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**REPORT ON A PERFORMANCE AUDIT  
OF THE PENNSYLVANIA STATE LOTTERY**

September 1987



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## I. INTRODUCTION

In early 1987 a number of concerns were raised about various aspects of the Pennsylvania State Lottery. These concerns related to management and operation of the Lottery as well as to the leveling off of Lottery sales growth rates and potentially negative prospects for the continued financial health of the State Lottery Fund.

Amid these concerns, a performance audit of the State Lottery was adopted as a staff project of the Legislative Budget and Finance Committee at a public meeting which was held on February 18, 1987. As directed by the Committee, this audit was to focus on such matters as program efficiency, effectiveness, and results, as well as on compliance considerations and the adequacy of existing administrative control systems within the State Lottery.

The audit was carried out in two stages during the period March through September 1987. The preliminary phase of the project culminated in the issuance of an interim report in June of 1987. The interim report presented basic descriptive information and historical statistical data on the State Lottery, discussed the role and benefits of the State Lottery, provided information on the projected capacity of the State Lottery Fund to provide continued funding support for state programs and identified various specific issues and areas of concern for further detailed audit examination. This final report contains the results of activities carried out during the detailed audit phase of the project (June through September 1987) in relation to issues and areas of concern outlined in the interim report. Also contained in this final report are findings which deal with certain additional areas which were identified during the detailed audit phase.

This final audit report consists of six sections: Section I provides introductory information; Section II contains audit findings which present interstate comparative data relative to lottery sales, profits, and distribution of proceeds in Pennsylvania and other lottery states; Section III contains the performance audit findings and recommendations; Section IV contains overview descriptive information and related statistical tables pertaining to the Pennsylvania State Lottery; Section V provides descriptive information on the audit methodology; and Section VI, Appendices, includes various supplemental information concerning the Pennsylvania State Lottery and lottery operations in other states.

Development of this report was facilitated by the cooperation and assistance which was received from the Pennsylvania Department of Revenue. The LB&FC staff expresses its appreciation to the Honorable Barton A. Fields, Secretary of Revenue, to George R. Andersen, Esq., Acting Executive Director of the State Lottery, to Carl Back, who served as a special management advisor to the State Lottery, and to the many other Lottery officials and staff who assisted in the audit effort. Special thanks are also extended to officials and staff of the Governor's Office of the Budget and to the many State Lottery retailers and players who provided input to the auditors concerning the State Lottery.

The LB&FC audit team was under the direction of the LB&FC Executive Director, Richard D. Dario, and the Chief Analyst John H. Rowe. The Team Leader for the audit was Gregory S. Martino. Thomas L. Boone, Robert L. Hollings and Randal E. Mortimore, Analysts were also assigned to the audit on a full-time basis. Patricia A. Berger, Staff Attorney, provided legal services and also assisted in the development of the audit report. Donna R. Nell, Shannon M. Opperman and Krista L. Williard provided secretarial assistance, and Charles V. Saia provided additional staff assistance.

Any questions or comments regarding this report should be directed to Richard D. Dario, Executive Director, Legislative Budget and Finance Committee, Room 400, Finance Building, P.O. Box 8737, Harrisburg, PA 17105-8737.

IMPORTANT NOTE REGARDING RESPONSIBILITY  
FOR FINDINGS AND RECOMMENDATIONS OF THIS REPORT

This report contains information developed by the Legislative Budget and Finance Committee (LB&FC) staff. The release of this report by the LB&FC should not be construed as an indication that the Members of the Committee necessarily concur with all the report findings and/or support the recommendations. The LB&FC as a body, however, supports the publication of the information within this report and believes it will be helpful to the Members of the General Assembly by promoting improved understanding of the issues.

## II. INTERSTATE COMPARATIVE DATA FINDINGS

Findings A through C present interstate comparative data concerning Lottery sales, net income or profit and the use of the state lottery dollar in Pennsylvania and other selected lottery states. These findings relate to the historical and current position of the Pennsylvania State Lottery relative to the other lottery states in terms of, for example, the distribution of lottery proceeds (i.e., among prizes, profits, commissions and operating expenses) and total gross and per capita sales and net income returned to the respective state governments as a result of Lottery operations. Also specifically examined are annual sales growth rates since 1977 in Pennsylvania and six other lottery states (Illinois, Massachusetts, Michigan, New Jersey, New York and Ohio).

A. COMPARATIVE INFORMATION ON GROSS AND PER CAPITA LOTTERY SALES IN PENNSYLVANIA AND OTHER LOTTERY STATES

FINDING: As of mid 1987, lotteries had been established in 27 states and the District of Columbia.<sup>1/</sup> The auditors examined gross sales of the individual lottery states both historically and for recent fiscal years. Also examined were the trends in sales growth rates which have occurred over the past decade in the Pennsylvania State Lottery and six other state lotteries (Illinois, Massachusetts, Michigan, New Jersey, New York and Ohio). Examination of this data indicates that:

1. For a number of years the Pennsylvania State Lottery ranked first among the states in gross lottery sales. As recently as FY 1984-85, the State Lottery held the number one position with \$1.29 billion in total sales. Based on available interstate comparative figures it appears that PA ranked fourth in FY 1986-87 in gross sales. Pennsylvania's sales at \$1.3 billion were exceeded by California, Illinois and New York with estimated sales of \$1.6, \$1.5 and \$1.5 billion, respectively. (See Table 1.)

2. After experiencing steady, continuous growth since 1972, the growth rate of Pennsylvania Lottery sales has slowed in recent years with an increase of less than 1.4% between FY 1985-86 and FY 1986-87 (the lowest annual growth rate experienced by the Pennsylvania Lottery since FY 1974-75.) (See Chart C.)

3. On a per capita basis, Pennsylvania FY 1986-87 Lottery sales at \$112 per capita are lower than the per capita sales rates of six other states. Massachusetts has the highest reported per capita sales amount at \$198. (See Table 1.)

4. To a greater degree than the sales growth patterns of lotteries in a sample of six other states (Illinois, Massachusetts, Michigan, New Jersey, New York and Ohio), Pennsylvania Lottery sales have "levelled-off" in recent years. During the period FY 1983-84 through FY 1985-86 total PA Lottery sales increased by 6.8%. During the same period, lottery sales in the six sample states indicate total sales increases ranging from about 17% in New Jersey to more than 175% in Massachusetts. (See Charts C to P.)

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1/See Appendix B for a map of current lottery states.

TABLE 1

Gross Sales Information and Per Capita Sales  
for State Lotteries, PA and All States  
Fiscal Years 1985-86 and 1986-87\*/

State	FY 1985-86		FY 1986-87*/	
	Gross Sales (\$ Millions)	Per Capita Sales	Gross Sales (\$ Millions)	Per Capita Sales
Arizona.....	\$120.9	\$37.93	\$ 130.0	\$ 40.63
California.....	2,045.7 <sup>a/</sup>	77.59 <sup>a/</sup>	1,600.0	60.61
Colorado.....	108.9	33.70	106.8	33.38
Connecticut.....	428.7	135.06	477.0	149.06
Delaware.....	40.9	65.75	45.0	75.00
Illinois.....	1,316.4	114.12	1,500.0	130.43
Iowa.....	89.1	30.89	92.0	31.72
Maine.....	38.7	33.25	50.0	41.67
Maryland.....	718.5	163.59	775.0	176.14
Massachusetts.....	1,004.1	173.1	1,150.4	198.34
Michigan.....	999.6	109.99	1,100.0	118.28
Missouri.....	294.1 <sup>b/</sup>	58.48 <sup>b/</sup>	165.3	33.06
New Hampshire.....	32.1	32.16	45.0	45.00
New Jersey.....	990.1	130.93	1,100.0	144.74
New York.....	1,315.0	73.95	1,458.0	81.91
Ohio.....	940.0	87.49	975.0	91.12
Oregon.....	87.9	32.71	130.0	48.15
PENNSYLVANIA.....	1,320.0	111.06	1,338.5	112.48
Rhode Island.....	56.0	57.85	NA	NA
Vermont.....	12.4	23.17	24.1	48.20
Washington.....	181.2	41.10	183.4	41.68
West Virginia.....	82.9 <sup>c/</sup>	42.82 <sup>c/</sup>	81.0	42.63

\*/Except for Pennsylvania and Massachusetts, FY 1986-87 figures are projected as reported by the Public Gaming Research Institute, Inc., Handbook of U.S. Lottery Fundamentals, 1987.

a/52 weeks ending 10/4/86.

b/49 weeks ending 12/27/86.

c/46 weeks ending 11/28/86.

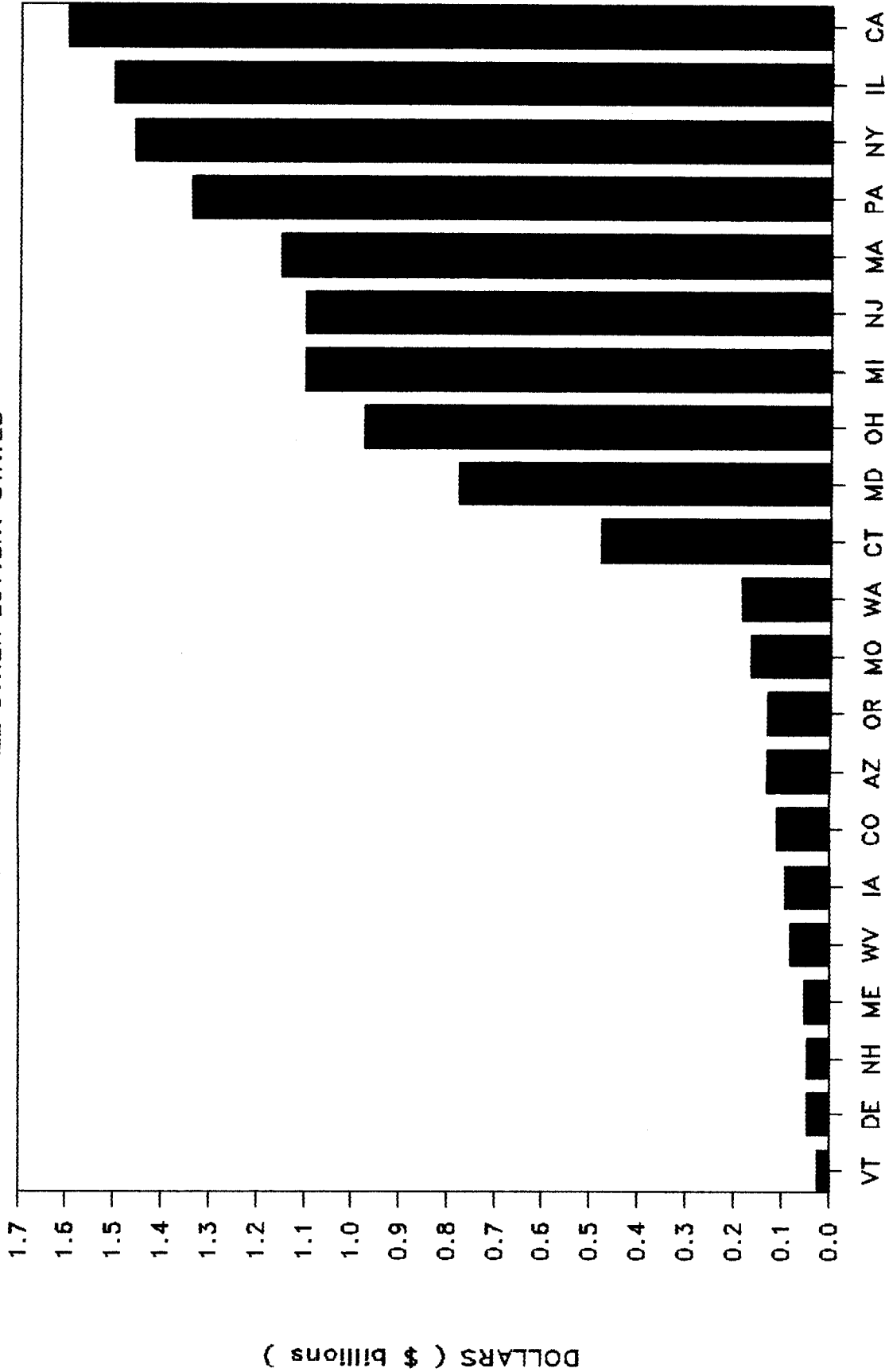
NA - Not Available

Source: Developed by the LB&FC staff from information contained in The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc.

CHART A

# GROSS LOTTERY SALES, FY 1987

PA AND ALL OTHER LOTTERY STATES



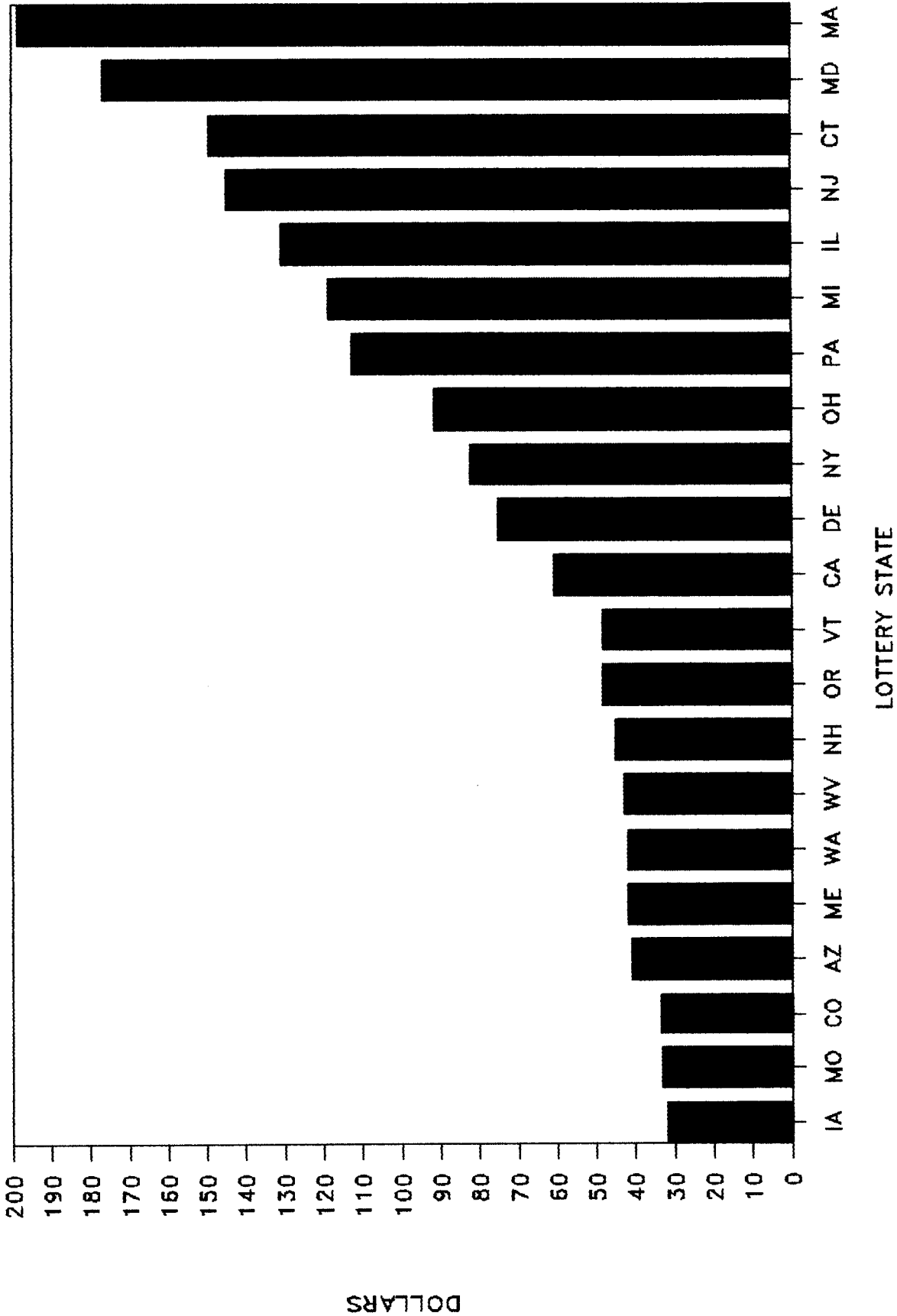
LOTTERY STATE

Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc., the Massachusetts State Lottery, and the Pennsylvania State Lottery.

CHART B

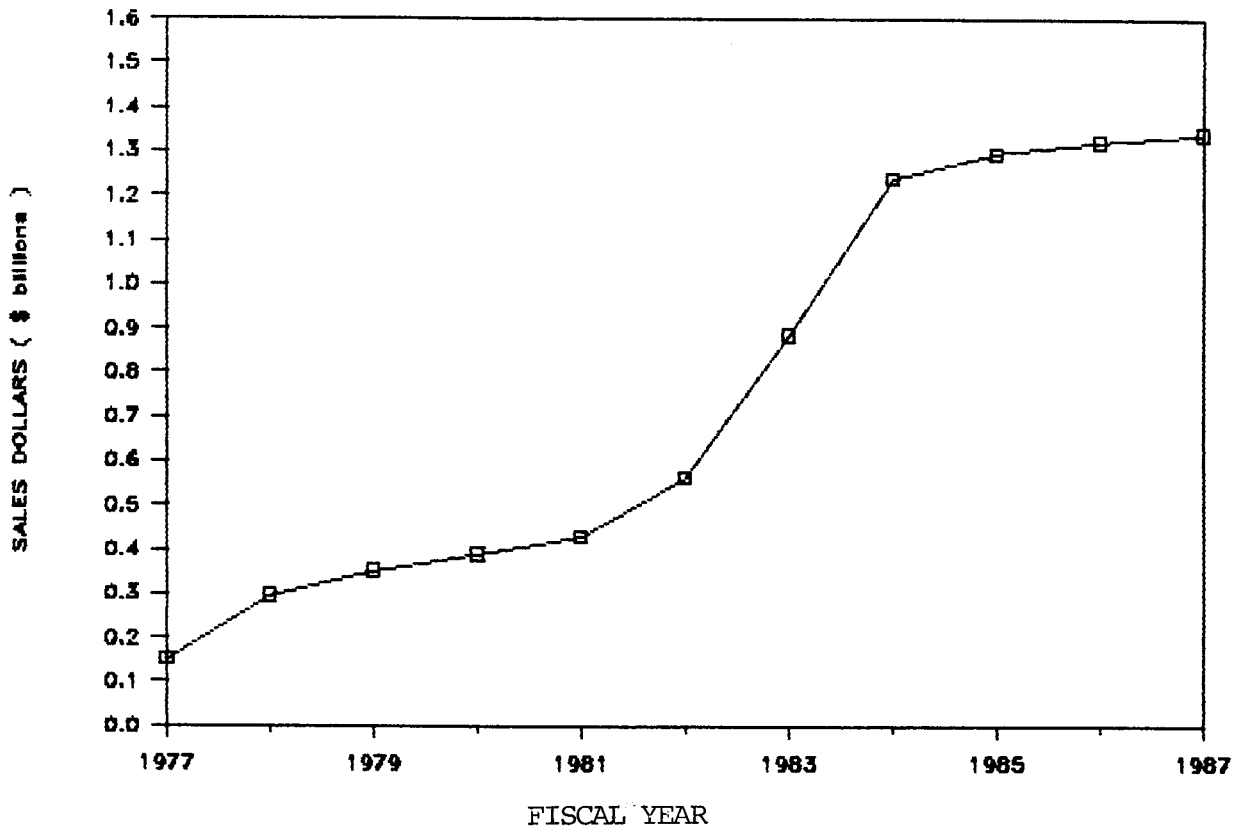
# PER CAPITA LOTTERY SALES, FY 1987

PA AND ALL OTHER LOTTERY STATES



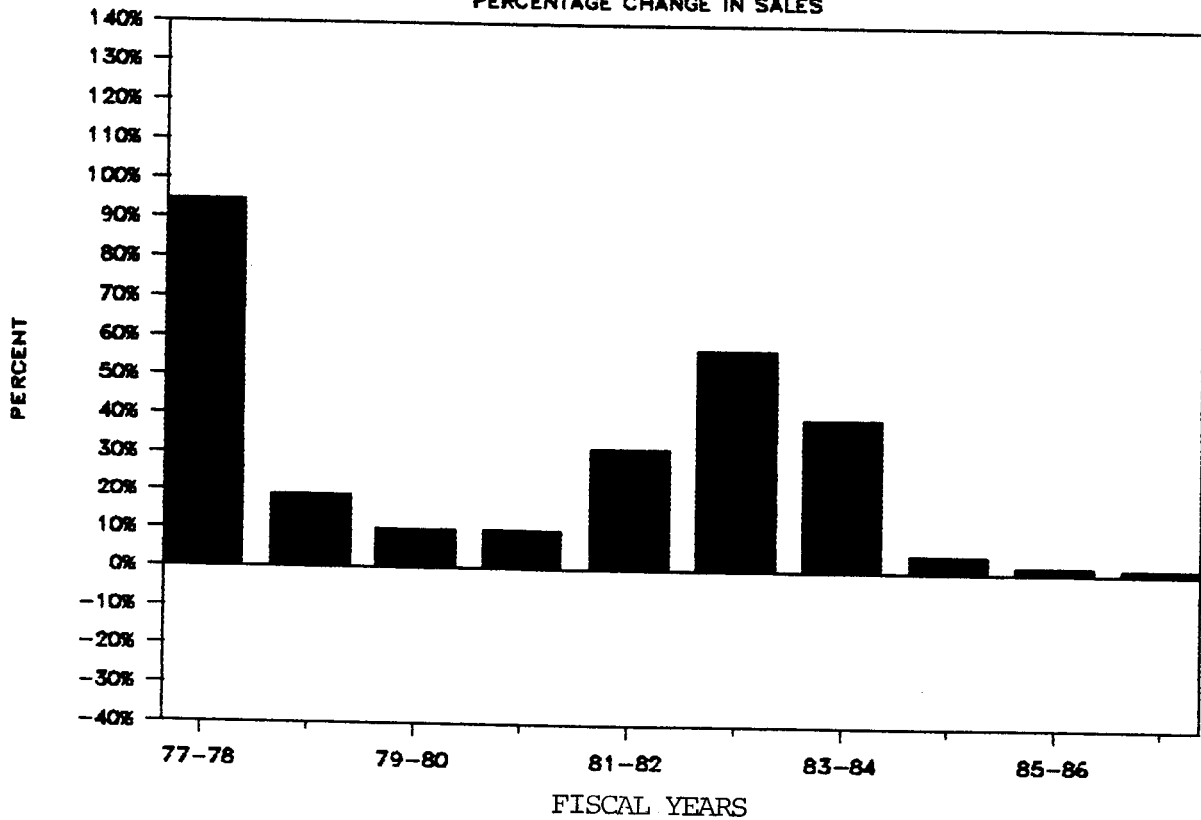
Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc., the Massachusetts State Lottery, and the Pennsylvania State Lottery.

C: PENNSYLVANIA STATE LOTTERY GROSS SALES



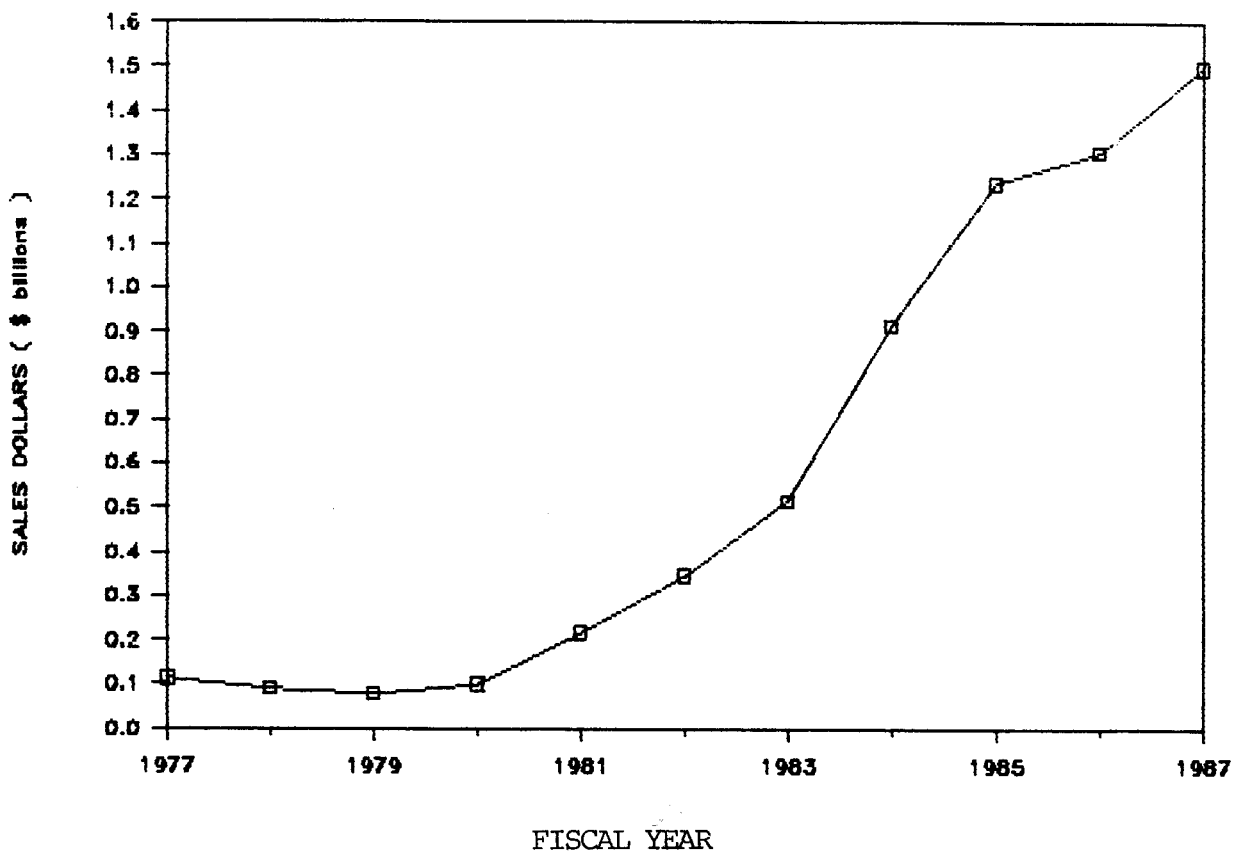
D: PENNSYLVANIA STATE LOTTERY

PERCENTAGE CHANGE IN SALES



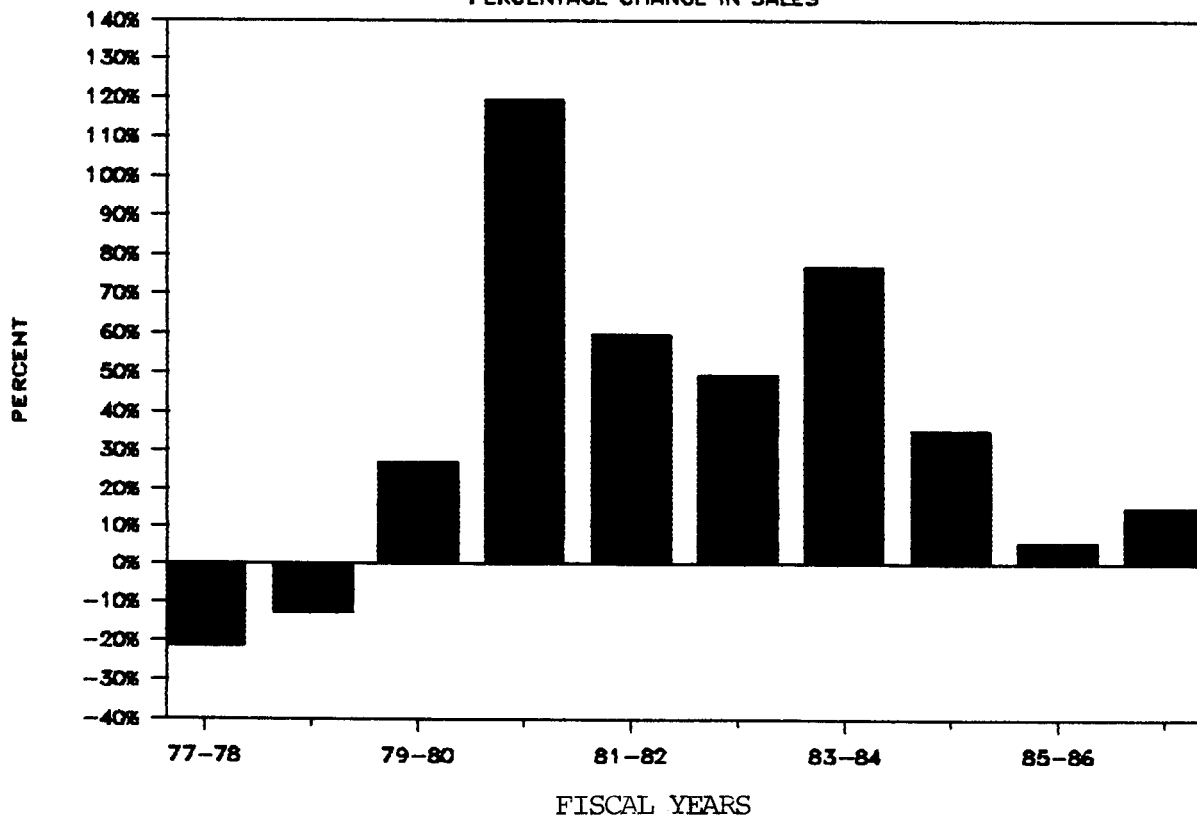
Source: Developed by LB&FC staff from information obtained from the Pennsylvania State Lottery.

