

An Evaluation

Wisconsin Lottery

Department of Revenue

2007-2008 Joint Legislative Audit Committee Members

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Janice Mueller
State Auditor

November 20, 2008

Senator Jim Sullivan and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Sullivan and Representative Jeskewitz:

As required by s. 13.94(1)(em), Wis. Stats., we have completed a program evaluation of the Wisconsin Lottery, which is administered by the Department of Revenue. Although annual sales have fluctuated, they increased from a total of \$482.9 million in fiscal year (FY) 2003-04 to \$494.7 million in FY 2007-08, or by 2.4 percent over the past five years. Net lottery proceeds provided \$146.5 million in property tax relief in FY 2007-08.

In FY 2005-06, the Wisconsin Lottery implemented an evaluation tool to assist in the development and management of instant games. We include a recommendation for the Wisconsin Lottery to include product information costs, which include spending to publicize individual games, in the evaluation tool and to require its contractor to regularly report on product information expenditures associated with specific games.

Between FY 2003-04 and FY 2007-08, the Wisconsin Lottery paid one contractor \$25.2 million for product information services and another contractor \$61.1 million for operations services such as computerized gaming system services. Formal annual performance evaluations are required under both contracts. While the Wisconsin Lottery meets regularly with its product information contractor to provide verbal feedback, it has not completed formal annual evaluations, as it does with its operations contractor. We include a recommendation for the Wisconsin Lottery to evaluate its product information contractor annually.

We appreciate the courtesy and cooperation extended to us by Wisconsin Lottery staff in the Department of Revenue. The Department's response follows the appendices.

Respectfully submitted,

Handwritten signature of Janice Mueller.

Janice Mueller
State Auditor

JM/DS/ss

Report Highlights ■

In FY 2007-08, Wisconsin Lottery ticket sales totaled \$494.7 million.

The Wisconsin Lottery provided taxpayers with \$146.5 million in property tax relief in FY 2007-08.

New instant games have been introduced more frequently and at higher prices than in the past.

The Wisconsin Lottery has not evaluated its product information contractor.

A 1987 amendment to the Wisconsin Constitution allowed the Legislature to create a state lottery and required that its net proceeds be distributed for property tax relief. The Wisconsin Lottery began operations in the following year and has been managed by the Department of Revenue (DOR) since 1995. Lottery tickets are the Wisconsin Lottery's primary revenue source and are sold at more than 4,100 retailer locations in Wisconsin. The Wisconsin Lottery offers "instant games," which include both scratch-off and pull-tab tickets, and "lotto games," which were formerly known as online games.

Ticket sales totaled \$494.7 million in fiscal year (FY) 2007-08, when total operating revenues were \$495.2 million. Net lottery proceeds provided a total of \$146.5 million in property tax relief in FY 2007-08, and an average property tax credit of \$86. In July 2008, the Wisconsin Lottery was authorized 94.6 full-time equivalent (FTE) positions.

As directed by s. 13.94(1)(em), Wis. Stats., we have completed a program evaluation of the Wisconsin Lottery. To do so, we reviewed:

- trends in lottery sales, operating revenues, and operating expenses;
- the Wisconsin Lottery's development and management of instant games, which generate the largest share of lottery revenue; and

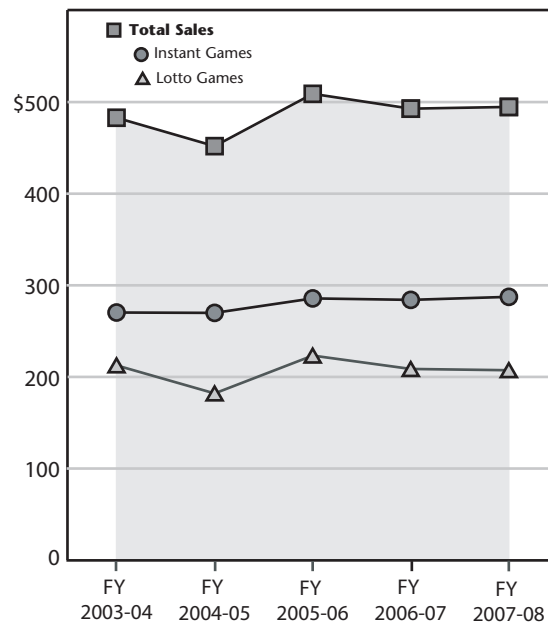
- the Wisconsin Lottery’s oversight of its contracts with private firms for lottery operations and product information services.

Revenues and Expenses

Total ticket sales fluctuated from year to year, as shown in Figure 1, but they increased 2.4 percent over the past five fiscal years. Sales of instant scratch-off and pull-tab game tickets increased from \$270.3 million in FY 2003-04 to \$287.4 million in FY 2007-08, or 6.3 percent, while sales of lotto games declined from \$212.6 million to \$207.3 million, or 2.5 percent.

Figure 1

Wisconsin Lottery Ticket Sales (in millions)



Wisconsin was one of four midwestern states that experienced a decline in per capita lottery sales from FY 2005-06 to FY 2006-07, the latest year for which comparable information is available for other states. It was fifth among seven midwestern states in per capita lottery sales in FY 2006-07.

In FY 2007-08, the Wisconsin Lottery's operating expenses totaled \$353.7 million. They included prizes paid to winning ticket holders; retailer compensation, including commissions and incentives; game development and production costs; product information services provided by a private firm; and other costs, such as staff salaries and fringe benefits.

Over the past five fiscal years, operating expenses increased by 3.3 percent, primarily because of increases in prizes, which rose as sales increased, and the Wisconsin Lottery's product information budget, which increased from \$4.6 million in FY 2006-07 to \$7.5 million in FY 2007-08. Statutes require that each year at least 50.0 percent of revenue from the sale of lottery tickets be returned to players as prize payments. The prize payout percentage increased from 57.0 percent in FY 2003-04 to 58.0 percent in FY 2007-08. Administrative expenses, which decreased from \$33.3 million in FY 2003-04 to \$32.6 million in FY 2007-08, are statutorily limited to 10.0 percent of operating revenues. In FY 2007-08, they were 6.6 percent of operating revenues.

Game Development

Effective game development and management help to maximize sales revenue and increase the net proceeds available to fund property tax relief. In recent years, the Wisconsin Lottery has introduced more instant games, including more affiliated games that can have special prize opportunities and are intended to generate interest among individuals who typically do not purchase lottery tickets. There were 113 instant scratch-off games available for sale at some point during FY 2007-08. Higher-priced instant games have been introduced more frequently in recent years.

In response to our 2005 recommendation (report 05-8), the Wisconsin Lottery implemented an evaluation tool to help develop and manage instant games. The evaluation tool is used to calculate each instant game's initial 12-week ticket sales and overall net sales, which reflect the game's total ticket sales less production costs and prizes paid. Analyzing net sales allows the Wisconsin Lottery to review game costs, evaluate trends in sales over a game's life, determine which games are most profitable, and identify strategies to increase the success of future games. We found that the Wisconsin Lottery has consistently used its evaluation tool to help develop future games.

Pull-tab ticket sales totaled approximately \$25.3 million in FY 1988-89. By FY 2007-08, they had decreased to \$3.2 million. The Wisconsin Lottery has attributed the decrease in pull-tab ticket sales, at least in part, to competition from private pull-tab vendors that operate illegally or under a statutory exemption allowing any

business to offer a game of chance with its products as part of a promotion. It does not expect pull-tab ticket sales to increase significantly unless illegal private games cease and the statutory exemption allowing legal pull-tab games is modified.

Wisconsin participates in Powerball, a lotto game played in 31 jurisdictions and administered by the Multi-State Lottery Association. During FY 2007-08, Powerball sales in Wisconsin totaled \$93.7 million. Currently, the Wisconsin Lottery also offers five other lotto games that are sold only in Wisconsin. During FY 2006-07 and FY 2007-08, it introduced two raffle-style lotto games in which a limited number of tickets were sold for a one-time drawing. However, both games fell far short of their sales goal of 500,000 tickets. The Wisconsin Lottery is conducting market research to determine how to improve the performance of raffle-style games and considering the possibility of introducing another raffle-style game in 2010.

