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Privatization of Lottery Operations (DOR -- Lottery Administration)

[LFB 2003-05 Budget Summary: Page 375, #3]

CURRENT LAW

The operation of the state lottery is the responsibility of the Lottery Division in the Department of Revenue (DOR). The Lottery Division is authorized 109.5 SEG positions in 2002-03, funded from the lottery fund. The Division's base funding in 2002-03, totals $62,831,200 SEG and includes $21,688,700 for general program operations, $28,352,000 for retailer compensation, and $12,790,500 for contracted vendor fees.

Under current law, the lottery division administrator may determine whether lottery functions should be performed by DOR employees or by one or more persons under contract with the Department of Administration (DOA), except that no contract: (a) may provide for the entire management or operation of the state lottery by any private person; or (b) may be entered into for financial auditing and security monitoring services. DOA must require separate bids or separate competitive sealed proposals for each of the following supplies and services, if provided by contract: (a) management consultation services; (b) instant lottery ticket supplies and services; and (c) online supplies and services.

Under current law, SEG-funded positions may be authorized only under the following procedures: (a) by law or in budget determinations; and (b) by the Joint Committee on Finance, acting under s. 13.101(2) of the statutes.

GOVERNOR

Delete 94.5 SEG positions in 2004-05 relating to the operation of the state lottery and authorize the lottery division administrator to determine whether any lottery functions, except for financial auditing services and procurement functions relating to the lottery, should be performed by one or more persons under contract with DOA. Shift $4,921,200 SEG budgeted in 2004-05 for salaries, fringe benefits and supplies and services to unallotted reserve for possible use to support such contracts. (A total of $122,800 SEG of this shifted funding is erroneously budgeted as an aids to individuals and organizations payment.)

Authorize DOR to request the Governor to create a full-time equivalent position, or a portion of a position, funded from gross lottery revenues to perform state lottery-related services that are not performed by one or more persons under contract with DOA. The procedure would be similar to the current s. 16.515/16.505(2) process. Upon receiving the DOR request: (a) the Governor may approve a different authorized level of positions than is requested; (b) if the Governor proposes any change to the number of authorized full-time equivalent positions, the Governor must notify the Joint Committee on Finance in writing of this proposed action; (c) if the Co-chairs of the Committee do not notify the Governor within 14 working days of the notification that the Committee has scheduled a meeting to review the proposed action, the proposed position changes may be made; and (d) if, within the 14 working day period, the Co-chairs notify the Governor that the Committee has scheduled a meeting to review the proposed action, the position changes may then be made only upon the approval of the Committee.

DISCUSSION POINTS

1. According to lottery officials, under current operating procedures Wisconsin had the fifth lowest per capita spending for lottery expenses of any of the 38 U.S. lotteries in 2000-01. The Wisconsin lottery is statutorily required to limit its operating expenses. Under current law, no more than 10% of gross lottery revenues for each year may be expended to pay the expenses for the operation and administration of the lottery (except as approved by the Joint Committee on Finance under s. 13.10 of the statutes).

2. In computing expenses subject to the 10% limitation, payments to vendors for on-line services and supplies are included and capital expenditures may be amortized. Compensation paid to retailers and monies appropriated to the Department of Justice for enforcement activities relating to the lottery are not included in the 10% calculation. Lottery administrative expenses constituted 8.32% of gross revenue in 2000-01 and 7.87% in 2001-02.

3. Many lottery functions are already contracted to private vendors. Lottery sales are conducted by approximately 3,700 private retailer outlets under contract with the state. Other major contracted functions include: (a) scratch and on-line ticket computer systems and services; (b) telecommunications; (c) TV shows and drawings; (d) accounting services; (e) ticket delivery; (f) advertising; and (g) ticket printing.

4. State employees oversee these contracts and perform the remaining functions for the operation of the lottery. The following table summarizes the functions performed by the Lottery Division. In addition to the 93.75 positions identified here, 15.75 positions supported by the lottery fund work outside the Lottery Division in DOR and provide human resources, procurement,

accounting and information technology support to the Division.

