



Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

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Joint Committee on Finance

Paper #697

Conversion of the Lottery Instant Ticket Inventory System (DOR -- Lottery Administration)

Bill Agency

[LFB 2007-09 Budget Summary: Page 495, #4]

CURRENT LAW

The state lottery is operated by the Lottery Division in the Department of Revenue (DOR) and is the one form of legal gambling in Wisconsin that is operated by the state, utilizing both state employees and contracted services, including private sector retailer outlets for lottery ticket sales. The state lottery offers two types of instant games: scratch ticket games and pull-tab games. In addition, the state lottery offers on-line games in which tickets are distributed from terminals linked to the state lottery's central office computer. Base funding for lottery general program operations totals \$19,026,100 SEG and the lottery division is authorized 95.55 SEG positions. Of these positions, 39.3 FTE are allocated to retailer relations work.

GOVERNOR

Provide \$243,800 SEG and delete 2.25 SEG positions in 2007-08 and delete \$212,000 SEG and 4.5 SEG positions in 2008-09 to institute a new system of instant ticket retailer inventory management for the state lottery's scratch ticket games. The provision would: (a) delete \$106,200 SEG and 2.25 SEG positions in 2007-08, and \$212,000 SEG and 4.5 SEG positions in 2008-09; and (b) provide one-time funding of \$350,000 SEG in 2007-08 for implementation of the new system. Increase projected lottery sales revenue by \$14.3 million in 2008-09 to reflect additional scratch ticket sales associated with the retailer inventory management initiative.

DISCUSSION POINTS

1. The DOR budget request for the lottery did not include a request for a new instant ticket retailer inventory system. However, a proposal for the initiative was made under the Department's 10% budget reduction plan, which included proposed initiatives to generate additional revenue to the state. The Department projected additional lottery revenues of \$14.3 million in 2008-09 by changing the inventory system. The projected sales gain in 2008-09 would represent an increase of 5.1% increase to estimated scratch ticket sales in 2006-07 (\$277.8 million).

2. The Governor is recommending the inventory initiative, as proposed by DOR, and has included an additional \$14.3 million in sales in 2008-09 in the projected lottery sales under the bill.

3. The proposed retailer inventory system would affect scratch ticket distribution only; on-line games or sales would not be affected by this initiative. Currently, each retailer makes decisions about the specific scratch games to be sold in the establishment and the quantities ordered, generally for a one-week period. Ticket orders are placed through the lottery's telemarketing staff. This staff, comprised of 10.3 FTE positions, assists retailers with ticket stocking decisions.

4. The implementation of the new inventory control system would permit a reduction of some of the lottery staffing that is currently associated with the telemarketing effort or related retailer support functions. Under the bill, \$106,200 and 2.25 positions in 2007-08 and \$212,000 and 4.5 positions in 2008-09 would be eliminated. Other retailer support staffing would be retained for continued retailer service support and for oversight of the new inventory system.

5. Under the current system, lottery officials believe that retailer stocks of scratch game tickets are not always optimal in terms of: (a) carrying certain scratch games when the sales of these games are most robust; and (b) maintaining an adequate supply of tickets.

6. By transitioning to a system whereby the lottery would distribute the right games and the correct number of tickets to retailers, sales could be optimized to take advantage of current market trends. As a result of this initiative, scratch ticket sales are projected under the bill to total an additional \$14.3 million in 2008-09. A \$14.3 million increase in sales revenue in 2008-09 would produce approximately \$4.3 million in additional funds for the lottery and gaming tax credit in that year. This would result in an increase in the annual, average lottery and gaming credit provided to primary homeowners of just under \$3. [The statewide average lottery and gaming credit for 2006(07) was approximately \$96.]

7. This retailer inventory control system, under which the lottery would centrally direct the distribution of scratch tickets to retailers is termed a "push distribution system," in that the lottery would "push" the appropriate amount of product to the correct retail locations. Lottery officials indicate that this type of system is similar to ones already in place for other retail product lines. For example, a soft drink supplier typically will stock a retailer location with the types and quantities of soft drinks that tend to sell best at that location.

