



**REPORT OF**

**THE**

**STATE AUDITOR**

**Colorado Lottery  
Department of Revenue**

**Performance Audit  
August 2008**

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Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Colorado Lottery. The audit was conducted pursuant to Section 24-35-218(1)(b)(II), C.R.S., which requires the State Auditor to conduct an analysis and evaluation of the Lottery at least once every five years. The report presents our findings, conclusions, and recommendations, and the responses of the Department of Revenue, Colorado Lottery, and Colorado Lottery Commission.

*Sally Symanski*

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# TABLE OF CONTENTS

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	PAGE
<b>Report Summary</b> .....	<b>1</b>
<b>Recommendation Locator</b> .....	<b>5</b>
<b>Description</b> .....	<b>11</b>
<b>FINDINGS AND RECOMMENDATIONS</b>	
<b>Chapter 1: Lottery Operations</b> .....	<b>19</b>
Wang Migration .....	<b>21</b>
Contract Management .....	<b>28</b>
Liquidated Damages .....	<b>34</b>
Internal Control System .....	<b>37</b>
Other Contract Monitoring .....	<b>38</b>
<b>Chapter 2: Fiscal Issues</b> .....	<b>43</b>
Prize Structure .....	<b>45</b>
Retailer Compensation .....	<b>49</b>
Scratch Ticket Management .....	<b>52</b>
Controls Over Assets .....	<b>54</b>
Sales Promotions .....	<b>58</b>
<b>Chapter 3: Lottery Administration</b> .....	<b>61</b>
Role of the Lottery Commission .....	<b>61</b>
Scratch Game Rulemaking .....	<b>65</b>
Background Investigations .....	<b>68</b>
Retailer Licensing Fees .....	<b>70</b>
Lawful Presence .....	<b>72</b>
Player Demographics .....	<b>75</b>
<b>APPENDIX A</b> .....	<b>A-1</b>
<b>APPENDIX B</b> .....	<b>B-1</b>
<b>APPENDIX C</b> .....	<b>C-1</b>



**Colorado Lottery  
Department of Revenue  
Performance Audit  
August 2008**

**Authority, Purpose, and Scope**

This performance audit was conducted pursuant to Section 24-35-218(1)(b)(II), C.R.S., which requires the State Auditor to conduct an analysis and evaluation of the Colorado Lottery (Lottery) at least once every five years. The audit work, performed from December 2007 to August 2008, was conducted in accordance with generally accepted government auditing standards. Our audit reviewed the Lottery's operations, including its contract management practices, controls over revenue and expenses, and administrative activities. Our audit also evaluated the Lottery Commission's (Commission's) role in overseeing the Lottery. In addition, our audit reviewed the Lottery's implementation of prior audit recommendations identified in our *2003 Colorado Lottery Performance Audit*. We acknowledge the assistance and cooperation provided by the Lottery, Department of Revenue (Department), and Lottery Commission in completing this audit.

**Overview**

In 1980 Colorado voters passed a referendum that added Article XVIII, Section 2(1) to the Colorado Constitution, allowing the establishment of a state-supervised lottery. Senate Bill 82-119 created the Colorado Lottery as a division within the Department of Revenue and established the Lottery Commission, which is statutorily authorized [Section 24-35-208, C.R.S.] to govern certain aspects of the Lottery, including promulgating rules for Lottery games and operations. The Lottery generates revenue primarily through the sale of scratch and jackpot lottery tickets at 2,900 retailers across the State. In Fiscal Year 2007 the Lottery recorded about \$456 million in ticket sales. This consisted of about \$297 million in scratch ticket sales for approximately 44 different scratch ticket games and about \$159 million in jackpot ticket sales for the Powerball, Lotto, and Cash 5 jackpot games.

