resume." Therefore, authorization by the state to permit the Lottery to operate video lottery terminals would breach the terms of the compact and jeopardize the revenue sharing agreement.

¹³ OPPAGA revenue estimates for super-jackpot and multi-state are based on per capita performance. The super-jackpot range is based on New York's Millennium game with and without a rollover. The multi-state range is based on cannibalization rates (the amount Lotto sales would decline) from 40% to 70%. For super-jackpot and multi-state, the current on-line transfer rate to the Educational Enhancement Trust Fund of 41.18% was used.

¹⁴ Expenses include all costs incurred in the operation and administration of the Lottery including advertising fees and vendor and retailer commissions.

¹⁵ Florida Lottery's ranking is based on the latest fiscal year data available from *La Fleur's 2007 World Lottery Almanac*. The 2008 edition of the almanac will be published in April 2008.

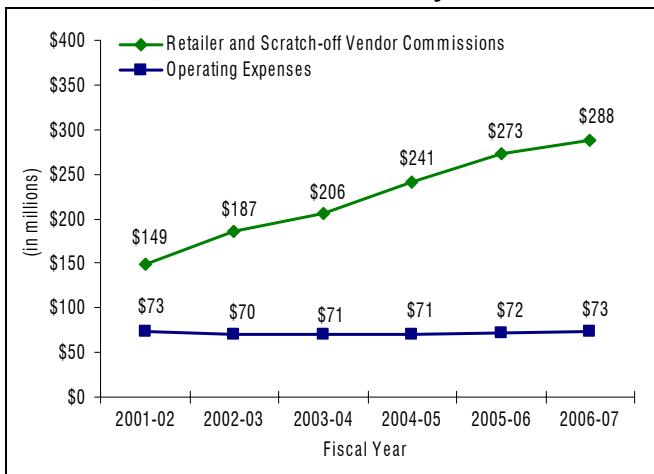
**Exhibit 4
The Lottery Administrative Expense Rate Has Declined Over Time**



Source: OPPAGA analysis of Lottery performance information submitted to the Legislature.

While the Lottery’s administrative expense rate has declined, actual dollars spent on administrative operations has increased. Between Fiscal Years 2002-03 and 2006-07, total administrative expenses increased 32% from \$293 million to \$386 million. As shown in Exhibit 5, retailer and scratch-off venter commissions account for this increase while Lottery in-house operating expenses remained relatively flat.¹⁶

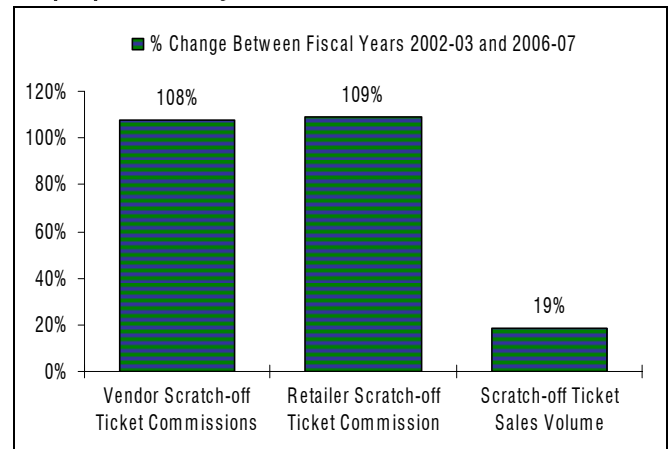
**Exhibit 5
Commissions, Driven by High Priced Scratch-Off Ticket Sales, Increased Substantially**



Source: OPPAGA analysis of Lottery financial statements.

The Lottery should modify its vendor payment structure to reflect current games. To increase sales and transfers to education, the Lottery has begun to offer higher value games such as \$20 scratch-off and \$20 on-line games. However, it has not changed its method for paying commissions to retailers to reflect these changes. Consequently, commissions to vendors and retailers have increased substantially and disproportionately to the volume of scratch-off tickets sold. As shown in Exhibit 6, commissions to vendors and retailers have increased by 108% and 109% respectively, over the past five years, while the number of tickets sold has increased by only 19%. This has occurred because commissions are tied to the dollar value of tickets sold rather than to the number of tickets sold.

