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Elimination of Lottery Positions, Contracting Lottery Functions, and Conflict of Interest Provisions (DOR -- Lottery Administration)

[LFB 2005-07 Budget Summary: Page 436, #3]

CURRENT LAW

The operation of the state lottery is the responsibility of the Lottery Division in the Department of Revenue (DOR). The Division is authorized 109.5 SEG positions in 2004-05, funded from the lottery fund. The Division's base funding totals $64,901,200 SEG, and includes $22,522,400 SEG for general program operations, $29,452,100 SEG for retailer compensation (paid to commercial retailers under contract to sell lottery tickets), and $12,926,700 SEG for contracted vendor fees associated with scratch and on-line ticket computer systems and services.

The Lottery Division administrator may determine whether lottery functions should be performed by DOR employees or by one or more persons under contract with the Department of Administration (DOA). However, no such contract may: (1) provide for the entire management or operation of the state lottery by any private person; or (2) be entered into for financial auditing and security monitoring services (except for warehouse and building protection services provided by DOA under certain circumstances). DOA must require separate bids or separate competitive sealed proposals for contracted management consultation services.

Finally, any lottery employee or the Secretary, Deputy Secretary, or Executive Assistant of DOR is prohibited from having a direct or indirect interest in, or being employed by, any lottery vendor while serving as a lottery employee, Secretary, Deputy Secretary, or Executive Assistant of DOR. This prohibition continues to apply for two years following the person's termination of service with the Division or the Department.

GOVERNOR

Contracting Lottery Functions. Delete 55.0 SEG positions in 2006-07 to reflect the administration's intent to contract with private vendors for the performance of certain lottery functions. Transfer a portion of the annual amounts budgeted for salaries, fringe benefits, and turnover reduction associated with the deleted positions (a total of $1,443,700 SEG) to unalloted reserve in 2006-07 for possible use to fund contractual services costs. No cost savings related to the contracting initiative are assumed under the bill.

Position reductions and funding transfers to unalloted reserve in 2006-07 would be made for the following: (1) 8.0 positions and $157,500 from lottery operations; (2) 38.0 positions and $1,028,200 from retailer relations; (3) 8.0 positions and $223,000 from product development; and (4) 1.0 position and $35,000 from lottery administration. Since the funding reductions represent only a portion of the salary-related funding for these affected positions in 2006-07, the apparent intent would be to phase-in the private contracts during the year.

Conflict of Interest Provisions. Modify certain existing lottery conflict-of-interest provisions, as follows: (1) provide that an employee in the Lottery Division who terminates employment with DOR may be employed by a vendor at any time after the employee's termination, if DOR has entered into a contract with the vendor, on or after the effective date of the biennial budget act, to perform lottery functions previously undertaken by the employee while employed in the Division; (2) provide that no employee in the Division may discuss with a vendor who is attempting to obtain a major procurement contract with the state any matter relating to the future employment of the employee with the vendor, unless the discussion relates to employment for services that were performed by lottery employees before the effective date of this provision, and the administrator provides prior written consent; and (3) provide that if a major procurement contract is for services that were performed by Division employees before the effective date of this provision, the contract may not be entered into unless it requires the vendor to offer employment to those Division employees who performed those services and whose positions were terminated on or after the effective date of this provision. The circumstances under (3) would first apply to major procurement contracts entered into on the effective date of the provision.

DISCUSSION POINTS

Current Contracting Authority and the Governor's Proposal

1. The Lottery Division is currently authorized to contract out lottery functions under s. 565.25(1m) of the statutes, relating to major procurement contracts. Consequently, no statutory modifications to lottery contracting provisions are required in order to undertake this type of privatization initiative. However, any potential future employment of state lottery employees by private vendors under certain conditions would require statutory changes affecting current law conflict-of-interest provisions, and these modifications have been included in the bill.

2. A variety of lottery functions are currently contracted to private vendors:

- The state contracts with approximately 3,700 private, for-profit retailer outlets for lottery ticket sales.

- The state contracts with 489 nonprofit organizations to sell pull-tab lottery tickets.