Lottery proceeds are distributed on a quarterly basis to other state entities as directed by the Colorado Constitution. Currently, the Constitution directs that 10 percent of Lottery proceeds be distributed to the Division of Parks and Outdoor Recreation, 40 percent to the Colorado Conservation Trust Fund, and 50 percent to the Great Outdoors Colorado Trust Fund (GOCO). The GOCO distribution is capped at \$35 million, to be adjusted each year for inflation from the 1992 Consumer Price Index of Denver. Through Fiscal Year 2007 proceeds in excess of the GOCO cap were distributed to the State Public School Fund Contingency Reserve; as of Fiscal Year 2008 excess funds are distributed to the Lottery Proceeds Contingency Reserve Fund. In Fiscal Year 2007 the Lottery directed \$119 million in proceeds to these beneficiary agencies. Since the Lottery first began selling tickets in 1983, the Lottery has distributed about \$1.9 billion to its beneficiary agencies.

## Summary of Key Findings

### Lottery Operations

A significant portion of the Lottery's operations are performed through contracts with outside vendors. Altogether, the Lottery expended about \$17.6 million in Fiscal Year 2007 for contract services related to its gaming system, scratch ticket production and delivery, advertising, and IT maintenance. We reviewed the Department's and the Lottery's management of contracts that are vital to the Lottery's operations and systems and identified the following issues:

- **Wang migration.** We found that 12 years after first indicating its intention to implement a new back office system, the Lottery has made little progress in moving back office functions off the Wang computer system. As of our audit, only one of the Lottery's six most critical back office functions had been moved off the Wang. The Lottery's continued use of the Wang system, the foundation of which is more than 25 years old, puts the State at risk of suffering substantial disruption in the Lottery's ability to perform basic functions, such as billing retailers in a timely manner for millions of dollars in revenue from ticket sales, should the system fail and the maintenance vendor be unable to repair the system.
- **Scientific Games contract management.** We found that neither the Department nor the Lottery has identified the lines of authority and responsibility for overseeing the Scientific Games contract or clearly defined and communicated to Scientific Games performance expectations related to the contract. In addition, the Lottery has not effectively used the assessment of liquidated damages to address contractor performance problems. As a result, during the five years since the contract was executed, neither the Department nor the Lottery has held Scientific Games accountable for complying with the terms of the contract, and it is questionable whether the State has received full value for the \$22 million spent on the contract as of June 30, 2008.
- **Other contract monitoring.** Overall, we found: (1) the Lottery has not always assigned a dedicated contract monitor for all of its contracts; (2) the Lottery's contract administration files are incomplete because contract information is scattered among multiple Lottery and Department staff; (3) senior management at both the Lottery and the Department do not always communicate contract-related decisions to the assigned contract monitors and relevant program staff; and (4) for one contract, staff approved payments without information on the Lottery's agreement with the contractor on specific pricing arrangements.

### Fiscal Issues

We reviewed fiscal issues related to the Lottery and identified several areas where the Lottery may be able to reduce expenses and thus, increase the amount of funds available for distribution to beneficiary agencies:

- **Prize structure.** We found the Lottery pays a greater percentage of its ticket sales as prizes than other comparable state lotteries. In Fiscal Year 2007 the Lottery paid out 61 percent of total sales, or approximately \$280 million, in total prizes for all of its jackpot and scratch ticket games. By comparison, the Minnesota and Wisconsin Lotteries paid 59 percent of total sales in prizes, and the Arizona Lottery paid 56 percent.
- **Retailer compensation.** In Fiscal Year 2006 the Lottery paid 7.4 percent of total ticket sales in retailer compensation (commissions plus bonuses), compared with the national average of 6 percent and the median rate of 6.3 percent. The Lottery's average commission rate of 6.5 percent is also higher than the national average commission rate of 5.7 percent. If the Lottery had applied the national average commission rate, the Lottery would have saved about \$4.3 million in retailer compensation expense in Fiscal Year 2006, and these funds would have been available to beneficiary agencies.