**Exhibit 6
Scratch-Off Ticket Commissions Increased Disproportionately to the Volume of Tickets Sold**



Source: OPPAGA analysis of Lottery financial statements and ticket sales data.

¹⁶ Operating expenses include in-house functions such as information services, marketing, public affairs, finance and budget, games administration, product development, security, field support, and other contracted services such as advertising.

Ideally, commissions to vendors and retailers should be structured to compensate them for their workload and reward them for performance. The Lottery's contract with the vendor that provides scratch-off games currently requires a commission of 2.25% of scratch-off ticket sales. That is, for each \$1 scratch-off ticket manufactured, delivered, and sold the vendor is paid 2.25 cents commission. Correspondingly, for each \$20 scratch-off ticket sold, the vendor is paid 45 cents, or 20 times the commission for selling a \$1 ticket. The Lottery historically has paid retailers a 5% commission on tickets sold, but it has not changed this commission structure to reflect the higher value games. As a result, retailers are currently paid a five-cent commission for each \$1 ticket and \$1 for each \$20 ticket they sell, although selling the higher-valued ticket does not increase their workload.

While these commission structures give vendors and retailers an incentive to produce and sell higher-value games, it is questionable whether the Lottery needs to offer up to 20 times higher commissions to do so. Given the Lottery has launched even higher priced scratch-off games (a \$30 scratch-off game in January 2008), it should take steps to ensure that vendors and retailers are fairly compensated while minimizing its administrative expenses.

The Lottery is working toward new commission structures for both its scratch-off vendor and retailers. The Lottery will negotiate new vendor payment terms as part of its latest procurement for scratch-off games. In November 2007, the Lottery issued a solicitation to procure a new scratch-off vendor contract. The Lottery is using an invitation to negotiate method of procurement to select the highest quality vendor capable of providing a complex set of services and commodities and plans to negotiate with them on price. When executed, this new contract is planned to replace the current contract that expires in September 2008. The Lottery also reports it will explore changes to its current retailer commission structure by conducting surveys and focus groups in the upcoming year.

Leased headquarters space exceeds its needs. Since our 2002 report, the Lottery has been unsuccessful in substantially reducing the amount of office space it leases. The Lottery continues to lease more than twice the amount of office space recommended by the Department of Management Services per full-time equivalent employee at an excess annual cost of \$884,000. Since the late 1990s the Lottery has reduced its need for office and warehouse space through staff reductions and outsourcing functions such as telemarketing and scratch-off ticket distribution. However, the Lottery has not commensurately lowered its operational costs by reducing the amount of space it leases.

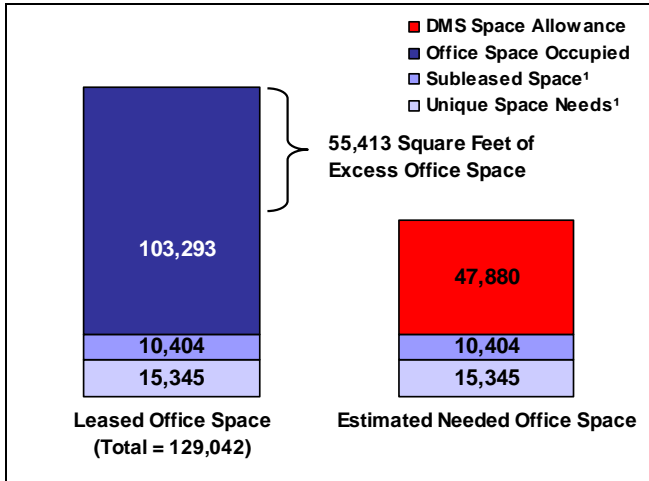
The Lottery's leases 157,653 square feet of space at its headquarters, which includes 129,042 square feet of office space (located mostly on its top two floors of a four-story building) and 28,611 square feet of air-conditioned warehouse space (located on the bottom two floors). The Lottery is in its final year of a 10-year lease (with two 5-year extension options available) and is paying a combined office and warehouse rate of \$15.96 per square foot per year for a total of \$2.5 million in Fiscal Year 2007-08.¹⁷