- The state contracts with private vendors for: (a) scratch and on-line ticket computer systems and services; (b) telecommunications; (c) accounting services; (d) ticket delivery; (e) advertising; and (f) ticket printing.

3. State employees oversee these contracts and perform the remaining lottery operation functions. Table 1 summarizes the functions that are being performed by Lottery Division staff under the Department's base budget. The "other lottery operations" function identified in the table includes such activities as warehouse inventory and security, player relations, and information technology services. The "administration" function in the table includes budget, strategic, and management services, human resources, legal counsel, and other administrative activities.

TABLE 1

Functions Performed by Current Lottery Positions

Lottery Function	FTE
Product Research, Development, and Support	9.00
Retailer Relations and Marketing	37.00
Other Lottery Operations	26.25
Administration	37.25
Total	109.50

4. Under the Governor's proposal, some or all of the following lottery functions would be contracted to private vendors: (a) retailer relations, including marketing; (b) product development, including game design and product research; and (c) other lottery operations, including player relations, warehouse services, and website design and maintenance.

5. According to administration officials, the Governor's proposal would retain state positions to perform the more traditional government roles of oversight, auditing, prize payouts, and contract compliance.

6. Based on updated staffing allocations, the positions that would be eliminated under the bill because of the contracting of certain lottery functions are shown in Table 2. Based on the amounts actually transferred under the bill to unalloted to fund these contractual services, the

Governor's recommendation assumes that the positions identified in the table would be eliminated on January 1, 2007.

TABLE 2

Lottery Positions Eliminated through Contracting

Functional Area	Deleted Positions
Retailer Relations	
Telemarketing	10.0
Field Marketing Representatives	19.0
Other Retailer Relations Staff	5.0
Management and Support Staff	4.0
Subtotal	38.0
Product Development	
Game Design	2.0
Product Research	5.0
Coordinator	1.0
Subtotal	8.0
Other Lottery Operations	
Player Relations and Special Events	4.0
Warehouse Services	4.0
Website Design and Maintenance	1.0
Subtotal	9.0
Total Positions Deleted	55.0

7. According to administration officials, the primary intent of the Governor's recommendation to contract additional lottery functions is to eliminate state positions. Administration officials have also expressed the view that the operation of the lottery may not be consistent with the core mission of the Department of Revenue, which is the collection of taxes. Under this view, the lottery is seen as the provider of a retail product to consumers. The contracting of the lottery's remaining consumer-related functions to private vendors appears to be based on the premise that such contractors would have greater expertise or would enjoy greater success in the operation of these types of lottery functions than is currently provided by state employees. It has also been stated that lottery sales could be improved by contracting additional lottery functions, presumably since vendor compensation could be based on a percentage of sales and various performance incentives might be available to vendor employees that could not be provided to state employees

8. These presumed benefits of lottery contracting are addressed in the following two sections. The first section considers the appropriateness and effectiveness of DOR's current lottery

governance and management. The second section analyzes issues relating to contracting lottery operations and the associated position reductions. A final section discusses the conflict-of-interest provisions under the bill.

Lottery Governance under DOR

9. The state lottery is the one form of legal gambling in Wisconsin that is operated by the state. Typically, state lotteries are run by state agencies, commissions, or boards. Of 40 state lotteries operating in the United States, governance information indicates that: (a) nine state lotteries are overseen by state agencies, eight of which are state departments of revenue or the equivalent; (b) 26 lotteries are overseen by state commissions or boards; and (c) five state lotteries are overseen by boards of quasi-public corporations.

10. A variety of governance options for the lottery have been tried in Wisconsin. Prior to October 1, 1992, three state agencies performed gambling-related functions: (a) the Department of Regulation and Licensing regulated charitable bingo and raffle activities; (b) the Lottery Board operated the state lottery; and (c) the Racing Board regulated pari-mutuel betting and racing.