Lottery Functions	FTE
Product Research, Development, and Support	9.00
Marketing (Telemarketing and Field Marketing to Retailers)	29.00
Retailer Relations, Training, and Support	9.00
Player Relations, Drawings, TV Show, and Special Events	18.00
Warehouse and Security	7.50
Information Technology Support	3.00
Administration	18.25
Total	93.75

5. According to administration officials, the intent of the Governor's recommendations is to evaluate "private-sector options for the state lottery retail trade and limiting the state's role to auditing and contract compliance." If the evaluation concludes that the private sector can operate the lottery in a more cost-effective manner than the state, a private vendor would be awarded a contract for the operation of the lottery. It is anticipated that any requests for information, the subsequent circulation of requests for proposals (RFPs), the review and evaluation of the RFPs and any final contract award could be concluded before the end of the 2003-04 fiscal year.

6. Under the bill, 94.5 SEG lottery positions would be eliminated on July 1, 2004. The elimination of these positions would leave 15.0 full-time equivalent (FTE) positions for all contract negotiation, compliance and financial auditing. The Governor also indicates that if the state operation of the lottery remains the most cost-effective means of program delivery, the lottery positions could be restored under the 14-day passive review process described above.

7. The funding transferred from the salary, fringe benefits and supplies and services lines was calculated on the basis of eliminating the following 94.5 FTE positions in 2004-05. First, all positions in the following subprograms of the Lottery Division would be deleted: (a) Secretary's office (-1.0 FTE); (b) retailer relations (-37.0 FTE); and (c) product development (-9.0 FTE). Second, most positions, with minor exceptions, in the following subprograms in the Division or in DOR would be deleted: (a) operations (-22.5 FTE, with 0.75 FTE retained); (b) human resource services (-2.0 FTE, with 1.25 FTE retained); and (c) lottery administration (-23.0 FTE, with 0.5 FTE retained). The Lottery Division administrator and other senior management positions are included in these position deletions.

8. The 15.0 FTE positions remaining under the bill in 2004-05 would include: (a) 2.0 accountants; (b) 1.0 attorney; (c) 1.0 budget and policy analyst; (d) 1.0 economist; (e) 1.0 financial management supervisor; (f) 2.0 financial specialists; (g) 3.0 information technology positions; (h) 2.0 purchasing agents; (i) 0.5 shipping and mailing clerk; and (j) 1.5 unspecified positions.

9. However, the current positions used to calculate the amounts transferred from the

salary, fringe benefits and supplies and services lines may or may not eventually be deleted. The proposed passive review process for reinstating lottery positions that would otherwise be deleted implies that a different mix of position classifications or numbers of positions deleted or retained could occur.

10. Lotteries in the United States are administered in a variety of ways, including: (a) stand-alone agencies; (b) as part of a state agency (as is the case in Wisconsin); (c) independent commissions; and (d) quasi-public corporations.

11. No U.S. lottery has attempted to contract with a vendor to perform all management and operational functions.

12. While the Governor's recommendation appears to be oriented towards a private management approach, it is not clear at this time what the scope or the specific form the lottery privatization would be. In response to inquiries to officials in DOA and DOR concerning whether the Governor's intent is simply to contract remaining lottery functions to a new or existing vendor or to have a new or existing vendor manage the overall operation of the lottery, including other contracts and vendors, it was indicated that: "The objective is to identify the most cost-effective solution. If the Department determines it would be cost-effective to privatize the Lottery then the approach could include either a parsing of services into several contracts for their constituent parts or a comprehensive contract that bundles all services. The budget bill does include a provision that would allow DOR to select either option."

13. Connecticut has moved from a lottery operated by a state agency to one operated by a quasi-public corporation. However, Connecticut initiated this conversion with a statutorily required study to develop a plan for the total or partial privatization of the Connecticut State Lottery, conducted by its Secretary of the Office of Policy and Management.

14. An extensive report, published in January, 1996, indicates that the Secretary assembled an interdisciplinary team that included legal advisors and two financial advisory firms. The team studied issues relating to finance, management, valuation, regulation and tax issues (both state and federal), legal rights and obligations, and public policy.