The Lottery currently occupies about 103,293 square feet of leased office space for its 266 employees at its headquarters, equating to 388 square feet per employee. The Department of Management Services has established a recommended standard of 180 square feet per employee, which equates to 47,880 square feet of office space for Lottery staff. Therefore, as shown in Exhibit 7, the department leases 55,413 square feet of excess office space (this comparison considers the Lottery's unique and special needs and space already subleased).¹⁸

¹⁷ The Lottery currently subleases office and warehouse space, reducing its lease payments by \$227,254 in Fiscal Year 2007-08 (\$166,048 for office space and \$61,206 for warehouse space).

¹⁸ Adjustments include the Lottery's subleased office space for its on-line and scratch-off ticket vendors (10,404 square feet) and its unique office space needs (15,345 square feet) including extra large meeting rooms, graphics studio, gaming system testing area, winner's lounge/payout room, central alarm station, dedicated computer/technology training room, forensics/ ticket testing and evidence areas, and video production space.

**Exhibit 7
The Lottery Leases 55,413 Square Feet of Office Space in Excess of Its Needs**



¹ The Lottery’s need for leased office space includes office space already subleased (10,404 square feet) and for unique and special needs (15,345 square feet).

Source: OPPAGA analysis of Lottery data.

In its recent report to the Legislature, the Lottery indicates it has continued to be unsuccessful in finding tenants to sublease its excess leased office space. However, the Lottery reports it is pursuing relocating its draw studio operations to its headquarters facility. The Lottery also reports that it has two upcoming potential opportunities to sublease excess office space.

- As part of its latest scratch-off ticket procurement, the Lottery reserved the right to mandate the successful vendor sub-lease office space for the telemarketing services.
- As part of its next general market advertising procurement, the Lottery will include a provision to reserve the right to mandate that the successful vendor sublease office space at the Lottery’s headquarters location.

While the Lottery has made some efforts to reduce its excess leased office space, it has not developed a detailed cost-benefit analysis that considers options including moving its headquarters building to another location as recommended in our 2007 report. Therefore, the Lottery should work with the Department of Management Services to complete a comprehensive cost-benefit

analysis and buy versus lease business case for meeting the Lottery’s long-term office and warehouse space needs. This business case should take into account the Lottery’s long-term program needs, explore the options of moving to state-owned property, requesting bids for other private leased space, negotiating with its current landlord for reduction in costs and/or the amount of space leased. The Lottery should also continue to work with the Department of Management Services to find suitable tenants to sublease its headquarters office and warehouse space. The Lottery should continue to submit progress reports on these efforts at least annually to the Governor, Legislature, and OPPAGA.

The Lottery has begun implementing our prior recommendations to improve vendor performance monitoring. The Lottery has taken steps to improve contract monitoring but more work needs to be done to ensure vendor accountability and identify opportunities for improved business operations in its future solicitations. Since our 2006 report, the Lottery created a new position to improve the department’s contract management processes. The new manager established monitoring tools and provided training for its staff who oversee vendor contracts.

This new approach to contract monitoring is in the process of being implemented. The department reports it has devised a way to track the large number of deliverables associated with its multi-million dollar contracts through multiple monitoring tools. The department is in the process of fitting these monitoring tools to its existing contracts and anticipates it will develop a comprehensive monitoring process for its new scratch-off vendor contract.