11. Then, as a result of 1991 Wisconsin Act 269, a three-member Wisconsin Gaming Commission was created, effective October 1, 1992, to coordinate and regulate all activities relating to legal gambling. This action: (a) eliminated the Lottery and the Racing Boards and transferred their functions to the Commission; (b) transferred the regulatory responsibilities for charitable bingo and raffles from the Department of Regulation and Licensing to the Commission; and (c) made the Commission responsible for the state's regulatory responsibilities under the state-tribal gaming compacts.

12. Next, under 1995 Wisconsin Act 27, the Gaming Commission was eliminated and was replaced by a Gaming Board, effective July 1, 1996. Also, on that date, the administration of the state lottery was transferred to DOR. All other Gaming Commission responsibilities were transferred to the Gaming Board.

13. Finally, under 1997 Wisconsin Act 27, the Gaming Board was eliminated and its functions were transferred to a Division of Gaming in DOA, effective October 14, 1997.

14. Throughout the early years of the Wisconsin lottery, management difficulties were evident, which may explain, in part, the ongoing efforts to fashion a workable governance structure for lottery operations. In recent years, however, a number of more positive factors can be cited. A serious sales decline from a record $518.9 million in 1994-95 to $401.2 million in 2000-01 has been reversed; sales have steadily increased since 2000-01 to a total of $482.9 million in 2003-04. In addition, DOR reports that administrative expenses of the state lottery totaled 7.69% of gross revenue in 2002-03, and 6.90% of gross revenue in 2003-04. These expenditures are well below the 10% maximum limitation required under statute. National data in 2002-03 indicates that Wisconsin had the fourth lowest per capita expenses for lottery operations in the nation.

15. While it can be argued that the operation of a state lottery is not consistent with the

core mission of DOR, it does appear that the agency has successfully managed the responsibility. Further, it is not uncommon for state lotteries to be operated by a state revenue department, especially in states where a gaming commission or board is not utilized.

Contracting and Position Reductions

16. Contracting initiatives similar to the one under the bill have been proposed before. One such initiative was considered as part of the 1995-97 biennial budget. The Governor proposed that virtually all remaining lottery functions be contracted to private firms by June 30, 1996. Under that initiative, 29 of the 121 lottery positions authorized at the time would have been retained as state positions to manage the lottery and monitor the work of private contractors.

17. The Legislature did not approve that privatization proposal, as recommended, but instead developed language that would have required the Gaming Commission and the Secretaries of DOR and DOA to cooperatively develop an implementation plan for the privatization of lottery functions. The plan would have set forth procedures for the implementation of contracts and contract oversight mechanisms relating to sales administration, marketing, ticket warehousing, instant ticket data processing, telephone sales and ticket delivery and would have identified state position reductions associated with each privatization initiative. The plan would have been subject to approval by the Joint Committee on Finance under a 14-day passive review process.

18. Although these privatization implementation plan provisions were subsequently item vetoed, the Governor continued administrative efforts to eliminate state lottery staff and privatize certain lottery functions.

19. The Legislative Audit Bureau (LAB) released an evaluation of the state lottery in March, 1997, which concluded that "… since early 1995, administration of the Wisconsin lottery has been impaired by largely unsuccessful attempts to privatize … ." The audit also found that "[d]uring 1995 and 1996, when privatization was being planned and attempted, large numbers of staff left or were re-assigned to positions outside the lottery before their jobs were assumed by private firms… . As a result, certain basic lottery functions, including informing retailers about available products, providing retailers with support and guidance on marketing lottery products, and publicizing lottery winners, have been performed minimally or have not been performed at all." Subsequently, reported lottery sales figures for the 1995-97 biennium when privatization efforts being attempted appeared to confirm the audit's conclusions. Sales declined nearly 10% compared to the 1993-95 biennium.

20. The state lottery was transferred from the Gaming Commission to DOR at the end of the 1995-96 fiscal year. The LAB cited this transition as one factor contributing to the lottery's privatization difficulties, even though the agencies involved in the transition appeared to be receptive to the transition and the privatization effort.

