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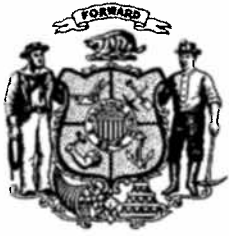
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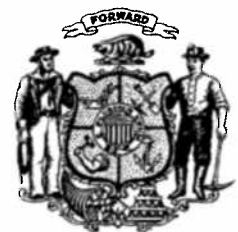


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**Report 08-13
November 2008**

An Evaluation

Wisconsin Lottery

Department of Revenue

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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,

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

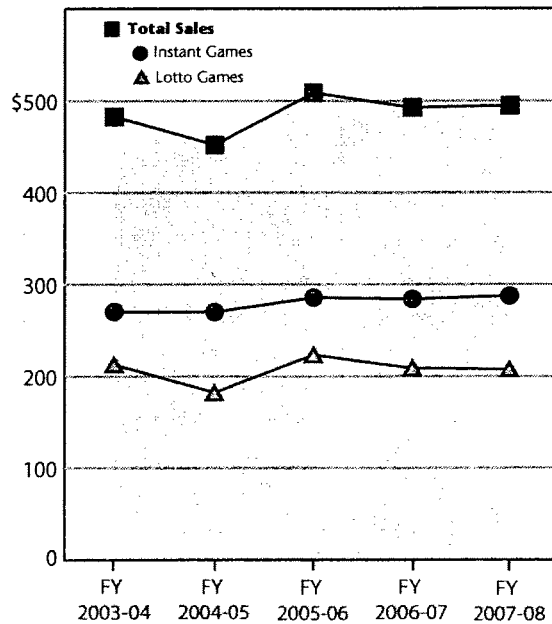
- the Wisconsin Lottery's oversight of its contracts with private firms for lottery operations and product information services.

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*).