Product Information Services Contract

The Wisconsin Lottery contracts with Hoffman York, a Milwaukee-based advertising firm, for product information services that publicize lottery games. From FY 1990-91 through FY 2006-07, the Wisconsin Lottery's annual product information budget was \$4.6 million. 2007 Wisconsin Act 20 increased the budget to \$7.5 million in each year of the 2007-09 biennium. Almost all of these funds are paid to Hoffman York, which received \$7.2 million in FY 2007-08 and used the funds primarily to purchase media time to publicize games.

Although the Wisconsin Lottery is contractually required to formally evaluate Hoffman York's performance annually, we found that it has not done so. Instead, agency officials provide ongoing verbal feedback and conduct quarterly surveys of Wisconsin residents to gauge their awareness and opinions of the Wisconsin Lottery. During the course of our audit, the Wisconsin Lottery began developing an evaluation form for its product information contractor.

To measure the effectiveness of Hoffman York's product information services, the Wisconsin Lottery compared initial 12-week ticket sales for 16 publicized scratch-off games with average 12-week sales data for comparable unpublicized scratch-off games that were introduced during the same period. We identified two ways for improving how the Wisconsin Lottery evaluates its product information services. First, it should include product information costs in its evaluation tool for instant games. Second, it should require Hoffman York to regularly report on the amounts spent to publicize individual games.

Operations Contract

The Wisconsin Lottery contracts with GTECH Corporation, a Rhode Island–based firm, for operations services that include telecommunications and instant and lotto ticket validation and tracking. Under the terms of the contract, GTECH receives 2.54 percent of lottery ticket sales, less any liquidated damages. In FY 2007-08, the Wisconsin Lottery paid GTECH \$12.3 million. In recent years, it has improved its evaluation of GTECH’s performance.

The GTECH contract authorizes the Wisconsin Lottery to assess liquidated damages to recover lost revenue when GTECH’s telecommunications systems fail or there are problems related to validating tickets. A total of \$1.5 million in liquidated damages has been assessed under the current contract. However, we found that the Wisconsin Lottery has not always assessed the liquidated damages allowed. In FY 2007-08, there were 30 incidents for which liquidated damages could have been assessed, but GTECH was assessed for only 18, and all assessments were for less than the maximum allowable amount.

It is appropriate for the Wisconsin Lottery to use its judgment in determining whether to assess contractually required liquidated damages, particularly when problems occur that are outside of GTECH’s control. However, if GTECH is at fault for a problem, as appears to have been the case in some of the 30 incidents in FY 2007-08, it is important for the Wisconsin Lottery to assess liquidated damages at a level that fully recovers its actual losses and encourages improved contractor performance.

Recommendations

We include recommendations for the Wisconsin Lottery to:

- ☑ annually evaluate its product information contractor and provide a copy of its evaluation form to the Joint Legislative Audit Committee by March 13, 2009 (*p. 31*);
- ☑ include product information costs in the evaluation tool it uses to assess instant games (*p. 33*);
- ☑ require its product information contractor to report quarterly on expenditures associated with specific games (*p. 33*); and
- ☑ review its procedures for assessing liquidated damages against its operations contractor (*p. 37*).

Introduction ■

Because ticket sales are the Wisconsin Lottery's primary revenue source, we reviewed sales data for both instant and lotto games during the past five fiscal years and compared them to the most recent lottery sales data available for other midwestern states. We also reviewed the property tax relief funded primarily by net proceeds from the Wisconsin Lottery, changes in staffing levels, and financial operations.

Lottery Sales

Total sales increased 2.4 percent from FY 2003-04 through FY 2007-08.

The Wisconsin Lottery's total sales fluctuated from year to year, as shown in Table 1, but they increased by 2.4 percent over the period shown. Sales of instant games, including scratch-off and pull-tab games, increased 6.3 percent, while lotto game sales decreased 2.5 percent over this time period. Lotto games include games such as Powerball and Megabucks.

Wisconsin's per capita lottery sales were fifth among seven midwestern states in FY 2006-07.

As shown in Table 2, Wisconsin was one of four midwestern states that experienced a decline in per capita lottery sales between FY 2005-06 and FY 2006-07, the latest year for which comparable information is available for other states. Wisconsin's per capita lottery sales declined 3.3 percent. Over this two-year period, per capita lottery sales in Michigan increased 6.4 percent, which was the largest increase among the seven midwestern states we reviewed. Wisconsin ranked sixth among these states in per capita lottery sales in FY 2005-06, and fifth in FY 2006-07.

Table 1

Wisconsin Lottery Sales
(in millions)

Fiscal Year	Instant Games	Lotto Games	Total Sales	Percentage Change from Prior Year
2003-04	\$270.3	\$212.6	\$482.9	–
2004-05	269.9	182.0	451.9	(6.4%)
2005-06	285.7	223.3	509.0	12.6
2006-07	284.1	208.7	492.8	(3.2)
2007-08 ¹	287.4	207.3	494.7	0.4

¹ Unaudited.

Table 2

Midwestern States' per Capita Lottery Sales

State Lottery	FY 2005-06	FY 2006-07	Percentage Change
Michigan	\$219	\$233	6.4%
Ohio	194	197	1.5
<i>Average</i>	<i>157</i>	<i>157</i>	<i>0.0</i>
Illinois	154	156	1.3
Indiana	130	124	(4.6)
Wisconsin	91	88	(3.3)
Minnesota	87	81	(6.9)
Iowa	114	79	(30.7)

Source: La Fleur's 2007 and 2008 World Lottery Almanacs and U.S. Census Bureau.

Wisconsin's per capita lottery sales of \$88 were significantly lower than the national average. Among the 43 United States jurisdictions that operated lotteries in FY 2006-07, Wisconsin ranked 30th in per capita lottery sales. Massachusetts ranked first, with per capita lottery sales of \$688, while North Dakota ranked last, with per capita lottery sales of \$35. Appendix 1 shows when lottery operations began, total sales, per capita sales, and per capita sales ranks for each of the 43 jurisdictions that operated lotteries in FY 2006-07.

Per capita lottery sales may vary among states for a number of reasons. First, lottery sales are affected by whether Indian gaming or other types of gaming are available in a state or neighboring states. Second, states with high levels of tourism may attract individuals who visit and purchase lottery tickets.

Third, states offer various lottery products at different prices. For example, Minnesota does not offer any instant game tickets priced more than \$10, while Texas offers a \$50 instant lottery ticket. Wisconsin's highest-priced instant game ticket costs \$20. Similarly, states offer different mixes of lottery products that are designed to appeal to players of different ages and with different interests. For example, Wisconsin is 1 of 10 states that offer pull-tab tickets and 1 of 17 states that offer raffle-style games for which the number of tickets sold for a game is limited. Delaware, New York, Oregon, Rhode Island, South Dakota, and West Virginia offer video lottery terminals, which are similar to slot machines but are connected to a centralized computer system that generates a random number for each wager and determines if it matches the winning number.

Differences in available payment and ticket ordering methods may also account for variations in states' per capita lottery sales. Wisconsin requires tickets to be purchased with cash, in person, and directly from a retailer. In some states, including Illinois and Michigan, there are no restrictions on acceptable payment methods, and retailers may decide which payment methods to offer. Illinois offers mail subscriptions for its Lotto and Little Lotto games. Allowing purchases by credit card, debit card, or check may lead to increased sales, but some state lottery offices believe these payment methods can increase problem gambling. Mail subscriptions make it easier for customers to play consistently but may make it more difficult to ensure that individuals under 18 years of age do not play.

Property Tax Credits

The Wisconsin Constitution requires that net proceeds from the Wisconsin Lottery be used only for property tax relief. Under current law, property tax relief is provided through a credit to owners of primary residences and through a farmland tax relief credit.