The department should continue to develop these monitoring tools for its multi-million dollar contracts and develop a system to assess vendor performance for its advertising contracts in order to determine under what conditions the expenditure of advertising dollars results in increased Lottery revenues.

The Lottery does not have a comprehensive marketing plan and has limited data on its marketing outcomes

The Lottery has improved its marketing activities but should take additional steps to strengthen its promotional efforts (including billboard, newspaper, radio, and television advertisements) by establishing a comprehensive marketing plan and additional mechanisms for evaluating its return on promotion investments.¹⁹

The Lottery has strengthened marketing but should develop a comprehensive marketing plan. The Lottery hired a new chief marketing officer in April 2007 who has taken steps to improve the department’s marketing planning process. The chief marketing officer in coordination with the Lottery’s product development and sales divisions established a marketing calendar with a year-long perspective. The year-long perspective provides leverage by planning and consolidating media purchases into annual blocks at reduced rates. The marketing calendar also helps to facilitate weekly discussions between the Lottery’s divisions and provides the basis for mid- and year-end reviews in which staff assess past marketing efforts and plan future marketing activities.

The Department could further improve its marketing activities by developing a comprehensive marketing plan. This plan would integrate existing Lottery product development, market research, media planning, and sales strategies. It would also establish specific marketing objectives, strategies, and budgets, establish an advertising plan including advertising objectives, strategies and budgets, and identify activities that the Lottery’s divisions and its contractors would perform during a year and identify how these activities and outcomes would be evaluated. This plan would help ensure that the Lottery’s marketing resources are spent in a way that maximizes the return to the state.

The Lottery is taking steps to more fully evaluate the outcomes of its marketing efforts and use this information to inform future marketing investment decisions. The Lottery’s ability to determine the effectiveness of its marketing activities is currently limited because it does not measure the return on investment achieved by its promotions by game, change in market share, or use quantitative benchmarks that analyze past campaign effects on sales. The Lottery’s evaluation efforts currently consist of analyzing consumer purchasing trends and comparing sales before and after a marketing campaign.²⁰

The Lottery is considering contracting with Ernst & Young to evaluate the effectiveness and return on investment of current marketing activities. The return on investment is defined as a measure of the profit earned from an investment.²¹ This evaluation could provide information the Lottery can use to establish quantitative benchmarks to measure the effectiveness of marketing campaigns and help it direct future marketing dollars towards the activities that are likely to have the best return on investment.

Recommendations

In Fiscal Year 2006-07, the Lottery transferred \$1.26 billion to the Educational Enhancement Trust Fund, \$39 million more than in Fiscal Year 2005-06. However, the Lottery continues to face the challenge of sustaining revenue growth and ensuring operational efficiency.

The Lottery and the Legislature have several options to enhance revenues. The department should

- continue to expand its retailer network to increase sales distribution and revenues by routinely acquiring information on potential retailers in order to improve its recruitment efforts;

¹⁹ Section 24.107, *F.S.*, recognizes the need for extensive and effective advertising and promotion of lottery games. Accordingly, the Legislature has maintained advertising funding for Lottery games at about \$35 million annually since Fiscal Year 2003-04.

²⁰ The return on investment evaluation should at a minimum account for sales, advertising expenditures, size of game jackpots, cannibalization of other Lottery games, and other factors that influence sales.

²¹ Lenskold, James D. *Marketing ROI: The Path to Campaign, Customer, and Corporate Profitability*. Columbia University Press, 2003.

- expand its use of multi-priced on-line games; and
- carefully evaluate the benefits and disadvantages of adding a super jackpot game and joining a multi-state game and providing the results of its assessment to the Legislature.

The Lottery is proposing to reinstate vending machines for instant lottery tickets. If the Legislature chooses to authorize this action, it could consider authorizing the Lottery to use vending machines to sell on-line games as well; to ensure that minors cannot use the machines, the current statutory provision that instant ticket lottery vending machines be under the supervision and within direct line of sight of the lottery retailer would need to be applied to vending machines that sell on-line tickets.