15. Of particular note in the Connecticut report was its negative assessment of the option relating to contracting with a private firm or consortium to manage the lottery for a period of years. That approach, according to the report, was not recommended after research showed that certain forms of privatization would likely raise federal tax and regulatory complications. Connecticut converted its state lottery to a quasi-public corporation, effective July 1, 1996.

16. Tennessee removed a constitutional prohibition of a state lottery in November, 2002. In preparation for the implementation of a state lottery, the Tennessee Comptroller of the Treasury Office of Research published a comprehensive report in February, 2003, that examined all U.S. lotteries, including administrative structures and procedures, and oversight roles. The report proposes lottery models based on goals to be established by the Tennessee General Assembly. The

report places great emphasis on explaining the implications of various choices that Tennessee must make in structuring its lottery. Currently, Tennessee is considering legislation to create a quasi-public corporation to manage its lottery.

17. Both the Connecticut and Tennessee reports provided extensive analysis of lottery-related issues prior to either state committing to a course of action. It could be argued that recommendations included in SB 44 for the Wisconsin Lottery would commit the state to an action (the elimination of 94.5 lottery positions, effective July 1, 2004) prior to a full evaluation of the lottery, a clear definition of privatization goals, or the development of a plan to implement the management privatization initiative (including the process for seeking, awarding, and implementing contracts) and a transition plan to assure that lottery functions are not interrupted.

18. Wisconsin DOR officials indicate that the 94.5 positions selected for deletion are "…those that provided services that could be purchased under a management contract." According to officials, "Positions were eliminated prospectively to create an impetus to an open restructuring of lottery operations." Following a determination of how to further privatize the lottery, the Department could presumably reestablish any necessary state positions under the 14-day passive review process that would be authorized under the bill.

19. An argument that careful evaluation and planning is appropriate and desirable prior to displacing current lottery operations could be advanced on the basis of prior actual experience in Wisconsin.

20. An initiative similar to the Governor's current proposal was considered in Wisconsin in 1995 and 1996. In January, 1995, the Governor proposed that virtually all remaining lottery functions be contracted to private firms by June 30, 1996. (This timeframe is identical to that in the current proposal.) Under the initiative, 29 of 121 lottery positions would have been retained to manage the lottery and monitor the work of private contractors. (Under the current proposal, 15 positions would be retained for this purpose.)

21. The Legislature did not approve the privatization proposal and instead would have required the Gaming Commission and the Secretaries of DOR and DOA to jointly and cooperatively develop an implementation plan for privatization initiatives, including a plan for the implementation of contracts and contract oversight mechanisms, relating to sales administration, marketing, ticket warehousing, instant ticket data processing, telephone sales and ticket delivery. The plan would also have identified state position reductions associated with each privatization initiative. The plan would have been subject to approval under a 14-day passive review process.

22. The Governor vetoed these provisions (from 1995 Wisconsin Act 27) and continued efforts administratively to eliminate staff and privatize the lottery. In March, 1997, the Legislative Audit Bureau (LAB), in an evaluation of the state lottery, concluded that "… since early 1995, administration of the Wisconsin lottery has been impaired by largely unsuccessful attempts to privatize …" The LAB also stated that "During 1995 and 1996, when privatization was being planned and attempted, large numbers of staff left or were re-assigned to positions outside the

lottery before their jobs were assumed by private firms…. As a result, certain basic lottery functions, including informing retailers about available products, providing retailers with support and guidance on marketing lottery products, and publicizing lottery winners, have been performed minimally or have not been performed at all." Lottery sales over the 1995-97 biennium declined nearly 17% as compared to 1994-95.

23. In 1995-96, the state lottery was transferred from the Gaming Commission to DOR. The LAB cites this transition as one factor contributing to the privatization difficulties, even though the agencies involved in the transition appeared to be receptive to the transition and the privatization effort. Other contracting difficulties were identified as follows: First, the LAB noted that the schedule to contract for lottery functions covered only 11 months. The LAB concluded that this timeline was "a highly ambitious schedule for obtaining and implementing the new contracts, which eventually proved to be unrealistic." Second, the widespread expectation that all but a few lottery positions would be eliminated, resulted in extremely high vacancy rates prior to contracts being implemented. (The LAB reported that in January, 1997, the lottery's vacancy rate was 63.5%.)