8. From a marketing perspective, the concept represents a rational approach to maximizing sales by taking quick advantage of sales trends. From a practical perspective for the lottery, it requires DOR to execute two major changes: (a) it must modify its retailer billing procedures for scratch tickets to fit the new distribution system; and (b) it must plan and implement an entirely new approach to one segment of its operations.

9. Under current operating procedures, which are established by administrative rule, all lottery tickets received by the retailer are deemed to have been purchased by the retailer. The retailer's electronic fund transfer account, established for lottery purposes, is required to be debited once a week by the state lottery for tickets received by the retailer the previous week. If the retailer fails to place sufficient funds in the electronic fund transfer account for the tickets received the previous week, the retailer is not allowed to receive more tickets until the state lottery is paid in full. Under rule, the lottery administrator is authorized to assess the retailer a surcharge, an interest penalty, or both, for each dishonored retailer's check or electronic fund transfer.

10. It should be noted that the current billing procedures require payment in approximately seven to 10 days. Under this system, retailers generally order only enough tickets for a one-week period. With such a quick billing process, most retailers do not always order an adequate number of tickets and the chances of running out of certain game tickets are increased (hurting sales). This system does not encourage retailers to maintain larger supplies to make sure that shortages will not occur.

11. Lottery officials indicate that new rules are being developed that would change the billing terms to allow a period of between 28 and 32 days before payment is made. According to DOR, these rule revisions are in progress and are expected to be finalized by the end of calendar year 2007. Lottery officials believe that this change will have a positive effect on retailers and the lottery even if the push distribution system is not approved. Under the new rules, retailers would have greater flexibility to maintain more adequate supplies of scratch tickets because there would be greater period of time to sell tickets before they had to be paid for.

12. Under a push distribution system, however, this change in the billing system would be critical. Under the proposed system, tickets would be provided to the retailer in quantities and by game-type that should sell well over a period of time. But this approach would not function well, if retailers had to pay for these tickets within a seven- to 10-day timeframe. Under the proposed system, lottery officials argue that the 28 to 32 day billing cycle would be a necessity.

13. Lottery officials indicate that some retailer groups have been consulted on the proposed retailer inventory changes and reaction has generally been positive. However, lottery officials caution that, as is case with any new system, retailers will have some initial discomfort with the push distribution approach. Their expectation is that within six months the system would operate smoothly; retailers will then be more comfortable with the system and should be seeing positive sales results.

14. The planning for the new distribution system itself appears to be in a very early stage

of development. The \$350,000 in one-time funding provided under the bill is based on an estimate for software development and testing that was developed in discussions between GTECH Corp. [the state lottery's vendor for on-line and instant ticket information technology (IT) services] and lottery officials. However, no budget detail or work specifications have been developed to this point in time. Therefore, it not possible to assess the adequacy of the funding amount provided under the bill.

15. Lottery officials indicate that GTECH would provide the services required for any new push distribution system because the distribution system would need to be closely integrated into the lottery's current IT system similar to the way the current telemarketing and ordering system is integrated into the GTECH IT systems. GTECH has provided advice on the potential move to a push distribution system and would continue to consult on the project. Further, the \$350,000 in one-time funding provided in 2007-08 under the bill for the new system would be paid to GTECH for the system software redesign.

16. It should be noted that, under a new contract with the state lottery, entered into in November, 2003, GTECH installed a new instant and on-line gaming system, upgraded computer terminals at retail locations, and assumed responsibility for telecommunications services previously provided by a separate vendor. According to the Legislative Audit Bureau (LAB), the new systems were functioning in September, 2004, but several problems developed. The contract allowed the Wisconsin Lottery to assess liquidated damages against GTECH for the computer failures and associated "downtime" for the lottery or its retailers. Through negotiations, the lottery received benefits with a value of \$822,363, including a \$250,000 credit for future upgrades.