In FY 2007-08, the Wisconsin Lottery distributed \$146.5 million in property tax credits.

Since 1988, approximately \$2.7 billion in property tax relief has been provided primarily through net proceeds from the Wisconsin Lottery. As shown in Table 3, \$714.8 million has been distributed over the past five fiscal years, including \$146.5 million in FY 2007-08. In FY 2007-08, the average property tax credit was \$86, or \$11 less than in FY 2006-07.

Table 3

Wisconsin Property Tax Relief¹

Fiscal Year	Amount Distributed (in millions)	Average Property Tax Credit
2003-04	\$131.6	\$83
2004-05	143.4	92
2005-06	133.3	82
2006-07	160.0	97
2007-08	146.5	86
Total	\$714.8	

¹ Property tax relief is funded by net proceeds from the Wisconsin Lottery and from other gaming-related appropriations, including racing and charitable bingo operations.

In October 2008, the Legislative Fiscal Bureau projected that \$120.0 million could be available for distribution as property tax relief in FY 2008-09, based on projected lottery sales of \$484.8 million. This would result in an average property tax credit of \$80 in FY 2008-09.

Staffing Levels

As shown in Table 4, the number of FTE positions authorized for the Wisconsin Lottery decreased from 109.5 in July 2004 to 94.6 in July 2006. It remains at that level. The 13.6 percent decrease in authorized positions results largely from the elimination of 10.85 FTE positions as part of 2005 Wisconsin Act 25, the 2005-07 Biennial Budget Act, and additional reductions made in response to the Governor's Accountability, Consolidation, and Efficiency (ACE) Initiative.

Table 4

Wisconsin Lottery Staffing Levels (FTE Positions)

	Authorized Positions	Vacant Positions	Percentage Vacant
July 2004	109.5	15.35	14.0%
July 2005	109.5	24.10	22.0
July 2006	94.6	12.70	13.4
July 2007	94.6	15.15	16.0
July 2008	94.6	12.80	13.5

The number of vacant positions has declined from a high of 24.10 in July 2005 and was 12.80 in July 2008. Positions were initially held vacant because the Governor had proposed privatizing Wisconsin Lottery operations and eliminating DOR's Lottery Division for the 2003-05 biennium, and eliminating 55.0 FTE positions in the Lottery Division for the 2005-07 biennium. Both proposals were deleted during the Joint Legislative Finance Committee's budget deliberations. However, as a result of the uncertainty regarding the future of the Wisconsin Lottery, hiring was delayed until after July 2005, when the 2005-07 Biennial Budget Act took effect. In order to control costs, Lottery officials stated that some positions have been held vacant since July 2007.

Financial Operations

We also examined the Wisconsin Lottery's revenues and expenses during the past five fiscal years. Section 25.75(3)(a), Wis. Stats., requires that each year at least 50.0 percent of the Wisconsin Lottery's revenues from the sale of lottery tickets be returned to players as prize payments, and other expenses are limited by both statutes and the Wisconsin Constitution.

Revenues

Total operating revenues were \$495.2 million in FY 2007-08.

Total operating revenues increased 2.5 percent over the five-year period shown in Table 5, and 0.4 percent from FY 2006-07 through FY 2007-08. They fluctuated largely as a result of changes in lotto game ticket sales.

Table 5

Wisconsin Lottery Operating Revenues (in millions)

Revenue Type	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08 ¹
Instant Game Ticket Sales	\$270.3	\$269.9	\$285.7	\$284.1	\$287.4
Lotto Game Ticket Sales	212.6	182.0	223.3	208.7	207.3
Subtotal	482.9	451.9	509.0	492.8	494.7
Retailer Fees and Miscellaneous Revenue	0.3	0.1	0.2	0.3	0.5
Total	\$483.2	\$452.0	\$509.2	\$493.1	\$495.2

¹ Unaudited.

Expenses

As shown in Table 6, the Wisconsin Lottery's operating expenses include prizes paid to winning ticket holders; retailer compensation, including commissions and incentives; game development and production costs, such as instant game ticket printing and delivery costs and lotto telecommunications charges; product information services provided by a private firm; and other costs, such as staff salaries and fringe benefits.

Table 6

Wisconsin Lottery Operating Expenses
(in millions)

Expense Type	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08 ¹
Prizes	\$275.2	\$262.2	\$293.9	\$292.1	\$286.8
Retailer Compensation	33.9	31.3	35.2	34.1	34.3
Game Development and Production ²	19.3	14.4	16.4	16.5	16.7
Product Information	4.6	4.6	4.6	4.5	7.4
Other ³	9.4	9.3	8.1	8.0	8.5
Total	\$342.4	\$321.8	\$358.2	\$355.2	\$353.7

¹ Unaudited.

² Includes contractor-provided operations services, instant game ticket printing, online telecommunications, and instant ticket delivery expenses.

³ Includes staff salaries, fringe benefits, supplies, and depreciation expenses.

Operating expenses increased by 3.3 percent from FY 2003-04 through FY 2007-08.

Operating expenses increased from \$342.4 million in FY 2003-04 to \$353.7 million in FY 2007-08, or by 3.3 percent, primarily because of increases in prizes, which rose as sales increased, and an increase in the Wisconsin Lottery's product information budget. Game development and production expenses decreased by 13.5 percent over the past five fiscal years, largely because of a reduction in costs that occurred when the operations contractor began providing telecommunications services. Table 6 does not include transfers the Wisconsin Lottery is statutorily required to fund, including transfers for compulsive gambling programs operated by what is now the Department of Health Services, law enforcement activities in the Department of Justice (DOJ), and administration of the lottery property tax credit by DOR. In FY 2007-08, these three transfers totaled \$1.0 million.

The Wisconsin Lottery returned 58.0 percent of sales to players as prize payments in FY 2007-08.

The amount the Wisconsin Lottery has returned to players as prize payments increased from \$275.2 million in FY 2003-04 to \$286.8 million in FY 2007-08. The Wisconsin Lottery's prize payout percentage, or prize payments as a percentage of total sales, was 57.0 percent in FY 2003-04, 58.0 percent in FY 2004-05, 57.7 percent in FY 2005-06, 59.3 percent in FY 2006-07, and 58.0 percent in FY 2007-08. In FY 2006-07, the latest year for which data were available, other midwestern states' prize payout percentages ranged from 56.7 percent in Iowa and Michigan to 60.6 percent in Indiana. Wisconsin's prize payout percentage of 59.3 percent in FY 2006-07 was second-highest among seven midwestern states.

Section 25.75(3)(b), Wis. Stats., limits the Wisconsin Lottery’s administrative expenses to no more than 10.0 percent of operating revenues. Its administrative expenses include all expenses except prize payments and retailer compensation and are primarily costs related to:

- instant ticket and lotto game development and production;
- product information services that publicize the Wisconsin Lottery; and
- staff salaries and fringe benefits.

As shown in Table 7, the Wisconsin Lottery’s administrative expenses have remained within the statutory limit in recent years. As a percentage of operating revenues, administrative expenses declined annually from FY 2003-04 through FY 2005-06. They have increased to 6.6 percent of operating revenues in FY 2007-08, largely because of an increase in the Wisconsin Lottery’s product information budget from \$4.6 million to \$7.5 million annually.

Table 7

Statutorily Defined Administrative Expenses as a Percentage of Operating Revenues
(in millions)

Fiscal Year	Total Statutorily Defined Administrative Expenses	Operating Revenues	Percentage of Total Revenues
2003-04	\$33.3	\$483.2	6.9%
2004-05	28.3	452.0	6.3
2005-06	29.1	509.2	5.7
2006-07	29.0	493.1	5.9
2007-08 ¹	32.6	495.2	6.6

¹ Unaudited.



Lottery Game Development ■

Effective game development and management help to increase the net proceeds available to fund property tax relief.