E: ILLINOIS STATE LOTTERY GROSS SALES



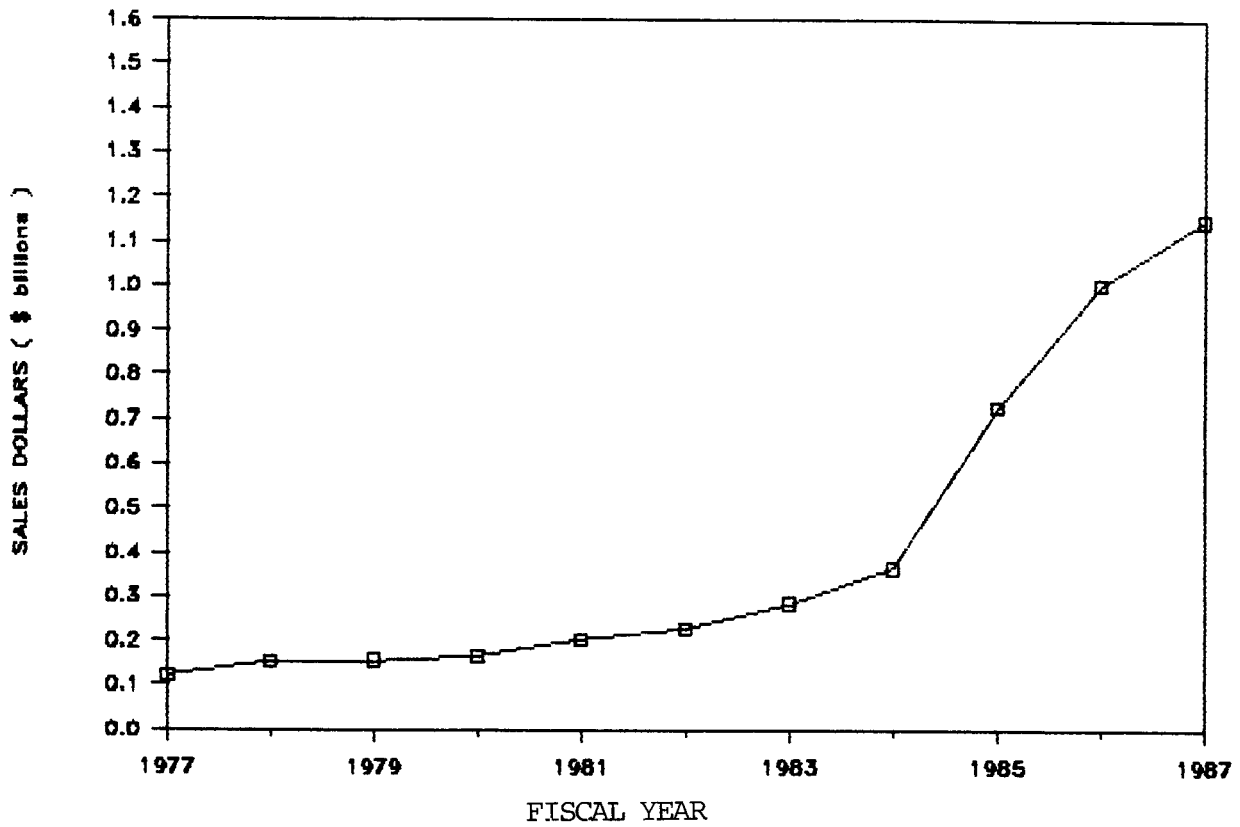
F: ILLINOIS STATE LOTTERY

PERCENTAGE CHANGE IN SALES



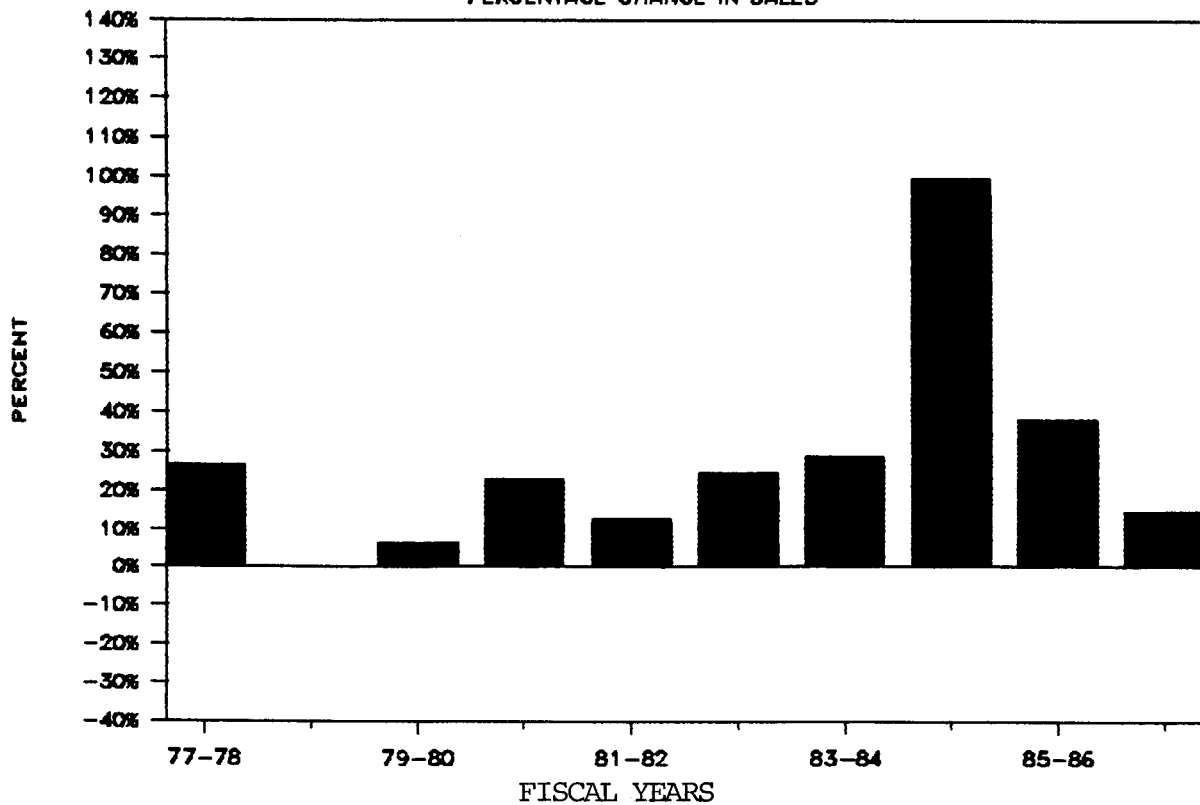
Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc. Note: 1987 data is estimated.

G: MASSACHUSETTS STATE LOTTERY GROSS SALES



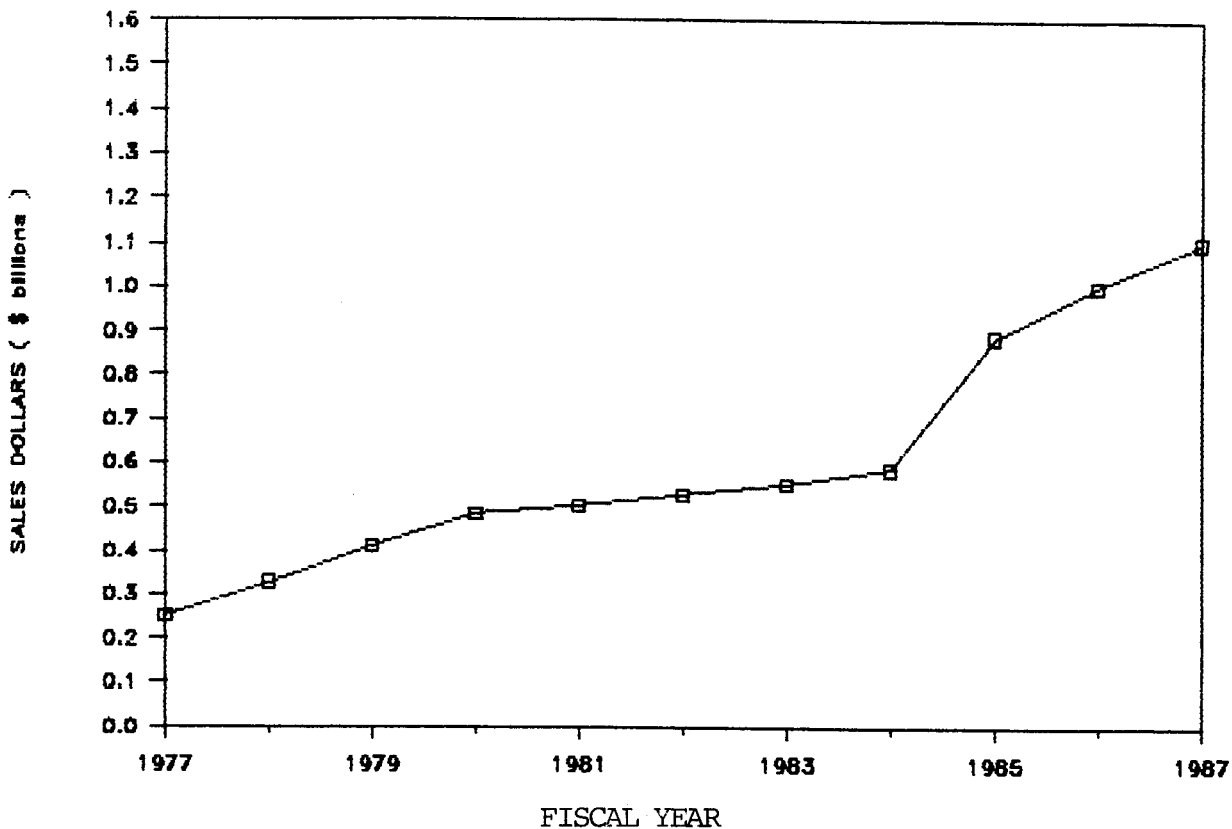
H: MASSACHUSETTS STATE LOTTERY

PERCENTAGE CHANGE IN SALES

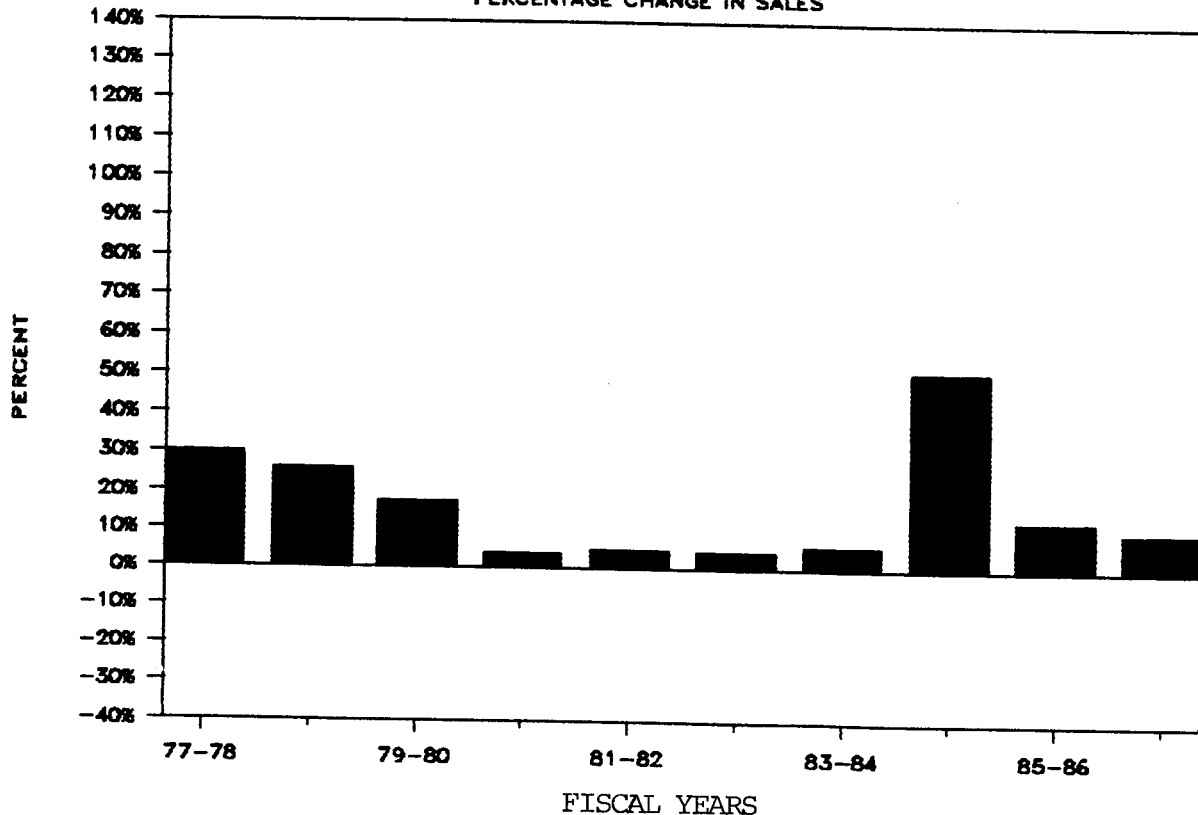


Source: Developed by LB&FC staff from information obtained from the Massachusetts State Lottery.

I: MICHIGAN STATE LOTTERY GROSS SALES

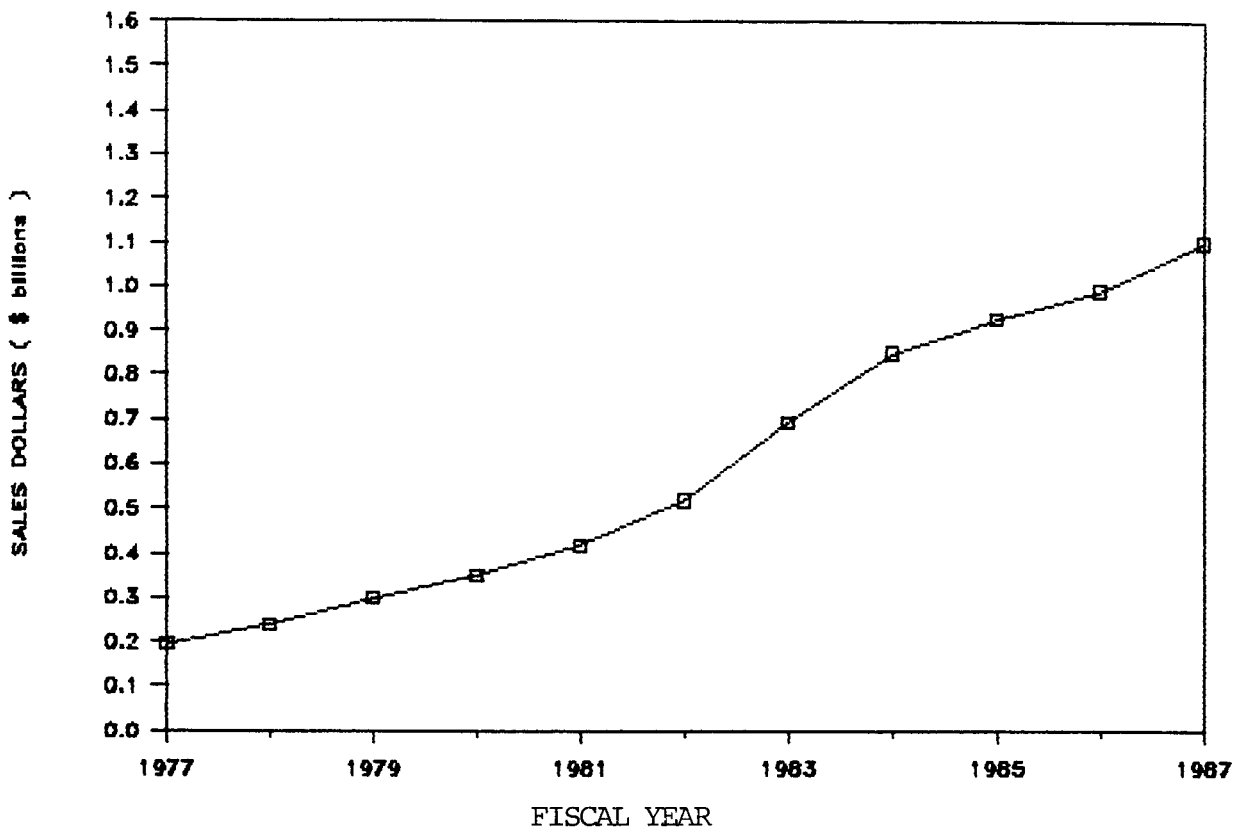


J: MICHIGAN STATE LOTTERY  
PERCENTAGE CHANGE IN SALES

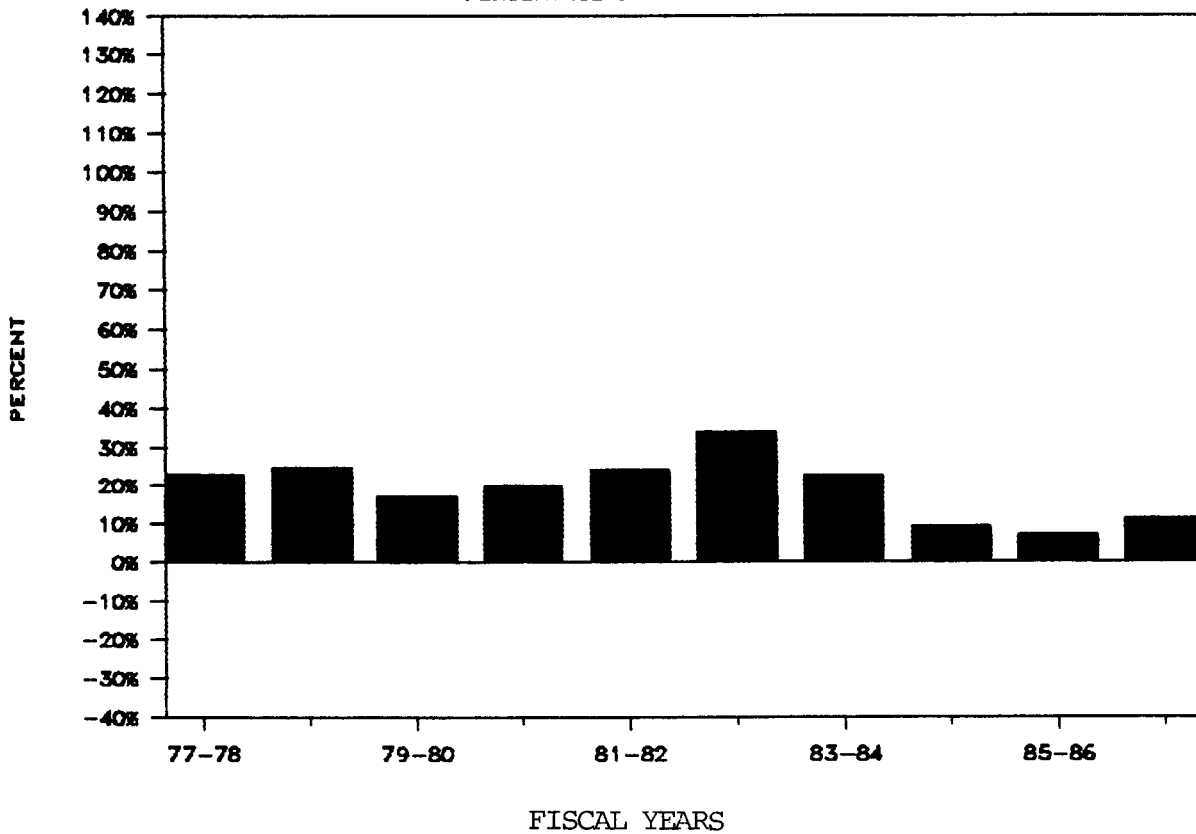


Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc. Note: 1987 data is estimated.

K: NEW JERSEY STATE LOTTERY GROSS SALES

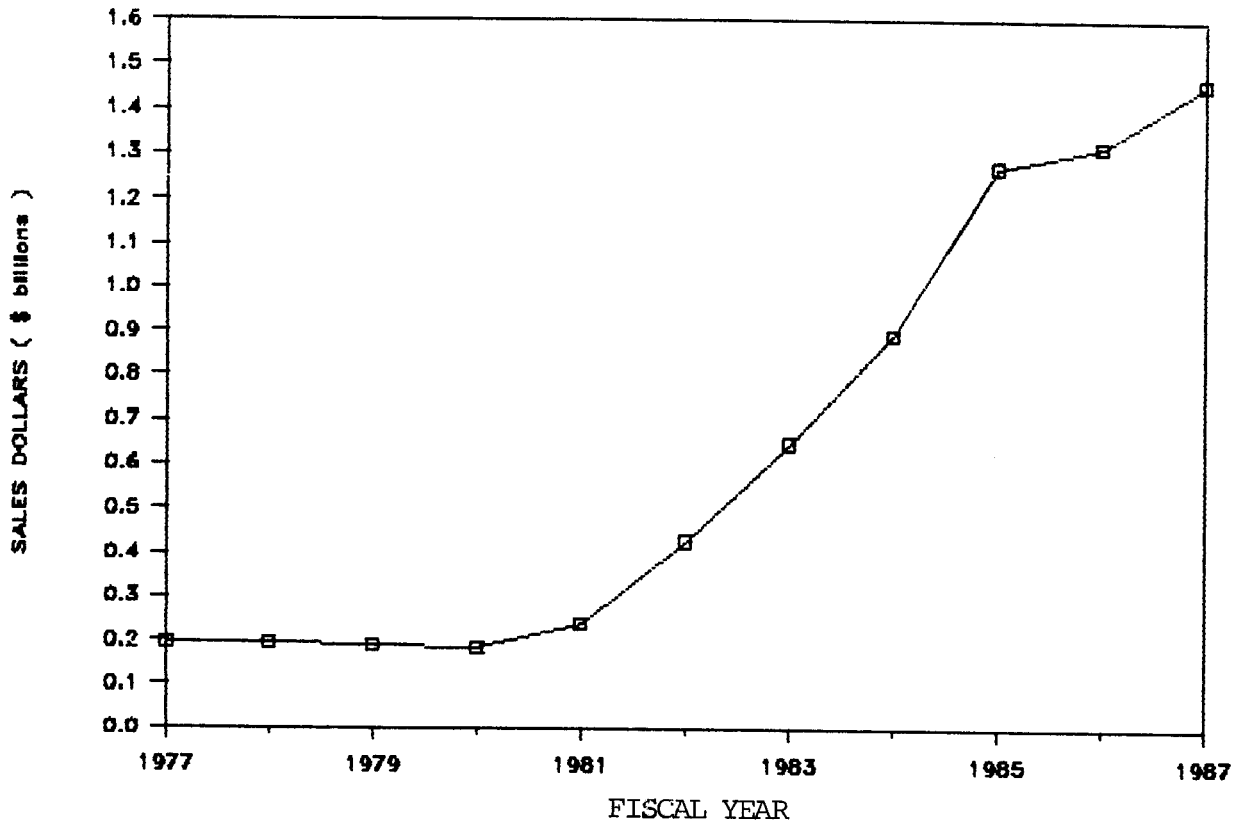


L: NEW JERSEY STATE LOTTERY  
PERCENTAGE CHANGE IN SALES



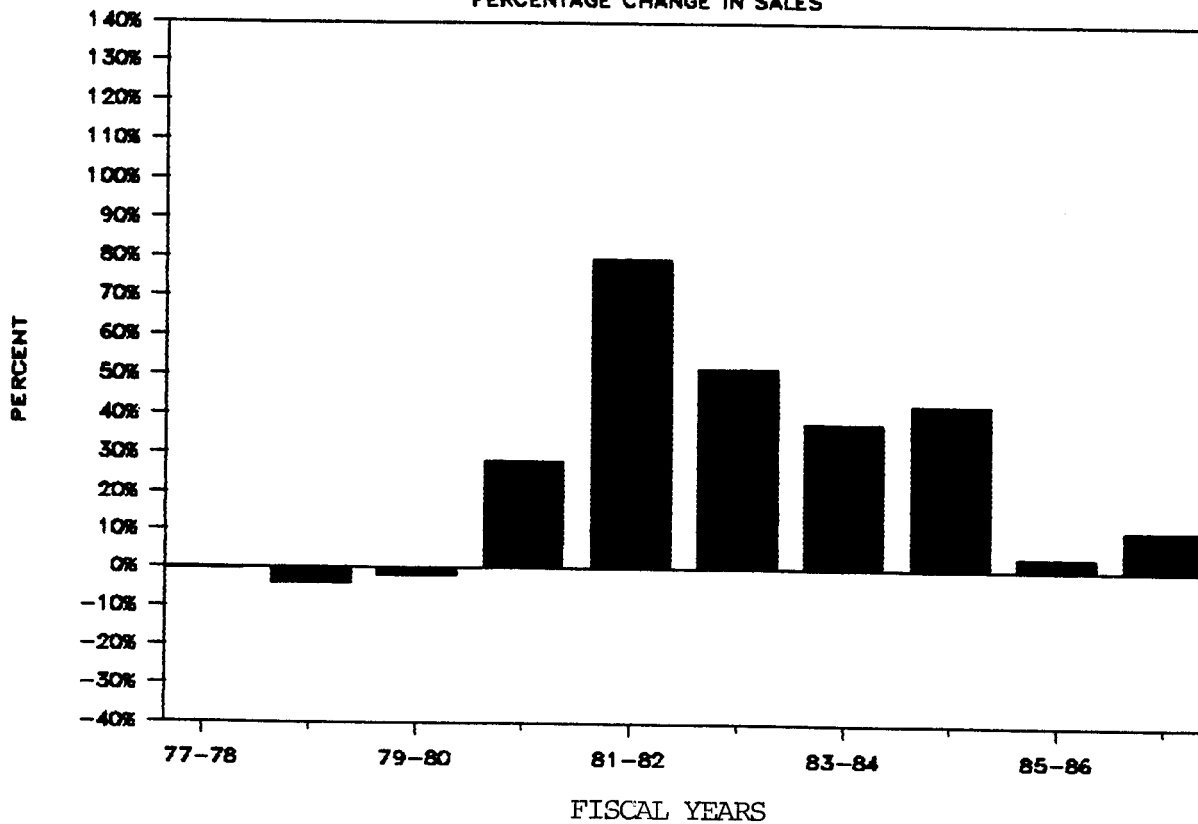
Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc. Note: 1987 data is estimated.