17. According to LAB, as of June 30, 2006, \$165,520 of the \$250,000 credit remained. Lottery officials now indicate that approximately \$115,000 of the credit should remain at the end of 2006-07. This credit could be applied to the software development costs for the proposed retailer inventory system, thus reducing the need for additional funds from \$350,000 to \$235,000. If the credit is not used for this purpose, lottery officials indicate that it would definitely be utilized for other upgrading purposes. However, it could be applied to the retailer inventory initiative.

18. Lottery officials indicate that only a handful of states have moved to some version of a push distribution system. These states include Michigan, Washington, and California and each of these states has a different approach. To this point in time, lottery officials have visited Michigan to assess that state's system. A visit to Washington is also planned in the near future. It is believed that the systems in these states may provide useful models for the development of the initiative in Wisconsin.

19. Under the Governor's provisions, lottery officials originally estimated that the system could be developed, tested, and implemented by January, 2008. Following further internal discussions, officials now indicate that this date would not be realistic. Instead, a July 1, 2008, implementation date is projected. This represents a six month delay in the implementation of the project.

20. As a result of this more recent information, the \$14.3 million sales increase in 2008-09 projected under the bill should be modified. A technical correction to the revenue estimate under the Governor's provision would result in a 50% reduction to the estimate due to the six-month implementation delay. The scratch ticket sales increase in 2008-09 would be reestimated to \$7.2 million, which is \$7.1 million less than the estimate under the bill.

21. In summary, the Department appears to have a clear idea on the direction it wants to move regarding retailer billing procedures, which are viewed as a positive change regardless of whether the push distribution system is implemented. The rule change process has been initiated and, if completed in 2007-08, as expected by lottery officials, the new billing system would be available if the proposed retailer inventory system is successfully implemented in 2008-09.

22. However, the proposed retailer inventory system itself appears to be in an early conceptual stage. No clear model for the system has been articulated and no plan (with specific objectives and timelines) has been developed for moving to a new system. Further, while the \$350,000 in one-time funding appropriated under the bill is considered a reasonable estimate of costs by lottery officials and GTECH, no specific breakdown of the required costs have been developed.

23. It could be argued that the proposal and its associated budget should be developed with more specificity before it is approved. In addition, new software systems typically take longer to develop than originally planned and this particular system may require a number of months to become fully implemented once the software is developed. It is possible that the full implementation of the system and its associated positive effect on lottery sales may not occur until late in 2008-09. The Committee could delete the Governor's provision and the Department could continue its development of the proposal and submit a request for its implementation in its 2009-11 budget request.

24. Alternatively, the Department could be required to develop a detailed implementation and cost plan for the initiative, including proposed administrative rules (or a summary of promulgated rules, if already completed) relating to retailer billing procedures, before funds are released for the project. The plan could be required to be submitted to the Committee, on or before January 31, 2008, under a 14-day passive review process. Under this alternative, the one-time funding of \$350,000 SEG would be: (a) reduced to \$235,000 [to reflect the use of \$115,000 in upgrade credits with GTECH for the project] and moved from 2007-08 to 2008-09 to allow time for the development of the plan; and (b) placed in the Joint Committee on Finance SEG appropriation for general program supplementation for release upon approval of the plan by the Committee.

25. This would provide the Department additional time to develop a detailed plan for the initiative. Lottery officials indicate that under this scenario a plan could be developed in 2007-08 and the software system design significantly advanced by utilizing the remaining GTECH upgrade credits discussed above. The target date for project implementation would be July, 2008. As discussed above, this six-month delay would affect the 2008-09 sales estimate and lottery scratch ticket sales would be reestimated from \$14.3 million to \$7.2 million.

26. Further, under this approach, \$106,200 SEG and 2.25 SEG positions deleted under the bill in 2007-08 would be restored to reflect the delay in the project until 2008-09. The \$212,000 SEG and 4.5 SEG positions deleted under the bill in 2008-09 would be restored, but the funding would be placed in unallotted reserve and released by DOA only if the push distribution system is not implemented. If the push distribution system is implemented in 2008-09, the following would be required: (a) the \$212,000 SEG would be retained in unallotted reserve to be lapsed to the lottery fund on June 30, 2009; and (b) \$212,000 SEG and 4.5 SEG positions would be required to be deleted under the standard budget adjustment for removing noncontinuing elements from the base in the 2009-11 budget process.