Effective game development and management help to maximize sales revenue and increase the net proceeds available to fund property tax relief. The Wisconsin Lottery adapts its instant game sales strategies by frequently adjusting the number and types of instant games available for sale, introducing higher-priced games, and offering games affiliated with a copyrighted or trademarked property. We reviewed its methodology for analyzing the performance of instant games, declining revenues from pull-tab ticket sales, and its decision not to implement a new ticket distribution system that was approved as part of 2007 Wisconsin Act 20. We also reviewed lotto games and 20th anniversary games.

Total Game Sales

As shown in Table 8, sales of instant scratch-off games totaled \$284.2 million and represented 57.5 percent of total sales in FY 2007-08. There were 113 instant scratch-off games available for sale at some point during that year, with approximately 30 available for sale at any given time. Pull-tab games generated an additional \$3.2 million in sales, while lotto game sales totaled \$207.3 million.

Table 8

Game Availability and Sales¹

Game Type	Number of Games Available	FY 2006-07		FY 2007-08		
		Total Sales (in millions)	Percentage of Total	Number of Games Available	Total Sales (in millions)	Percentage of Total
Instant						
Scratch-off	136	\$280.0	56.8%	113	\$284.2	57.5%
Pull-tab	11	4.1	0.8	10	3.2	0.6
Subtotal	147	284.1	57.6	123	287.4	58.1
Lotto						
	7	208.7	42.4	7	207.3	41.9
Total	154	\$492.8	100.0%	130	\$494.7	100.0%

¹ The number of games available for sale during at least one point of the fiscal year.

Instant Games

As shown in Table 9, introductions of new instant games generally increased over the past five fiscal years.

Table 9

Introductions of New Instant Lottery Games

Fiscal Year	Affiliated Games	Unaffiliated Games	All Games
2003-04	3	57	60
2004-05	7	58	65
2005-06	5	55	60
2006-07	9	60	69
2007-08	9	65	74

Affiliated games can have special prize opportunities and are intended to generate interest among individuals who typically do not purchase lottery tickets. The Wisconsin Lottery introduced nine

affiliated instant games in FY 2007-08. Appendix 2 lists the affiliated instant lottery games introduced since FY 2003-04.

Additional costs are associated with the development of affiliated games, typically through negotiated compensation agreements with third-party vendors that have obtained the licensing rights from the copyright or trademark holders. Compensation varies by vendor and by game but is typically provided through:

- a fixed licensing fee;
- a royalty based on the number of tickets printed or sold; or
- a prize purchased from the vendor to use for the game, such as a motorcycle or a truck.

Prize purchases for all affiliated games introduced from FY 2003-04 through FY 2007-08 totaled \$956,700, while licensing fees and royalties for those games totaled \$618,600. Other development costs, such as ticket printing, have varied by game. For example, ticket printing costs are based on the number of tickets printed and whether the game ticket had additional features, such as special graphics and imaging, which typically cost more to produce.

Higher-priced instant games have been introduced more frequently in recent years.

As shown in Table 10, higher-priced instant games have been introduced more frequently in recent years, in response to lottery player demand. Ten games priced at \$5 or more were introduced in FY 2003-04, while 23 such games were introduced in FY 2007-08.

Table 10

Number of Instant Lottery Games Introduced, by Game Price

Game Price	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08
\$1	22	19	19	18	16
\$2	19	21	18	19	17
\$3	9	11	8	13	18
\$5	8	11	10	14	17
\$10	2	3	3	4	4
\$20	0	0	2	1	2
Total	60	65	60	69	74

The Wisconsin Lottery believes that a key element in maximizing instant game sales is providing a wide selection that offers a variety of different play styles and game prices. Game management decisions are based on a number of factors, including:

- weekly sales of instant games currently available;
- whether all of the top prizes of an instant game have been won;
- ticket inventories of instant games currently available for sale;
- scheduled introductions of other instant games; and
- the mix of instant games currently available based on price, play style, and theme.

The sales performance of instant games currently available may hasten or delay the scheduled introduction of new instant games. As a result, the instant game introduction schedule requires frequent adjustments. Most instant games are available for sale for at least 12 weeks, although some may be available for a shorter period if they are seasonal, such as a game with a theme related to Valentine's Day.

Evaluating Instant Games

In FY 2005-06, the Wisconsin Lottery implemented an evaluation tool to help develop and manage instant games.

In 2005, we recommended that the Wisconsin Lottery develop a written methodology to analyze instant game costs and revenues. In FY 2005-06, the Wisconsin Lottery implemented an evaluation tool to help develop and manage instant games. This tool identifies the key features of each instant game, such as its theme and play style; provides a justification for the game, showing how it complements other games currently available for sale; and estimates development costs and sales. The evaluation tool is used:

- to identify factors that may have influenced the game's performance, such as the theme, play style, or whether similar Wisconsin Lottery games were available for sale during the same period; and
- to calculate each game's initial 12-week ticket sales and its net sales, which are total ticket sales less game production costs and game prizes paid.

Lottery staff indicated that initial 12-week sales and net sales provide two different but complementary measures from which to draw conclusions about game performance. Initial 12-week sales data allow a game’s popularity to be compared to other games introduced during the same fiscal year and at the same price. According to the Wisconsin Lottery, sales for most games are highest immediately after introduction and decrease steadily over time, although sales for instant games such as poker and blackjack are initially lower than sales for many other games but remain steady over time.

Analyzing net sales allows the Wisconsin Lottery to review game costs, evaluate trends in sales over a game’s life, determine which games are most profitable, and identify strategies to increase the success of future games. For example, in FY 2006-07 the evaluation tool indicated that the Wisconsin Lottery’s Summerfest game had lower net sales than had been expected. The Wisconsin Lottery determined that retailers had returned a large number of tickets because players stopped purchasing tickets for the game after Summerfest ended, even though prizes were still available. The following year, it reduced its printing and ticket return costs by adjusting its ticket order to ensure that all tickets would be sold before Summerfest concluded.

We reviewed the Wisconsin Lottery’s use of its evaluation tool for all games launched in FY 2006-07 and FY 2007-08 for which final sales data were available. We found that the Wisconsin Lottery consistently used the tool to help develop future games.

The evaluation tool is an effective way to evaluate instant games and determine which have and have not been successful, as well as the reasons for those outcomes. However, it does not aggregate net sales information for multiple instant games. Because introductions of higher-priced instant games have increased in recent years, we calculated the net sales for all instant games introduced over the past five fiscal years. Because complete cost information was not available, we assumed that all prize payments were made for each game offered and estimated each game’s Lottery staffing costs, which are not included in the evaluation tool.

Higher-priced instant games tend to have lower rates of return but higher net proceeds.

As shown in Table 11, both average costs per game and average sales per game increased as prices increased. Net proceeds per game were also higher for higher-priced games. However, as a percentage of average sales per game, net proceeds were higher for games costing \$1 and lower for games costing \$20, indicating that higher-priced games tend to have lower rates of return. As noted, however, the Wisconsin Lottery believes it is important to offer a variety of instant games at varying prices.

Table 11

Average Net Sales of Instant Games, by Price
(Games Introduced from FY 2003-04 through FY 2007-08)

	\$1	\$2	\$3	\$5	\$10	\$20
Number of Games Introduced ¹	94	94	59	56	16	5
Average Prize Expense per Game ²	\$1,494,600	\$2,402,800	\$2,433,400	\$3,902,800	\$6,495,500	\$14,209,000
Average Printing and Staffing Costs per Game ³	35,200	48,800	50,000	56,400	65,400	92,700
Average Licensing Costs per Game	0	0	6,200	4,600	0	0
Average Costs per Game⁴	\$1,529,800	\$2,451,600	\$2,489,600	\$3,963,800	\$6,560,900	\$14,301,700
Average Sales per Game⁵	\$2,382,700	\$3,402,500	\$3,546,500	\$5,521,700	\$8,487,600	\$17,296,400
Net Proceeds per Game	\$852,900	\$950,900	\$1,056,900	\$1,557,900	\$1,926,700	\$ 2,994,700
Net Proceeds as a Ratio of Average Sales	35.8%	27.9%	29.8%	28.2%	22.7%	17.3%

¹ Does not include four combination games that have both scratch-off and pull-tab features.