M: **NEW YORK STATE LOTTERY GROSS SALES**



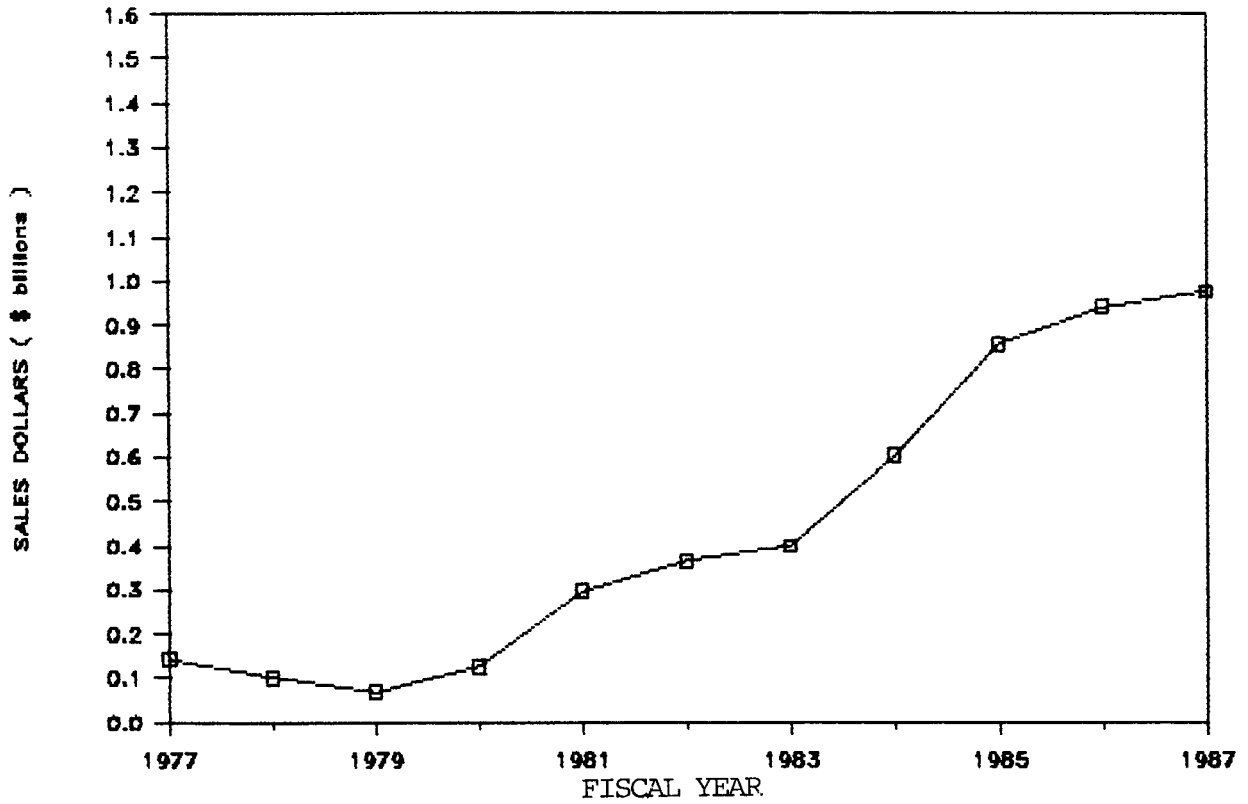
N: **NEW YORK STATE LOTTERY**

PERCENTAGE CHANGE IN SALES

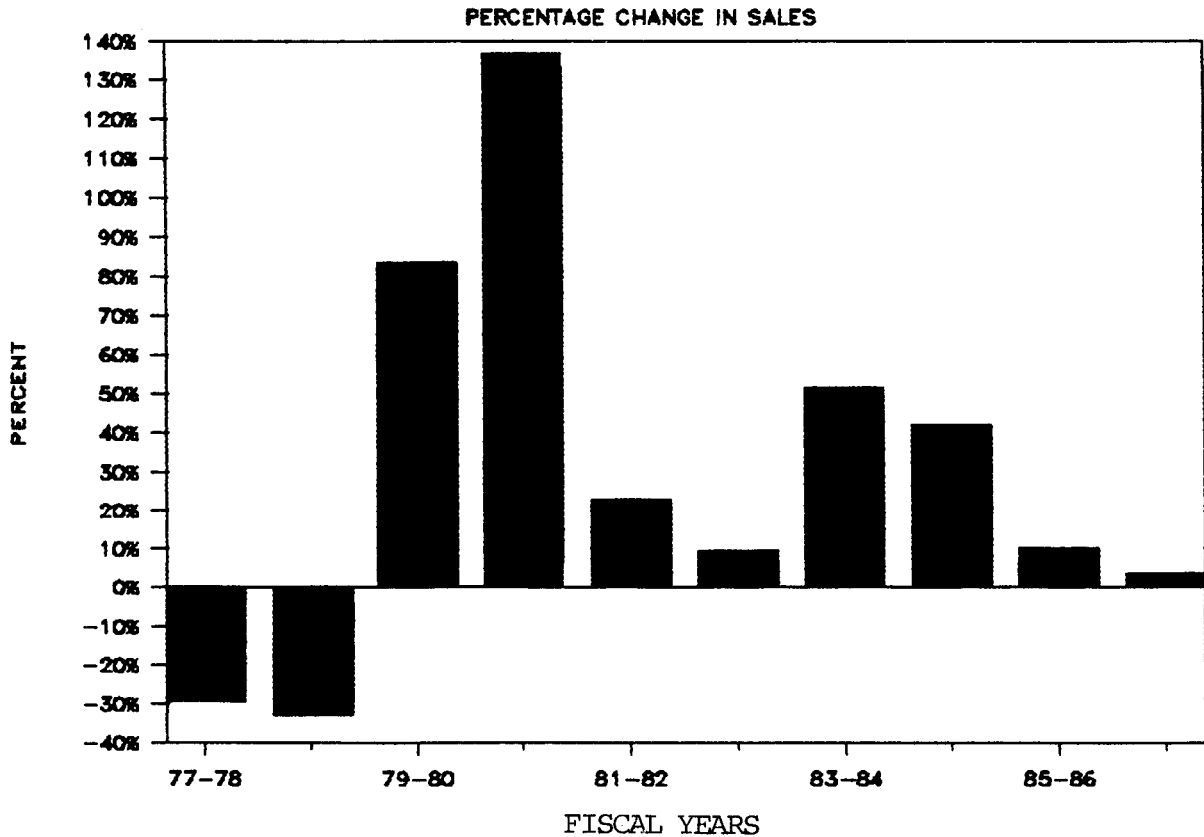


Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc. Note: 1987 data is estimated.

O: OHIO STATE LOTTERY GROSS SALES



P: OHIO STATE LOTTERY



Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc. Note: 1987 data is estimated.

B. COMPARATIVE INFORMATION ON THE USE OF THE LOTTERY SALES DOLLAR IN PENNSYLVANIA AND OTHER LOTTERY STATES

FINDING: State law requires that all monies derived from the operation of the State Lottery be deposited into the State Lottery Fund. Lottery revenues are used to pay prizes, cover operational costs and retailer commissions, and finance (through net income or profits) the operation of various senior citizen benefit programs. The law specifies that the amount used for prizes not be less than 40% of gross lottery sales. The auditors examined the percentage distribution of Pennsylvania State Lottery funds among these categories for fiscal years 1985-86 and 1986-87 and also compared the percentage breakdown of Lottery prizes, profits, commissions and operating expenses in the Pennsylvania Lottery to the corresponding distribution of lottery proceeds in other lottery states (this latter comparison focused on FY 1985-86 data--the latest fiscal period for which data was available for all states). This review indicated the following: (See Table 2 and Charts Q and R.)

1. Following the payment of prizes and commissions and the covering of operating expenses, the Pennsylvania State Lottery had net income or profits (available for benefit programs) of 40.7% of gross sales in FY 1985-86 and 41.6% in FY 1986-87. In both fiscal years, the legally mandated 40% prize level was provided for with prizes accounting for 50.1% in FY 1985-86 and 49.0% in FY 1986-87. Operating expenses and commissions remained basically unchanged at a combined level of approximately 9.3% of gross sales.

2. Based on a comparison of FY 1985-86 for Pennsylvania and 21 other lottery states, the following is indicated:

- PA compares favorably in terms of net profits (i.e., percentage of gross lottery sales remaining after payment of prizes, commissions and operating expenses). PA with profits of 40.7% of gross sales (available for senior citizen benefits) ranked sixth among the states and was slightly above the "all states" average of 39.4%.

- PA, at 50.1%, is in the mid-range and is essentially the same as the "all states" average in terms of percentage of gross sales paid as prizes. Massachusetts ranked first at 59.3%, New York lowest at 45.4%.

- The percentage of gross sales paid as commissions in PA, at 6.7%, is fifth highest among all states and exceeds the "all states" average of 5.6%.

- PA compares very favorably in terms of percentage of gross sales expended for operating expenses. Only two states, Illinois and New Jersey, reported percentages of operating costs lower than PA's 2.5%. The "all states" average was reported to be 5.0%.

TABLE 2  
 Use of the Lottery Sales Dollar in  
Pennsylvania and Other Lottery States - 1986 Data  
 (As Percentage of Gross Sales)

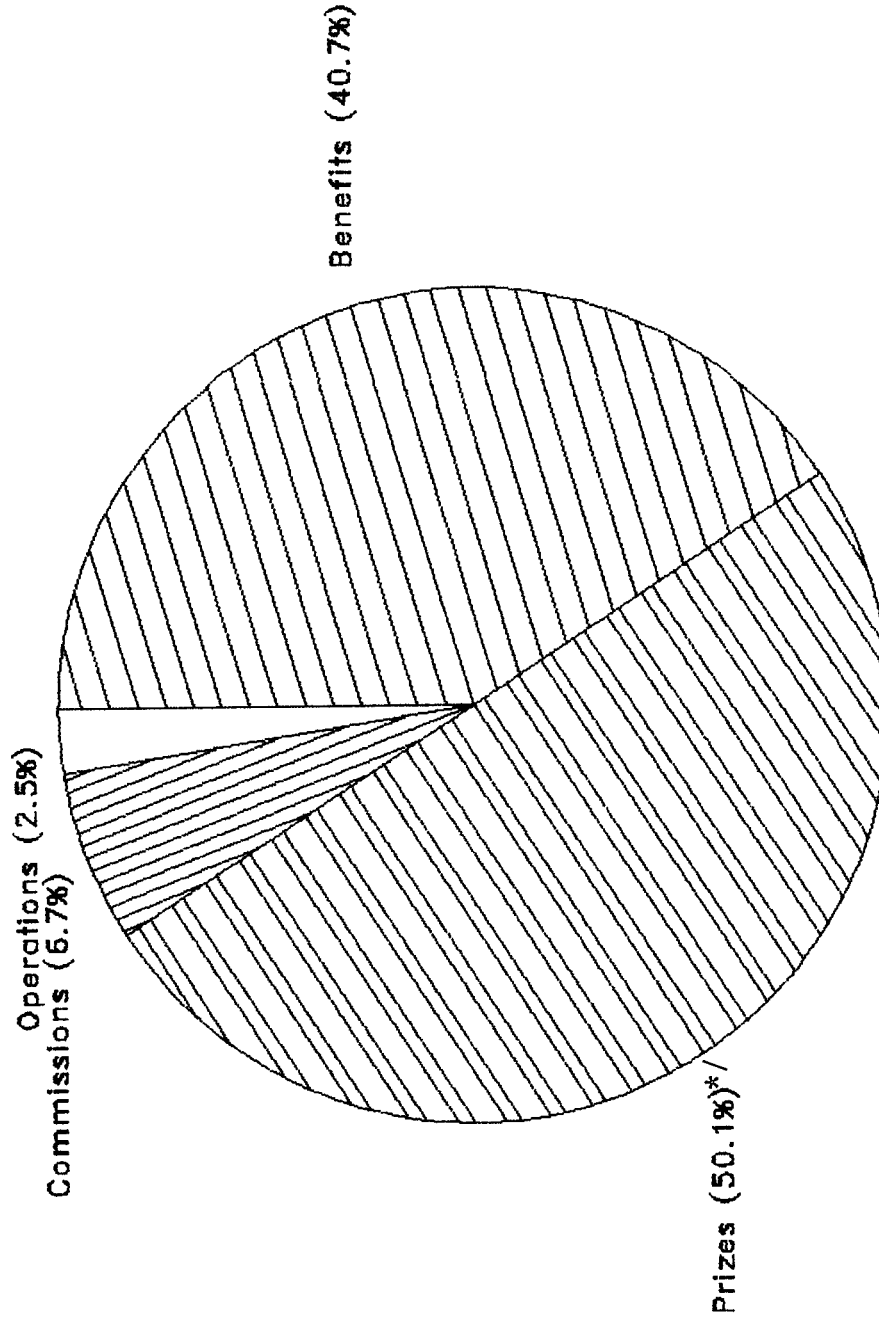
<u>Net Income (Profits)</u>		<u>Prizes</u>	
Maryland.....	45.1%	Massachusetts.....	59.3%
Connecticut.....	44.5%	Colorado.....	55.4%
New York.....	43.1%	Oregon.....	52.3%
Illinois.....	41.8%	Maine.....	51.8%
New Jersey.....	40.9%	Connecticut.....	50.8%
<u>PENNSYLVANIA.....</u>	<u>40.7%</u>	California.....	50.2%
Ohio.....	40.5%	New Jersey.....	50.1%
Delaware.....	40.4%	Vermont.....	50.1%
Washington.....	40.0%	<u>PENNSYLVANIA.....</u>	<u>50.1%</u>
Michigan.....	39.1%	West Virginia.....	49.5%
West Virginia.....	38.8%	Ohio.....	49.3%
California.....	38.3%	Illinois.....	49.2%
Missouri.....	38.2%	New Hampshire.....	49.1%
Rhode Island.....	36.1%	Delaware.....	48.2%
Arizona.....	34.9%	Michigan.....	48.1%
Massachusetts.....	31.0%	Iowa.....	47.6%
Iowa.....	30.7%	Rhode Island.....	47.1%
Maine.....	30.3%	Maryland.....	47.0%
New Hampshire.....	30.3%	Missouri.....	46.5%
Oregon.....	29.0%	Washington.....	45.7%
Vermont.....	26.4%	Arizona.....	45.6%
Colorado.....	25.5%	New York.....	45.4%
All States.....	39.4%	All States.....	50.0%
<u>Operating Expenses</u>		<u>Commissions</u>	
Vermont.....	18.5%	Rhode Island.....	12.5%
Iowa.....	16.2%	Delaware.....	8.4%
New Hampshire.....	15.7%	New Jersey.....	7.1%
Oregon.....	13.8%	Michigan.....	6.8%
Arizona.....	13.5%	<u>PENNSYLVANIA.....</u>	<u>6.7%</u>
Colorado.....	13.2%	Maine.....	6.6%
West Virginia.....	11.7%	Illinois.....	6.6%
Maine.....	11.3%	New York.....	6.1%
Missouri.....	9.8%	Arizona.....	6.0%
Washington.....	9.3%	Colorado.....	5.8%
California.....	6.4%	Iowa.....	5.6%
Michigan.....	5.9%	Missouri.....	5.6%
Massachusetts.....	5.7%	Ohio.....	5.5%
New York.....	5.4%	California.....	5.1%
Connecticut.....	4.8%	Maryland.....	5.1%
Ohio.....	4.7%	Washington.....	5.1%
Rhode Island.....	4.4%	Vermont.....	5.0%
Delaware.....	3.0%	New Hampshire.....	5.0%
Maryland.....	2.8%	Oregon.....	5.0%
<u>PENNSYLVANIA.....</u>	<u>2.5%</u>	Massachusetts.....	4.0%
Illinois.....	2.4%	West Virginia.....	NA
New Jersey.....	1.9%	Connecticut.....	NA
All States.....	5.0%	All States.....	5.6%

Source: Developed by LB&FC staff from lottery information contained in the 1987 U.S. Gaming Industry, Laventhol & Horwath, and data obtained from the Pennsylvania State Lottery.

CHART Q

# DISTRIBUTION OF LOTTERY SALES

FISCAL YEAR 1985-86

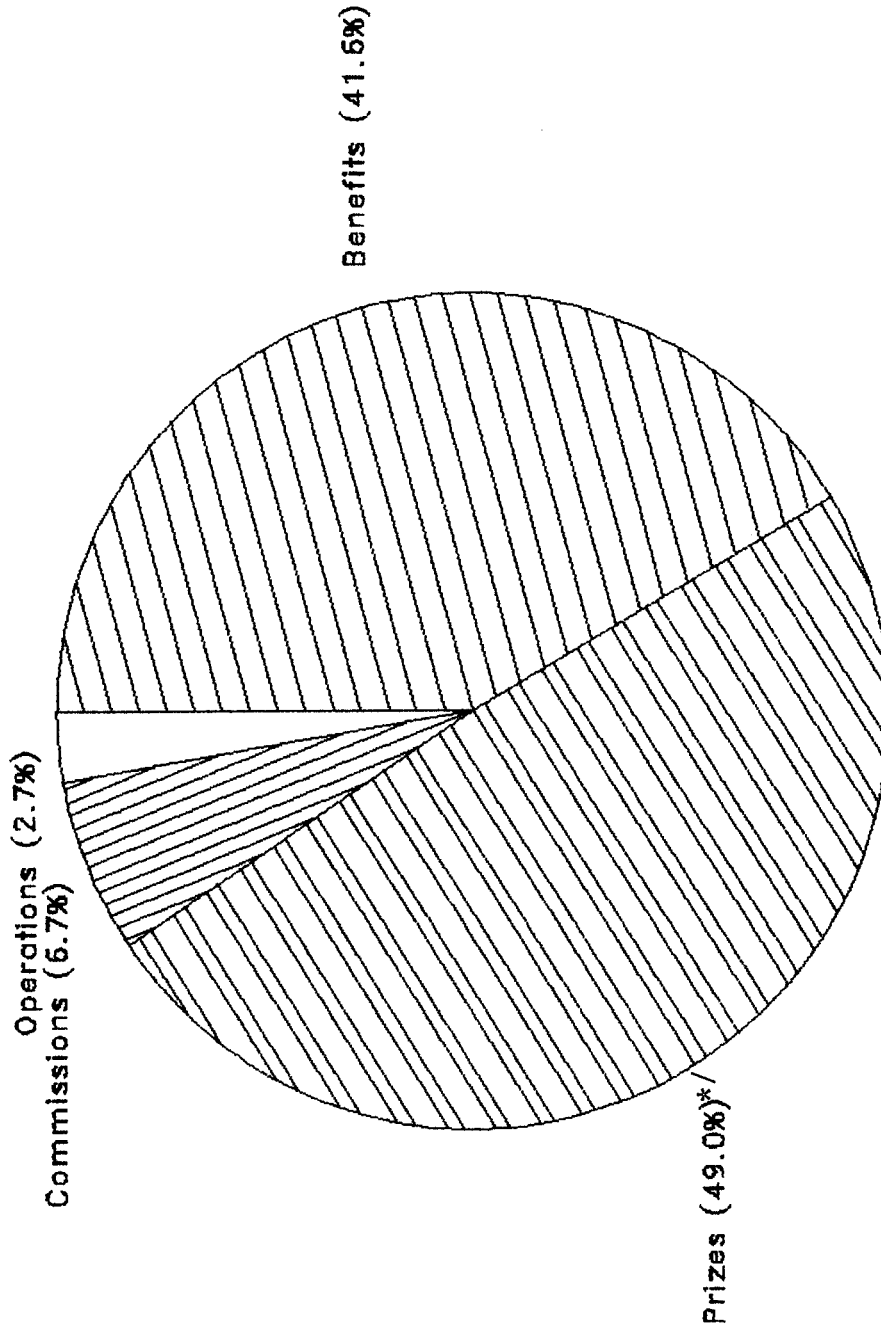


\*/Includes both actual prizes and payout for in lieu of state personal income taxes established by Act 29 of 1983.

Source: Developed by LB&FC staff from information obtained from the Pennsylvania State Lottery.

CHART R  
DISTRIBUTION OF LOTTERY SALES

FISCAL YEAR 1986-87



\*/Includes both actual prizes and payout for in lieu of state personal income taxes established by Act 29 of 1983.

Source: Developed by LB&FC staff from information obtained from the Pennsylvania State Lottery.

C. COMPARATIVE INFORMATION ON NET LOTTERY INCOME OR PROFIT RETURNED TO STATE GOVERNMENT IN PENNSYLVANIA AND OTHER LOTTERY STATES

FINDING: State Lotteries are essentially business enterprises. The success of a state lottery, like that of a private business, can be measured in terms of profitability, particularly as it compares with the degree of success achieved by other businesses (i.e., state lotteries) in the same industry. As of mid-1987, lotteries had been established in 27 states<sup>1/</sup> and the District of Columbia. Proceeds from lottery operations supplement public programs with lottery-generated revenue in some cases earmarked for specific purposes while in other cases being deposited into the individual state's general fund for discretionary use by the state legislature. (See Appendix C.) Lottery revenue has become a very important source of income for state governments and, in Pennsylvania, has provided for the funding and operation of numerous programs that benefit the health and welfare of the Commonwealth's senior citizen population. Pennsylvania is the only lottery which dedicates its profits exclusively to programs benefiting senior citizens. During FY 1986-87, total benefit appropriations from Lottery profits amounted to approximately \$557 million. The auditors examined the levels of net Lottery income or profit returned to the Commonwealth in relation to profits generated in other lottery states both historically and for FY 1986-87. This examination indicated:

1. The Pennsylvania State Lottery has generated more in total net proceeds to state government since start-up than any other state lottery. Total net proceeds of \$3.3 billion were reported through January 1987. (See Table 3.)

2. Based on actual data for PA and available estimated FY 1986-87 net income for all other lottery states, it appears that PA ranks fourth behind New York, Illinois and California in terms of total net income returned to state government.

3. On a per capita basis, PA ranks seventh among all states in respect to total net income or lottery profits. The PA per capita figure is \$47, \$29 less than the top ranking amount returned by the Maryland State Lottery.

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1/See Appendix B for a map of current lottery states.

TABLE 3

Comparative Information on Gross Lottery Revenues  
and Net Proceeds to the States Since Start-Up of Lotteries  
in Pennsylvania and Other States

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<u>State</u>	<u>Start-Up Date</u>	<u>Gross Revenues Since Start-Up<sup>a/</sup> (\$ Millions)</u>	<u>Net Proceeds to State Since Start-Up<sup>a/</sup> (\$ Millions)</u>
Arizona.....	7/81	\$442.4	\$156.3
California.....	10/85	\$1,800.0	\$692.5
Colorado.....	1/83	\$360.0 <sup>a/</sup>	\$144.0
Connecticut.....	2/72	\$2,100.0	\$906.5
Delaware.....	10/75	\$254.3	\$97.0
Illinois.....	7/74	\$5,100.0	\$2,200.0
Iowa.....	8/85	\$139.0	\$39.2
Maine.....	6/74	\$139.0	\$32.6
Maryland.....	5/73	\$4,500.0	\$1,900.0
Massachusetts.....	3/72	\$4,900.0	\$1,700.0
Michigan.....	11/72	\$6,500.0	\$2,500.0
Missouri.....	1/86	\$287.1	\$31.2 <sup>b/</sup>
New Hampshire.....	3/64	\$222.0	\$75.1 <sup>b/</sup>
New Jersey.....	1/70	\$6,100.0	\$2,600.0
New York.....	1/67	\$6,100.0	\$2,800.0
Ohio.....	8/74	\$4,100.0	\$1,600.0
Oregon.....	4/85	\$154.1	\$52.4
PENNSYLVANIA.....	3/72	\$8,000.0	\$3,300.0
Rhode Island.....	5/74	\$4,200.0	\$154.0
Vermont.....	2/78	\$43.0	\$12.0
Washington.....	11/82	\$695.5 <sup>c/</sup>	\$270.1
West Virginia.....	1/86	\$84.1 <sup>c/</sup>	\$30.0

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\* /Data collected January 1987.

<sup>a/</sup> Figure includes revenue to July 1, 1986.

<sup>b/</sup> Figure include proceeds from June 1986.

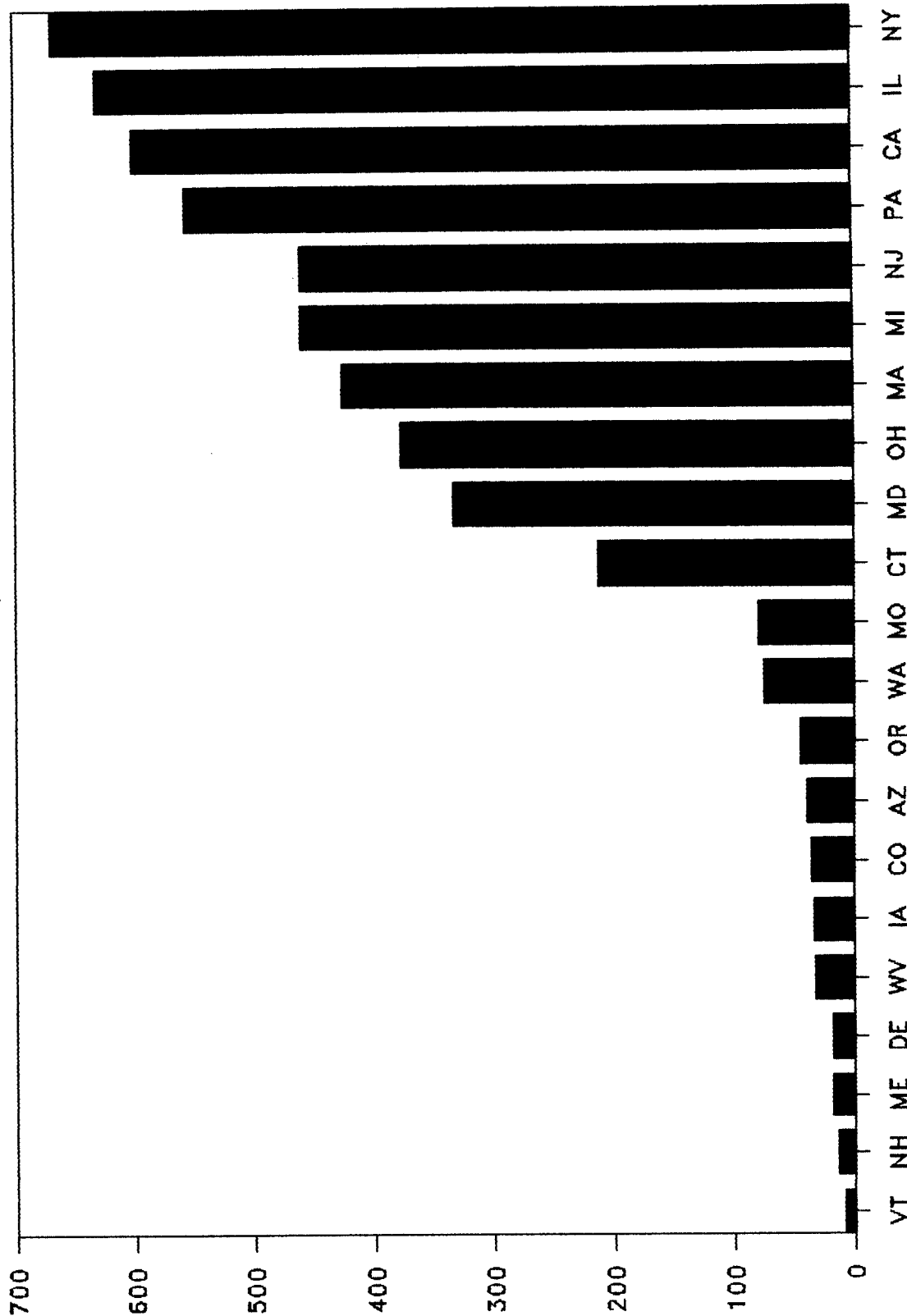
<sup>c/</sup> Figure includes revenues through November 1986.

Source: Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc.

CHART S

# LOTTERY NET INCOME RETURNED TO STATE

ALL LOTTERY STATES, FY 1987



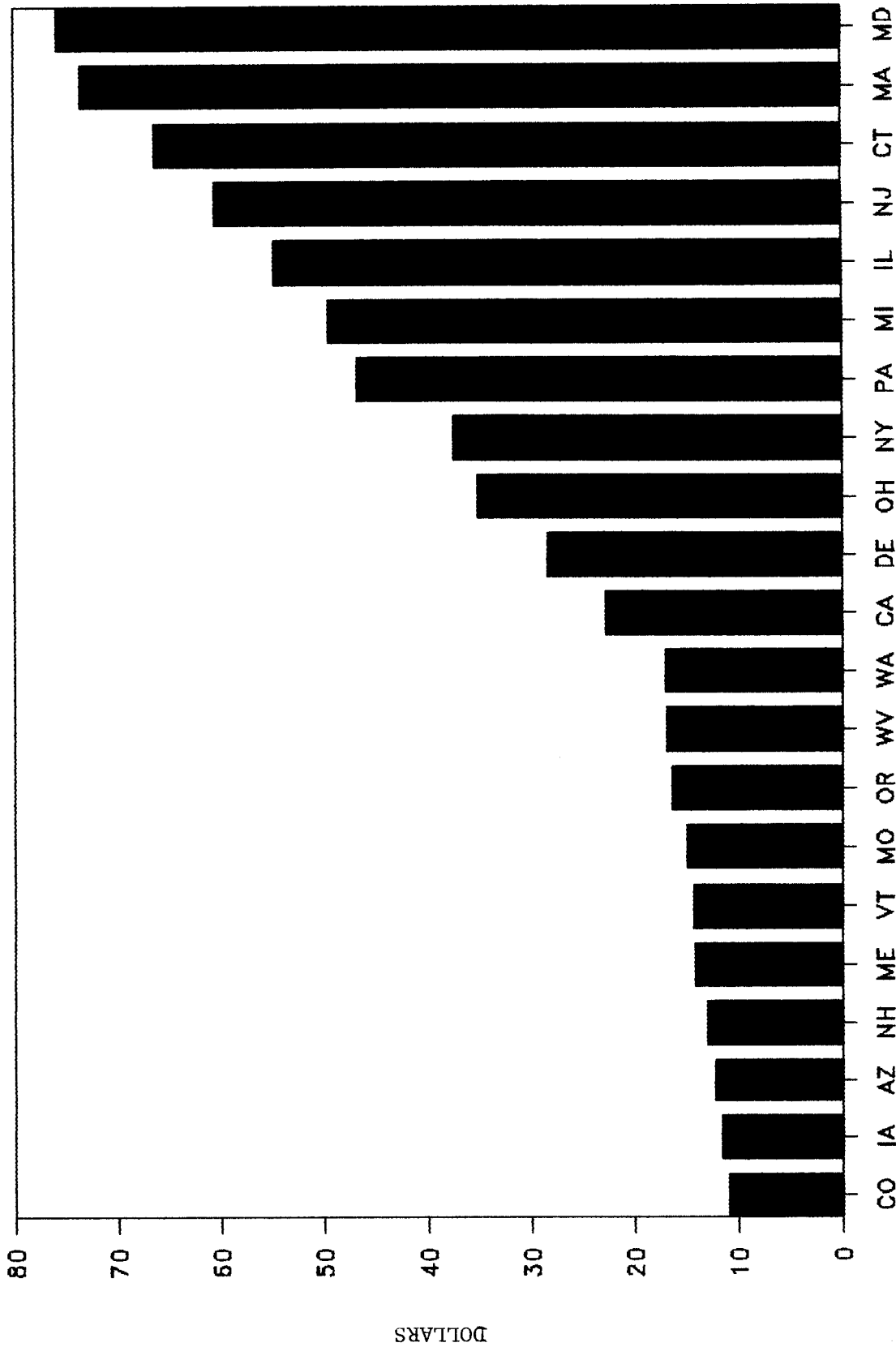
## LOTTERY STATE

Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc., the Massachusetts State Lottery, and the Pennsylvania State Lottery. Note: In addition to Lottery revenues, Massachusetts figure includes revenues derived from charitable games (e.g., bingo).

CHART T

# PER CAPITA LOTTERY NET INCOME

RETURNED TO STATE GOVERNMENT, FY 1987



## LOTTERY STATE

Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc. Note: In addition to Lottery revenues, Massachusetts figure includes revenues derived from charitable games (e.g., bingo).