24. The current proposal before the Legislature similarly provides for a short timeline (the 2003-04 fiscal year) in which to evaluate the functions of the lottery, develop bid specifications, conduct the bidding process, negotiate and award a contract and provide for a transition process to assure that lottery functions are not interrupted.

25. According to DOR officials, the following twelve-month schedule would allow the agency to complete the process. The RFP would be released in August, 2003, or upon passage of the biennial budget bill. Responses to the RFP would be due 60 days from its release (October, 2003). Evaluation would take approximately 60 days followed by the issuance of a letter of intent (December, 2003). The required appeals period and final contract negotiations would require approximately 90 days to complete (March, 2004). Based on this proposed timeframe, DOR officials anticipate that there would be approximately a three-month period for implementation before July 1, 2004. However, recent DOR experience with other lottery-related RFPs suggests that this timeline might be optimistic.

26. DOR is currently involved in an RFP process for the primary lottery computer systems and services. The current contract terminates in June, 2004. It is a complex RFP process because the current computer system will be replaced.

27. The Department began the planning and RFP development phase in January, 2001. In June, 2002, initial RFPs were released. The first proposals were rejected and a second round of RFPs was released in February, 2003. A vendor is expected to be selected in June, 2003. It is anticipated that the appeals process and final negotiations may take about two to three months and the transition process to the new computer system will cover about nine months.

28. This current RFP process will take more than 2.5 years to complete. The process was complicated by a number of factors; however, if these factors had not developed, the process would still have taken about two years to complete.

29. While a privatization RFP process may or may not be as difficult to implement as this computer system upgrade has been, it is likely to be quite complex. Based on the experience with the computer system RFPs, the outcome of the 1995-96 effort to privatize, and taking into account the LAB assessment of the 1995-96 effort, it could be argued that up to two years may be required to evaluate, plan for, and implement a successful privatization initiative.

30. Administration officials argue that if the initiative takes longer than one year, or if the evaluation shows that privatization is not more cost effective and the current operation of the lottery should be continued, the bill would provide a process to restore lottery positions under a 14-day passive review process.

31. While this provision would allow for the reauthorization of lottery positions in 2004-05, a concern may be raised that many of the restored positions would be vacant, because employees could be expected to leave, as was the case in 1995 and 1996. The loss of trained personnel and their attendant expertise may damage lottery operations in 2004-05 and beyond. On the other hand, it could be argued that employee losses may be minimized by the limited job prospects in the current economy.

32. The 14-day passive review process to reauthorize deleted SEG lottery positions would be a new mechanism for the approval of SEG-funded positions by the Joint Committee on Finance. Under current law, SEG-funded positions may be authorized only under the following procedures: (a) by law or in budget determinations; and (b) by the Joint Committee on Finance, acting under s. 13.101(2) of the statutes. The proposed approval mechanism, under the bill, would be needed in order to expedite the reauthorization of positions if more than 15.0 FTE positions are viewed as necessary to provide proper oversight of a privately managed lottery, or if the privatization effort is abandoned. Consequently, it could be argued that the 14-day passive review approval mechanism is only necessary because of the approach taken under the bill of eliminating staff before future staffing needs are clearly determined.

33. Questions can also be raised concerning the magnitude of the staff reduction, under the bill. As noted above, a reduction of 94.5 positions would leave 15.0 positions for contract negotiation, compliance and auditing. Under this provision, Wisconsin would have the smallest lottery staff in the country. The LAB evaluation of the lottery published in April, 1995, which examined the Governor's January, 1995, proposal to reduce lottery staff to 29 employees, stated that "According to officials in other states, it is not unusual to employ a significant number of staff to oversee and monitor contracts, and contracting has not resulted in the establishment of regulatory agencies with few staff."

34. The Texas State Lottery is often cited as being the most privatized state lottery in the United States. It contracts with a "lottery operator" that performs multiple functions, including instant ticket and on-line game management, warehousing, ticket distribution, marketing and sales. Texas also has separate vendors for ticket printing and advertising. State employees are responsible for licensing retailers, product development, security (including background investigations) and monitoring vendors for contract compliance. The Texas lottery is operated under a stand-alone

agency that also manages charitable bingo operations. Excluding staff for charitable bingo, the agency is authorized 289 FTE positions for the state lottery. A Texas lottery official stated that oversight and contract compliance functions are a very important focus of the state agency, given the need to maintain the integrity of lottery operations.