² Assumes that all prizes were won and redeemed.

³ Staffing costs are based on an estimate of salaries and fringe benefits for the time spent developing instant lottery games.

⁴ Does not include indirect costs, such as retailer compensation, telecommunications services, and product information expenses.

⁵ Based on sales through August 31, 2008.

Pull-tab Games

Pull-tab ticket sales totaled \$3.2 million in FY 2007-08.

In FY 1988-89, pull-tab ticket sales totaled approximately \$25.3 million. However, as shown in Table 12, pull-tab ticket sales were only \$6.9 million in FY 2004-05 and decreased to \$3.2 million in FY 2007-08.

Table 12

Pull-tab Game Availability and Sales

Fiscal Year	Games Available	Total Sales (in millions)	Percentage Change
2003-04	11	\$3.7	–
2004-05	12	6.9	86.5%
2005-06	12	5.3	(23.2)
2006-07	11	4.1	(22.6)
2007-08	10	3.2	(22.0)

Sales of pull-tab tickets have decreased for a variety of reasons. In prior years, the Wisconsin Lottery noted that taverns and gas stations, as well as nonprofit organizations that may sell pull-tab tickets to raise funds, have shown less interest in doing so, possibly because of other gaming options that are now available. In February 2008, the Wisconsin Lottery reported to the Joint Legislative Finance Committee that competition from private pull-tab vendors—whether operating illegally or under s. 100.16(2), Wis. Stats., which exempts promotional games of chance offered with a product from the State’s prohibition on private lotteries—accounts at least in part for the decline in pull-tab sales. Special promotions at businesses such as fast-food restaurants are believed to not detract from the Wisconsin Lottery’s pull-tab sales, but the report indicated that sales have decreased because of competition from a small number of businesses that distribute either coupon or collectible “milk cap” pull-tab tickets to gas stations and taverns. In 2001, the First District Court of Appeals of Wisconsin ruled that a business with such a ticket design qualified for the statutory exemption.

The Wisconsin Lottery believes that s. 100.16(2), Wis. Stats., allows for an unintended loophole in gaming law and provides few protections for those who purchase private pull-tabs. For example, the statute does not require verification of advertised odds or authorize independent audits to determine whether prizes were awarded appropriately.

Private pull-tab operators typically pay retailers commission rates higher than the Wisconsin Lottery’s statutorily required rates.

The Wisconsin Lottery also indicated that private pull-tab games have a competitive advantage over its own games. For example, retailers may prefer to sell private pull-tab tickets because they are typically paid a commission between approximately 20.0 and 30.0 percent of ticket sales, whereas the Wisconsin Lottery is statutorily prohibited from paying more than 6.25 percent of instant game ticket sales to for-profit retailers.

The Wisconsin Lottery refers pull-tab tickets that it believes are illegal and do not qualify for the statutory exemption to DOJ, which also receives referrals from private citizens and local law enforcement agencies about their use. As shown in Table 13, DOJ investigated 13 cases of suspected illegal pull-tab games from FY 2004-05 through FY 2007-08. It referred all 13 cases to district attorneys, but its records do not indicate whether charges were filed. DOJ indicates that district attorneys were often hesitant to prosecute these cases because of other priorities and the prevalence of privately operated pull-tab games in Wisconsin taverns and gas stations, and it has therefore investigated fewer pull-tab cases in recent years.

Table 13

Pull-tab Cases Investigated by DOJ

Fiscal Year	Number of Cases
2004-05	5
2005-06	4
2006-07	3
2007-08	1
Total	13

The Wisconsin Lottery has responded to competition from private pull-tab games by introducing pull-tab tickets with higher prize amounts. However, it does not expect its pull-tab ticket sales to increase significantly unless illegal private games cease and the statutory exemption is explicitly limited to promotions that are clearly occasional and unrelated to the primary products and services provided by a business. It should be noted that there are no reliable estimates about how much the Wisconsin Lottery’s pull-tab ticket sales would increase if statutes were modified.

Other Issues

The Wisconsin Lottery has traditionally allowed retailers to determine the quantity and type of instant game tickets they receive. In contrast, an automated or “push” ticket distribution system determines the quantity and type of game tickets most likely to be successful at a given retail location and then automatically distributes these tickets. In its 2007-09 biennial budget request, the Wisconsin Lottery proposed implementing a push distribution system, which it believed would increase ticket sales. 2007 Wisconsin Act 20 authorized the implementation of a push distribution system, pending approval by the Joint Legislative Finance Committee of an implementation and cost plan. If the plan had been approved, Act 20 would have appropriated \$235,000 in FY 2008-09 to fund the system and would have eliminated 4.5 FTE staff positions that help distribute Wisconsin Lottery tickets to retailers.

In FY 2007-08, the Wisconsin Lottery reviewed similar ticket distribution systems in other states and met with software developers to study the feasibility of implementation in Wisconsin. It determined that:

- the potential increase in sales was less than it had initially estimated, primarily because retailers in Wisconsin appear to manage ticket inventories better than retailers in other states do;
- states with push distribution systems incurred additional costs when retailers returned tickets they did not want to sell; and
- the software systems used in other states could not be readily deployed in Wisconsin, and although an alternative could be developed to accommodate Wisconsin’s specific needs, the likelihood of software failure would increase with using an untested system.

In January 2008, the Wisconsin Lottery decided not to implement an automated ticket distribution system.

For these reasons, the Wisconsin Lottery reported to the Joint Legislative Finance Committee in January 2008 that it had decided not to implement a push distribution system for the present time. Instead, it plans to explore ways to increase ticket sales by better tracking and managing retailers’ ticket inventories. The \$235,000 appropriated for the system has not been spent, and the 4.5 FTE positions that would have been eliminated remain filled.

Although some states continue to sell instant lottery tickets after the top prizes in a game have been won, s. 565.27(5), Wis. Stats., requires

the Wisconsin Lottery to notify retailers and provide them with signs for display stating when all top prizes for an instant game have been claimed. In addition, the Wisconsin Lottery stops distributing the game’s tickets to retailers, who may return any unsold tickets for refund or continue to sell them. According to the Wisconsin Lottery, some individuals continue to play a game even after its top prizes have been claimed, in order to have the opportunity to win other prizes; however, retailers that continue to sell tickets are required by administrative rule to display the signs indicating that no top prizes remain. When Wisconsin Lottery field representatives visit retailers, they are to ensure the signs are posted. The Wisconsin Lottery’s Web site also provides information about the instant games for which top prizes have been won.

Lotto Games

Wisconsin currently participates in Powerball and five other lotto games.

Wisconsin participates in Powerball, a lotto game played in 31 jurisdictions and administered by the Multi-State Lottery Association. As shown in Table 14, the Wisconsin Lottery also currently offers five other lotto games that are sold only in Wisconsin. During FY 2007-08, Powerball sales in Wisconsin totaled \$93.7 million.

Table 14

Wisconsin Lottery Lotto Games

Game	Date of Introduction	Drawing Frequency	Odds of Winning Maximum Prize	FY 2007-08 Sales (in millions)
Powerball	April 19, 1992	Twice Weekly	1:146.1 million	\$93.7
SuperCash!	February 4, 1991	Daily	1:1.6 million	27.9
Pick 3	September 21, 1992	Daily	1:1,000	25.8
Megabucks	June 20, 1992	Twice Weekly	1:7.0 million	19.0
Badger 5	February 17, 2003	Daily	1:170,000	25.4
Pick 4	September 15, 1997	Daily	1:10,000	11.8

During FY 2006-07 and FY 2007-08, the Wisconsin Lottery introduced two raffle-style lotto games in which a limited number of \$10 tickets were sold for a one-time drawing. It introduced these games based on the success of similar games in other states. However, both games fell far short of the goal of selling 500,000 tickets, as shown in Table 15. The Wisconsin Lottery is conducting market research to determine how to improve the performance of raffle-style games, with the possibility of introducing another raffle-style game in 2010.