### III. PERFORMANCE AUDIT FINDINGS AND RECOMMENDATIONS

This section presents additional findings resulting from the performance audit of the State Lottery. This audit involved activities such as the following: a review of the State Lottery's enabling legislation, internal operating procedures and related laws and regulations; distribution and analysis of survey questionnaires (e.g., to Lottery employees, retailers and players); review of administrative control systems; sampling and examination of files and inventory systems (both in the Lottery's headquarters and area marketing offices); meetings and interviews with staff of the State Lottery; contacts with organizations associated with the Lottery industry and with public gaming and lottery consultants; and collection of comparative data from officials and staff of lotteries in other states. Please see Section V for a more complete discussion of the audit methodology.

The findings in this section are divided into twenty-three subject areas, Findings D through Z. Information presented within a subject area is not intended to be inclusive of the subject area.

D. NEED TO ADDRESS AND REACT TO LEVELING-OFF OF STATE LOTTERY SALES

FINDING: As of September 1987, State Lottery management does not appear to have identified a clear plan or strategy to react to and address the actual and projected leveling-off of State Lottery sales. Growth in Pennsylvania Lottery sales has slowed in recent years and some persons associated with the State Lottery have at times indicated that this may be due to a "maturing effect." A specific and comprehensive study has not been done by Lottery officials, however, of this growth change that would substantiate that the current sales situation is due to a "maturing effect." The auditors have analyzed recent Pennsylvania sales patterns and compared them with sales patterns in other selected lottery states. (See Finding A.) It appears to the auditors that there are other state lotteries which, while at approximately the same stage of their chronological development, are not experiencing the same low sales growth pattern that has developed and is currently projected for the foreseeable future in the Commonwealth. Following a history of steady Lottery growth and national leadership in total lottery sales, Pennsylvania now finds itself uncharacteristically falling behind other states in total lottery sales and annual lottery growth rates. In FY 1984-85, the Pennsylvania State Lottery ranked first nationwide in total sales with \$1.29 billion. In FY 1985-86 Pennsylvania was overtaken in total sales by California, and based on FY 1986-87 estimates the Pennsylvania State Lottery may rank fourth in total lottery sales behind New York, Illinois and California. (See Finding A for more detailed interstate comparative information on gross and per capita lottery sales.) Chart illustrates that since 1984 Pennsylvania's annual growth in lottery sales ranks lowest among a sample of six other state lotteries of comparable age and product mix. During the period FY 1983-84 through FY 1985-86, total Pennsylvania Lottery sales increased by 6.8%. A comparison of lottery sales in the six sample states indicate total sales increases ranging from about 17% in New Jersey to more than 175% in Massachusetts. It is also significant to note that lottery sales growth projections in Pennsylvania at 2.9% through FY 1987-88 are lower than the percentage increases projected in Illinois, New Jersey, and New York of 7.7%, 5.0%, and 4.1%, respectively. Despite these projections, the current Acting Executive Director of the State Lottery has expressed the opinion to the auditors that the State Lottery has not reached its full sales potential. This position is consistent with that expressed by the previous State Lottery Executive Director who noted the need to be attentive to methods to attract new players. Those "in the 25-55 years old managerial-professional group that are not presently buying our products or only do so infrequently" were particularly noted as a potential target group. As expressed in the findings presented in this report, audit activities also indicated that there are a number of program, administrative and operational alternatives and options available to the State Lottery which have the potential to increase sales in Pennsylvania. For

example, the computer equipment currently in use for "on-line" Lottery games in Pennsylvania is outmoded and limited in its ability to provide innovations and game enhancements (see Finding Q.) Installation of state-of-the-art technology available to the lottery industry could hold considerable potential for increasing sales. Other options available include the testing of lottery sales through direct mail and the expansion of retail outlets into airports and shopping malls. Player-activated terminals (PATs) are also a possibility for selected locations to handle peaks in customer traffic. The auditors also became aware during the audit of currently available technology which would provide for enhancements or game options not currently available in Pennsylvania. For example, PATs are available that would make it possible for persons to play lottery games using a credit card issued by a state lottery. Opportunities for increased sales also appear to exist if "Big 4" lottery drawings were to be held as frequently as they are in other states (see Finding N) and if a systematic strengthening and training of the Lottery's district lottery representative workforce would occur (see Finding H). It is also significant to note that Pennsylvania ranks among the lowest of the lottery states in terms of its advertising expenditures as a percentage of gross sales. Referring to lottery growth rates, a national gaming and lottery consultant noted that lotteries . . . "with the strongest marketing programs, the most innovative new products, the most dramatic advertising and promotion campaigns, will still continue to produce good results for the states involved." The auditors recognize that PA State Lottery sales have been growing in recent months. For example, as of March 1987, sales were more than \$10 million behind prior year sales levels; by June 30, 1987, sales had reached a point which exceeded prior year sales by \$18 million. A number of actions were taken by State Lottery officials which may have contributed to this growth, including the use of the weekly "Saturday Spin" for instant games and a restructuring of the Super 7 game (adding a new prize level and greater jackpots). It is recommended that the Administration act expeditiously to make permanent appointments in key acting and vacant positions at the State Lottery and that a specific plan and strategy be developed by the new management team to revitalize and promote State Lottery sales growth patterns. The posture and approach adopted will have a direct relationship on future growth and the continued financial health of the State Lottery Fund. The auditors also recognize that whatever actions are taken to address Lottery sales and profitability carry with them philosophical and social as well as potential fiscal implications and recommend that the General Assembly consider establishing in law a requirement that the State Lottery conduct an ongoing program to identify and deal with Lottery-related gambling problems (e.g., compulsive and/or addictive gambling behavior) that may exist or develop among the Lottery-playing public. (See Finding X.)

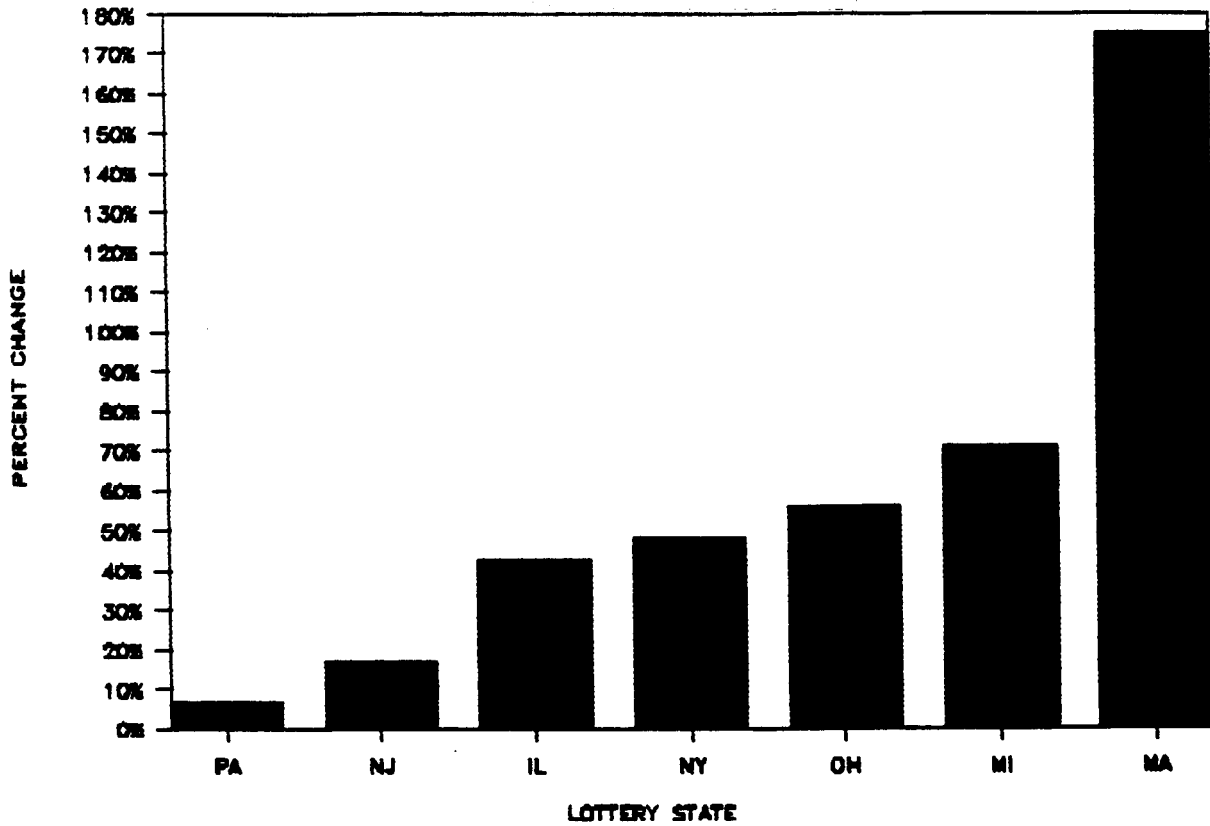
TABLE 4

Historical Summary of State Lottery Gross Sales  
Fiscal Year 1972-73 through FY 1991-92 (Projected)

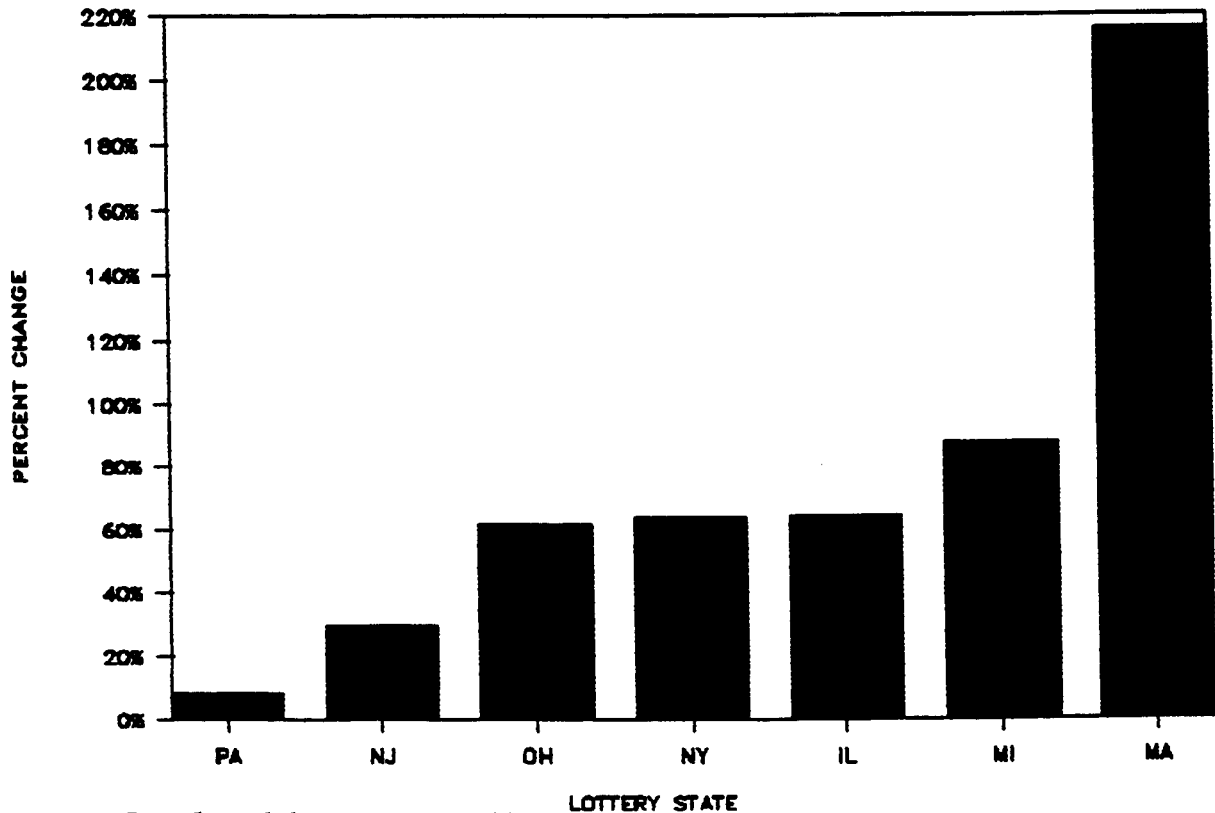
<u>Fiscal Year</u> <u>Ending 6/30</u>	<u>Total Lottery</u> <u>Sales (\$ Millions)</u>	<u>Sales + or -</u> <u>(Percent Change)</u>
1973.....	\$124.4	--
1974.....	\$128.5	3.25%
1975.....	\$115.6	-10.00%
1976.....	\$136.9	18.42%
1977.....	\$151.7	10.80%
1978.....	\$295.5	94.76%
1979.....	\$351.4	18.94%
1980.....	\$387.4	10.24%
1981.....	\$427.0	10.23%
1982.....	\$562.3	31.67%
1983.....	\$885.4	57.48%
1984.....	\$1,236.0	39.60%
1985.....	\$1,294.7	4.75%
1986.....	\$1,320.2	1.96%
1987.....	\$1,338.5	1.38%
1988 (Sales Goal).....	\$1,378.2	2.9 %
1989 (Projected).....	\$1,392.0	1.0%
1990 (Projected).....	\$1,405.9	1.0%
1991 (Projected).....	\$1,420.0	1.0%
1992 (Projected).....	\$1,434.2	1.0%

Source: Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc., and data obtained from the PA State Lottery and the Governor's Office of the Budget.

U: CHANGE IN SALES, FY 1984 TO FY 1986



V: CHANGE IN SALES, FY 1984 TO FY 1987 (EST.)

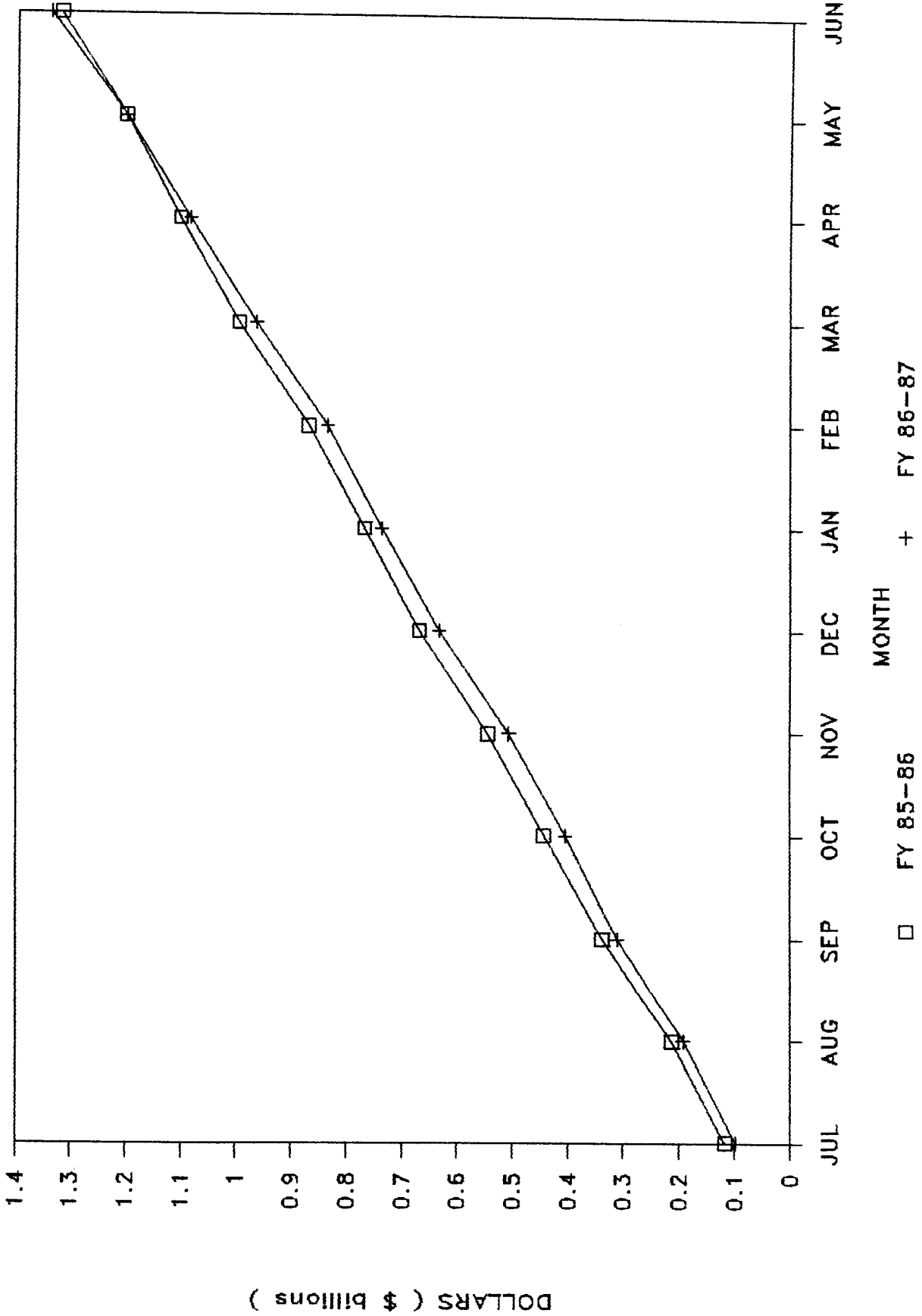


Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc., the Massachusetts State Lottery, and the Pennsylvania State Lottery.

CHART X

# ACCUMULATED PA LOTTERY TICKET SALES

FY 1985-86 AND FY 1986-87



Source: Developed by LB&FC staff from information obtained from the Pennsylvania State Lottery.

E. NEED TO DEVELOP AND ADOPT A "BUSINESS PLAN" FOR STATE LOTTERY OPERATIONS

FINDING: A state lottery has characteristics which are distinctly different in goals and purposes than those that are typical of a state agency. A state lottery is, in terms of goals and purposes, more characteristic of a private business enterprise than a state government organization. Similar to a business enterprise the primary goal of a state lottery is to generate profit, and, therefore, a state lottery like a business must be marketing motivated, customer-oriented and sales driven. The Pennsylvania State Lottery has recognized this in its 1984-85 Annual Report by characterizing the Lottery as a profit-motivated business. If a private sector enterprise, the State Lottery would rate within the Fortune 500's listing of top corporations. A public gaming and lottery consultant contacted by the auditors pointed out that "although government-owned, a lottery is a business which is subject to the same supply/demand laws as every other business in a free-market economy." Given this recognition that the Lottery is essentially a business-type operation it follows that business concepts and practices should be utilized wherever possible. It appears essential that such an enterprise develop and adopt a business philosophy and plan which identifies the organization's "mission" including a clear and integrated statement of goals and objectives. The current Acting Executive Director of the State Lottery indicated concurrence with the need for such a "plan" and indicated that, although begun, such a plan has not been formalized for the State Lottery. A 1986 publication on the subject of motivation in business stated as follows: . . . Good companies know what they are about and are able to communicate this across all levels of the organization. When a company can express a clear and integrated set of goals, expectations, and values--a mission--it is most likely to be effective. . . . Business professors interviewed by the auditors at the Wharton School of the University of Pennsylvania confirmed the importance of such a mission statement for a business-type organization. Business planning and policy formulation is a generally accepted practice in the private sector. Business planning has been described as a process which requires analysis of anticipated internal and external future circumstances and "developing within the context of that future a company objective, guidelines for action (policies), implementation plans, an organization, and controls designed to achieve the objective." The auditors noted that the Massachusetts State Lottery obtained the assistance and service of a private business consulting firm "to professionalize the business techniques of the various levels of (lottery) management." The auditors recommend that the PA State Lottery give consideration to taking similar action in the near future. Given the current leveling off of the Lottery's sales growth rate and impending major personnel changes and internal reorganization and restructuring it would appear to be an opportune time to seek assistance from a private business consulting firm to

shape and implement a formal "business plan" and organization for the State Lottery while providing and/or assisting in the development of specialized training programs for at least management level and field marketing personnel. Assistance should also be sought from the consultant to identify current State Lottery processes and procedures which, although common to state agency operations, are essentially "unbusinesslike" and which may be hampering the Lottery's ability to operate in a business-like manner. Developments in this regard, including information on the "business plan" adopted by the State Lottery should be made available to the General Assembly. Any aspects of the business plan which is developed which would require legislative action should be so identified and communicated to the pertinent standing committees of the General Assembly.

F. NEED TO RECOGNIZE LIMITATIONS ON STATE LOTTERY FUND CAPACITY TO FINANCE EXISTING AND NEW/EXPANDED PROGRAMS

FINDING: Considerable concern has been expressed in recent months concerning the financial health of the State Lottery Fund and the continued capacity of the Fund to provide funding support for state programs. Estimates developed by the Governor's Office of Budget as of June 1987 indicate that the State Lottery Fund could be running a deficit of nearly \$150 million by fiscal year 1989-90. (See Appendix F.) Within this context, it is important to stress the distinction between the State Lottery Fund and the State Lottery. The projections cited above relate to the condition of the Fund only and to its ability to support existing programs. The projections do not relate to the viability of the Lottery games and the ability of the Lottery to pay its operational costs, commissions and/or prizes. As stated by Auditor General Don Bailey in March 1987, ". . .it is important to bear in mind that the issue is not the health of the lottery and its ability to keep its promise by paying prizes to those who win its games. The issue is the ability of the Lottery Fund (revenues available after prize payout and operational expenses) to keep pace with the needs of the many programs its supports." This issue is obviously a very critical situation and one which would appear to require joint attention and action by the Administration and the General Assembly. The auditors observed that attempts have been made in recent months to clarify the ability of the State Lottery Fund to continue to meet current program funding requirements and actions were taken to transfer funding responsibility for certain programs back to the General Fund. In his FY 1987-88 budget message, the Governor proposed increased Lottery financing in the form of an \$8 million increase in in-home services to the elderly but also recommended that funding responsibility for \$19.8 million in supplemental security income payments and retarded elderly community residential services be transferred from the State Lottery Fund to the General Fund. The auditors observed that the Governor's recommendations were accepted as reflected in the FY 1987-88 "General Appropriation Act" resulting in a net reduction in funding responsibility for the State Lottery Fund of approximately \$12 million. When originally enacted, Pennsylvania's "State Lottery Law" restricted program funding from the State Lottery Fund to financing of property tax relief for the elderly (which in FY 1972-73 amounted to \$25 million). From that starting point, the array of senior citizen programs and services has grown to encompass 17 separate programs which in total in FY 1987-88 require funding totaling \$616.7 million. (See Tables 5 and 6.) The various programs created since the inception of the Lottery, including property tax and rent rebates in 1973, free and discounted public transit in 1974, inflation - dividends in 1980, discounted vehicle registration and aging programs assistance in 1982 and prescription drug assistance in 1984 have placed heavy burdens on the Fund. Projections made by the Governor's Budget

Office indicate that financing of existing program benefits alone will require nearly \$900 million by FY 1991-92. It is recommended that the Governor's Office of the Budget, in conjunction with the Department of Revenue and other involved agencies, continue to closely monitor and highlight (in a long-range planning sense) projected costs for senior citizen programs funded from the State Lottery Fund in relation to the projected availability of State Lottery Fund revenues. Such information is needed so that both the Legislature and the general public can maintain realistic expectations concerning the Fund's ability to support currently existing Lottery-funded programs or to cover the costs of newly conceived programs. Status reports on the condition of the State Lottery Fund (such as those prepared by the Budget Office in March and June 1987) should be periodically developed and made available to the Appropriations and other pertinent standing committees of the General Assembly. (A copy of the June 1987 report is shown in Appendix F.)

TABLE 5

Amounts Expended From the State Lottery Fund for Senior Citizen  
Program Benefits, FY 1972-73 through FY 1991-92 (Projected)  
(\$ Million)

<u>Fiscal Year</u>	<u>\$ Amount</u>
1972-73.....	\$ 25.4
1973-74.....	35.9
1974-75.....	70.5
1975-76.....	70.7
1976-77.....	71.1
1977-78.....	74.6
1978-79.....	76.6
1979-80.....	152.2
1980-81.....	149.0
1981-82.....	194.3
1982-83.....	211.9
1983-84.....	431.3
1984-85.....	565.5
1985-86.....	586.2
1986-87.....	<u>625.6</u>
Total to June 30, 1987.....	<u>\$3,340.8</u>
1987-88 (Available).....	616.7
1988-89 (Projected).....	697.7
1998-90 (Projected).....	776.6
1990-91 (Projected).....	824.7
1991-92 (Projected).....	878.8

Source: Developed by LB&FC staff from information compiled by the Office of the PA Auditor General, March 1987, and the Governor's Office of the Budget.

TABLE 6

Chronology of Assignment of Senior Citizen Program Funding Responsibilities to the State Lottery Fund, 1972 to the Present  
(\$ Thousands)

Program Funded	FY in Which Funding Initiated	Administering Agency	Funding Levels		
			Initial FY Amount	FY 1987-88 Available	FY 1991-92 Projected
1. One-Time Start-Up Loan Payment to General Fund.....	1971-72	--	\$ 1,000	N/A	N/A
2. Property Tax and Rent Assistance.....	1972-73	Revenue	\$25,446	\$120,681	\$115,926
3. Free Transit for the Elderly.....	1973-74	DOT	\$10,755	\$69,503	\$119,140 <sup>a/</sup>
4. Harristown Rent.....	1978-79	DGS	\$265	\$101	\$85
5. Harristown Utility and Municipal Charges.....	1978-79	DGS	\$47	\$87	\$100
6. Senior Citizen Inflation Dividend.....	1979-80	Revenue	\$28,400	\$34,653	\$31,882
7. Free Transit-County Grants.....	1980-81	DOT	\$9,080	b/	N/A
8. Vehicle Registration.....	1981-82	DOT	\$2,849	\$2,500	\$2,500
9. Aging Programs.....	1981-82	Aging	\$6,200	\$52,077	\$58,600
10. Transportation Grants.....	1982-83	Aging	\$4,100	c/	N/A
11. Pharmaceutical Assistance Program (PACE).....	1983-84	Aging	\$100,000	\$100,000	\$338,000
12. Medical Assistance Long-Term Care Facilities.....	1983-84	DPW	\$100,000	\$140,000	\$140,000
13. Personal Income Tax-Prizes.....	1983-84	Revenue	\$13,899	\$14,471	\$15,059
14. Department of Aging - General Operations.....	1984-85	Aging	\$1,523	\$2,440	\$2,850

TABLE 6 (Cont.)

Chronology of Assignment of Senior Citizen Program Funding Responsibilities to the State Lottery Fund, 1972 to the Present  
(\$ Thousands)

Program Funded	FY in Which Funding Initiated	Administering Agency	Funding Levels		
			Initial FY Amount	FY 1987-88 Available	FY 1991-92 Projected
15. In-Home Services.....	1984-85	Aging	\$12,000	\$24,000 <sup>d/</sup>	\$32,000
16. Pre-Admission In-Home Services.....	1984-85	Aging	\$4,615	\$13,300	\$17,700
17. Attendant Care for Senior Citizens.....	1984-85	Aging	\$5,000	\$5,400	\$6,200
18. Drug Education for Senior Citizens.....	1984-85	Aging	\$192	\$50	\$50
19. Senior Center Renovations.....	1984-85	Aging	\$10,100	c/	N/A
20. Pre-Admission Assessment.....	1984-85	DPW	\$1,639	\$2,505	\$3,050
21. Medicare Part B.....	1984-85	DPW	\$8,000	\$9,330	\$11,340
22. Supplemental Grants to the Aged.....	1984-85	DPW	\$17,600	e/	N/A
23. Elderly Shared Rides.....	1984-85	DOT	\$28,272	\$40,350	a/
24. Demand Response Equipment Grants.....	1984-85	DOT	\$954	\$2,300	\$2,300
25. Alzheimer's Disease.....	1985-86	Aging	\$495	\$100	\$100
26. Community Mental Retardation Services - Elderly.....	1985-86	DPW	\$2,200	e/	N/A
27. Ridership Verification.....	1985-86	DOT	\$75	\$100	\$100
Totals.....				\$633,948	\$896,982

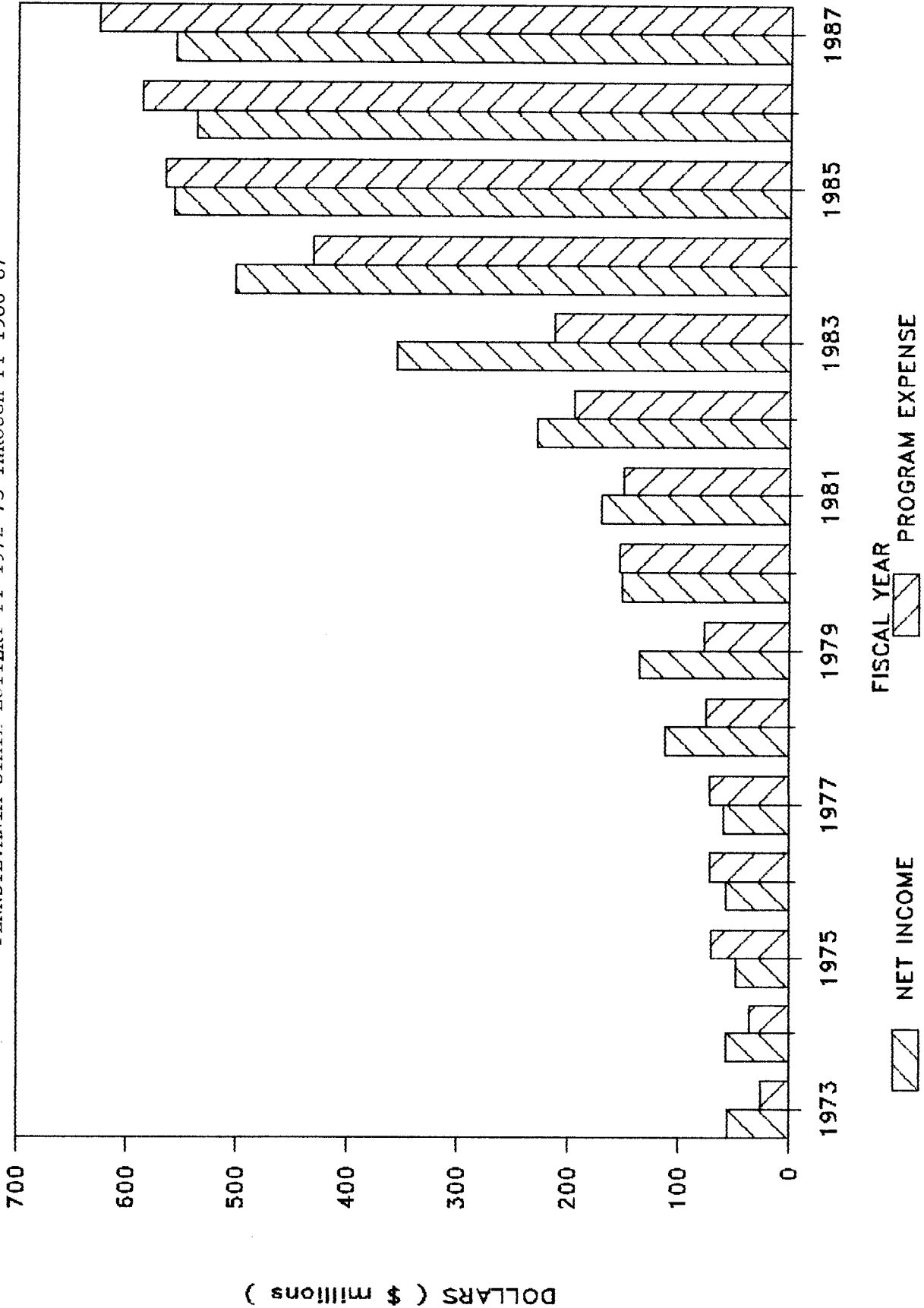
Footnotes to Table 6

- a/For FY 1991-92, Free Transit for the Elderly and Elderly Shared Rides combined as Senior Transit.
- b/This program was for two years, FY 1980-81 and FY 1981-82.
- c/This program was for one year only.
- d/Includes an increase of \$8,000,000 from FY 1986-87 as requested by the Governor.
- e/Funding responsibility for this program was transferred back to the General Fund effective FY 1987-88.