21. Other contracting difficulties were identified as follows. First, the LAB noted that the time available for the development of contracts for the privatization of lottery functions was

only 11 months. The LAB concluded that this timeline was "a highly ambitious schedule for obtaining and implementing the new contracts, which eventually proved to be unrealistic." Second, the widespread expectation that all but a few lottery positions would be eliminated, resulted in extremely high vacancy rates prior to the implementation of the contracts. The LAB reported that in January, 1997, the lottery's vacancy rate was 63.5%.

22. Another lottery privatization initiative was proposed in the 2003-05 biennial budget bill. The Governor proposed authorizing the lottery division administrator to determine whether any lottery functions (other than financial auditing services and lottery-related procurements) should be performed by one or more persons under contract with DOA.

23. The Governor's intent was to evaluate "private-sector options for the state lottery retail trade and limiting the state's role to auditing and contract compliance." Further, if the evaluation concluded that the private sector could operate the lottery in a more cost-effective manner than the state, a private vendor was to be awarded a contract for the operation of the lottery. The Governor recommended the deletion of 94.5 SEG positions in 2004-05, indicating that the intent of the initiative was to contract out the entire operation of the lottery, with limited exceptions.

24. The Governor's privatization recommendation and the proposed deletion of 94.5 positions advanced in the 2003-05 biennial budget bill was deleted by the Finance Committee. The Committee developed an alternative approach providing that no contract could provide for the entire management or operation of the lottery by any private vendor unless the contract was first approved by the Finance Committee.

25. For any such approval to proceed DOR and DOA would have been required to jointly submit a lottery privatization evaluation to the Committee describing all of the following:

- What functions would be contracted.

- What management authority the vendor would have toward the state with respect to such issues as lottery advertising and prize payout levels.

- How a management or operations vendor would interact, if at all, with other lottery vendors.

- Whether management bids would require some form of profit-sharing and, if so, a description of the profit-sharing mechanism.

- A transition plan to assure the successful conversion of the lottery to new management.

26. The privatization evaluation plan would have been required to include a schedule for the phase-out of state positions and a rationale for the number and classification of state positions that would be retained. All of these alternative provisions developed by the Committee and passed by the Legislature were subsequently vetoed by the Governor.

27. The Committee's actions on the contracting initiative in the 2003-05 biennial budget reflected a concern that no planning for such a contracting venture had first been undertaken to insure that the proposal was a feasible one that could be implemented such that lottery operations would not be adversely affected. Again, the intent of the provision was to contract for virtually the entire operation of the lottery. The lack of planning and evaluation had been a major factor in the disruption to state lottery operations associated with contracting efforts in the mid- to late-1990s.

28. The Governor's current lottery privatization recommendation, which is more limited than the 2003-05 proposal, assumes that the private vendor contracts would be executed before the middle of the 2006-07 fiscal year so that 55.0 Lottery Division positions could be eliminated on January 1, 2007. The ability to assess: (a) the extent to which the implementation of one or more privatization contracts could be successfully achieved on such a timeline; (b) the appropriateness of the number of state positions that would be eliminated; or (c) the potential for any cost savings or lottery sales increases due to such contracting, is hampered by the fact that the Department has not developed evaluation and planning materials relating to possible contracting options.

29. The Department did not propose to contract additional lottery functions in its 2005-07 biennial budget request, nor did DOR's strategic planning documents, submitted with the budget request, include any description of projected plans to pursue additional contracting of lottery activities. As a result, DOR has not yet researched the potential feasibility, fiscal implications, timeline constraints, or transitional requirements of contracting these lottery functions.

30. Further, while the administration argues that the state lottery could be operated more cost-effectively with private vendors and result in higher sales, such results may not be forthcoming unless vendors are given a free hand to expand the lottery enterprise and share in the resulting profits. DOR officials indicate that the contract remuneration would likely be based on a percentage of sales, but it is not known at this time at what level these sales percentages might be set in order to accommodate the interests of a private firm.

31. Thus, a private management option for the lottery may require a reorientation of the state lottery to an enterprise that seeks to maximize profits. This approach may imply changes in the current restrictions on lottery operations. For example, a private vendor may wish to have greater flexibility with respect to advertising (which could raise constitutional questions) or be allowed to set maximum prize payout amounts (which would require statutory changes).