Table 15

Wisconsin Lottery Raffle-style Games

Game	Date of Introduction	Date of Drawing	Ticket Sales Goal	Tickets Sold	Sales (in millions)
Million Dollar Draw	March 4, 2007	May 1, 2007	500,000	345,635	\$3.5
Holiday Millions	November 4, 2007	January 1, 2008	500,000	368,477	3.7

The Wisconsin Lottery occasionally conducts special promotions of lotto games to attract new players and to encourage current players to try additional games or play more often. It coordinates the timing of these promotions in an attempt to maximize their effects on sales. Since it obtained the software necessary to conduct special promotions of lotto games in 2002, the Wisconsin Lottery has conducted 13 such promotions, including:

- tripling all secondary prizes for SuperCash!, based on the results of an extra drawing;
- awarding \$1,000 to 1 out of every 4,000 players who purchase a \$5 Megabucks ticket; and
- providing players who purchase a \$5 ticket for a lotto game with an additional \$1 ticket, which is known as a quick-pick because the game terminal randomly assigns numbers for an additional play for the next drawing of that game.

20th Anniversary Games

The Wisconsin Lottery introduced four new scratch-off games to celebrate its 20th anniversary.

In April and May 2008, the Wisconsin Lottery celebrated its 20th anniversary by introducing four new anniversary-themed scratch-off games:

- a \$1 game with enhanced graphics and an additional 6.0 percent prize payout above the typical payout percentage; and
- \$3, \$5, and \$10 games with enhanced graphics and additional 2.0 percent prize payouts above the typical payout percentages for games sold at those prices.

The 20th anniversary theme was also used to publicize the Wisconsin Lottery at events such as Summerfest, the Lumberjack World Championships, and the City of Madison's Art Fair on the Square.

The Wisconsin Lottery conducted special anniversary-themed promotions to attract new players and retain current players. For example, individuals who purchased a ticket costing \$5 or more for any of six lotto games during June 2008 received an additional quick-pick play for that game's next drawing. It also conducted a one-time drawing in which individuals who submitted \$5 in non-winning tickets from any of the four 20th anniversary instant games or the six lotto games were given a chance to win a \$100,000 jackpot or one of ten \$20,000 prizes. The Wisconsin Lottery received more than 400,000 entries and conducted the jackpot drawing at Miller Park before a Milwaukee Brewers baseball game in September 2008.



Lottery Contracting ■

The Wisconsin Constitution prohibits the expenditure of public funds or of revenues derived from lottery operations for promotional advertising, and it directs any advertising to provide information about the chances of winning and the prize structure. The Wisconsin Lottery contracts with Hoffman York, a Milwaukee-based advertising firm, for product information services and with GTECH Corporation, a Rhode Island-based firm, for operations services that include telecommunications and instant and lotto ticket validation and tracking. We evaluated the Wisconsin Lottery's efforts to monitor both contractors' performance and analyzed how it assessed the effectiveness of product information services received.

Product Information Contract

The Wisconsin Lottery contracts with Hoffman York for product information services.

In April 2006, the Wisconsin Lottery entered into a two-year product information contract with Hoffman York, which has held similar contracts since 1992. The current contract allows for three optional one-year renewal periods by mutual agreement and was renewed in 2008 until April 2009. The Wisconsin Lottery is currently drafting a request for proposals for a new product information contract but is uncertain when the process will be completed or a new contract will begin.

With input from agency staff, Hoffman York annually creates a plan for providing information about the Wisconsin Lottery and individual games through print, radio, television, and other media. Typically, new games or game features that are most likely to

interest players, such as a new style of play, a holiday theme, or a special offer, are publicized. However, not all new games or game features are publicized. Hoffman York also provides creative expertise in designing the product information, and it purchases space in newspapers and air time on radio and television.

In FY 2007-08, the Wisconsin Lottery's annual product information budget increased to \$7.5 million.

The Wisconsin Lottery's annual product information budget was \$4.6 million from FY 1990-91 through FY 2006-07 and increased to \$7.5 million in each year of the 2007-09 biennium under 2007 Wisconsin Act 20. Almost the entire amount is paid to Hoffman York; a small amount is spent on printing and related costs. Costs incurred by Wisconsin Lottery staff for product information services are not paid through the annual product information budget but are instead covered by the Wisconsin Lottery's general operations funds. Product information staff include one employee who serves as a full-time liaison to the product information contractor, another who analyzes product information issues for approximately 20 to 25 hours per week, and others who occasionally work on product information issues.

As shown in Table 16, Hoffman York was paid \$25.2 million for product information services from FY 2003-04 through FY 2007-08. It used these funds primarily to purchase media time to publicize Wisconsin Lottery games. In FY 2007-08, the firm reported spending \$4.5 million on television-related publicity, \$1.2 million on radio-related publicity, \$0.6 million on Internet-related publicity, \$0.4 million on newspaper and other print-related publicity, and other amounts on items such as renting billboards and publicizing games at Milwaukee Brewers baseball games.

Table 16

Wisconsin Lottery Payments to Hoffman York

Fiscal Year	Amount
2003-04	\$ 4,552,100
2004-05	4,531,400
2005-06	4,506,000
2006-07	4,391,500
2007-08	7,230,600
Total	\$25,211,600

Section 16.75(3m)(b), Wis. Stats., encourages state agencies to make 5.0 percent of their purchases of goods and services from certified minority-owned businesses. Hoffman York’s contract with the Wisconsin Lottery requires the firm to purchase goods and services equaling 5.0 percent of total contract expenditures from certified minority-owned businesses and to furnish proof of compliance every quarter. In FY 2007-08, Hoffman York reported it spent \$395,600, or 5.5 percent of its contract expenditures, on goods and services from certified minority-owned businesses.

Evaluating Hoffman York’s Performance

The Wisconsin Lottery has not formally evaluated Hoffman York’s performance, as required by its contract.

Although the Wisconsin Lottery is contractually required to formally evaluate Hoffman York’s performance annually, using criteria jointly determined by both parties, we found that it has not done so and until recently had not determined the evaluation criteria. Instead of completing formal evaluations, the Wisconsin Lottery indicated that it has evaluated the firm in other ways. For example, agency officials provide verbal feedback about Hoffman York’s performance during annual meetings to discuss product information plans for the upcoming year. In addition, the Wisconsin Lottery’s liaison to the product information contractor has regular contact with Hoffman York staff, which allows performance issues to be addressed on an ongoing basis.

One measure the Wisconsin Lottery has used to evaluate Hoffman York’s performance and guide its product information plans is a quarterly survey of approximately 350 Wisconsin residents, which gauges awareness and opinions about the Wisconsin Lottery, including survey respondents’ levels of participation and their ability to recall product information. The Wisconsin Lottery believes that the survey’s findings, such as that one-quarter of respondents recall commercials, show that Hoffman York’s efforts are successful.

Although ongoing feedback and surveys are important components of effective contract management, they do not replace the benefits of the annual evaluations required by contract. In August 2008, during the course of our audit, the Wisconsin Lottery began developing an evaluation form for its product information contractor. Upon completion, the form is expected to be used for quarterly and annual evaluations of the contractor’s performance.

Recommendation

We recommend the Wisconsin Lottery annually evaluate its product information contractor and provide a copy of its evaluation form to the Joint Legislative Audit Committee by March 13, 2009.

Measuring Product Information Effectiveness

While the Wisconsin Lottery believes that product information expenditures increase ticket sales, determining the precise effect publicity has on individual game sales is challenging. For example, several economic factors such as the price of gasoline and other consumer goods affect ticket sales. In addition, publicity increases the public's awareness of the Wisconsin Lottery in general and likely increases ticket sales of unpublicized games.