Source: Developed by LB&FC staff from Governor's Budget Documents, FY 1973-74 through FY 1987-88, and "The State Lottery Fund Financial Statement" prepared by the Office of the Budget, June 24, 1987.

# NET INCOME (PROFITS) TO PROGRAM EXPENSE

PENNSYLVANIA STATE LOTTERY FY 1972-73 THROUGH FY 1986-87



Source: Developed by LB&FC staff from information obtained from the Pennsylvania State Lottery and the Governor's Office of the Budget.

G. DEFICIENCIES RELATED TO STAFFING OF STATE LOTTERY MARKETING FUNCTION

FINDING: It appears that certain deficiencies exist relative to the staffing of the internal marketing function of the State Lottery. Problems identified include staff vacancies, absence of technical support positions, a decline in the marketing field staff workforce and the absence of formal marketing training for field staff. The position of Director of Marketing, which has responsibility for planning, coordinating and directing the overall marketing functions of the State Lottery, has been vacant since May 1987. The auditors were informed in late August that a Director of Marketing had been hired and would begin work in mid-September 1987. The auditors also observed that the Lottery does not have technical support personnel among its marketing staff who could be available to carry out market research and analysis, generate and interpret sales data, carry out forecasting activities and perform other related statistical and analytical support functions. Such personnel would generally be present in a sales-oriented business enterprise. At the time of the audit, the central office marketing staff consisted of the Acting Director of Marketing, two Assistant Directors, a numbers games coordinator, a chain store account manager, and three administrative support personnel. The auditors also observed that despite an increase in the number of retailers or field agents (from 8,179 to 8,897 in the last four years), the number of Lottery field representatives designated as district lottery representatives (DLRs) has declined from 70 to 56. There also appears to be a current need to clarify and redefine the marketing role and functions of the DLRs and to provide formal ongoing marketing training for individuals in these positions. Additionally, one of the Lottery's six area marketing offices (Clearfield) has been without an area manager since February 1986. During this period, one of the area managers from the Pittsburgh Area Office has been acting area manager for Clearfield on a part-time basis creating a situation in which neither office receives her full attention. Insufficient attention to dealing with these staffing deficiencies would appear to potentially restrict the State Lottery's ability to effectively market the Lottery during a period in which sales are leveling off. (See Finding D.) The Acting Executive Director of the State Lottery indicated concurrence with the need to add technical support positions to the marketing staff. It is recommended that such positions be added and that their role and functions within the recently reorganized central office structure be clearly defined. It is further suggested that the Department of Revenue act as expeditiously as possible to fill the vacant area marketing manager position and that a comprehensive staffing analysis be done to assess the adequacy of the size of the current DLR work force, identifying area marketing regions in which additional positions may be needed. The State Lottery should also establish ongoing marketing training programs for the DLR field staff.

H. POTENTIAL TO INCREASE LOTTERY SALES THROUGH REDEFINITION, CLARIFICATION AND ENHANCEMENT OF THE MARKETING ROLE AND FUNCTIONS OF THE STATE LOTTERY'S DISTRICT LOTTERY REPRESENTATIVES

FINDING: It appears that there is potential to increase State Lottery sales through a redefinition, clarification and enhancement of the marketing role and functions of the State Lottery's district lottery representatives (DLRs). As of July 1987, the State Lottery had among its complement a total of 56 DLR positions, down from 70 in FY 1984 (while the number of Lottery retailers has increased from 8,179 to approximately 8,900). According to the current job description for the position, DLRs are responsible for "a wide range of sales/promotional activities within an assigned area." All lotteries appear to employ a staff of such sales representatives to service retailer locations (for example, to provide supplies, point-of-sale materials, educate retailers on new programs and ensure that retailers have the materials needed to operate). Until 1982 when a contracted courier service was employed, the DLR's essentially constituted a ticket delivery force. In 1984, on-line retailers replaced the State Liquor Stores as Lottery claim centers, and pickup of unsold tickets was discontinued when game close-out activities were transferred to the Instant Games Control section of the State Lottery. Along with these major operational changes to the Lottery, the role and responsibilities of the DLR also changed. DLRs no longer routinely deliver ticket stock to retailers, nor do they pick up unsold instant tickets at the end of a game. Audits of retailer cash, adherence to Lottery procedures, and helping retailers market Lottery products have become the major focus of DLR activities. Lottery officials have indicated to the auditors that they agree that the role of the DLR has changed and that there is currently a need for the DLRs to be retrained and to develop specific marketing skills. The auditors observed that while changes in the role and functions of the DLRs have occurred corresponding adjustments in the position's job description and/or DLR manual have not been made (See also Finding U.) As a result of the reduction in the complement of DLRs and a general lack of specialized marketing skills and training, it appears that State Lottery retailers may not be receiving all of the field support they need to sell tickets and to understand the changes in Lottery games, rules and regulations which occur. Also, with the number of retailers each DLR is required to serve (statewide ratio of 159 retailers to each DLR as of July 1987), a low-sales retailer may not be given the help to improve simply for lack of time of the DLR. Among a sample of six state lotteries sampled by the auditors, the ratio of retailers to field representatives was lower than Pennsylvania's in all but one of the states (Ohio 66:1; Massachusetts 100:1; New Jersey 137:1; Illinois 138:1; Michigan 138:1; and New York 260:1). The Lottery's advertising firm conducted a 24-month pilot test project ending June 30, 1987, involving supervision and direction of the marketing and operational activities of District 1-F in the

Philadelphia marketing region of the State Lottery (in lieu of DLR services). As described in a January 1987 report to the State Lottery, this project involved the testing of various "promotionally oriented test programs," including a marketing concept referred to as "Maximum Density Distribution" (a method designed to obtain new, incremental sales). The essential conclusions of the advertising firm's test project were that the net result of all the activities involved in the project was a "statistically significant growth in both sales and profits for the Lottery." The report noted that the marketing innovations tested could be replicated statewide and that with proper training the existing DLR Lottery field force could implement the concepts tested. It was projected that if the procedures, principles and practices of the "District 1-F" project were properly adopted statewide, "new gross sales could be as high as the \$30 million range." The report further concluded that "the role of the Lottery field marketing force is critical to maximization of sales." The report cautioned against assuming that the Lottery and its products sell themselves. The auditors recommend that serious consideration be given by State Lottery management to the conclusions of the pilot project test program performed by its advertising firm and implement additional pilot projects incorporating the DLR methods and techniques suggested by the advertising firm as means of increasing sales. According to the Acting Executive Director of the State Lottery, the Lottery plans on applying some of the techniques from the "District 1-F" project throughout the remaining Lottery marketing areas. Lottery officials have also indicated that they plan to increase the number of DLRs during FY 1987-88 as the budget permits. The auditors recommend that the Lottery develop a comprehensive ongoing training program involving outside sales and marketing professionals to improve the marketing skills of the DLRs. The training should include those techniques proven effective in the test project conducted by the Lottery's advertising firm in addition to guidelines on how to use all available resources, i.e., sales reports, demographic/geographic surveys, and the Lottery's computer programs. As part of the training program, the DLRs should be provided with an updated procedures manual. (See Finding U.) It is further recommended that the Lottery revise the DLR's job description and qualifications to reflect the changing role and current expectations for the position and develop specific performance standards and incentive programs for the DLRs.

I. ABSENCE OF FORMALLY ESTABLISHED PROCESS FOR INTERNAL MARKETING  
DECISION-MAKING

FINDING: It does not appear that the State Lottery has a formally established internal approach for formulating important marketing decisions and strategies. While the State Lottery has a marketing staff, it does not have a formally identified group of State officials and other key Lottery staff to consider and make important Lottery marketing strategy decisions. Additionally, the Department of Revenue and State Lottery officials have not developed a comprehensive long-range Lottery marketing plan.1/ The absence of such a plan is particularly significant given the current pattern and projected future leveling off in Lottery revenues. In its response to the LB&FC's interim performance audit report, the Lottery stated, "While technically, the Lottery does not have a formal marketing strategy team in its organizational chart, there are regular and frequent meetings of the chief executive, deputy executives, marketing director, and members of the advertising agency who consider and plan marketing activities." The auditors recognize that while such informal marketing sessions may occur, direct input is lacking from retailers and Lottery field staff and it does not appear that long-range strategic marketing plans or approaches are formalized. In advocating an "assertive approach" to marketing as the key to lottery growth, a state lottery executive director noted that . . . by formalizing agency business plans and developing strategic market plans, each lottery can have a blueprint for determining the measurement of success. Goals and objectives not met can be modified, so that a lottery agency can be managed by a plan, rather than managed by "crisis." Because of its geographic nature, Pennsylvania faces certain special considerations in marketing its Lottery games. As noted by the Lottery's former Director of Marketing, the Commonwealth has the largest rural population in the United States and "the needs of this group must be addressed when planning marketing and advertising strategies." On the other hand, the marketing of the Lottery must reach the state's five major metropolitan areas. As discussed in Finding A, marketing to these diverse target groups has been carried out within an advertising budget that has been maintained "at one of the lowest levels in North America." It is recommended that a specifically designated marketing team be formally established within the State Lottery and that this group be responsible for the development and periodic revision of a comprehensive marketing plan and strategy for the State Lottery. It is suggested that this group include the Secretary of Revenue or his/her designee as well as key officials and staff of the State Lottery. In developing marketing plans for the Lottery, this group should routinely solicit advice and input from the Lottery's contracted advertising agency and other pertinent service contractors, from lottery and

public gaming consultants and business consultants (on an as needed basis) and from the Lottery advisory group representing Lottery employees, retailers and players which is proposed in Finding W of this report.

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1/The State Lottery receives advertising and related services under contract with a private advertising agency. Under the terms of the contract, the agency is "to furnish professional advertising services and advice, including marketing assistance." Among the agency's responsibilities are the design of advertising campaigns, the placement of media advertising, the development of suggestions for game changes and enhancements, participation in overall marketing strategies and the completion of research activities concerning the effectiveness of State Lottery marketing. The development of a comprehensive marketing plan is not, however, among the agency's activities.

J. INFREQUENT REBIDDING OF CERTAIN MAJOR SERVICE CONTRACTS

FINDING: It appears that the State Lottery has maintained and continued major service contracts with private vendors, in some cases, for extended periods of time, through contract amendments and extensions. The State Lottery contracts with a number of private vendors for a variety of services used in the operation of the Lottery including development and printing of instant game tickets, on-line game development and operations, advertising, and courier delivery of ticket stock. (Please see Exhibit 1 for descriptive information concerning these contracts.) While no irregularities were found by the auditors in the issuance of these contracts relative to the procedures established by the Office of the Budget in the "Contracting for Services Manual," including issuance of a Request for Proposals (RFP) prior to awarding a contract in certain instances, the frequency of the Lottery's renewal of major service contracts has been inconsistent and lacking in standardization. For example, the State Lottery has maintained a continuous contractual arrangement with its current advertising firm since 1980. While each contractual period was no more than two years in length, the contract has remained in effect through numerous amendments with one rebidding of the contract occurring in 1984. (Please see Exhibit 2 for a chronology of the contract extensions.) Additionally, the Lottery's current computer services vendor for on-line Lottery games has provided such services to the PA State Lottery since 1978. An RFP for this contract was issued by the Lottery in 1981, and the current vendor was the successful bidder. Amendments have extended this agreement through December 31, 1988. In another case, contracted courier delivery services have been provided to the State Lottery by the same firm since 1982. An RFP for this service was issued in 1986 and two proposals were received; however, one bidder was determined not to be qualified.1/ The existing contract holder, Purolator Courier Corporation, was the successful bidder. The first Purolator contract was amended four times extending it two years, and the second contract has been amended once, extending it one year. While the initial contracting periods for these agreements have not exceeded three years, frequent renewals and amendments have extended them for lengthy periods of time. A Council of State Governments publication entitled "Buying Professional and General Services: A Guide" cites the benefits which a state agency can realize through the presence of competition in the acquisition of professional contracted services. Among the benefits noted are "best vendor thinking" and "better pricing." As stated in the "Guide," "if the state does not solicit competition and works with only one or two firms, there is a danger that the best firm will not be chosen," and . . . "the total value received is greater whenever professional services are purchased through competition." A Department of Revenue official indicated to the auditors that in

the future RFPs for major service contracts with the State Lottery will be issued on a regular and routine basis reflecting a contracting policy reportedly established by the incoming Administration. The auditors recommend that the Lottery continue to adhere to standard Commonwealth contracting guidelines and that consideration be given to establishing specific guidelines concerning the frequency with which major service contracts will be rebid (e.g., at the expiration of the initial agreement, after one renewal, etc.)

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1/This vendor reportedly did not have PUC authorization to provide delivery services in the Commonwealth.

EXHIBIT 1

Major Service Contracts In Effect Between the  
PA State Lottery and Private Vendors As of FY 1987-88

<u>Vendor</u>	<u>Contracted Service</u>	<u>Term of Current Contract</u> <sup>a/</sup>	<u>Contract</u> <sup>b/</sup> <u>Amount</u>	<u>Expiration Date</u>
Control Data Corporation.....	Provision of on-line games computer equipment	7 1/2 years	\$18.8	12/31/88
British American Bank Note Corporation.....	Printing/ of instant game tickets	3 years	\$15.0	4/9/90
Lewis Gilman & Kynett, Inc.....	Advertising	4 years	\$8.9 <sup>d/</sup>	6/30/88 <sup>e/</sup>
Purolator Courier Corporation..	Courier delivery services	2 years	\$3.7 <sup>d/</sup>	6/30/88

<sup>a/</sup>Includes amendments to current contract.

<sup>b/</sup>Maximum contract amount in millions, including increases made through contract amendments and extensions.

<sup>c/</sup>This vendor located a ticket printing production facility in Fort Washington, Pennsylvania. This facility reportedly began operation in August 1987.

<sup>d/</sup>This represents the maximum contract cost for the current one-year extension.

<sup>e/</sup>The State Lottery reported that it intends to issue a new Request for Proposal (RFP) for advertising services during FY 1987-88.

Source: Developed by LB&FC staff through review of contract data provided by the State Lottery and the Department of Revenue.

EXHIBIT 2

Chronology of Award, Rebid and Extensions of Major State Lottery Service Contracts

<u>Current Vendor</u>	<u>Year of First Contract</u>	<u>Chronology</u>
Control Data Corporation	1978	The first Control Data Corporation contract was amended once with no time change and the second contract awarded in 1981, was amended four times, extending it four and one-half years.
Lewis Gilman & Kynett, Inc.	1980	The first Lewis Gilman & Kynett contract was amended three times, extending it two years. The second contract, awarded in 1984, has been amended four times, extending it three years.
Purolator Courier Corporation	1982	The first Purolator contract was amended four times, extending it two years. The second contract, awarded in 1986, has been amended once, extending the term of the contract one year.
British American Bank Note Corporation	1987	The British American Bank Note contract was awarded in April 1987 for a term of three years.

Source: Developed by the LB&FC staff through review of contract data provided by the State Lottery and the Department of Revenue.

K. FURTHER REFINEMENT OF THE ALLOCATION/DISTRIBUTION SYSTEM FOR LOTTERY INSTANT GAME TICKETS MAY BE BENEFICIAL

FINDING: While it appears that the State Lottery has made improvements in its system of allocation and distribution of instant game tickets, further refinement of the process may prove beneficial. The current allocation/distribution of instant tickets is an automated system that operates through the Lottery's network of on-line computer terminals. The "continuous" allocation process revolves around retailer "settlement" (i.e., notification that tickets have been sold and monies deposited to a bank account) of sold packs of instant Lottery tickets which triggers allocation from the central office (with distribution via courier delivery service) of additional tickets based on pre-established retailer credit limits. As noted in the LB&FC's interim performance audit report on the State Lottery, a misallocation of tickets for an instant game, resulting in Lottery retailers running out of tickets, may have resulted in a significant loss of potential sales for the State Lottery in late 1986. After changes had been made by the State Lottery to correct this problem, excessive allocations were reported in March 1987 with some on-line retailers refusing shipments of instant game tickets. In April 1987, the Lottery introduced a continuous allocation process (based on average weekly sales) that replaced the tickets being settled as a game neared its end with tickets for the next game. The system also has a timing factor that can be activated near the end of a game to reduce or cut off shipments to retailers with low average sales. Based on examination by the auditors of allocation system records for the period early June through early August 1987 ("Summer Fun" instant game), it appears that the over-allocation and under-allocation problems which had recently been experienced were adjusted for by the system changes. It also appears to the auditors that the potential exists for further refinement of the current system primarily through closer monitorship of the frequency of ticket deliveries and status of retailer ticket stock. Management information in these areas is not routinely developed by the State Lottery. Manual development of such information by the auditors was carried out based on allocation records for the "Summer Fun" instant game time period. This analysis indicated that some retailers made settlements every day and correspondingly received deliveries of replacement tickets five days a week and that some retailers with high credit limits maintained correspondingly high numbers of ticket packs throughout an instant game. The auditors recommend that retailer credit limits set by the Lottery be reviewed and adjusted on a routine basis, using historical sales data stored in the existing computer system, to prevent the potential security and control problems that can be created by allowing retailers to accumulate large supplies of tickets. The auditors also recommend that the settlement and delivery procedures be reviewed to determine whether or not the frequency of courier deliveries can be reduced without creating ticket shortages or security problems for

retailers. It is suggested that the Lottery develop a system to monitor the frequency of courier stops per retailer, to investigate any which seem too frequent or irregular, and to consider if opportunities exist to modify the allocation system to reduce the overall number of courier deliveries which are necessary. It appears that less frequent deliveries may be possible, especially during the first week of new games, and that cost savings could be realized (see Exhibit 3).

### EXHIBIT 3

#### Analysis of Frequency of Delivery of Instant Lottery Game Tickets to A Sampling of State Lottery Retail Agents

1. The auditors examined the frequency of delivery to a sample of twelve Lottery retail agents with "low," "medium," and "high" volumes of sales for a 1987 instant game ("Summer Fun"). These classifications were developed by the auditors based upon the ticket pack allocation limit of the retailer (4 and under - low, 5 through 12 - medium, and over 12 - high). This examination indicated that while a low volume retailer may receive 1 or 2 deliveries of tickets during the course of a game, medium and high volume retailers may receive ticket deliveries from Purolator every day of the week. For the retailers sampled, deliveries averaged from 1.00 to 9.27 packs of instant tickets per delivery (under the present contract with Purolator, the cost of delivery is the same, \$5.25, for either one pack or up to eighteen packs - when delivered to one location).

2. An examination of Purolator Courier invoices for two eight-week games in 1987 ("Fortune Spin" and "Big Wheel") indicated that first week deliveries (when each retailer receives the initial game allocations) averaged 15,238, or almost 1.75 deliveries per retailer.

The auditors recognize that the continuous allocation system is designed to maintain a constant inventory of tickets on hand for the retailer and that Lottery management staff believes that the expense of several repeat deliveries each week to a high-volume retailer is more than offset by the potential negative impact on sales a shortage of tickets may have. While daily deliveries may be appropriate in some cases, it seems that there is room in the system for "fine tuning" that could result in less frequent deliveries to some retailers without a loss of sales due to ticket shortages. In the case of the first week deliveries described above, for example, there would appear to be potential for savings. For the two games examined, first week deliveries averaged about 1.75 deliveries per retailer. If deliveries could be consolidated into 1 per retailer for the first week of instant games, the Lottery could realize a savings in annual delivery costs of approximately \$260,000 (assuming 8 games per year, 9,000 retailers, and \$5.25/delivery).

Source: Developed by LB&FC staff.

L. COMPARATIVE COSTS OF COURIER VERSUS IN-HOUSE METHODS OF LOTTERY TICKET DELIVERY SHOULD BE CONSIDERED

FINDING: The delivery of ticket stock by a courier service is a fairly common method of delivery used by Pennsylvania and a number of other state lotteries. The State Lottery currently uses the service of a contracted courier for the delivery of instant lottery tickets, point-of-sale material, and on-line ticket stock. Prior to 1982, Lottery staff persons (District Lottery Representative - DLRs) were responsible for delivery of these materials. Effective July 1987, courier delivery services were extended to on-line ticket stock delivery to the Philadelphia area resulting in courier delivery of all Lottery ticket stock throughout the state. The auditors found that, as of the time of the audit, eight state lotteries were using a courier service for delivery of all or part of their ticket distribution. Under the current \$3.7 million contract in Pennsylvania with the contracted delivery service (Purolator Courier Corporation), the PA State Lottery pays \$5.25 per delivery drop; this charge appears to be in line with Purolator fees charged other state lotteries for ticket distribution: California, \$5.30, and Maryland, \$5.00.1/ The contract for a courier service was rebid by the State Lottery in 1986 and Purolator Courier, which was determined to be the sole qualified bidder, was awarded the contract. The contract with Purolator has been extended and presently is scheduled to expire in 1988. A Lottery official and several Lottery employees have suggested to the auditors that the Lottery could deliver ticket stock to retailers at far less cost than the present contract with Purolator. This would presumably entail a dedicated in-house delivery force of Lottery employees and vehicles. The auditors recommend that, prior to rebidding the next contract for courier services or extending the existing contract with Purolator, the State Lottery conduct a comparative cost analysis of the utilization of a private courier service to deliver Lottery ticket stock versus the establishment of an in-house state employee delivery force to carry out comparable services. This analysis should consider the various ticket distribution possibilities, ranging from full distribution of all ticket stock to delivery of only instant game tickets and/or on-line ticket stock. Also considered should be selective delivery to only certain areas of the state in which courier or in-house delivery would be most cost-effective. Some Lottery states reportedly divide ticket delivery responsibilities between in-house staff and private vendors. The results of this analysis should be used in determining the specific delivery system that will be most cost-effective for the State Lottery. Information on the outcome of the comparative cost analysis should also be presented to the appropriate standing committees of the General Assembly.

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1/According to an official of the Purolator Courier Corporation these three states, California, Maryland and Pennsylvania, were the only state lotteries which were being serviced by Purolator as of August 1987.

M. OPERATIONAL AND ORGANIZATIONAL CHANGES MADE BY INTERNAL STATE  
LOTTERY MANAGEMENT STUDY TEAM

FINDING: An internal Department of Revenue management study conducted at the State Lottery simultaneous with a segment of the LB&FC performance audit identified a number of organizational and operational deficiencies. In response to concerns about the management and operations of the State Lottery, the incoming Administration established an internal study team which consisted of a special "management advisor" and analyst staff from the Pennsylvania Department of Revenue. The work of this group occurred between late March and mid-August 1987. A written management report resulting from the study team's work was presented to the Secretary of Revenue in May 1987, and a reorganization plan, revised organization chart and related functional statements were reportedly prepared and presented to the Secretary of Revenue in mid-August 1987. The auditors had ongoing communication with the Lottery's "management advisor" and reviewed the internal task force's May 1987 report. Many of the issues identified in the report were likewise noted by the LB&FC staff during the preliminary survey phase of this performance audit. Such issues included uneven workload distributions, insufficient attention to cross-training of Lottery personnel and to the development of "back-up" staffing capabilities as well as functional fragmentations in the internal organization and administrative structure of the Lottery. Also noted were backlogs in Lottery processing activities, weaknesses in internal communications within the Lottery, deficiencies related to the role and functioning of the State Lottery field staff and the absence of sufficient inventory, procurement and budgetary control systems. The auditors observed that the State Lottery's management review has resulted in specific corrective actions being taken to address certain of these areas. These include the reduction of processing backlogs, the development and implementation of various administrative control systems, the initiation of cross-training of Lottery staff and the holding of weekly meetings to facilitate communications among Lottery staff. The auditors recognize the efforts of the task force as a very beneficial activity and one which is compatible with the objectives of the LB&FC performance audit process. The current Acting Executive Director of the State Lottery has indicated that the internal management study process is an ongoing process and that it will be extended in more depth to the area marketing offices by the Lottery's new marketing director who is to begin work in mid-September 1987. The auditors support the continuation of this process and recommend that the implementation of the work of the internal management review be coordinated with response actions taken in relation to the recommendations contained in this performance audit report. It should be noted that the auditors are unable to comment on the reorganization plan which the internal management review group proposed for the State Lottery. This plan was requested from

the Secretary of Revenue in late August 1987 but was not made available to the auditors. It is recommended that details of the reorganization plan that is presently under consideration be made available to the General Assembly and that the State Lottery consult with and receive input on this plan from a lottery gaming consultant and/or private business consulting firm before finalization and implementation of the plan occurs. (See Finding E.)

N. POTENTIAL TO INCREASE LOTTERY SALES BY INCREASING FREQUENCY OF "BIG 4" NUMBERS GAME

FINDING: It appears that the potential exists to increase State Lottery sales through increasing the frequency of the "Big 4" numbers game. Pennsylvania is one of 15 lottery states which offers a four-digit numbers game in its mix of lottery games. Such numbers games permit the lottery player to choose his or her own four-digit number, the winner being determined by a drawing. The Pennsylvania State Lottery initiated a "Big 4" game in late 1980 and presently conducts "Big 4" drawings three times per week, on Tuesday, Thursday, and Saturday. During fiscal year 1986-87, the "Big 4" game generated approximately \$98.5 million in sales for the Pennsylvania State Lottery. Of the five lottery games offered in the Commonwealth ("Lotto," "Big 4," "Daily Number," "Instant Games," and "Super 7"), the "Big 4" ranks last in terms of total sales generated. As shown on Table , all states which have four-digit lottery games run such games more frequently than does Pennsylvania. Two states offer the game seven days a week and the 12 others have such drawings six days per week. (The District of Columbia Lottery also offers six drawings per week.) There are indications that considerable growth in lottery sales could be realized if the number of "Big 4" drawings held per week in Pennsylvania were increased. A lottery gaming consultant who is a past executive director of the Pennsylvania State Lottery told the auditors that he believes "that the Pennsylvania State Lottery is still capable of growth and can probably achieve a three percent growth rate in sales simply by increasing the number of "Big 4" drawings...." The current Assistant Director of Marketing for the State Lottery also expressed the opinion to the auditors that the "Big 4" game could be offered six days a week without "cannibalizing" or cutting into the sales of other lottery games. A 1987 report prepared by the Lottery's marketing/advertising firm stated the following regarding the "Big 4": "two additional drawings could yield an estimated \$30 million in revenue during the 1987-88 fiscal year." Although the marketing/advertising firm made suggestions for a July 1987 introduction, the State Lottery has not acted and reportedly had no plan to increase the number of "Big 4" drawings as of September 1987. A Revenue Department official informed the auditors that one reason that the number of "Big 4" drawings has not been expanded relates to a concern that additional sales generated would likely be concentrated among individuals who have the least amount of disposable income. The auditors concur that the effect of game expansion on individual segments of the player market is a legitimate concern which would require formal study to document. It is recommended that the State Lottery give strong consideration to increasing the number of "Big 4" drawings held per week. Prior to making this decision, however, it is suggested that further study be conducted to determine if such action would negatively affect specific player groups and/or would reduce sales in other

lottery games. Likewise, consideration should be given as well to the impact, if any, such action might have on the chronic or compulsive gambler. (See Finding X.) It is suggested that valuable insights concerning the effects of more frequent four-digit drawings might be obtained by the Lottery through contacts with lottery agencies in other states which have more frequent games.