In order to enhance operational efficiency, the Lottery should take additional steps described below.

- Establish alternative vendor and retailer payment terms in its future contracts to attract and retain quality vendors and retailers while maximizing revenues to the state.
- Work with the Department of Management Services to develop a detailed cost-benefit analysis and buy versus lease business case to reduce its leased office space. This assessment should include assessing the options of moving to state-owned property, moving to a new, smaller leased building, and negotiating with its current landlord for a reduction in leasing costs and/or the amount of space leased.
- Develop its vendor performance monitoring system to ensure accountability and to help identify further operational efficiencies.
- Develop a comprehensive marketing plan and expand its evaluation of marketing outcomes.

Agency Response

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 review and response.

The Secretary's written response to this report is in Appendix A followed by OPPAGA comments.

Appendix A

CHARLIE CRIST
Governor



LEO DIBENIGNO
Secretary

FLORIDA LOTTERY

March 11, 2008

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

Dear Mr. Vanlandingham:

Thank you for the opportunity to respond to your office's February 2008 draft report entitled, "Lottery Profits Continue to Increase; Options Available to Enhance Transfers to Education." Although we disagree with certain elements of OPPAGA's analysis and recommendations, we are in agreement with many of the statements expressed in this year's report.

Our response is organized around your recommendations.

Options to Enhance Revenues

The department should continue to expand its retailer network to increase sales distribution and revenues by routinely acquiring information on potential retailers in order to improve its recruitment efforts.

The Lottery's commitment to expanding its retailer network is even stronger than a year ago; and its efforts, more intensive. Our current strategies go far beyond "routinely acquiring information on potential retailers" to include:

- Renewed attempts to persuade additional major corporate chains to become Florida Lottery Retailers. As a result, K-Mart, Save-A-Lot, Murphy Oil, Miami Subs and others already have joined the Lottery team or currently are in the process of doing so.
- A special competition among our sales staff to identify viable Lottery retailer candidates, which has yielded more than 200 new retailer applications in its first month.
- Enlisting our gaming system vendor's (GTECH's) technicians, stationed around the state, in identifying retailer prospects for us.



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- Forging a new partnership with the Florida Retail Federation that greatly enhances our campaign to reach potential new retailers with word of the benefits of working with the Florida Lottery.
- Conducting three comprehensive Retailer Recruitment Seminars per year. This year, we actually are conducting four such seminars. Seminars have been completed in Jacksonville and Orlando, and are scheduled for Fort Myers and West Palm Beach. These meetings serve as focal points for regional retailer recruitment, placing an emphasis on attracting business owners from under-represented minority businesses.

The department should expand its use of multi-price on-line games.

Concur. The OPPAGA report notes the success of our EZMatch™ add-on option as a multi-price, on-line game. As this response is prepared, the Florida Lottery's flagship game, FLORIDA LOTTO™ has just been relaunched with a multi-price promotion. Additionally, next month, player research will begin on four new potential on-line games. It is likely that one of these games will be launched as either a higher-price-point or multi-price game next fall. (It should be noted that "on-line" games do not refer to Internet-based wagering, but rather games that are sold through traditional lottery terminals.) EZMatch, the new LOTTO add-on, and the upcoming on-line games described above, all utilize the Lottery's variable prize authority granted us by the Legislature in 2005.

The department should carefully evaluate the benefits and disadvantages of adding a super jackpot game and joining a multi-state game and providing the results of its assessment to the Legislature.

Pursuant to its mandate to maximize educational enhancement revenues, the Florida Lottery continually strives to offer the most appealing set of games possible within financial and legal constraints. This commitment is carried out through an on-going product development process involving staff dedicated to each product line, weekly meetings of an inter-disciplinary Product Development Team and an extensive marketing research program.