32. Given the absence of any research or assessment of contracting out additional lottery functions, it is difficult to draw any conclusions about the optimal number of positions that could be eliminated or the timing of any such reduction in staff. Providing for the elimination of 55.0 lottery positions prior to undertaking the prerequisite cost-benefit evaluations and transition planning could lead to a repeat of the staffing disruptions and negative sales impacts that were experienced in 1995 and 1996.

33. The issues described above were all matters of concern to the Finance Committee when a more extensive lottery privatization proposal was before it during 2003-05 budget

deliberations. Given that the current contracting proposal has not yet been developed in any detail, the Committee may want to require a formal review of the contracting plans once they have been developed.

34. Thus, one alternative would be to require DOR to submit to the Joint Committee on Finance a contracting plan, for approval under s. 13.10 of the statutes, that would include: (a) a specification of what lottery functions would be contracted; (b) what management authority the vendor would have relative to the state concerning, but not limited to issues relating to lottery advertising and prize payout levels; (c) a description of the terms of the contract relating to the basis on which private vendors would be paid; (d) a transition plan to assure the successful conversion of the lottery functions to private vendors; and (e) a schedule for phasing out state positions and a rationale for the number and classification of state positions that would be retained.

35. On the other hand, since the Department already has the authority under current law to contract out these additional lottery functions, the detailed planning and reporting requirements outline above may not needed in the present circumstances.

36. Whether the Committee requires further review or not, there does not appear to be any compelling reason to eliminate positions in advance of actually implementing contracts with one or more private vendors. The Committee may find it prudent to delay any position reductions until the Department has prepared for, and implemented, the contracting initiative.

37. If DOR were to undertake the contracting of additional lottery functions during the 2005-07 biennium under its current authority, the appropriate number of positions could be vacated as the orderly transition of lottery functions to private vendors occurred. These vacated positions would then be subject to elimination as a standard budget adjustment in the 2007-09 biennial budget.

Conflict-of-Interest Provisions

38. The recommended modifications to current law lottery conflict-of-interest provisions are intended to afford displaced state lottery workers the opportunity for employment with a private vendor that contracts to perform one or more lottery services previously undertaken by the state. The provisions also include the requirement that the vendor must offer employment to those state employees who performed those services and whose positions would be terminated.

39. While the Committee may approve these modified conflict-of-interest provisions in order to facilitate the hiring of terminated state workers, it could be argued that these modifications would not address a major issue facing such displaced lottery employees. Under these provisions, a displaced lottery employee could be offered a position with the private vendor, but there is no assurance that the wages or fringe benefits in the new position would be comparable to the employee's compensation in his or her current state position. The employment prospect could be available, but not necessarily attractive for many state employees. However, eliminating the two-year waiting period to take employment with a vendor may assist some displaced state workers to

continue employment with a private vendor.

40. It could also be argued that the provision in the bill requiring a vendor to offer employment to state lottery workers whose positions are terminated as a result of a contract could actually impede the contracting effort. While state employees may have good prospects for these private sector jobs, dictating to a prospective contractor the individuals that must be offered employment is unusual and could affect the ability of the prospective vendor to be responsive to any request for proposals or to offer the most cost-effective contract.

41. The Committee could choose to delete the provision requiring a vendor to offer employment to lottery employees whose positions were terminated as a result of the contract; but approve the remaining conflict-of-interest modifications, as follows: (a) the elimination of the two-year waiting period for the employment of a state employee by a private vendor; and (b) the associated provision providing that no lottery employee may discuss with a vendor who is attempting to obtain a major procurement contract with the state any matter relating to the future employment of the employee with the vendor, unless the discussion relates to employment for services that were performed by lottery employees before the contract is awarded, and the administrator provides prior written consent.