TABLE 7

Frequency of Four-Digit ("Big 4") Lottery Numbers Games,  
Pennsylvania and Other Lottery States\*/

<u>State</u>	<u>Frequency of Four-Digit Games Per Week (Days)*</u>
Connecticut.....	6
Delaware.....	6
Illinois.....	7
Maine.....	6
Maryland.....	6
Massachusetts.....	6
Michigan.....	6
New Hampshire.....	6
New Jersey.....	6
New York.....	7
Ohio.....	6
Oregon.....	6
PENNSYLVANIA.....	3
Vermont.....	6
West Virginia.....	6

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\*/Note: Not all lottery states have four-digit numbers games; the lottery operated by the District of Columbia also offers "Big 4" drawings six days per week.

Source: Developed by the LB&FC staff from the Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc.

0. ABSENCE OF STATE LOTTERY FEE MANAGEMENT SYSTEM

FINDING: The State Lottery does not have an established fee management system which provides for periodic review and assessment of the appropriateness of Lottery fee charges. As shown on Exhibits 4 and 5, four categories of fees were being charged by the State Lottery at the time of the audit for: (1) processing of annual Lottery retailer licenses; (2) Lottery telecommunications services (data line charge) for Lottery retailers; (3) installation of on-line computer terminals; and (4) relocation of on-line computer terminals. The proceeds from these fees, which are recorded as augmentations to reduce the general operating expenses of the State Lottery, amounted to \$2.4 million in FY 1986-87. It appears that adjustments in these charges may be warranted. A Lottery official informed the auditors that the Lottery does not formally or informally review the appropriateness of the fee rates charged and the auditors were unable to identify the specific basis of the fee rates which are currently in effect. For example, the auditors observed that the license processing fees for retailers under consideration to receive on-line terminals and charges to on-line retailers for telephone company services do not appear to be offsetting the pertinent costs being incurred by the State Lottery. The "Commonwealth Fee Report" (issued by the Governor's Office of Budget and Administration in 1981) advocated a process that would "periodically review fees and make recommendations for fee changes" with fees being analyzed to determine "the degree to which they are recovering their related costs." As stated in the "Fee Report," "the guiding policy for this effort has been to bring fee rates more into line with the governmental cost of conducting the associated activities." It would appear that unrecovered Lottery operating expenses and costs reduce the funds which are available for the programs that the State Lottery Fund supports. A proposal initiated within the Marketing Office of the State Lottery in March 1987 recommended increases in weekly line charges for Lottery retailers and in installation costs with cost savings to the Lottery for fiscal year 1987-88 estimated at \$1.0 million. As of September 1987, the Acting Executive Director of the Lottery informed the auditors that he was examining the charges to on-line retailers to determine their equity and whether the Lottery was recouping a fair portion of actual expenses incurred. It is recommended that the State Lottery develop a formal fee management system through which all of the fees which it charges are reviewed on a regular basis according to established policies and guidelines for determination of the appropriateness of the fee rates (relating to the extent or percentage of which actual costs associated with the services provided by the Lottery are to be recovered through the fees charged). It is recommended that the State Lottery identify all activities pertinent to the processing of applications for licenses and requests for on-line terminals and that the costs of other fee-related activities be documented and that the corresponding fees be charged at a rate sufficient to enable

the Lottery to recover a reasonable specified percentage of the pertinent activities. In this process, the fee increase proposal developed by the Lottery's Marketing Division in 1987 should be considered. It is recommended that the State Lottery establish its fees in regulation and that adjustments be made through the regulatory process as necessary.

EXHIBIT 4

Fees Charged by the Pennsylvania State Lottery

<u>Fee Type</u>	<u>Fee Amount</u>	<u>Frequency</u>	<u>Payers</u>	<u>Receipts, FY 1986-87</u>
License Processing Fee.....	\$ 15	Annual	Licensees and Applicants	\$ 104,210 <sup>a/</sup>
Telephone Data Line Charge.....	\$ 15	Weekly	On-Line Retailers	\$2,265,000 <sup>b/</sup>
Data Line Installation Charge....	\$200	Per Installation	Retailers with Approved Requests for On-Line Terminals	c/
Data Line Relocation Charge.....	\$500	Per Relocation	Relocated On-Line Retailers	c/

a/ Does not include receipts from the \$5 portion of the license processing fee deposited in a restricted receipts account for coverage against unsold ticket losses. (See Finding Y.)

b/ Includes reimbursements of data line installation and relocation costs.

c/ Included in reimbursements of telephone data line costs.

Source: Compiled by LB&FC staff from information obtained from the PA State Lottery, PA Department of Revenue.

EXHIBIT 5

Relationship Between Fees Charged by the  
Pennsylvania State Lottery and Associated Fee-Related Costs Incurred

- Fee Type: License Processing Fee  
Fee Amount: \$15/year  
Associated Costs Reported by State Lottery: Not Available  
Explanation/Associated Costs: No organizational unit within the State Lottery is involved exclusively in the processing of applications for licenses and requests for terminals; the actual costs cannot be readily determined from existing financial documents. Five dollars from each \$15 license processing fee is deposited into a restricted receipts account to cover tickets lost through burglary, robbery or fire (see Finding Y). The remaining \$10 is used to reduce Lottery operating expenses.
- Fee Type: Telephone Data Line Charge  
Fee Amount: \$15/week  
Associated Costs Reported by State Lottery: \$37 weekly as of 5/87  
Explanation/Associated Costs: According to Lottery officials, the Lottery had tried to follow an informal rule of augmenting its revenues by charging on-line retailers at least 50% of the statewide average costs for telephone lines. However, the officials indicated that the Lottery was recovering less than 50% of the cost in early 1987. A Department of Revenue official told the LB&FC auditors that, on July 1, 1987, Bell of Pennsylvania was scheduled to begin providing long-line telephone service for State Lottery retailers in all locations except the Erie vicinity, where service would be provided by GTE. Bell submitted a proposal to furnish the long-line service at a significantly lower cost than AT&T, which had been providing the service. According to the Revenue official, the changeover represented potential savings in long-line charges. Noting that costs might drop to a point where \$15 per week would represent 50% of the total line charge after the changeover, a Lottery official expressed a preference for charging on-line retailers \$20 per week to recover losses already incurred and to provide a cushion if costs did not drop as much as anticipated.
- Fee Type: On-Line Terminal (Data Line) Installation Charge  
Fee Amount: \$200 per Installation  
Associated Costs Reported by State Lottery: \$795 minimum as of 5/87  
Explanation/Associated Costs: The State Lottery has been charging new on-line retailers \$200 to cover a portion of the cost of installing the telecommunications data lines for their terminals. By early 1987, the actual cost ranged from \$795 to \$1,440 per installation. The conversion of the long-line service to the Bell system (see #2 above) is expected to keep the cost at \$795 for most areas of the state unless the rates increase. Lottery officials have expressed preferences for increasing the charge to the retailer to 50% of the statewide average cost, the minimum cost of \$795, or an amount equal to the statewide average cost.

EXHIBIT 5

Relationship Between Fees Charged by the  
Pennsylvania State Lottery and Associated Fee-Related Costs Incurred  
(Continued)

4. Fee Type: On-Line Terminal (Data Line) Relocation  
Fee Amount: \$500 per Relocation  
Associated Costs Reported by State Lottery: \$795 min. as of 5/87  
Explanation/Associated Costs: A change in a retailer's location requiring new telecommunications data lines incurs the same cost as the installation of data lines for a new terminal (see #3 above). Lottery officials have expressed a preference for charging retailers the full cost of relocating terminals at their request.

Source: Developed by LB&FC staff from information provided by the PA State Lottery and the Office of Fiscal Management, PA Department of Revenue.

P. LACK OF FORMAL WRITTEN PROCESS FOR LICENSING OF ON-LINE LOTTERY RETAILERS

FINDING: The State Lottery does not have a formal written process through which applications for on-line Lottery retailer licenses are awarded, and it appears that procedures followed in this process are not uniform among the Lottery's six area marketing offices. On-line Lottery games accounted for \$1.1 billion or 84% of total Lottery sales during FY 1986-87. As of July 1987, 33% or approximately 3,000 of the State Lottery's approximately 9,000 retail agents were on-line retailers. In order to become an on-line retailer, there are specific steps which must be taken by an interested retailer. The auditors observed, however, that the current on-line retailer application process is unwritten and appears to be characterized by several deficiencies. These deficiencies include: (1) the lack of formal written criteria for the selection of on-line retailers; (2) Lottery area marketing office practices and procedures for the on-line retailer application process appear to be non-uniform; (3) the retailer is not required to complete an application and it appears that the burden of the application process is carried by the District Lottery Representative (DLR) (the DLR is required to fill out a "site survey" for each retailer applying for an on-line license, requiring approximately 2.5 hours to complete); and (4) lack of a computer system to track the status and provide management information regarding on-line retailer applications. It appears to the auditors that the lack of written procedures and criteria for the on-line retailer application and selection process may lead to uncertainty in the minds of existing retailers and potential future lottery retailers about the specific steps and criteria used for the selection of an on-line retailer. It also appears that the current process, with the burden of work on the DLR, reduces the amount of time the DLR has to provide marketing/sales assistance to other Lottery retailers. The auditors also noted that the records of the status of individual retailers' requests are maintained manually in the Marketing Division at Central Lottery Headquarters; a computer tracking system could eliminate the manual process and provide information on the status of an individual's application for management and inquiry response purposes. Additionally, a computer tracking system could provide management with summary information on elapsed time to process on-line retailer applications. The auditors recommend that the Lottery develop written procedures for processing requests for on-line terminals, standard formats for keeping records of requests in area offices, written criteria for selecting locations for terminals, and a computerized system for tracking requests. The auditors also recommend that the Lottery revise the application process to require the applicant to complete an initial application prior to the DLR visitation and site survey. Additionally, it is recommended that the on-line retailer licensing process, including retailer selection criteria, be established in regulation by the State Lottery.

Q. CERTAIN LIMITATIONS EXIST IN CAPABILITIES OF CURRENT ON-LINE LOTTERY COMPUTER TERMINALS

FINDING: "On-line" computer terminals in use at almost 3,000 of the Pennsylvania State Lottery's approximately 9,000 retailer locations are outmoded and lacking in state-of-the art capabilities which are presently available to the Lottery industry. "On-line" Lottery games (i.e., those involving ticket-generating terminals hooked up to a central computer via telecommunications lines, such as numbers and lotto games) accounted for approximately \$1.1 billion or 84% of gross Lottery sales in the Commonwealth FY 1986-87. As of the time of the audit, the Pennsylvania State Lottery was being supplied with on-line terminals through an \$18.8 million contract with a private vendor. Two types of terminal models (referred to as the TVT and the TDT) were being provided to the State Lottery under the terms of the current agreement. Although both models give Lottery retailer operators the capability to sell tickets for numbers games, cancel tickets, process winning tickets, and obtain accounting reports, the older model (TDT) does not have any unused memory capacity. Additionally, a Lottery official informed the auditors that the TDT is not able to sell tickets when it is downloading information (when stored data is being transferred to the central computer) or before and after any management function is used. As of July 1987, between 35% and 40% of numbers game revenue was coming from sales processed through the older TDT terminals. An official of the Lottery's computer vendor (Control Data Corporation - CDC) explained to the auditors that PA Lottery retailers being "brought on line" for the first time are given TDTs since the contractor (CDC) does not have any other models available in storage for the PA Lottery. The auditors thus found that the PA State Lottery is presently using the maximum functional capability of approximately 50% of its on-line terminals in retailer locations. As a result of the limited capabilities of current system on-line equipment, the Lottery is not able to offer game enhancements and innovations and, for example, is not able to offer its "quick-pick" option for numbers games other than "Super 7." (When a recent Super 7 jackpot reached \$5,000,000 over 45% of the plays were "quick picks.") One Lottery official told the auditors that, although neighboring states with "quick-pick" games were attracting Pennsylvania players when jackpots were high, residents of other states were at the same time discouraged from playing PA Lotto because the "quick-pick" option was not available. Available TVTs (the superior of the two models available to the PA Lottery under the present contract agreement) are reportedly placed in existing highest volume locations. A CDC official stated that, if negotiations with the PA Lottery resulted in a requirement for additional TVTs, terminals could be supplied at a cost from the CDC's inventory of TVTs originally used in the State of New York, where a newer advanced model is now being used. CDC officials indicate that their firm has available and would be able to supply an even more sophisticated model that is

being marketed to states currently in or approaching the procure-  
ment process. According to the CDC official, the PA Lottery has  
indicated that funds for replacing the old TDT equipment or enhanc-  
ing its memory capacity are not available. The State Lottery's  
current contract agreement with its computer vendor for on-line  
games is scheduled to expire on 12/31/88. As of July 1987, the  
State Lottery was reportedly seeking a consultant to assist in the  
preparation of a request for proposal (RFP) from on-line vendors  
capable of supplying a full-range of state-of-the-art equipment to  
the State Lottery. A Lottery official described the existing  
system as adequate but outdated and said that the Lottery wanted  
to take advantage of the availability of other equipment. Tenta-  
tive plans and scheduling by the Lottery call for signing of a  
contract with an on-line vendor in April 1988, testing equipment  
by August 1988, and initiating installation and start-up of the  
new system before the existing CDC contract expires at the end of  
calendar year 1988. The auditors recommend that the State Lottery  
aggressively pursue its plans to obtain an upgraded state-of-the-  
art system for its on-line games and consider the full range of  
equipment available to the lottery industry. At a minimum, the  
new system should be capable of validating instant tickets, pro-  
cessing transactions faster, storing larger quantities of data,  
and offering new options and game enhancements. It is suggested  
that Lottery officials look into system enhancements and equipment  
being installed and implemented in other states and the resulting  
impacts on sales which are reported. In addition to contacting  
the Lottery's current vendor, the auditors visited the headquar-  
ters of another corporation which serves the computer needs of the  
lottery industry and received explanation and demonstration of  
currently available lottery equipment. These demonstrations indi-  
cated that state-of-the-art technology can be adapted to meet the  
needs of individual clients. It is recommended that State Lottery  
officials continue in their efforts to obtain improved computer  
terminals via the rebidding of the contract for this service, and  
make every effort to take advantage of the latest technology avail-  
able to the lottery industry. In the interim, it is suggested  
that the State Lottery carefully study the cost/benefit implica-  
tions of negotiating with its current vendor to upgrade at least  
the TDT component of its system (or to take other action) to ex-  
pand system capabilities over the final 15 months of the current  
contract and conduct such negotiations if warranted.

R. ABSENCE OF AN EDP DISASTER RECOVERY PLAN

FINDING: A portion of the computer services which support the operations of the Pennsylvania State Lottery are not covered by an EDP disaster recovery plan. The State Lottery currently does not have a written disaster recovery plan for its IBM System 38 Computer nor is there an arrangement for an alternative data processing site for use in the event of a disaster. The State Lottery currently utilizes an IBM System 38 computer at its central headquarters for various administrative and operational functions including text processing, business graphics, inventory control, and the bar coding system used to track ticket settlement envelopes. The State Lottery also uses the computer services of the Department of Revenue's Bureau of Computer Services and of Control Data Corporation, the private firm which currently holds the contract with the State Lottery to supply on-line numbers games. The auditors have determined that both the Revenue Department's Bureau of Computer Services and Control Data Corporation have EDP disaster recovery plans and alternative site arrangements for use in the event of a disaster. Several groups involved in auditing EDP systems, including the U.S. General Accounting Office and the consulting firm of Price Waterhouse, cite the need for and value of correcting such EDP deficiencies. Additionally, Commonwealth management directives require agencies under the Governor's jurisdiction to establish a disaster recovery plan and to provide for an alternate processing site. The Director of Security informed the auditors that he is presently in the process of developing a disaster recovery plan and that this plan will be part of a comprehensive "Business Recovery Plan" for the State Lottery which is currently under development. As of August 15, 1987, the Lottery had completed a first draft of their Disaster Recovery Plan. The Plan is scheduled for completion by September 30, 1987. The Director also stated that the Lottery does not have an alternate data processing formal site agreement but expressed the belief that one is not necessary due to the local availability of compatible systems. It is recommended that the Lottery process in a timely manner the establishment of a formal EDP disaster recovery plan and that further consideration be given to the need to develop a formal contractual arrangement for a specific compatible off-site data processing facility for emergency back-up purposes.

S. DEFICIENCIES IN STATE LOTTERY INVENTORY SYSTEM

FINDING: It appears that there are several weaknesses in the State Lottery's inventory system. The State Lottery's central computerized inventory system does not appear to provide sufficient information to Lottery management staff at the central office level and does not maintain information on inventory levels at the Lottery's six area marketing offices. The auditors found that the State Lottery does currently maintain a computerized inventory control system (IBM System 38) for its central warehouse. However, the Lottery's marketing offices are not presently tied into this central system and each office maintains a manual inventory record. The Director of Computer Systems and Operations for the State Lottery told the auditors that as originally conceptualized, the computerized inventory control system would have been on-line at each of the Lottery's area offices via a direct connection to the Lottery's central headquarters' computer in Middletown. However, due to Commonwealth procedures and Management Directive 235.10, the Lottery was not permitted a direct connection between the Lottery central office and its area offices but was rather required to route all communications through the Commonwealth's network system. Terminals in Lottery area offices are, however, presently not capable of communicating with the Lottery's IBM System 38 in the Lottery's central headquarters reportedly because of switching limitations in the network system. An official of the DGS network has indicated to the auditors that the Lottery's IBM System 38 does not support a communications feature needed by the network system, but this can be overcome with a modification of the network to enhance the scope of interface. Prices for this modification are being developed and should be ready by the end of September. The Director of Operations told the auditors that, in his opinion, there are two problems with the current inventory control system: (1) there is currently no way for Lottery headquarters to keep track of inventory usage at the area offices, and (2) the system does not provide for the tracking of total items purchased and used by the Lottery (i.e., it does track current stock levels). The Supervisor of the Storage and Distribution Center told the auditors that the Lottery has created a computer application called the "Extended Inventory System" based on a "canned" inventory software package that, although not specifically designed for the Lottery, has been tailored by in-house programmers to enhance its applicability to the Lottery. This program records and maintains a file of items shipped to each area office. It does not, however, record inventory distribution from an area office and the area offices presently do not have access to the "Extended Inventory System." The Supervisor of the Storage and Distribution Center told the auditors that he would like to see a system in place which would provide monthly reports on what the area offices use. Currently, no inventory reports are prepared for submission to the central office by the area offices and no internal spot-checks of field inventories are

conducted. The auditors conducted spot-checks of randomly selected items in four area offices. This spot-check activity did not identify inconsistencies or missing items. It was also noted that the present inventory control system does not have the capabilities to automatically reorder an inventory item when it falls below a preset balance. Currently the items which need to be reordered are being manually identified and processed. The auditors were informed that each area office has a store keeper/stock clerk who is responsible for these manual functions and who also keeps track of inventory in the area office's warehouse and the distribution of such inventory. With an individual already responsible for inventory at each area warehouse and with terminals already in place, it would simply be a matter of entering the inventory and distribution information into the terminal in order to maintain a centralized inventory system, if the necessary system linkages can be arranged. The Director of Operations told the auditors that he believes that if such changes to the inventory control system were implemented, it would reduce costs and would give Lottery management staff better control over its inventory. The auditors recommend that the Lottery make enhancements to its computerized inventory control system and further explore with the network possible solutions to the technological problems associated with communication between the terminals at the area offices and the IBM System 38.

T. STEPS TAKEN TO DEAL WITH PROBLEMS RELATED TO DISPOSAL OF REDEEMED AND UNSOLD INSTANT LOTTERY TICKETS

FINDING: The Pennsylvania State Lottery has taken steps to deal with problems that existed in the disposal of redeemed and unsold Instant Lottery ticket stock. As identified in the LB&FC's June 1987 interim audit report on the State Lottery, over 79 million returned and excess or unused Instant Lottery tickets were destroyed during calendar year 1986, and a backlog of 18 to 27 million tickets had developed at the Lottery's headquarters as of May 1987. This situation created safety, security and storage problems at the Lottery headquarters. The Director of Operations stated that for security reasons, there are only two ways to destroy instant tickets. These are shredding and disposal in a landfill and incineration, with incineration being the preferred method. The Harrisburg Steam Generating Plant has been used for this purpose. The auditors found that the Lottery has eliminated the backlog which existed in May 1987 and has also taken steps to establish a back-up destruction method for times when the Harrisburg Steam Generating Plant is unavailable. The auditors were informed that via a memorandum dated June 30, 1987, the PA State Lottery notified the Director of the Department of Revenue's Bureau of Administrative Services of the Lottery's interest in being included in the Department's service purchase contract for industrial shredding services as a "back-up" destruction method for Lottery ticket stocks. The auditors recommend that the State Lottery continue to pursue the establishment of a back-up system through coordinated efforts with the Department's Bureau of Administrative Services and recommend that the Lottery establish written guidelines relating to the destruction of Lottery ticket stock, including criteria related to when the back-up destruction method is to be used. Procedures to follow in using the shredding method, with particular attention to security considerations, should also be developed.

U. NEED TO UPDATE THE LOTTERY RETAIL AGENT AND FIELD STAFF MANUALS

FINDING: Operations and procedures manuals provided by the State Lottery to retail agents and district lottery representatives (DLRs) appear to be outdated and in need of revision. The DLRs' manual has not been updated since 1982 and the Lottery retailer agents' manual has not been revised since 1984. Each manual appears to be lacking up-to-date information concerning current Lottery regulations and operating procedures. Although both manuals are in loose-leaf formats to allow for updates and revisions, information does not appear to be current. For example, the DLR manual still describes the pick-up and delivery of instant tickets using the branch banks and the use of PA Liquor Control Board State Stores as Lottery claim centers. (The State Lottery changed its ticket distribution process in 1982 to a private courier delivery service which eliminated the branch banks. Additionally, in 1984, on-line retailers replaced the PLCB State Stores as the lottery claim centers.) In the case of the retailer agents' manual, procedures for the return of partially sold packs of instant tickets are described although they have been discontinued. Additionally, the payment procedures described in the retailer manual are outdated with those in current practice. Retailers presently can pay on-line winning tickets up to a maximum of \$2500 rather than the \$600 maximum described in the manual. Although the auditors did not do a comprehensive review of the manuals, it was noted that there are instances when procedures stated in the manual differ from those promulgated in the PA Code (See Finding V.) According to a Department of Revenue official, the retailer agents' manual is currently undergoing revision. There was, however, no indication that changes to the DLR manual were underway at the time of the audit. As a result of the Lottery's failure to provide up-to-date and accurate manuals, both Lottery retailers and DLRs may be unclear about current policies/procedures and may not be fully aware of any changes that may have taken place since the last manual revisions. Additionally, the retailers and the DLRs do not have the benefit of a current reference document to aid and guide them in the performance of their duties. It would also appear that the outdated manuals have limited use and may, in fact, be misleading when used by new retailers and DLRs for training purposes. The auditors recommend that the Lottery proceed expeditiously with the planned update of the Lottery retailer agents' manual and further recommend that the Lottery initiate and establish a specific timetable for revision of the DLR manual. It is recognized that updating of the DLR manual may, to some degree, be dependent upon corresponding activities aimed at redefining and restating (e.g., in job descriptions) the role and functions of the DLR position. (See also Finding .) The auditors also suggest that these manuals be prepared in loose-leaf binders for ease of updating and that updates and revisions be disseminated as necessary.

V. NEED FOR REVIEW AND UPDATE OF STATE LOTTERY REGULATIONS

FINDING: Regulations governing the operations of the Pennsylvania State Lottery appear to be in need of comprehensive review and, in at least several instances, appear to no longer be valid and require updating. Regulations for the Pennsylvania State Lottery were first promulgated in 1972. While various sections of the regulations have been periodically updated, in particular those sections governing the operation of new games, it appears to the auditors that certain sections concerning the administration of the Lottery do not accurately reflect current operations. For example, a regulation pertaining to the issuance of licenses, 61 PA Code §805.4, states the licensing fee as \$13 per year. The licensing fee currently being charged is \$15 per year and has been charged at this rate since 1980. Additionally, regulations governing the delivery of instant Lottery tickets do not accurately reflect the procedure which is currently in operation. The regulations for this procedure, 61 PA Code §809.1 et seq., state that tickets will be delivered by the Lottery to banks throughout the Commonwealth, to be received by authorized agents of the PA Lottery. These specific regulations were last amended in 1975. Instant Lottery tickets have been delivered by Purolator Courier Corporation directly to Lottery retailers since 1982. The Commonwealth Documents Law, Act 1968-240 as amended (45 P.S. §1102 et seq.), requires agencies to give "...public notice of its intention to promulgate, amend or repeal any administrative regulation." The notice is to include the text of the proposed regulations with indication of those sections which are being changed, a statement of the authority under which the regulation is promulgated, a brief explanation of the regulation or change, a request for written comments and any other statement required by law. Initiating changes to regulations through a contract or internal policy as it appears the State Lottery may have done does not meet the requirements of the Act as these notice requirements are not fulfilled. The Acting Executive Director of the State Lottery has concurred that there is a need to comprehensively review all lottery regulations and to update them as necessary. The auditors recommend that the State Lottery initiate a thorough review of its existing regulations for the purpose of identifying and amending those which do not accurately reflect current operations and procedures in use by the State Lottery. Further, it is suggested that consideration be given to the possible need to promulgate additional regulations to cover areas which may not presently be dealt with in the regulations.

W. ABSENCE OF FORMAL MECHANISMS FOR RECEIVING INPUT FROM STATE LOTTERY PERSONNEL, RETAILERS AND PLAYERS

FINDING: There is no formal mechanism in place through which the State Lottery can receive input and advice from its employees, retailers, and players. Although the Lottery management staff periodically receives research data reflecting selective retailer and player input through reports developed by the Lottery's contracted advertising firm and an employee suggestion box system in place in the central office, there appears to be no formal method available for regular, direct communication and dialogue within the Lottery system. A Lottery official stated that Lottery retailers use a variety of informal methods to convey their ideas and comments regarding Lottery operations. These include the writing of letters and other contacts to district lottery representatives and lottery area offices. Another Lottery official also stated that, in his opinion, one of the reasons for not having a more formal system of receiving input directly from field staff, retailers, and players relates to the lack of staff to properly collect and analyze the input and information that might be generated. As a result of an internal "management review" of the Lottery conducted while the LB&FC audit was in progress, a recommendation was made to develop a "bottoms-up feedback system" to take advantage of the special knowledge of the Lottery's field representatives. As of August 1987, the Lottery had not yet taken action to establish such a system. The Lottery did recently take steps, however, to solicit input from their retailers. Discussion occurred during the audit concerning the possible use of the "Lottery Line," a monthly newsletter to Lottery retailers as a vehicle for soliciting input from Lottery retailers. The August 1987 issue of this monthly newsletter contained a one-page, tear-off, mail-in sheet for retailer suggestions and ideas concerning the "Lottery Line" and ways in which services to Lottery customers might be improved. A number of Lottery employees and retailers who responded to LB&FC audit questionnaires expressed dissatisfaction with what they perceive as the Lottery management's failure to solicit or be receptive to suggestions from the field. Some indicated that by not listening to the field staff benefit is not obtained from the source which is closest to the retailers and players and that Lottery officials will lose touch with the players if they do not listen to the retailers. A report issued by the Wisconsin Legislative Reference Bureau on public gaming indicates that the obtaining of player feedback is an important ingredient in building and maintaining public participation in a lottery. The auditors also noted that a select committee of the Florida State Senate recommended that a "state lottery council" be established to advise the newly created Florida State Lottery. It was recommended that this council serve as a "resource" for the lottery providing it "with private-sector perspectives on the operation of a large marketing enterprise." The auditors received various ideas on how to increase input from the staff, retailers, and players including a

"suggestion of the month" contest, the establishment of regular meetings between the Lottery's district lottery representatives and management staff, and the creation of a retailer advisory committee. While the auditors recognize the recent modification to the "Lottery Line" as an attempt to obtain input from retailers, the auditors recommend that additional steps be taken by the Lottery to develop the "feedback" system called for in its internal management study. It is also recommended that consideration be given to the establishment of a special advisory committee to the State Lottery. This advisory committee should include Lottery retailers and field staff representation from each of the Lottery's area marketing regions as well as individuals from the private sector who could bring an outside business perspective to the committee. It is further suggested that the State Lottery design and disseminate (through Lottery retailer locations) special lottery player comment/input postcards through which direct player communication can be made with Lottery management staff. Such cards could be similar to the "Hot Line" cards placed by the PA Turnpike Commission at each service plaza to solicit input and comments from Turnpike patrons. Player input received through this and other means should be routinely summarized and provided to Lottery management and also be taken into account by the special advisory committee discussed above.