More than once over the years, as a part of its normal course of business, the Florida Lottery has evaluated the benefits and disadvantages of adding a super jackpot game or joining a multi-state game. We have chosen not to go forward at this time with either a super jackpot game or a multi-state game because our evaluations have consistently led us to the conclusion that other game alternatives were a better choice for Florida in terms of maximizing contributions to Educational Enhancement funding and maintaining the popularity of the Florida Lottery brand. These evaluations, as well as player preference research, continue on a regular basis.

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The “super jackpot game” suggestion, included in prior OPPAGA reports, was based on the New York Lottery’s *Millennium* game in 2000. That game was a precursor to more recent raffle-styled games launched by Florida and several other lotteries over the past two years. The Florida Lottery game launch schedule for FY 2008-09 includes the third consecutive year of the very popular *Holiday Millionaire Raffle*. Additionally, it is important to point out that both the 1999 changes to LOTTO and the recent launch of the multi-price version of FLORIDA LOTTO addresses the players’ desire for higher jackpots.

Additional Steps to Enhance Operational Efficiency

The department should establish alternative vendor and retailer payment terms in its future contracts to attract and retain quality vendors and retailers while maximizing revenues to the state.

The Lottery is in the midst of an Invitation to Negotiate (ITN) competitive procurement process to select a Scratch-off game vendor for a contract term beginning October 1, 2008. The ITN was issued in November 2007, replies were received on January 18, and the Lottery is currently reviewing those replies. During the ensuing negotiations, the Lottery’s plan is to evaluate alternative vendor compensation frameworks in order for the state to receive the best value. However, it should be noted, that at the time of this writing, we are in the “cone of silence” of the procurement process and cannot discuss details further.

Changes to the compensation arrangements for the more than 13,000 businesses serving as Lottery retailers are under active discussion. Some states offer different compensation models for retailers, but at this time there is no clear evidence that one particular model works best in maximizing revenue. However, more study and consultation is needed before revising these provisions.

The department should work with the Department of Management Services to develop a detailed cost-benefit analysis and plan to reduce its leased office space.

The Florida Lottery has considered OPPAGA’s 2007 recommendation to move to a new facility location in the Tallahassee area. The Lottery also made numerous attempts to sublease office and warehouse space. For the reasons explained below, it is the position of the Florida Lottery that it is not feasible to move at this time, and that it is prudent to renew the current lease agreement. Nevertheless, the Lottery will continue to pursue other appropriate initiatives cited in the report, e.g., streamlining business operations (moving the draw studio into Headquarters), potential telemarketing co-location, and subleasing.

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Discussions with DMS regarding available state-owned rental space have led us to the conclusion that no suitable space is available. The Lottery has also researched privately-owned properties, with reduced square footage requirements. Our first search identified available properties ranging in size from 500 to 20,000 sq. ft.; of those spaces, the rental rates ranged from \$18.00 to \$27.31 per square foot. Subsequent searches have failed to locate any comparable properties. No property is available of the size and type needed to accommodate the Lottery's unique requirements. Additionally, the current Landlord has proposed a new rental rate, now including janitorial and lawn service, of \$17.59 per sq. ft. for the Lottery to stay in place.

The cost of relocation, carefully considered in our response to OPPAGA's 2002 review, also is a factor in our decision. Six years ago, we estimated the relocation cost at \$5 million. The Lottery's unique redundancy requirements for information technology and security substantially increase the cost of relocation. It is entirely possible that current relocation costs would be even higher than before, making such an action infeasible in this time of serious budget constraints.

Nor is construction of a new facility on state-owned property a viable option. DMS has advised us that more than five years would be needed to acquire land, get approvals from DMS, secure legislative funding, obtain required permits, and construct a facility. Additionally, the cost of new construction has been estimated by DMS at \$200 per square foot. Based on OPPAGA's recommendation of using approximately 103,000 square feet for a Lottery operations facility, the construction cost to build a new facility would be approximately \$20.6 million plus at least \$5 million in relocation costs requiring legislative funding approval.