27. Under the alternatives to modify or delete the Governor's provision for the retailer inventory system, sales estimates would be adjusted. As a result, sum sufficient appropriations for retailer compensation and lottery vendor fees would require modification to reflect the sales estimate changes.

ALTERNATIVES TO BILL

1. Approve the Governor's recommendation to provide \$243,800 SEG and delete 2.25 SEG positions in 2007-08 and delete \$212,000 SEG and 4.5 SEG positions in 2008-09 to institute a new method of instant ticket inventory management system for the state lottery's scratch ticket games. The provision would: (a) delete \$106,200 SEG and 2.25 SEG positions in 2007-08, and \$212,000 SEG and 4.5 SEG positions in 2008-09; and (b) provide one-time funding of \$350,000 SEG in 2007-08 for implementation of the new system. Modify the scratch sales revenue increase projected under the bill from \$14.3 million to \$7.2 million in 2008-09 to reflect a six-month delay in project implementation.

ALT 1	Change to Bill			Change to Base		
	Revenue	Funding	Positions	Revenue	Funding	Positions
SEG	-\$7,100,000	\$0	0.00	\$7,200,000	\$31,800	- 4.50

2. Modify the Governor's recommendation by deleting \$115,000 SEG in one-time funding in 2007-08 (to instead provide a total of \$235,000) for the instant ticket inventory management system for the state lottery's scratch ticket games to reflect the availability of credits with the lottery's information technology service provider. Modify the scratch sales revenue increase projected under the bill from \$14.3 million to \$7.2 million in 2008-09 to reflect a six-month delay in project implementation.

ALT 2	Change to Bill			Change to Base		
	Revenue	Funding	Positions	Revenue	Funding	Positions
SEG	-\$7,100,000	-\$115,000	0.00	\$7,200,000	-\$83,200	- 4.50

3. Delete the Governor's provision. Instead, place \$235,000 SEG in one-time funding in 2008-09 in the Joint Committee on Finance SEG appropriation for general program supplementation for the development of the instant ticket inventory management system. Require the Department to develop a detailed implementation and cost plan for an instant ticket retailer inventory system, including proposed administrative rules (or a summary of completed rules, if already promulgated) relating to retailer billing procedures. Require that the plan be submitted to the Joint Committee on Finance, on or before January 31, 2008, under a 14-day passive review process. Provide that the \$235,000 SEG for the development of the instant ticket retailer inventory system be released for expenditure upon approval of the implementation and cost plan by the Joint Committee on Finance.

Place \$212,000 SEG in base funding associated with 4.5 SEG retailer support positions in unallotted reserve. Provide that the \$212,000 in position-related funding be released for expenditure, if the instant ticket retailer inventory system is not implemented in 2008-09.

If the instant ticket retailer inventory system is implemented, require that: (a) \$212,000 SEG in unallotted reserve lapse to the lottery fund on June 30, 2009; and (b) \$212,000 SEG and 4.5 SEG positions be deleted under the standard budget adjustment for removing noncontinuing elements from the base in the 2009-11 budget process.

Estimate an increase of \$7.2 million in scratch ticket sales in 2008-09 (\$7.1 million less than the estimate under the bill). Modify the appropriation estimates for retailer compensation and vendor fees to reflect this change to the bill.

ALT 3	Change to Bill			Change to Base		
	Revenue	Funding	Positions	Revenue	Funding	Positions
SEG	-\$7,100,000	\$203,200	4.50	\$7,200,000	\$235,000	0.00

4. Delete provision. Reduce the scratch ticket sales estimate by \$14.3 million in 2008-09. Modify the appropriation estimates for retailer compensation and vendor fees to reflect this change to the bill.

ALT 4	Change to Bill			Change to Base		
	Revenue	Funding	Positions	Revenue	Funding	Positions
SEG	-\$14,300,000	-\$31,800	4.50	\$0	\$0	0.00

Prepared by: Art Zimmerman