X. NEED TO RECOGNIZE POTENTIAL PROBLEMS OF LOTTERY-RELATED GAMBLING ADDICTION

FINDING: The Pennsylvania State Lottery does not presently have a formal program to identify and deal with situations in which the presence of legalized lottery gambling creates hardships for individuals and society as a result of compulsive or addictive gambling behavior. To date, the State Lottery has not committed resources to such activities and has reportedly become aware only informally and sporadically with instances of suspected Lottery-related gambling addiction. While the benefits of the State Lottery to Pennsylvania's senior citizens are evident, the auditors believe that the Lottery may also have a negative impact on some individuals who may invest a greater portion of their incomes than they can reasonably afford with unrealized expectations of quick wealth. It has been advocated that states with legalized gambling (including lotteries) as a source of revenue have an obligation to apply a portion of that revenue to investigating and dealing with the negative consequences for individuals and society stemming from compulsive gambling. The auditors found that several states, including Connecticut, Iowa, Ohio, Maryland, New Jersey, and New York, have already committed resources to establishing such programs, at least on a pilot basis. For example, by law, Iowa earmarks 0.5% of gross lottery revenue to assist individuals and families in difficulties because of gambling. While State Lottery profits provide funding for a number of government programs for the senior citizens of Pennsylvania, some sociologists and economists question the Lottery's impact on the poor, the young and the compulsive. A March 1987 article in the Philadelphia Inquirer reported that several studies have noted the effects of lotteries upon these groups. A study conducted by two professors at Indiana University found that ". . . poor people bet a substantially larger portion of their incomes on lotteries than others and that state lotteries placed a greater relative burden on low-income families than on high-income families." Another study conducted in New Jersey noted that although lottery players in that state must be 18 or older, 43% of the high school students surveyed played the Lottery. Additionally, Lottery opponents have raised the issue that state lotteries enlarge the problem of compulsive gambling in this country, either by providing an easy outlet for gamblers to receive gratification or by making gamblers out of those who otherwise would not bet. A research study conducted at Rutgers University of the incidence of pathological gambling in the Delaware Valley area from 1977 (the year the Daily Number was introduced) to 1984 indicated that compulsive gambling in this area increased by as much as 94%. While research conducted by the Veterans Administration in Washington, D.C., has found that ". . . no data exists supporting the contention that lotteries increase compulsive gambling . . . [as they] do not possess any of the addictive qualities that turn people in to compulsive gamblers," the executive

director for the Council on Compulsive Gambling of New Jersey stated in a newspaper article dated March 1987 that an estimated 12% of the Council's calls for help come from lottery players. Responses to an audit questionnaire to lottery players (made available at selected PA Lottery retailer locations) provide some degree of perspective on the extent to which some individuals play the lottery. For example, certain players reported spending between \$80 and \$100 per week on lottery tickets, and one individual stated that her son spends his grocery money on tickets. It is recommended that the General Assembly give consideration to amending the "State Lottery Law" to specifically require that the State Lottery establish an ongoing program to identify and assist individuals and families who may be experiencing financial difficulties associated with excessive lottery playing. It would appear that support for such a program may exist within the Executive Branch. In his Executive Budget Message for FY 1987-88, the Governor referred to the need to seek "realistic growth in revenues while being sensitive to problems of gambling addiction and reliance on the patronage of the poor." Prior to the establishment of such a program, it is suggested that the Lottery examine existing studies and literature regarding the relationship between lottery playing and compulsive gambling and that the Lottery then conduct or cause to be conducted a study specific to the impact of the Lottery on the incidence of compulsive gambling in the Commonwealth. The results of this study should be made available to the appropriate standing committees of the General Assembly. It occurs to the auditors that the financing of such a study and program should be considered by the Lottery as a "cost-of-doing business" expense.

Y. ISSUES RELATED TO SPECIAL RESTRICTED RECEIPTS ACCOUNT TO COVER LOTTERY RETAIL AGENTS AGAINST LOSS OF UNSOLD TICKETS THROUGH ROBBERY, BURGLARY AND FIRE

FINDING: It appears that a special restricted receipts account used to maintain a reserve for lottery tickets which are "lost" by Lottery retailers creates unnecessary accounting and administrative activities. State Lottery regulations, Title 61 of the Pa. Code, §805.4(b), establishes a "license processing fee" (currently charged at a rate of \$15 per year) for the State Lottery and states that part of the fee shall be set aside for a fund to cover lottery agents who lose unsold tickets through burglary, robbery, fire, or similar occurrences. Five dollars from each \$15 license processing fee goes into a special restricted receipts account to cover the above mentioned retailer losses. (The remainder of the license processing fee is recorded as an augmentation to reduce the general operating expenses of the State Lottery). The administration of the restricted account is governed by a procedures manual that is entitled "Agent Loss and Coverage Procedure." As of June 30, 1987, the balance in this special restricted receipts account was approximately \$73,450. Expenditures from the account during FY 1986-87 were reported at about \$43,000. A Lottery official expressed the opinion that the Lottery could eliminate the restricted receipts account and could cancel the lost tickets without making the bookkeeping entries that the transfer of funds required. The Comptroller for the Department of Revenue indicated to the auditors that he concurred with this opinion that the current procedure creates unnecessary accounting and administrative transactions. The auditors recommend that the State Lottery review the continued need for the restricted receipts account and that State Lottery regulations be revised accordingly if a decision is made to eliminate this practice.

Z. NEED TO BETTER PUBLICIZE INCREASE OF "LOW-TIER" PRIZES IN LOTTERY INSTANT GAMES

FINDING: It appears that the State Lottery may not have taken sufficient steps to inform the public of recent changes made in the prize structure of its instant games. Although the State Lottery has taken steps to "download" (i.e., provide for a greater proportion of lower-tier or lower dollar value of winning tickets) the instant games prize structure (due, at least in part to, market research and developments in other states), it appears that many players could be unaware of this change. Throughout the course of the audit, the auditors received input from Lottery retailers and others concerning the perceived need to offer more lower-tier prizes in the instant games, thereby increasing player interest and satisfaction with a potential resultant increase in Lottery instant ticket sales. Similar comments were received from a considerable number of Lottery players who responded to an LB&FC player questionnaire that was made available at selected Lottery retailer locations. The auditors found that odds of winning prizes of \$100 or lower have been improved during the past year and a half and the top instant prize dollar amount has been lowered. As shown on Table 8, instant game prizes have been "downloaded" to a point wherein 98.8% of the cash value of all prizes in a recent game ("Hot Wheel") was \$100 or less. This contrasts to 84.1% and 87.7% for certain instant games offered in 1985. It appears to the auditors that the prize structure changes made in Pennsylvania Lottery games may not have been effectively communicated to the Lottery playing public. The potential would thus seem to be that players may be spending less or may be decreasing the number of instant tickets which they purchase because of misconceptions concerning the odds of their winning a prize. The auditors were informed by the Lottery's assistant director of marketing for instant games that the Lottery did not conduct any special advertising activities designed to communicate prize structure changes but did publish the revised odds on the game brochures that are printed for each instant game. It is recommended that appropriate marketing/advertising means be developed by the State Lottery to educate the public to instant prize structure changes which have occurred and which may occur in future games.

TABLE 8

Illustration of "Downloading" Prize Structure to "Lower Tier" Prizes  
for a Sample of PA State Lottery Instant Lottery Games

<u>Instant Lottery Game</u>	<u>Date of Introduction</u>	<u>Percent of Cash Value of All Prizes \$100 or Less</u>
Pennsylvania Double.....	August 1985	84.0552%
7-11-21.....	October 1985	92.5710%
Winter Green.....	December 1985	87.7033%
PA Lucky Draw.....	February 1986	93.7309%
The Good Life.....	April 1986	89.3471%
PA Pride.....	December 1986	98.2363%
Summer Fun.....	June 1987	98.1904%
Hot Wheel.....	July 1987	98.8384%

Source: Developed by LB&FC staff based on odds of winning as published in PA State Lottery regulations.

#### IV. BACKGROUND DESCRIPTIVE INFORMATION ABOUT THE PA STATE LOTTERY

##### A. Legal Background

The Division of the State Lottery was created within the Department of Revenue by Act 1971-91, 72 P.S. §3761-1 et seq., known as the "State Lottery Law." The purpose of the Act was ". . .to establish a lottery to be operated by the State, the net proceeds of which [were] to be used after June 30, 1972 exclusively for the purpose of providing property tax relief for the elderly for taxes paid in 1971 and thereafter. It [was] further intended to provide a means through which to curb illegal gambling operations in Pennsylvania." The State Lottery Commission, established under Section 4 of the Act, was comprised of a chairman and four members appointed by the Governor and confirmed by two-thirds of the Senate. The powers and duties of the Commission under Section 5 of the Act were to ". . .advise and make recommendations to the Secretary of Revenue regarding the functions and operations of the State lottery." The powers and duties of the Secretary of Revenue enumerated in Section 6 include operating and administering the Lottery and promulgating rules and regulations governing its establishment and operation. These rules and regulations include, but are not limited to, the type of lottery, ticket price, sizes and numbers of prizes, manner of selecting winning tickets, manner of payment of prizes, frequency of drawing winning tickets, types of locations at which tickets may be sold, method of selling tickets, licensing of agents, compensation of agents, apportionment of total revenue, and other matters necessary for the efficient and economical operation of the lottery. The Act further requires the Secretary to report monthly to the Governor and Legislature the total lottery revenues, disbursements and expenses and to make an annual report of this information including recommendations for changes to the Act.

Section 7 of the Act established qualifications for lottery sales agents and empowered the Secretary to refuse to grant a license or suspend or revoke a license in certain instances. Section 12 of the Act created a State Lottery Fund to be comprised of all monies received from the operation of the State Lottery. The Act restricts appropriations from the Fund to the payment of prizes, the payment of expenses in the operation of the lottery, and funding of property tax relief for the elderly and for transfer to the General Fund, through June 30, 1972, for the repayment to the General Fund of the amount appropriated to the Lottery Fund. Section 16 of the Act also provided for an initial appropriation of up to \$1,000,000 from the General Fund. Other provisions of the Act exempted lottery prizes from state and local taxes and established guidelines for the assignability of prizes (Sections 9 and 10), unclaimed prize monies (Section 14) and bank deposits and control of lottery transactions (Section 15).

Later legislation broadened the purposes of the Act. Act 1972-338 provided for the funding of certain free local transportation to persons 65 years of age or older pursuant to the "Pennsylvania Urban Mass Transportation Assistance Law of 1967." Act 1980-184 modified this provision to limit free transportation to certain fixed route local transit services, and provided

for reduced fare on group ride transit service to persons 65 years of age or older pursuant to the "Pennsylvania Rural and Intercity Common Carrier Surface Transportation Assistance Act." The use of monies from the State Lottery Fund was also expanded to include these programs.

The State Lottery Commission was abolished by Act 1982-291 and its powers and duties transferred to the Secretary of Revenue. This Act also provided for a \$4,100,000 Transportation Assistance Grant to be appropriated from the Lottery Fund to the Department of Aging for fiscal year 1982-83 for transportation grants to Area Agencies on Aging.

#### B. Descriptive Overview of the Pennsylvania State Lottery

After the approval of Act 1971-91, establishing a lottery, and the appointment of the first Executive Director in October 1971, the Pennsylvania State Lottery put its first 50¢ ticket on sale March 7, 1972. Total sales amounted to approximately \$54 million for the abbreviated 1971-72 fiscal year.

The first senior citizens' benefits from Lottery proceeds became available in FY 1972-73, when property tax rebates up to a maximum of \$200 were offered. The following year, the Lottery introduced incentive games for its retailers. New benefits included free transit for the elderly and rent rebates that were retroactive to 1972.

The first instant game tickets went on sale in May 1975. The Lottery introduced The Daily Number, its first pick-your-own game, in March 1977 at 500 computerized locations. By FY 1978-79, maximum property tax and rent rebates had increased to \$400. A year later, inflation dividends up to \$95, retroactive to calendar year 1978, were added.

The Lottery put more pick-your-own games on the market in the years that followed. Big 4 was offered starting in November 1980 and Lotto was added in April 1982. Also in FY 1981-82, maximum rebates and inflation dividends rose to \$500 and \$125 respectively; and the PA Department of Aging began receiving payments from the Lottery Fund to provide services for senior citizens.

Another major benefit program was added in FY 1983-84, when the Pharmaceutical Assistance Contract for the Elderly (PACE) enabled eligible senior citizens to purchase prescription drugs at \$4 per prescription. During the same fiscal year, annual Lottery sales increased by more than 30% for the third consecutive year and exceeded one billion dollars for the first time.

As of June 30, 1987, annual sales had surpassed the billion-dollar mark for the fourth time. Total sales over the history of the Lottery had reached approximately \$8.8 billion. Approximately \$4.3 billion had been paid out in prizes and approximately \$3.3 billion had been used for program benefits. In addition to the benefits already mentioned, the Lottery Fund provides nursing home care, medical assistance payments, reduced fares for demand responsive transportation, in-home and community services through the PA Department of Aging, reduced vehicle registration fees, income maintenance assistance, and community mental retardation services.

The PA Lottery had 8,921 retailers, including 2,982 with on-line (number game) terminals, as of June 1987. Introduced in August 1986, Super 7, the newest number game, allows players to pick seven of eighty numbers for a weekly drawing. The Lottery continues to offer Lotto (six of forty numbers with two drawings each week), Big 4 (four digits with three drawings each week), and The Daily Number (three digits with six drawings each week). Continuous instant Lottery games give players the opportunity to determine the immediate outcome by scratching off instant game tickets.

Under state law, the State Lottery is organizationally located within the Pennsylvania Department of Revenue. The Secretary of Revenue has overall responsibility for the operation and administration of the State Lottery. As of April 1987, the Lottery was organized into four divisions: the Executive Director's Office, Marketing Division, Games Control Division, and Operations Division. An organizational realignment occurred in May 1987 at the State Lottery and a reorganization plan, including a revised organization chart and related functional statements was submitted to the Secretary of Revenue in mid August 1987. Information on this plan was not made available to the auditors. Chart Z does, however, reflect the organization chart as provided to the auditors in June 1987. The central operations of the State Lottery are located in Middletown, PA. Additional area marketing offices are located in Horsham (Philadelphia area), Wilkes-Barre, Harrisburg, Clearfield, Pittsburgh, and Meadville (Erie area). As of July 1987, the Lottery had an authorized complement of 189 full-time employees. (Please refer to Table 10 for a breakdown of the Lottery complement, by division and area office.)

The operations of the State Lottery are financed from Lottery sales which are deposited in the State Lottery Fund. During FY 1986-87, the operational costs of the Lottery accounted for approximately 2.7% of total Lottery revenues. The fiscal year 1986-87 operating expenditures of the State Lottery were \$38.2 million. A breakdown of FY 1986-87 Lottery expenditures, by purpose, is shown in Table 11.

### C. The State Lottery Fund

The State Lottery Fund was created by Section 12 of Act 1971-91. It provided that all monies received from the operation of the State Lottery were to be deposited into the Fund to be used for the payment of Lottery prizes and required that the amount used for prizes not be less than 40% of the amount of tickets sold. Monies remaining after the payment of prizes and operating expenses were to be transferred to the General Fund through June 30, 1972, after which date, they were to remain in the State Lottery Fund to be allocated for the exclusive purpose of providing property tax relief for the elderly for taxes paid in 1971 and, therefore, pursuant to the provisions of the "Senior Citizens Property Tax Assistance Act." If sufficient funds were not available in the State Lottery Fund for the purposes of this Act, additional funds were to be appropriated from the General Fund.

Act 1971-91 restricted appropriations from the State Lottery Fund to payment of prizes, State Lottery administrative expenses, property tax relief for the elderly as provided in the Act and transfer to the General Fund through June 30, 1972, and for repayment to the General Fund for the money appropriated to the State Lottery Fund pursuant to this Act.

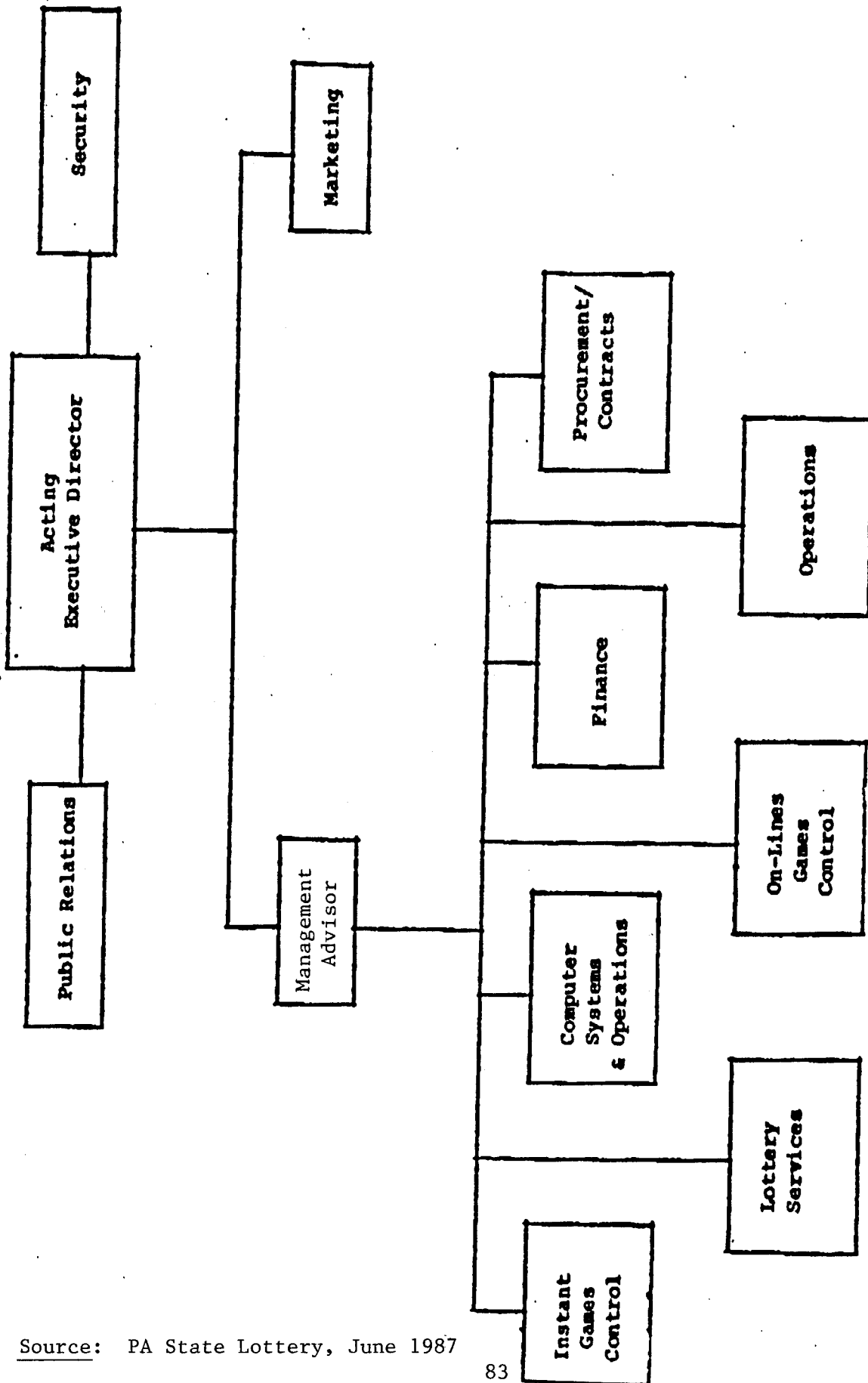
Various amendments to Act 1971-91 have expanded the uses of the State Lottery Fund. Act 1972-338 provides for the use of State Lottery Fund monies for free local transit for persons 65 years of age or older under the "Pennsylvania Urban Mass Transportation Assistance Law of 1967." Act 1980-184 further provides for use of the Fund to provide free fixed route local transit services and reduced fare on group ride transit service to persons 65 years of age or older pursuant to the "Pennsylvania Rural and Intercity Common Carrier Surface Transportation Assistance Act." Act 1982-291 provided for a transportation assistance grant of \$4,100,000 to be appropriated from the State Lottery Fund to the Department of Aging in fiscal year 1982-83. Additionally, funding for other senior citizen programs are provided for in various other statutes enacted since the initiation of the State Lottery.

D. Financial, Expenditure and Other Related Tables

Presented on pages 84 to 87 are several tables which provide information on FY 1986-87 State Lottery operating expenses and historical information on the distribution of gross Lottery ticket sales and Lottery games sales history, by game and fiscal year.

CHART Z

Pennsylvania State Lottery Organization Chart



Source: PA State Lottery, June 1987

Note: A reorganization plan for the State Lottery, including a revised organization chart and related functional statements, were reportedly prepared and submitted to the Secretary of Revenue in mid-August 1987. Although requested in writing by the auditors, these items were not made available to the audit team.

TABLE 9

PA Lottery Game Sales History by Game and Year  
(in \$ Thousands)

Fiscal Year Ending 6/30	50¢	\$1.00	Instant	Other	Daily Number	Big Four	Lotto	Super 7	Total a/
1973	\$88,145	\$36,276	\$ -0-	\$ -0-	\$ -0-	\$ -0-	\$ -0-	\$ -0-	\$ 124,421
1974	58,292	70,174	-0-	-0-	-0-	-0-	-0-	-0-	128,466
1975	47,486	54,578	13,546	-0-	-0-	-0-	-0-	-0-	115,610
1976	34,084	34,907	67,913	-0-	-0-	-0-	-0-	-0-	136,904
1977	38,559	17,333	47,336	5,593	42,882	-0-	-0-	-0-	151,703
1978	26,068	14,699	62,006	5,048	187,634	-0-	-0-	-0-	295,455
1979	21,345	14,014	64,015	4,525	247,520	-0-	-0-	-0-	351,419
1980	18,176	8,894	72,369	-0-	287,962	-0-	-0-	-0-	387,401
1981	14,999	5,544	64,049	-0-	318,902	23,519	-0-	-0-	427,013
1982	11,371	4,110	96,342	-0-	386,499	51,699	12,233	-0-	562,254
1983	-0-	-0-	183,450	-0-	453,090	63,957	184,914	-0-	885,411
1984	-0-	-0-	198,893	-0-	480,911	68,237	487,983	-0-	1,236,023
1985	-0-	-0-	200,582	-0-	503,416	79,114	511,631	-0-	1,294,742
1986	-0-	-0-	208,369	-0-	514,055	99,380	498,365	-0-	1,320,169
1987 <sup>b/</sup>	-0-	-0-	210,196	-0-	532,748	98,531	306,510	190,531	1,338,516
1988 <sup>b/</sup>	-0-	-0-	30,276	-0-	70,799	13,303	35,699	28,923	179,000
-----									
1988(Goal)	\$ -0-	\$ -0-	\$211,500	\$ -0-	\$533,000	\$99,500	\$265,200	\$269,000	\$1,378,200

a/May not add due to rounding.

b/Through August 17, 1987.

c/Represents Lottery games sales goals established by the State Lottery.

Source: Pennsylvania Tax Compendium 1985-86 Fiscal Year, PA Department of Revenue and "Pennsylvania State Lottery Sales Analysis" (sales through August 17, 1987).

TABLE 10

Personnel Complement of the Pennsylvania State Lottery,  
As of January 1984-1986 and July 1987

	<u>January 1984</u>	<u>January 1985</u>	<u>January 1986</u>	<u>July 1987<sup>a/,b/</sup></u>
<u>Executive Director's Office.....</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>14</u>
<u>Games Control Division.....</u>	<u>69</u>	<u>66</u>	<u>64</u>	<u>56<sup>c/</sup></u>
<u>Operations Division.....</u>	<u>43</u>	<u>42</u>	<u>40</u>	<u>31<sup>d/</sup></u>
<u>Marketing Division.....</u>	<u>107</u>	<u>104</u>	<u>95</u>	<u>88</u>
Marketing Headquarters.....	9	9	7	8
Area Marketing Offices:				
Horsham.....	25	24	23	19
Wilkes-Barre.....	13	12	11	11
Harrisburg.....	14	16	14	14
Clearfield.....	11	11	11	9
Pittsburgh.....	25	23	22	19
Meadville.....	<u>10</u>	<u>9</u>	<u>7</u>	<u>8</u>
Total.....	<u>234</u>	<u>227</u>	<u>214</u>	<u>189</u>

a/The total approved complement of the State Lottery as of July 1987 was 189. As of that time, total filled positions were 187, vacancies 2.

b/As reported by the State Lottery, the breakdown of the Lottery complement shown below reflected the July 1987 official complement. The Lottery also reported, however, that due to a recent reorganizational change the division structure had been changed and staff have been reassigned. These changes had reportedly not been made official as of July 1987.

c/Does not include 8 temporary employees.

d/Does not include 3 temporary employees.

Source: Developed by LB&FC staff from Pennsylvania State Lottery personnel records.

TABLE 11

FY 1986-87 Pennsylvania State Lottery Operating Expenses, by Purpose

<u>Purpose</u>	<u>FY 1986-87</u>
Personnel Services (Salaries, Wages and Benefits).....	\$ 5,992,432
Advertising.....	8,975,798
Freight Charges/Postage.....	3,806,481
Telephone Costs/Communication.....	371,023
Printing.....	1,500,806
Instant Game Contracts.....	6,613,599
Contract Maintenance Service Agreements.....	92,886
EDP Equipment and Service.....	6,264,804
Motorized Equipment Supplies, Rentals and Repairs.....	310,975
Rent of Real Estate.....	284,277
Travel.....	97,764
Electricity/Heating Fuel.....	44,329
Department Specialized Services.....	3,277,943
Supplies/Materials/Food.....	86,265
Fees/Services/Conferences/Dues/Contracted Repairs.....	102,793
Interest Penalties.....	7,293
Insurance, Surety Fidelity Bond.....	5,564
Other Equipment Rentals.....	21,097
Fixed Assets (Equipment and Furniture).....	<u>350,644</u>
Total.....	<u>\$38,206,773<sup>a/</sup></u>

a/Includes augmentations of \$2,370,110 from license fees, telephone line charges, and the sale of vehicles.

Source: Developed by LB&FC staff from "Pennsylvania State Lottery Statement of Expenditures," dated June 30, 1987.

TABLE 12

## DISTRIBUTION OF GROSS PENNSYLVANIA STATE LOTTERY TICKET SALES

	SALES	BENEFITS	% OF SALES	PRIZES	% OF SALES	COMMISSIONS	% OF SALES	OPERATIONS	% OF SALES
1972-73	\$124,421,092	\$55,846,705	44.89%	\$54,400,194	43.72%	\$7,403,055	5.95%	\$6,771,138	5.44%
1973-74	128,466,272	56,826,803	44.23%	55,726,989	43.38%	8,149,352	6.34%	7,763,128	6.04%
1974-75	115,609,592	47,311,883	40.92%	51,360,928	44.43%	7,563,359	6.54%	9,373,422	8.11%
1975-76	136,904,181	56,255,253	41.09%	60,962,468	44.53%	8,956,751	6.54%	10,729,709	7.84%
1976-77	151,702,852	58,095,989	38.30%	69,956,657	46.11%	12,033,499	7.93%	11,616,707	7.66%
1977-78	295,455,445	111,810,527	37.84%	142,970,304	48.39%	25,982,915	8.79%	14,691,699	4.97%
1978-79	351,418,704	134,947,007	38.40%	173,529,705	49.38%	26,856,895	7.64%	16,085,097	4.58%
1979-80	387,400,948	150,955,776	38.97%	189,811,196	49.00%	30,342,368	7.83%	16,291,608	4.21%
1980-81	427,011,940	169,200,840	39.62%	205,481,540	48.12%	33,453,789	7.83%	18,875,771	4.42%
1981-82	562,256,049	227,121,536	40.39%	274,069,652	48.74%	38,440,348	6.84%	22,624,513	4.02%
1982-83	885,407,310	355,392,567	40.14%	439,922,770	49.69%	60,358,643	6.82%	29,733,330	3.36%
1983-84	1,236,023,313	501,956,880	40.61%	620,969,287	50.24%*	83,180,097	6.73%	29,917,049	2.42%
1984-85	1,294,742,469	557,941,487	43.09%	619,071,035	47.81%*	86,702,603	6.70%	31,027,344	2.40%
1985-86	1,320,169,541	537,850,652	40.74%	661,488,502	50.11%*	87,955,013	6.66%	32,875,374	2.49%
1986-87	1,358,515,734	556,582,527	41.58%	656,234,391	49.03%*	89,862,153	6.71%	35,826,663	2.68%
TOTALS	\$8,755,505,442	\$3,578,096,432	\$4,275,955,618	\$607,240,840	\$294,212,552				

\*/Includes the amount of actual prizes awarded and the payout in lieu of State Personal Income Taxes as provided by Act 29 of 1983 (\$13.6 million in FY 86-87, \$14.4 million in FY 85-86, \$14.7 million in FY 84-85, and \$13.9 million in FY 83-84).

Source: Developed by LB&FC staff from information obtained from the PA State Lottery.



## V. AUDIT METHODOLOGY

The LB&FC's performance audit of the Pennsylvania State Lottery was carried out during the period March through September 1987. The audit involved a variety of audit survey and field work activities, with on-site work conducted at both the State Lottery's headquarters and field locations. A review of the State Lottery's enabling legislation and related laws and regulations was carried out early in the process. Sampling and examination of State Lottery files, service contracts, operating and procedures manuals and internal reporting systems also occurred during the preliminary survey phase of the project. The auditors also observed and analyzed internal operating procedures, reviewed staff complement levels and Lottery organizational structure and examined and tested the various administrative control systems in place at the Lottery (e.g., inventory controls, EDP system controls, and budgetary and procurement controls). A literature search to identify pertinent periodicals, journals and lottery trade publications was also carried out.