This leaves the option of trying to meet state workspace standards at the Lottery's current location. The OPPAGA report recognizes the Lottery's efforts to reduce our leased office space by attempting to sub-lease our space. In order to maintain the security, integrity, and high level of public confidence in Florida Lottery operations, any subleasing of space in the Headquarters building requires restricted access to the Lottery by non-Lottery employees. Discussions with sublease candidates have indicated that subleasing any portion of the Lottery headquarters building to a non-Lottery tenant will require major remodeling. There have been discussions about the need for a new/separate entrance and internal reconfiguration of the building to accommodate new tenants. The Lottery has been in discussions with the building owner who has not expressed interest in paying for these reconfigurations. However, the Lottery continues to actively pursue subleasing opportunities with interested parties.

As previously recognized by OPPAGA, achieving the DMS "average target" of 180 square feet per employee would require major reconfiguration of the current facility. Likely impacts on the unique structural support system in the facility, especially cubical

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and hard wall placements, greatly complicate reconfiguration. In addition, the structural support columns cannot be moved or adjusted; therefore, effective and efficient space utilization is very much constrained. Full implementation of DMS recommended workspace standards may not be possible given the structural realities of the building, the unique needs of the Lottery's operation, and the cost of relocating the Lottery or leasing/creating a new building.

The department should develop its vendor performance monitoring system to ensure accountability and to help identify further operational efficiencies.

The Lottery's efforts to improve contract monitoring are noted in this OPPAGA report. However, we take issue with the OPPAGA analysis indicating that the Lottery is "attempting to rely on a single checklist to monitor a contract." Due to the Lottery's unique and diverse business activities, the General Services Contract Manager has developed and provided several tools that may be used to make determinations with regard to a contractor's performance and the receipt of contractual deliverables. Lottery Contract Managers are being trained in the use of the recommended Programmatic Monitoring Tool for monitoring deliverables and the contractor's performance in detail. This tool is expandable, providing space for: identifying contract deliverables; services and/or commodities; a rating system; a section for memorializing how ratings were determined; and a section for notating deficiencies and how those will be resolved. The General Services Contract Manager has also provided another tool, the Contract Close-out Checklist that can be used to assist contract managers in ensuring all deliverables are received prior to contract close-out. Additionally, contract managers are being trained in requirements related to acceptance of services and deliverables prior to invoice approval.

The General Services Contract Manger also provides administrative oversight for all contracts. For cooperatively managed agreements, assistance includes aiding contract managers in the preparation and understanding of monitoring tools, researching and reviewing contractually related documents, meeting with stakeholders, reviewing competitive procurement documents, and providing assistance as requested by the contract managers.

The department should develop a comprehensive marketing plan and expand its evaluation of marketing outcomes.

It first is necessary to express disagreement with one report finding discussed in this context: "The Lottery's marketing efforts are hindered by the lack of a formal marketing plan and limited data on its marketing outcomes." In regard to planning, we wonder what the basis for this finding is in light of the several planning functions identified below and, more importantly, in view of the Florida Lottery's very considerable success in recent years in terms of building sales, increasing EETF profits and managing costs.

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This finding risks creating the erroneous impression that Lottery does not do sufficient market planning. As noted in the report, the Lottery already has developed a master marketing calendar, which mostly focuses on tactics. In addition to that, it should be understood that the Lottery:

- Has prepared a *Long Range Program Plan* setting out sales goals and strategies for the next five fiscal years;
- Annually adopts a set of fiscal year sales goals, for both Scratch-off games and On-line games, for the state as a whole and each of the nine Lottery administrative districts;
- Annually goes through a budgetary allocation planning process that distributes fiscal resources among the Lottery's divisions for the fiscal year;
- Has set launch schedules for specific Scratch-off and On-line games six-to-eight months into the future, supported by media efforts;
- Receives annual industry review and outlook presentations from its major game vendors;
- Develops a detailed action plan for every new game or promotion launch, including print, television, and radio marketing; and,
- Holds weekly inter-disciplinary meetings with both game vendors to discuss product plans.