35. An alternative to the staffing reduction proposed under the bill would be to delay the elimination of the positions until a later date (such as, January 1, 2005). This modification would result in a longer timeframe for the privatization initiative to be evaluated and planned. The 14-day passive review mechanism for approving the reauthorization of lottery positions could be retained to allow for timely adjustments to future state staffing needs.

36. Another alternative would be to retain all current lottery position authorizations for the 2003-05 biennium. This approach would allow for a more realistic timeframe for the privatization initiative to be evaluated and planned. Following the evaluation and planning stage, specific position reductions could be proposed by the Department during a transition phase to the new contract or could be implemented as part of the 2005-07 biennial budget process. This approach may better ensure the operational integrity of the lottery by preventing the loss of key staff prior to the implementation of contracts. This alternative would also allow for a more informed decision relating to the level of ongoing state lottery position needs. Further, under this alternative, the 14-day passive review mechanism for the approval of reauthorized positions could be eliminated. Unneeded positions could be eliminated in 2004-05 (thus removing them from the adjusted base position authorization in the 2005-07 biennial budget) under s. 13.101(2) of the statutes or, alternatively, as part of the 2005-07 biennial budget process.

37. An additional issue that the Committee may wish to consider relates to the potential shift in focus of the lottery under private management. The recent Tennessee study cited above discusses the mutually exclusive nature of lotteries set up to maximize profits and those "designed to accommodate interest in betting without fostering that interest." Wisconsin has always taken a conservative approach about how aggressive the state lottery should be in encouraging gaming behavior. This has likely suppressed lottery sales to some extent. This conservative approach is reflected in the state's prohibition of promotional advertising, its budgetary cap on advertising expenditures, and legislative control of prize payout levels.

38. It can be argued that the state lottery could be operated more cost-effectively with a private firm providing overall management. However, as the Connecticut study concluded, private firms may not consider assuming a management role unless given a free hand to grow the lottery enterprise and share in the resulting profits. Thus, a private management option for the lottery may require a reorientation of the state lottery to one seeking to maximize profits in order to attract private management bids. This approach may imply changes in the current restrictions on lottery operations. For example, a private vendor may wish to have greater flexibility with respect to advertising (which could raise constitutional questions) or to be allowed to set maximum prize payout amounts (which would require statutory changes).

39. It is not known at this time what sort of profit-sharing mechanism might be

employed to accommodate the interests of a private firm. When DOA and DOR were asked about possible profit-sharing mechanisms, they indicated: "No determination has been made at this time regarding privatization options. Should the Department determine that it would be cost-effective to privatize the Lottery it would select a model that would maximize revenue available for property tax relief."

40. It appears that a prior evaluation of lottery privatization may be helpful to determine: (a) what functions would be contracted; (b) what management authority the contractor would have relative to the state (for example, with respect to advertising and prize payout levels); (c) what relationship this contractor would have with other lottery vendors; (d) whether management privatization would involve some form of profit sharing and what form this might take; and (e) a transition plan to assure the successful conversion of the lottery to new management. A transition plan could also include a schedule for phasing out state positions and a rationale for the number and classification of state positions that would be retained.

41. Revenue officials believe that the RFP process itself will clarify these very issues and will provide a basis for subsequent decisions on contracting for private management. In their view: "The parameters of the RFP would be broad enough so that the vendors could address different scenarios and pieces much like the current computing services RFP is structured."

42. The Committee could conclude that such an evaluation should be completed and reviewed before any final decision is made on lottery privatization. Under this alternative, the Governor's recommendation would be deleted and 94.5 SEG positions would be restored in 2004-05. The Committee could also require that such an evaluation, including a transition plan be submitted by DOR and DOA to the Joint Committee on Finance, under s. 13.10 of the statutes, at such time as the evaluation and plan are complete. If the plan is approved, state position reductions could then be implemented prior to the end of the 2004-05 and base position authority for the 2005-07 biennium reduced accordingly.