Throughout the audit, the members of the audit team conducted meetings and interviews with key Lottery officials and staff. Contact was also maintained with the Department of Revenue staff person who headed a special internal management study team at the Lottery and who was designated by the Secretary of Revenue as a special "management advisor" to the State Lottery. Members of the audit team also made field visits to each of the State Lottery's six area marketing offices and, in addition to file review, testing of administrative controls and other activities, met with Lottery area managers and a sampling of District Lottery Representatives during these visits. Visits were also made to a sampling of Lottery retailer locations.

Input and information for purposes of the audit was also solicited and received via survey questionnaires which were distributed to all State Lottery employees and to a sample of approximately 1,100 Lottery retail agents. A questionnaire to Lottery players was also made available through selected retailer locations in each of the six Lottery marketing areas.

A number of other contacts and site visits were made. These included discussion with the Governor's Office of the Budget concerning projections of program funding requirements of the State Lottery Fund and meetings with representatives of firms which provide contracted services to the State Lottery, including the firms which provide courier delivery, ticket printing, advertising, and "on-line" lottery games computer services. Other visits were made to a Lottery test marketing district to observe and gain information on a special marketing pilot project which was being conducted by the Lottery's advertising firm and to the Lycoming County Fair to observe the operation of a newly established mobile Lottery promotional program. Information was also obtained on state-of-the-art equipment which is available to the lottery industry and demonstrations of certain equipment were received by the auditors.

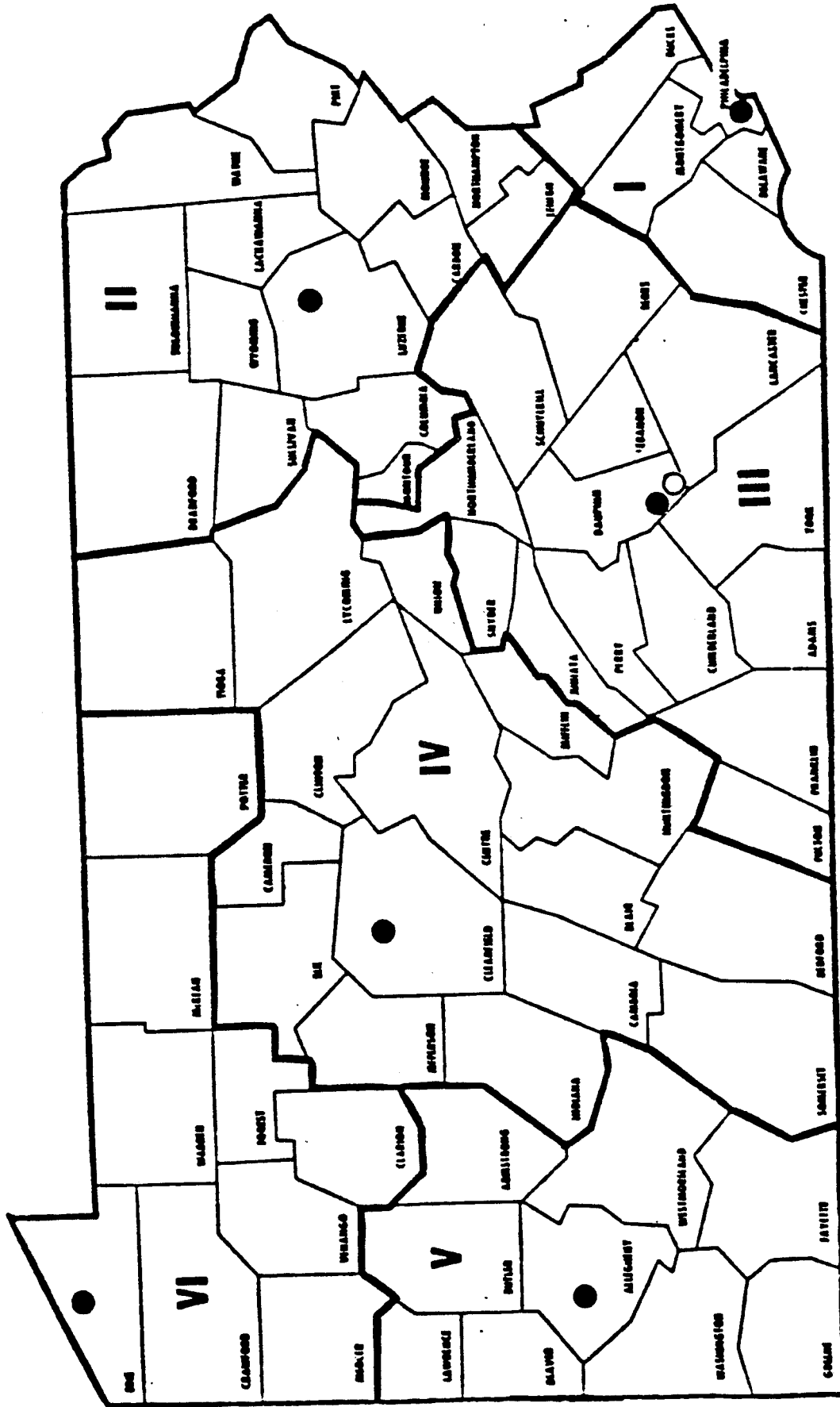
The auditors also met with lottery and public gaming consultants and travelled to The Wharton School of the University of Pennsylvania to interview business faculty in relation to audit examination of the operation of the State Lottery as a business enterprise. Additional contacts were made with the Public Gaming Research Institute and inquiries were made of lottery officials in other selected states in order to obtain interstate comparative information regarding lottery sales and other audit-related issues.

VI. APPENDICES



APPENDIX A

Map of Pennsylvania State Lottery Area Marketing Offices

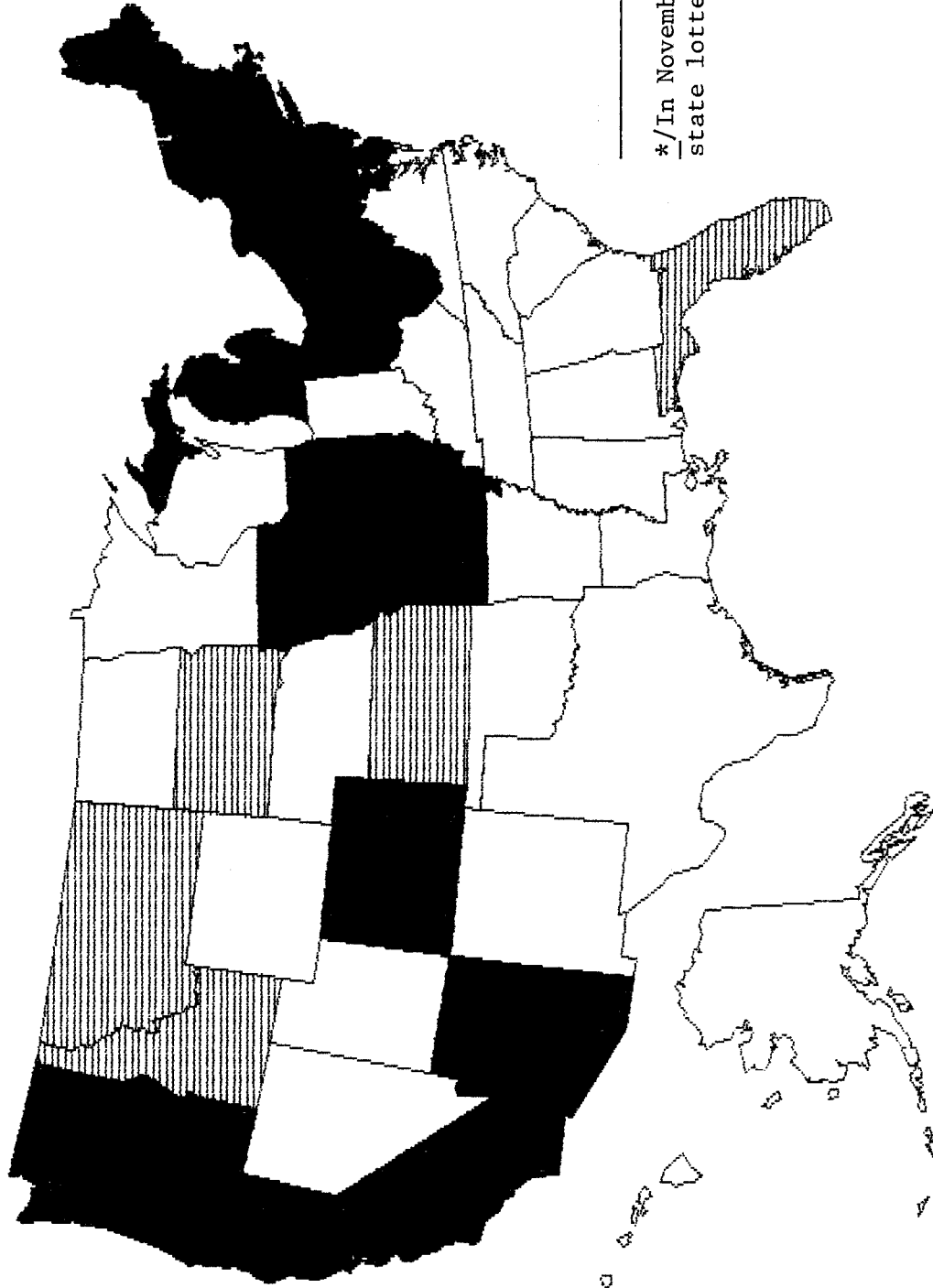


- - Area Office
- I - Philadelphia (Horsham)
- II - Wilkes-Barre
- III - Harrisburg
- IV - Clearfield
- V - Pittsburgh
- VI - Erie (Meadville)
- - Lottery Headquarters

Source: Pennsylvania State Lottery's Field Representative's Manual

APPENDIX B

# LOTTERIES IN THE U.S.



\*/In November 1986 elections, five new state lotteries were approved.

Source: Developed by LB&FC staff from information obtained from The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc.

APPENDIX C

**STATE LOTTERIES:  
AUTHORIZATION, INITIAL OPERATION, AND USE OF NET REVENUE**

STATE	AUTHORIZATION	INITIAL OPERATION	USE OF NET REVENUES
ARIZONA	INITIATIVE	JULY 1981	Yearly minimum set by legislature for local transportation assistance fund. Balance to general fund.
CALIFORNIA	INITIATIVE	OCTOBER 1985	Public education.
COLORADO	REFERENDUM	JANUARY 1983	50% for capital construction, 40% for conservation trust fund, 10% for parks and recreation.
CONNECTICUT	LEGISLATION	FEBRUARY 1972	General fund.
DELAWARE	LEGISLATION	NOVEMBER 1975	General fund.
DISTRICT OF COLUMBIA	INITIATIVE	AUGUST 1982	General fund.
ILLINOIS	LEGISLATION	JULY 1974	Education.
IOWA	LEGISLATION	AUGUST 1985	Economic betterment, education, agricultural projects, roads.
MAINE	REFERENDUM	JUNE 1974	General fund.
MARYLAND	INITIATIVE, LEGISLATION & REFERENDUM	MAY 1973	General fund.
MASSACHUS.	LEGISLATION	MARCH 1972	Distributed to 351 cities and towns for discretionary use. The first \$3 million of lotto is allotted for the arts.
MICHIGAN	LEGISLATION	NOVEMBER 1972	Primary and secondary education (earmarked in 1981).
MISSOURI	REFERENDUM	JANUARY 1986	General Fund.
NEW HAMP.	LEGISLATION	MARCH 1964	Education.
NEW JERSEY	REFERENDUM	JANUARY 1971	Education and state institutions. \$75,000 per year for compulsive gambling studies.
NEW YORK	REFERENDUM	SEPTEMBER 1976	Elementary and secondary education.
OHIO	LEGISLATION	AUGUST 1974	General fund, until 1983; education since 1983.
OREGON	INITIATIVE	APRIL 1985	Economic development.
PENNSYLVANIA	LEGISLATION	MARCH 1972	Senior citizens.
RHODE ISLAND	REFERENDUM	MAY 1974	General fund.
VERMONT	REFERENDUM	FEBRUARY 1978	General fund (debt retirement and capitol construction).
WASHINGTON	REFERENDUM	NOVEMBER 1982	General fund.
WEST VIRGINIA	REFERENDUM	NOVEMBER 1985	General fund.
TRI-STATE	LEGISLATION	SEPTEMBER 1985	To respective states (Maine, New Hampshire and Vermont).

SOURCE: Assorted Annual Reports, Financial Reports, and The Book of States (Lexington: Council of State Governments). July/August 1986 - September 25, 1986  
Prepared by Maryland State Lottery.

APPENDIX D

**LOTTERY GOVERNANCE**

From: Florida Senate Select Committee On Lottery

	<u>AGENCY</u>	<u>BOARD/COMMISSION</u>	<u>HOW APPOINTED</u>
ARIZONA	State Lottery	5-member commission	by Governor
CALIFORNIA	State Lottery	5-member commission	by Governor w/consent of Senate; serve at pleasure
COLORADO	Dept. of Revenue, State Lottery Division	5-member commission	by Governor w/consent of Senate; serve at pleasure
CONNECTICUT	Dept. of Rev., Div. of Special Revenues, Lottery Unit	5-member Gaming Policy Board	by Governor w/consent of both houses
DELAWARE	Dept. of Finance; State Lottery Office	-	-
DISTRICT OF COLUMBIA	Lottery and Charitable Games Control Board	5-member board	by Mayor w/consent of City Council
ILLINOIS	Dept. of the Lottery	5-member board	by Governor
IOWA	Iowa Lottery Agency	5-member board	by Governor w/consent of Senate
MAINE	State Lottery Commission	5-member commission	by Governor w/consent of Council
MARYLAND	State Lottery Agency	5-member commission	by Governor w/consent of Senate
MASSACHUSETTS	Office of State Treasurer, Lottery Commission	5-member commission	Treasurer, Sec. of Public Safety, Comptroller & 2 appointed by Governor
MICHIGAN	Bureau of State Lottery	-	-
MISSOURI	Division of State Lottery	3-member commission	by Governor w/consent of Senate
NEW HAMPSHIRE	Sweepstakes Commission	3-member commission	by Governor w/consent of Council
NEW JERSEY	Dept. of Treasury, Division of State Lottery	7-member commission	Treasurer & 6 appointed by Governor w/consent of Senate; serve at pleasure
NEW YORK	Dept. of Taxation & Finance, Div. of Lottery	-	-
OHIO	State Lottery Commission	9-member commission	by Governor w/ consent of Senate
OREGON	State Lottery Commission	5-member commission	by Governor w/consent of Senate; serve at pleasure
PENNSYLVANIA	Dept. of Rev., Division of State Lottery	-	-
RHODE ISLAND	State Lottery Commission	9-member commission	3 Senators appointed by majority leader; 3 Reps appointed by Speaker, 3 appointed by Governor
VERMONT	State Lottery Commission	5-member commission	by Governor w/consent of Senate; serve at pleasure
WASHINGTON	State Lottery Commission	5-member commission	by Governor w/consent of Senate
WEST VIRGINIA	State Lottery Commission	7-member commission	by Governor w/consent of Senate

APPENDIX D  
(Continued)

LOTTERY GOVERNANCE (cont'd)

	APPOINTMENT OF DIRECTOR	POWERS OF DIRECTOR	POWERS OF BOARD
ARIZONA	by Governor	Rulemaking, supervision licensing, contracting	Policymaking, apportionment of revenues
CALIFORNIA	by Governor w/consent of Senate; serves at pleasure	Supervision, contracting	Rulemaking
COLORADO	by Executive Director, Dept. of Revenue	Supervision, licensing	Rulemaking, contracting
CONNECTICUT	by Exec. Dir. of Div. w/consent of board	Supervision	Licensing, approval of rules and contracts
DELAWARE	by Sec. of Finance w/ approval of Governor	Supervision, rulemaking licensing, contracting	--
DISTRICT OF COLUMBIA	by Board	Supervision, powers delegated by board	Rulemaking, contracting, licensing
ILLINOIS	by Governor w/consent of Senate	Supervision, rulemaking licensing, contracting	Advisory body
IOWA	by Governor w/consent of Senate; serves at pleasure	Supervision, licensing contracting	Rulemaking, approval of contracts
MAINE	by Governor w/consent of Council	Supervision, licensing contracting	Rulemaking, apportionment of revenues, approval of contracts
MARYLAND	by Governor w/consent of Senate; serves at pleasure	Supervision, rulemaking licensing, contracting	Approval of rules and contracts
MASSACHUSETTS	by Treasurer w/ Governor's approval; serves at pleasure of Treasurer	Supervision, contracting	Rulemaking, licensing, approval of contracts
MICHIGAN	by Governor w/consent of Senate; serves at pleasure	Supervision, rulemaking licensing, contracting	--
MISSOURI	by Commission	Supervision, licensing, contracting	Rulemaking
NEW HAMPSHIRE	by Commission	Powers delegated by board	Supervision, rulemaking, contracting, licensing
NEW JERSEY	by Governor w/consent of Senate; serves at pleasure	Supervision, licensing contracting	Rulemaking
NEW YORK	by Comm. of Tax & Finance; serves at pleasure of Comm.	Supervision, rulemaking licensing, contracting	--
OHIO	by Governor w/consent of Senate; serves at pleasure	Supervision, licensing contracting	Rulemaking
OREGON	by Governor w/consent of Senate; serves at pleasure	Supervision, contracting	Rulemaking
PENNSYLVANIA	by Governor w/consent of Senate	Supervision, rulemaking licensing, contracting	--
RHODE ISLAND	by Governor w/approval of Comm. serves at pleasure of Comm.	Supervision, licensing contracting	Rulemaking, approval of contracts
VERMONT	--	Supervision, licensing contracting	Rulemaking, approval of contracts
WASHINGTON	by Governor w/consent of Senate; serves at pleasure	Supervision, licensing, contracting	Rulemaking
WEST VIRGINIA	by Governor; serves at pleasure	Supervision	Rulemaking, contracting, licensing

Source: The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc.

APPENDIX E

ODDS OF WINNING LOTTERY PRIZES						
<u>State</u>	<u>Lotto Format</u>	<u>Odds on Winning Lotto Jackpot</u>	<u>Odds on Winning 3-Digit Straight Bet</u>	<u>Odds on Winning 4-Digit Straight Bet</u>	<u>Odds on Winning Any Prize Current Instant Game</u>	<u>Odds on Winning Jackpot Other Games</u>
ARIZONA	6/39	1 in 3.3 m	1 in 1,000	1 in 10,000	1 in 10	-
CALIFORNIA	6/49	1 in 13.9 m	1 in 1,000	1 in 10,000	1 in 9	-
COLORADO	-	-	-	-	1 in 5.8	-
CONNECTICUT	6/40	1 in 3.8 m	1 in 1,000	1 in 10,000	1 in 6	-
DELAWARE	6/34	1 in 1.3 m	1 in 1,000	1 in 10,000	1 in 5	-
D.C.	6/36	1 in 1.9 m	1 in 1,000	1 in 10,000	1 in 5	2-Digit 1 in 4,950
ILLINOIS	6/44	1 in 7.0 m	1 in 1,000	1 in 10,000	1 in 4.5	Lotto 7/39 1 in 15.4m
IOWA	6/36	1 in 1.9 m	1 in 1,000	1 in 10,000	1 in 5	-
MAINE	6/36*	1 in 1.9 m	1 in 1,000	1 in 10,000	1 in 6.7	-
MARYLAND	6/40	1 in 3.8 m	1 in 1,000	1 in 10,000	1 in 8	-
MASSACHUS.	6/46	1 in 9.4 m	1 in 1,000	1 in 10,000	1 in 5	-
	6/36	1 in 1.9 m	-	-	-	-
MICHIGAN	6/44	1 in 7.0 m	1 in 1,000	1 in 10,000	1 in 4	-
MISSOURI	6/39	1 in 3.2 m	1 in 1,000	1 in 10,000	1 in 5	-
NEW HAMPSHIRE	6/36*	1 in 1.9 m	1 in 1,000	1 in 10,000	1 in 4	-
NEW JERSEY	6/42	1 in 5.2 m	1 in 1,000	1 in 10,000	1 in 5	-
NEW YORK	6/48	1 in 12.3 m	1 in 1,000	1 in 10,000	1 in 5	WIN 10 (10/80) 1 in 8.9 m
	6/40	1 in 3.8 m	-	-	-	-
OHIO	6/44	1 in 7.0 m	1 in 1,000	1 in 10,000	1 in 11	-
OREGON	6/42	1 in 5.2 m	1 in 1,000	1 in 10,000	1 in 4	-
PENNSYLVANIA	6/40	1 in 3.8 m	1 in 1,000	1 in 10,000	1 in 4	Super 7 (7/80) 1 in 9.6 m
VERMONT	6/36*	1 in 1.9 m	1 in 1,000	1 in 10,000	1 in 5.5	-
WASHINGTON	6/44	1 in 7.0 m	1 in 1,000	1 in 10,000	1 in 5	-
WEST VIRGINIA	6/30	1 in .594m	1 in 1,000	1 in 10,000	1 in 5	-
General Notes						
* Tri-State Megabucks						

Source: The Handbook of U.S. Lottery Fundamentals, 1987, Public Gaming Research Institute, Inc.

APPENDIX F

State Lottery Fund Financial Statement  
 Fiscal Year 1985-86 (Actual) through Fiscal Year 1991-92 (Projected)  
 (\$ Thousands)

	STATE LOTTERY FUND						
	ACTUAL 1985-86	AVAILABLE 1986-87	BUDGET 1987-88	PLAN YR1 1988-89	PLAN YR2 1989-90	PLAN YR3 1990-91	PLAN YR4 1991-92
BEGINNING BALANCE	\$265,969	\$258,352	\$206,600	\$164,126	\$48,829	(\$148,357)	(\$401,947)
PRIOR YEAR RESERVE	\$119,410	\$110,493	\$113,238	\$116,242	\$116,531	\$115,716	\$113,850
ADJUSTED BEGINNING BALANCE	\$385,379	\$368,845	\$319,838	\$280,368	\$165,360	(\$32,641)	(\$288,097)
TICKET SALES	\$1,320,170	\$1,340,000	\$1,378,200	\$1,391,982	\$1,405,902	\$1,419,961	\$1,434,160
LESS FIELD PAID PRIZES AND COMMISSIONS	\$587,318	\$557,440	\$573,331	\$579,065	\$584,855	\$590,704	\$596,611
NET TICKET REVENUES*	\$732,852	\$782,560	\$804,869	\$812,917	\$821,047	\$829,257	\$837,549
PRIOR YEAR LAPSE	\$17,173	\$12,051	\$0	\$0	\$0	\$0	\$0
MISCELLANEOUS REVENUE	\$37,917	\$28,197	\$25,889	\$22,713	\$13,987	\$0	\$0
TOTAL FUNDS AVAILABLE	\$1,173,321	\$1,191,653	\$1,150,596	\$1,115,998	\$1,000,394	\$796,616	\$549,452
LESS GOVERNMENT/LOTTERY COSTS	\$218,303	\$244,568	\$249,548	\$252,973	\$256,456	\$260,009	\$263,615
LESS PROGRAM COSTS	\$586,173	\$632,642	\$620,680	\$697,665	\$776,579	\$824,704	\$878,788
LESS CURRENT YEAR RESERVE	\$110,493	\$113,238	\$116,242	\$116,531	\$115,716	\$113,850	\$114,787
PLUS CURRENT YEAR LAPSE **	\$0	\$5,395	\$0	\$0	\$0	\$0	\$0
ENDING BALANCE	\$258,352	\$206,600	\$164,126	\$48,829	(\$148,357)	(\$401,947)	(\$707,738)

Assumptions:

1. Implementation of Department of Aging's PACE cost containment proposal excluding co-pay.
2. Transfer of SSI and Medicare Part B costs from Lottery to General Fund.
3. 1987-88 revised revenue estimate and 1% annual revenue increase in out years.

Source: Governor's Office of the Budget, June 24, 1987.

APPENDIX F (Continued)

	ACTUAL 1985-86	AVAILABLE 1986-87	BUDGET 1987-88	PLAN YR1 1988-89	PLAN YR2 1989-90	PLAN YR3 1990-91	PLAN YR6 1991-92
TREASURY DEPARTMENT GOVERNMENT/LOTTERY REPLACEMENT CHECKS	\$15	\$20	\$20	\$20	\$20	\$20	\$20
DEPARTMENT OF AGING GOVERNMENT/LOTTERY GENERAL GOVERNMENT OPERATIONS	\$2,367	\$2,369	\$2,440	\$2,537	\$2,639	\$2,744	\$2,850
GRANTS AND SUBSIDIES							
AGING PROGRAMS	\$46,637	\$50,560	\$52,077	\$53,640	\$55,250	\$56,900	\$58,600
PHARMACEUTICAL ASSISTANCE FUND	\$100,000	\$100,000	\$100,000	\$172,000	\$246,000	\$289,000	\$338,000
IN-HOME SERVICES	\$14,000	\$16,000	\$24,000	\$26,000	\$28,000	\$30,000	\$32,000
PRE-ADMISSION IN-HOME SERVICES	\$9,441	\$12,300	\$13,300	\$14,400	\$15,500	\$16,600	\$17,700
ATTENDANT CARE FOR SENIOR CITIZENS	\$5,100	\$5,400	\$5,400	\$5,600	\$5,800	\$6,000	\$6,200
DRUG EDUCATION FOR SENIOR CITIZENS	\$50	\$50	\$50	\$50	\$50	\$50	\$50
SENIOR CENTER RENOVATIONS	\$0	\$0	\$0	\$0	\$0	\$0	\$0
ALZHEIMER'S DISEASE	\$495	\$100	\$100	\$100	\$100	\$100	\$100
SUBTOTAL PROGRAM COSTS	\$175,723	\$184,410	\$194,927	\$271,790	\$350,700	\$398,650	\$452,650
DEPARTMENT TOTAL	\$178,090	\$186,779	\$197,367	\$274,327	\$353,339	\$401,394	\$455,500
DEPARTMENT OF GENERAL SERVICES GOVERNMENT/LOTTERY HARRISTOWN RENTAL CHARGES HARRISTOWN UTILITY AND MUNICIPAL CHARGES	\$109 \$89	\$103 \$86	\$101 \$87	\$94 \$89	\$90 \$93	\$90 \$97	\$85 \$100
DEPARTMENT TOTAL	\$198	\$169	\$188	\$183	\$183	\$187	\$185
DEPARTMENT OF PUBLIC WELFARE GRANTS AND SUBSIDIES							
MEDICAL ASSISTANCE-LONG TERM CARE FACILITIES	\$140,000	\$140,000	\$140,000	\$140,000	\$140,000	\$140,000	\$140,000
PRE-ADMISSION ASSESSMENT	\$1,653	\$1,973	\$2,505	\$2,630	\$2,760	\$2,900	\$3,050
MEDICARE PAP' B PAYMENTS	\$8,182	\$8,528	\$9,330	\$9,797	\$10,286	\$10,800	\$11,340
SUPPLEMENTAL GRANTS TO THE AGED	\$17,600	\$17,600	\$0	\$0	\$0	\$0	\$0
COMMUNITY MENTAL RETARDATION SERVICES-ELDERLY	\$2,200	\$2,200	\$0	\$0	\$0	\$0	\$0
DEPARTMENT TOTAL PROGRAM COSTS	\$169,635	\$170,301	\$151,835	\$152,427	\$153,046	\$153,700	\$154,390







COMMONWEALTH OF PENNSYLVANIA  
DEPARTMENT OF REVENUE  
HARRISBURG, PENNSYLVANIA  
17127

THE SECRETARY

September 21, 1987

Mr. Richard D. Dario  
Executive Director  
Legislative Budget and Finance Committee  
Room 400, Finance Building  
Harrisburg, PA 17105-8737

Dear Mr. Dario:

Thank you for the opportunity to comment on the Legislative Budget and Finance Committee's draft report. We find it to be a very thorough analysis of many of the issues facing the Pennsylvania State Lottery.

We would like to make several points regarding the use of comparative statistics. First, we believe that the Pennsylvania, State Lottery with sales of \$1.338 billion actually ranks third in gross sales for fiscal year 86-87, behind New York, at \$1.458 billion and California, at \$1.392 billion. We are also pleased to advise that Pennsylvania ranked first in sales for the second quarter of calendar 1987 (April-June).

Additionally, while state comparisons of lottery sales, per capita sales, game mix, etc., are a common (and popular) measure of success, we must temper such comparisons by our realization that there are major differences in populations from numbers, socio-political and socio-economic standpoints. The measure of these differences (or even of the similarities) is at best theoretically uncertain. The many facets of this sales-driven operation dictate against a truly definitive analysis of cause and effect. Nevertheless, we do compare "apples to oranges", and we do measure our own success against the success of our sister lotteries. We should not, however, delude ourselves by believing that we are statistically alike, that any one initiative we undertake is determinative, or presume that we can totally control the playing habits of Pennsylvanians.

The relative growth rates of lotteries present a moving target for study. A state, for example, just implementing lotto, will enjoy a much higher "rate" of growth. Perhaps this measurement of comparison, qualified as it is by demographic and marketing determinations, is best left for intrastate, "before and after", analysis.

Mr. Richard Dario  
September 21, 1987

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Per capita "sales" must be considered the best measurement for sales comparisons, but even here, careful review of yield is cautioned. The percentage of sales returned as prizes also drives player reinvestment, which inflates sales, but with a lower net yield. This is particularly true of Massachusetts, as noted in your study.

While we cannot immediately endorse all of the recommendations made in the report, we will consider (and in many cases already have considered) the findings in our planning and decision making process. We thank you for the thorough and professional approach taken by the auditors, and for the positive experience it has been.

Sincerely,



Barton A. Fields  
Secretary of Revenue