The Wisconsin Lottery has taken steps to measure the effectiveness of Hoffman York's product information services.

To measure the effectiveness of Hoffman York's product information services in FY 2005-06 and FY 2006-07, the Wisconsin Lottery compared initial 12-week ticket sales for 16 publicized scratch-off games with average 12-week sales data for comparable unpublicized games that were introduced during the same period. The Wisconsin Lottery analyzed 12-week ticket sales because it publicizes individual games during the first several weeks after their introduction and believes that this is an adequate period of time to determine the effect of product information services on ticket sales.

Using the Wisconsin Lottery's methodology and expenditure information, we confirmed that initial 12-week sales of the 16 games were, on average, considerably higher for the publicized games. However, the Wisconsin Lottery typically publicizes games and features that are likely to interest players. As a result, it may be publicizing games that would have performed well without publicity. In addition, it did not take into account other costs that may have increased ticket sales, such as costs related to higher prize payouts or licensing rights associated with affiliated games.

We identified two ways for improving how the Wisconsin Lottery evaluates product information services. First, we believe it should include product information costs in its instant game evaluation tool, which analyzes a game's initial 12-week sales and net sales. As noted, 12-week sales data allow a game's popularity to be compared to other games, while net sales data allow the Wisconsin Lottery to review a game's overall costs and sales and identify strategies to increase the success of future games.

Second, we believe the Wisconsin Lottery should require Hoffman York to regularly report on the amounts spent to publicize individual games. Currently, Hoffman York provides information indicating the amounts it spent on particular media campaigns, which often involve multiple games that are simultaneously publicized. However, it does not always report on the amounts spent publicizing individual games. Having game-specific information would allow the Wisconsin Lottery to better assess the effectiveness of the product information services it purchases.

☑ Recommendation

We recommend the Wisconsin Lottery:

- *include product information costs in the evaluation tool it uses to assess instant games; and*
- *require its product information contractor to report quarterly on expenditures associated with publicizing specific games.*

Operations Contract

The Wisconsin Lottery contracts with GTECH for operations services.

Since 1989, the Wisconsin Lottery has contracted with GTECH for computerized gaming system services, which include telecommunications networking; data facilities; and related infrastructure, products, and services to support the operation of the Wisconsin Lottery. Under the terms of a seven-year contract that began in June 2004 and will expire in June 2011, GTECH receives 2.54 percent of lottery ticket sales, less any liquidated damages. The contract allows for two optional one-year renewal periods by mutual agreement.

As shown in Table 17, the Wisconsin Lottery has paid GTECH a total of \$61.1 million for operations services from FY 2003-04 through FY 2007-08, including \$12.3 million in FY 2007-08. GTECH is required to purchase at least \$700,000 in goods and services from certified minority-owned businesses over the seven-year contract period and encouraged to spend 5.0 percent of its total contract payments from the Wisconsin Lottery on such purchases. From June 2004 through June 2008, GTECH spent \$894,600, or 1.8 percent of its total contract payments during that period, on goods and services provided by certified minority-owned businesses.

Table 17

Wisconsin Lottery Payments to GTECH

Fiscal Year	Amount
2003-04	\$12,383,700
2004-05	11,344,800
2005-06	12,602,100
2006-07	12,415,500
2007-08	12,327,100
Total	\$61,073,200

Evaluating GTECH's Performance

In recent years, the Wisconsin Lottery has improved its evaluation of GTECH's performance. Its contract with GTECH includes provisions for ongoing monitoring and review of the firm's performance, as well as for a formal annual review based on jointly established evaluation criteria. In 2005 (report 05-8), we found that the Wisconsin Lottery had not completed any annual reviews and, therefore, recommended that it develop formal review criteria and annually evaluate GTECH's performance.

In recent years, the Wisconsin Lottery began its formal evaluation of GTECH's performance.

In December 2006, the Wisconsin Lottery developed formal review criteria, including the number of equipment failures and system malfunctions and the resulting amounts of liquidated damages assessed in areas such as reliability, network availability, and software quality. In March 2007, it first evaluated GTECH's performance and noted that the firm had not resolved 125 requests for programming changes as of October 2006. In response, GTECH indicated that it would devote one full-time administrator to address requests for programming changes and improve the quality and consistency of future software updates, and that it would implement a software update in July 2007 to reduce the number of outstanding requests for programming changes from 125 to 25.

In May 2008, the Wisconsin Lottery evaluated GTECH's performance for calendar year 2007. GTECH received performance ratings that varied from "average" in software quality to "excellent" in network availability. However, the evaluation noted that GTECH:

- had not delivered contractually required gaming system features that are intended to reduce the likelihood of human error in validating lottery tickets;
- had not corrected ongoing performance problems related to terminals used by retailers that do not sell a significant number of lottery tickets, known as low-volume terminals; and
- had 32 requests for programming changes outstanding as of March 2008.

In June 2008, GTECH indicated that it would continue to work to provide all contractually required gaming system features, replace ten low-volume terminals with higher-performing terminals, and address the requests for programming changes.

Liquidated Damages

From FY 2004-05 through FY 2007-08, the Wisconsin Lottery assessed GTECH \$1.5 million in liquidated damages.

Under the terms of its contract with GTECH, the Wisconsin Lottery may assess various amounts of liquidated damages to recover lost revenue when GTECH’s telecommunications systems fail or problems occur related to validating tickets. As shown in Table 18, the Wisconsin Lottery assessed a total of \$1.5 million in liquidated damages from FY 2004-05 through FY 2007-08. Assessment amounts declined from FY 2004-05 through FY 2006-07 but increased in FY 2007-08, largely because of a September 2007 incident in which GTECH was assessed \$206,000 when a portion of its satellite network malfunctioned. The malfunction impaired gaming system terminals throughout Wisconsin, and it took GTECH more than five hours to resolve the problem.

Table 18

Liquidated Damages Assessed by the Wisconsin Lottery on GTECH

Fiscal Year	Amount
2004-05 ¹	\$ 714,600
2005-06	367,500
2006-07	131,800
2007-08	268,000
Total	\$1,481,900

¹ Includes \$37,000 in liquidated damages in June 2004, which was the first month of GTECH’s current contract with the Wisconsin Lottery.

Table 18 does not include a \$250,000 credit issued by GTECH in September 2004 as part of negotiations to resolve problems that occurred during implementation of the Wisconsin Lottery’s new operations system in 2004. The Wisconsin Lottery has used the credit to purchase software upgrades from GTECH, and \$73,000 of the credit remained unused as of August 2008.

We found that the Wisconsin Lottery has not always assessed the liquidated damages that are allowed under the contract. In FY 2007-08, there were 30 incidents for which liquidated damages could have been assessed, but the Wisconsin Lottery assessed GTECH for only 18, and assessments were lower than the maximum allowable amounts for all 18. Because liquidated damages are intended to recover actual losses incurred as a result of GTECH’s failure to perform, the Wisconsin Lottery bases assessments on

average ticket sales for the six weeks before an incident and any unusual circumstances that may have caused an incident. For example:

- After scheduled maintenance in October 2007, GTECH's satellite network failed, which caused more than 3,000 retailer terminals to malfunction after midnight for up to 55 minutes. Although the Wisconsin Lottery was permitted to assess \$50,000 in liquidated damages for the incident, it assessed only \$300, based on a comparison of average and actual sales during the incident.
- In October 2007, GTECH's satellite network again failed, which caused more than 1,500 terminals to malfunction for up to 11 minutes. Although the Wisconsin Lottery was permitted to assess \$6,000 in liquidated damages for the incident, it did not assess any damages because actual ticket sales during the system malfunction exceeded average sales.
- In July 2007, severe weather affected the gaming system network and caused more than 200 retailer terminals to malfunction for seven minutes. Although the Wisconsin Lottery was permitted to assess \$2,000 in liquidated damages for the incident, it did not assess any damages because actual ticket sales during the system malfunction exceeded average sales.
- In September 2007, some retailers that use telephone lines to connect their terminals to the Wisconsin Lottery's gaming network experienced problems. GTECH determined that the retailers' telephone company caused the incident. Although the Wisconsin Lottery was permitted to assess more than \$6,600 for the incident, no damages were assessed because GTECH's equipment did not cause the problem.