43. The bill, as drafted, would authorize the lottery division administrator to determine whether any lottery functions, except for financial auditing services and procurement functions relating to the lottery, should be performed by one or more persons under contract. The Secretary of DOR has requested that the word "financial" be deleted from the language under the bill so that the provision would state "except for auditing services and procurement functions." The requested change would, according to DOR, allow the lottery "… to perform more broad-based management auditing of any privatized lottery functions." The request appears to be reasonable and, if the Governor's recommendation is approved, the Committee may wish to make this change.

44. Under the privatization proposal, the current law requirement that DOA must require separate bids or separate competitive sealed proposals for instant lottery ticket supplies and services and online supplies and services would be eliminated. This change would allow bidders to submit integrated bids to provide both instant ticket and on-line supplies and services. The elimination of this provision was part of the Department's 2003-05 biennial budget request. Department officials indicate that technological advances now allow contractors to provide integrated systems for instant

and on-line games that are more cost effective than stand-alone systems. If the Governor's privatization provisions are deleted, the Committee could consider eliminating the requirement for separate bids for instant ticket and online supplies and services.

ALTERNATIVES

1. Approve the Governor's recommendation to delete 94.5 positions in 2004-05 relating to the operation of the state lottery and authorize the lottery division administrator to determine whether any lottery functions, other than financial auditing services and procurement functions relating to the lottery, should be performed by one or more persons under contract with DOA. Shift $4,921,200 budgeted in 2004-05 for salaries, fringe benefits and supplies and services to unallotted reserve for possible use to support such contracts. Authorize DOR to request the Governor to create a full-time equivalent position, or a portion of a position, funded from gross lottery revenues under a 14-day passive review type process.

2. Modify the Governor's recommendation by deleting the 94.5 SEG positions effective January 1, 2005, rather than on July 1, 2004.

3. Approve the Governor's recommendation to authorize the lottery division administrator to determine whether any lottery functions, other than financial auditing services and procurement functions relating to the lottery, should be performed by one or more persons under contract with DOA. Delete the provision to eliminate 94.5 SEG positions in 2004-05 and transfer $4,921,200 budgeted in unallotted reserve and as an aids to individuals and organizations payment in 2004-05 to the salaries, fringe benefits and supplies and services lines. Delete the provisions relating to a 14-day passive review process to restore deleted lottery positions.

Alternative 3	SEG
2004-05 POSITIONS (Change to Bill)	94.50

4. *In addition to Alternative 1, 2 or 3,* provide that the lottery division administrator would be authorized to determine whether any lottery functions, except for auditing services and procurement functions relating to the lottery, should be performed by one or more persons under contract with DOA. This alternative would allow auditing services performed by the state to include more than financial auditing services, as provided under the bill.

5. Delete the Governor's recommendation. Subject to approval by the Secretary of Revenue, provide that the lottery administrator may determine whether lottery functions shall be performed by DOR employees or by one or more persons under contract with DOA, except that no contract may provide for the entire management of the lottery or for the entire operation of the lottery by any private person unless approved by the Joint Committee on Finance under s. 13.10 of the statutes. For approval to proceed on a contract to provide for the entire management of the lottery or for the entire operation of the lottery by any private person, require DOR and DOA to

jointly submit to the Joint Committee on Finance a lottery privatization evaluation describing: (a) what functions would be contracted; (b) what management authority the vendor would have vis à vis the state with respect to issues including, but not limited to, lottery advertising and prize payout levels; (c) how a management or operations vendor would interact, if at all, with other lottery vendors; (d) whether management bids will require some form of profit sharing and, if so, a description of the profit-sharing mechanism; and (e) a transition plan to assure the successful conversion of the lottery to new management. Require that the plan include a schedule for phasing out state positions and a rationale for the number and classification of state positions that would be retained.

Alternative 5	SEG
2004-05 POSITIONS (Change to Bill)	94.50

6. Delete provision.

Alternative 6	SEG
2004-05 POSITIONS (Change to Bill)	94.50

7. *In addition to Alternative 5 or 6*, eliminate the current law provision that DOA must require separate bids or separate competitive sealed proposals for instant lottery ticket supplies and services and online supplies and services

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