42. Since the conflict-of-interest provisions in current law are designed to protect against certain unethical behavior that potentially could occur between state employees and private vendors when contracts are pending or contemplated, an argument could be made that these protections should not be modified because additional private vendor contracts for current lottery functions are being contemplated. Based on this view, the Committee may wish to maintain current law and make no changes with respect to the lottery conflict-of-interest provisions.

ALTERNATIVES

A. Position Reductions

1. Approve the Governor's recommendation to delete 55.0 SEG positions in 2006-07 to reflect the administration's intent to contract with private vendors for the performance of certain lottery functions. Transfer salary, fringe benefit, and turnover reduction funding associated with the positions (totaling $1,443,700 SEG) to unalloted reserve in 2006-07.

2. Delete the provision to eliminate 55.0 SEG positions in 2006-07 to reflect the administration's intent to contract with private vendors for the performance of certain lottery functions. Delete the transfer of salary, fringe benefit, and turnover reduction funding associated with the positions (totaling $1,443,700 SEG) to unalloted reserve in 2006-07. [Under this alternative, the ability to contract for lottery functions performed by state employees continues to be available under current law provisions, and state position vacancies could be eliminated at a future date.]

Alternative A2	SEG
2006-07 POSITIONS (Change to Bill)	55.00

3. *[The following alternative may be adopted in addition to either alternative A1 or A2.]* For any contracting initiative in the 2005-07 biennium, require the Department of Revenue to submit to the Joint Committee on Finance a contracting plan, for approval under s. 13.10 of the statutes, that includes: (a) a specification of what lottery functions would be contracted; (b) what management authority the vendor would have relative to the state with respect to issues including, but not limited to, lottery advertising and prize payout levels; (c) a description of the terms of the contract relating to the basis on which private vendors would be paid; (d) a transition plan to assure the successful conversion of the lottery functions to private vendors; and (e) a schedule for phasing out state positions and a rationale for the number and classification of state positions that would be retained.

B. Conflict of Interest Provisions

1. *[The following alternative may be adopted in addition to either Alternative A1, A2, or A3.]* Approve the Governor's recommendation to modify existing lottery conflict-of-interest provisions to provide that: (a) an employee in the Lottery Division who terminates employment with the Department may be employed by a vendor at any time after his or her date of termination, if the Department has entered into a contract with the vendor, on or after the effective date of the biennial budget act, to perform lottery functions that were previously performed by the employee while employed in the Division; (b) no employee in the Division may discuss with a vendor who is attempting to obtain a major procurement contract with the state any matter relating to the future employment of the employee with the vendor, unless the discussion relates to employment for services that were performed by lottery employees before the effective date of this provision, and the administrator provides prior written consent; and (c) if a contract for a major procurement is for services that were performed by employees in the Division before the effective date of this provision, the contract may not be entered into unless the contract requires the vendor to offer employment to those employees in the Division who performed those services and whose positions were terminated on or after the effective date of this provision. The circumstances under (c) would first apply to major procurement contracts entered into on the effective date of the biennial budget act.

2. *[The following alternative may be adopted in addition to either Alternative A1, A2, or A3.]* Modify existing lottery conflict-of-interest provisions to provide that: (a) an employee in the Lottery Division who terminates employment with the Department may be employed by a vendor at any time after his or her date of termination, if the Department has entered into a contract with the vendor, on or after the effective date of the biennial budget act, to perform lottery functions that were previously performed by the employee while employed in the Division; and (b) no employee in the Division may discuss with a vendor who is attempting to obtain a major procurement contract with the state any matter relating to the future employment of the employee with the vendor, unless

the discussion relates to employment for services that were performed by lottery employees before the effective date of this provision, and the administrator provides prior written consent.

Delete the provision that if a contract for a major procurement is for services that were performed by employees in the Division before the effective date of this provision, the contract may not be entered into unless the contract requires the vendor to offer employment to those employees in the Division who performed those services and whose positions were terminated on or after the effective date of this provision and that this provision would first apply to major procurement contracts entered into on the effective date of the provision.

3. *[The following alternative may be adopted in addition to either Alternative A1, A2, or A3.]* Delete the Governor's conflict-of-interest provisions.

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