It is appropriate for the Wisconsin Lottery to use its judgment in determining whether to assess liquidated damages, particularly when problems occur that are outside of GTECH's control, such as severe weather that disrupts the gaming system network. However, if GTECH is at fault for a problem, as appears to have been the case in some of the 30 incidents in FY 2007-08, it is important for the Wisconsin Lottery to assess liquidated damages at a level that fully recovers its actual losses and encourages improved contractor performance.

Recommendation

We recommend the Wisconsin Lottery review its procedures for assessing liquidated damages against its operations contractor, in order to ensure that it is appropriately compensated for telecommunications systems failures and problems related to validating tickets.

■ ■ ■ ■

Appendix 1

National Lottery Sales
FY 2006-07

Jurisdiction	Year Lottery Operations Began	Sales (in millions)	Per Capita Sales	Per Capita Sales Rank
Arizona	1981	\$ 462.2	\$ 72.92	38
California	1985	3,318.3	90.78	29
Colorado	1983	455.9	93.78	28
Connecticut	1972	959.1	273.86	6
Delaware	1975	118.3	136.76	23
District of Columbia	1982	256.8	436.56	2
Florida	1988	4,122.1	225.85	11
Georgia	1993	3,178.4	333.00	4
Idaho	1089	130.5	87.06	31
Illinois	1974	1,999.0	155.53	22
Indiana	1989	789.1	124.35	24
Iowa	1985	235.1	78.67	35
Kansas	1987	233.9	84.26	32
Kentucky	1989	744.2	175.46	16
Louisiana	1991	354.2	82.50	33
Maine	1974	230.0	174.63	17
Maryland	1973	1,577.3	280.74	5
Massachusetts	1972	4,436.5	687.86	1
Michigan	1972	2,342.6	232.59	9
Minnesota	1990	422.6	81.31	34
Missouri	1986	934.3	158.93	20
Montana	1987	41.6	43.40	42
Nebraska	1993	114.5	64.52	39
New Hampshire	1964	263.6	200.30	13
New Jersey	1970	2,351.3	270.70	7
New Mexico	1996	148.0	75.15	37
New York	1967	6,652.4	344.73	3
North Carolina	2006	861.7	95.10	26
North Dakota	2004	22.6	35.39	43
Ohio	1974	2,259.4	197.04	14
Oklahoma	2005	215.1	59.46	40
Oregon	1985	354.6	94.63	27
Pennsylvania	1972	3,076.3	247.44	8
Rhode Island	1974	244.8	231.46	10

Jurisdiction	Year Lottery Operations Began	Sales (in millions)	Per Capita Sales	Per Capita Sales Rank
South Carolina	2002	\$ 988.2	\$224.19	12
South Dakota	1987	39.8	50.00	41
Tennessee	2004	984.9	159.97	19
Texas	1992	3,774.2	157.89	21
Vermont	1978	104.5	168.23	18
Virginia	1988	1,362.3	176.65	15
Washington	1982	492.6	76.15	36
West Virginia	1986	192.7	106.32	25
Wisconsin	1988	492.8	87.97	30
United States	–	\$52,338.4	\$184.59	–

Source: La Fleur's 2008 World Lottery Almanac and U.S. Census Bureau.

Appendix 2

Affiliated Instant Lottery Games

(by Fiscal Year of Introduction)

FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08
Bonus Slingo®	Cream Puff Cash ¹	Blue Ribbon Bucks ¹	Blue Line Slingo®	Slots of Slingo®
Double Up Slingo®	Bucks & Trucks	Word Search®	Spicy Hot Cash ¹	Summerfest ¹
The Price is Right™	Battleship™	Harley-Davidson®	Summerfest ¹	Yahtzee®
	Cherub Slingo®	Cool Winnings ¹	Milwaukee Brewers®	Pac-Man™ Cash
	Plinko (Price is Right)™	Lucky Slingo® Tripler	Lucky Charm Slingo®	Red Hot Slingo®
	Slingo® Doubler		Uno®	Deal or No Deal™
	Sweet 16 ¹		Race to Win ¹	Monopoly®
			Monopoly®	Super Vegas Nights ¹
			Slingo® Times 5	Tetris

¹ Games established through partnership agreements with entities to engage in joint advertising opportunities.



State of Wisconsin • DEPARTMENT OF REVENUE

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Jim Doyle
Governor

Roger M. Ervin
Secretary of Revenue

November 14, 2008

Janice Mueller
State Auditor
22 E. Mifflin St., Suite 500
Madison, WI 53703

Dear Ms. Mueller:

On behalf of the Department of Revenue and the Wisconsin Lottery, thank you for the recent program evaluation of the Lottery. As usual, the Audit Bureau staff has exhibited the highest degree of professionalism in conducting the audit.

We are proud of meeting our mission of providing property tax relief to the citizens of Wisconsin. As the audit report states, "Net lottery proceeds provided a total of \$146.5 million in property tax relief in FY2007-08, and an average property tax credit of \$86." Additionally, we focus on efficient operations, transparency and accountability to the taxpayers of Wisconsin. As noted in the audit report, Lottery administrative expenses were 6.6 percent of operating revenues, well below the 10 percent required by law. We remain committed to holding the line on expenses in order to deliver the maximum possible property tax relief.

We are in agreement with all the recommendations and comment on some of them.

Lottery Product Information Effectiveness

It is important to state that product information - advertising - works. In 1993, the Lottery ceased its advertising and the result was dramatic with the Lottery losing approximately \$19.5 million in instant ticket sales - a loss of at least \$25 for every \$1 of advertising not spent. Clearly, product information is effective. We continuously seek the best measurement tools to determine the effectiveness of a particular ad or ad campaign.

As the audit notes, "determining the precise effect publicity has on individual game sales is challenging." The difficulty in measuring the effect of advertising should not deter us from attempting to measure its effect. The Lottery constantly looks for ways to improve processes and better measure performance. To that end, the Lottery accepts the audit recommendations to include advertising costs in evaluations, to require the Lottery contractor to provide quarterly reports on expenditures and to conduct a formal evaluation of any contractor.

GTECH Liquidated Damages

The audit notes that in several cases the Lottery did not assess liquidated damages allowed under its contract with GTECH, the gaming vendor, where the Lottery could not demonstrate a loss of sales. Wisconsin law requires that liquidated damage assessments be "reasonable in light of the anticipated or actual loss" (*Wassenaar v. Panos*, 111 Wis.2d 518, 526-527, 331 N.W 357, 361-362 (1983), citing Sec. 356 (1), Restatement (Second) of Contracts (1979).) We focus on "reasonable in light of anticipated or actual loss."

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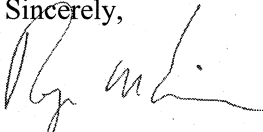
Nevertheless, to ensure that the Lottery is compensated for any losses, the Lottery accepts the audit recommendation that the Lottery review its procedures for assessing liquidated damages for failures by GTECH.

Illegal and Grey Market Pull Tabs

The audit report discusses the effect that illegal and grey market pull tabs have on Lottery pull tab sales, but notes that "there are no reliable estimates about how much the Wisconsin Lottery's pull tab ticket sales would increase if statutes were modified" to permit Lottery-only sales. On the contrary, Lottery staff has performed a market analysis and estimate that the Lottery could generate an additional \$23 million per year in revenue.

The Lottery remains focused on its mission to provide property tax relief to Wisconsin homeowners and will accomplish that mission through the most efficient and effective means possible. Again, thank you.

Sincerely,



Roger Ervin, Secretary
Wisconsin Department of Revenue