The Lottery will continue to lengthen the time horizon of its product/promotion launch planning calendar to provide more lead time to its marketing, sales and other divisions as well as to its game vendors. The Lottery also will take steps to ensure widespread awareness of its strategies and launch schedule. Further, we question what comparisons OPPAGA can point to that would validate their assertion that organizations that have adopted a 'formal marketing plan', as defined by OPPAGA, realized better sales performance than the Florida Lottery. Finally, we cannot agree with this finding when OPPAGA failed to provide a specific definition of a 'formal marketing plan' that materially differs from the Lottery's marketing planning process.

The Lottery also will continue its practice of analyzing the sales and EETF returns of its game and promotion launches. The second part of the OPPAGA report finding relates to the Lottery's limited measurement of the effectiveness of its marketing activities. Here too, we are concerned that this finding creates the mistaken impression that the Lottery does not carefully analyze the impacts of its actions. In fact, conducting player research and calculating the likely returns to education finding is one of the key tools we use to constantly improve our product launches, marketing campaigns, and sales performance. In short, we strive to duplicate our successes and learn from our mistakes. Over the years, the Lottery has frequently used return-on-investment analyses to support budget

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requests and statutory change proposals. Often these analyses have been examined and adopted by the Revenue Estimating Conference.

In addition, the Lottery provided OPPAGA with its return on investment analysis of games and promotions using the variable prize payout authority granted by the Legislature in 2005. In response the footnote on page 10 of the report, our analysis did indeed account not only for sales and advertising expenditures, but also retailer incentive expenditures and additional prize costs. It controlled for jackpot levels, in the few cases in which that is relevant, by adjusting for jackpot size in the sales increment calculation. This particular analysis did not address cannibalization of sales of other games, but our submittals to the Revenue Estimating Conference almost always do.

In closing, the Florida Lottery always welcomes suggestions for ways to improve our performance and productivity. Thank you for the time and attention your staff and you have devoted to this year's review.

Sincerely,



Leo DiBenigno
Secretary

LD/dh/ms

OPPAGA Comments to Agency Response

Regarding the leased headquarters space, OPPAGA provides the following clarification to the agency response on pages 14 through 16:

The Lottery's current leased headquarters facility was designed and built over 20 years ago to accommodate business functions that no longer take place in the building such as shipping and receiving scratch-off tickets and telemarketing. Furthermore, the Lottery's headquarters workforce has been reduced by half, and the Lottery has been unable to find suitable tenants to sublease the majority of its excess leased space, which has cost the state over \$5 million since 2002. For these reasons, OPPAGA recommended the Lottery conduct a detailed cost benefit analysis of options that would meet its headquarters facilities needs prior to its lease expiration in 2008. The Lottery's actions described above are limited and do not appear to have fully assessed options such as soliciting bids from the private sector; relocating the Lottery to a state-owned building, or constructing a new headquarters building at the Capital Circle Office Complex.

Regarding the marketing plan and evaluation, OPPAGA provides the following clarification to the agency response on pages 17 through 18:

While the Lottery has taken many steps to plan and assess its marketing activities, OPPAGA is recommending the Lottery take additional steps by developing a comprehensive marketing plan with detailed evaluations of its marketing investments. Current Lottery market planning activities are primarily done at a high level. For example, its budgetary allocation planning process distributes resources at the division level but does not address the allocation of resources for individual marketing activities in relation to specific goals, objectives, and outcome measures such as return on-investment. A more comprehensive marketing approach would include situational and SWOT (strengths, weaknesses, opportunities, and threats) analyses, marketing strategies and implementation plans, and performance standards tied to Lottery goals and objectives for each marketing effort. We believe that a comprehensive marketing plan detailed at a lower level will furnish management with additional tools to evaluate the performance of marketing efforts, improve resource allocations, and optimize returns to the state.

The Florida Legislature

Office of Program Policy Analysis and Government Accountability



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