### Lottery Administration

We evaluated the administration of the Lottery and identified several issues, including the following:

- **Role of the Lottery Commission.** We found that the role and responsibilities of the Lottery Commission have not been clearly defined and communicated to Commission members since the Commission was reclassified from a Type 1 to a Type 2 commission in 2004. With the reclassification, the Commission's authority is limited to promulgating rules and providing advice and input on the administration of the Lottery. Neither the Lottery nor the Commission has established a charter or bylaws to clarify the Commission's role or sought to update conflicting statutes and rules to reflect the change in the Commission's authority.
- **Scratch game rulemaking.** The rulemaking process for 12 scratch ticket games we reviewed took between 91 and 114 days. The length of the process makes it difficult for the Lottery to respond quickly to market demands, which can result in lost revenue for the Lottery and reduce the amount of proceeds for beneficiary agencies.
- **Background investigations.** We found that since 2004 the Lottery has not complied with statutory requirements [Section 24-35-204(3)(c), C.R.S.] to conduct full criminal background investigations on Lottery employees, employees of Lottery contractors, Lottery Commission members, and officers of licensed retailers. Also, we found the Lottery has not been consistent in conducting follow-up investigations on employees, vendor employees, or Commission members since 2004.

Our recommendations and the responses from the Department of Revenue, Colorado Lottery, and Lottery Commission can be found in the Recommendation Locator and in the body of the report.

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	25	Migrate off the Wang system and fully implement a new back office system as soon as possible by: (a) using the results of the business process review to develop and implement a Wang migration plan; (b) clearly documenting the role Scientific Games is to play in the migration; and (c) establishing an organizational structure with appropriate levels of authority to oversee the planning and migration processes.	Colorado Lottery	Agree	a. Implemented b. April 2009 c. Implemented
2	32	Improve management of the Scientific Games gaming system contract by: (a) establishing clear lines of authority and responsibility for overseeing the contract and (b) developing a plan for resolving all outstanding performance issues, modifying the contract as necessary to clearly reflect current performance expectations, and setting deadlines for meeting those expectations.	Department of Revenue  Colorado Lottery	Agree  Agree	a. Implemented b. June 2009  a. Implemented b. June 2009/ Ongoing
3	36	Ensure the effectiveness of liquidated damages as a remedy for nonperformance by: (a) assessing liquidated damages in a timely manner and (b) evaluating whether liquidated damages should be assessed against Scientific Games as a result of not providing required data reports in December 2007 and January 2008 and, if so, assessing the appropriate amounts.	Colorado Lottery	Agree	Implemented
4	38	Ensure the independence of the Lottery's Internal Control System by managing the system internally or contracting directly with the vendor that provides the system.	Colorado Lottery	Agree	July 2009

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
5	41	Improve contract monitoring practices for all contracts by: (a) developing contract monitoring procedures that assign dedicated contract monitors; outline standard processes and expectations for staff who manage Lottery contracts, including what documentation should be maintained in contract administration files; address communications regarding contract-related decisions; and ensure contract monitors are familiar with pricing agreements and review and approve vendor payments; (b) providing contract management training to Lottery staff responsible for monitoring contracts; and (c) evaluating whether the role of the contract manager position adds value to the Lottery's procurement and contracting processes and, if necessary, clarifying the position's responsibilities in relation to staff contract monitors and determining how to more effectively integrate the contract manager position into the contract management process.	Colorado Lottery	Agree	December 2008
6	48	Maximize the amount of revenue available to beneficiary agencies by evaluating the prize structures on all jackpot and scratch ticket games on a regular basis to determine if adjustments should be made. This evaluation should include studies of prize payout modifications to determine the effect changes have on sales and revenue and review of other states' data. The Lottery should use this information when designing games and prize structures.	Colorado Lottery	Agree	January 2009
7	51	Consider cost-saving opportunities related to the Lottery's retailer compensation plan by evaluating the potential effect of lowering commission rates to better align with national averages and determining the impact on the retailer base and on Lottery net proceeds, taking action as appropriate.	Colorado Lottery	Agree	October 2009

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
8	54	Incorporate opportunities for reducing administrative expenses when evaluating options for the Lottery's new scratch ticket distribution and inventory management system. Opportunities that should be explored include reductions and reallocations in its fleet, warehouses, and staff.	Colorado Lottery	Agree	July 2010
9	57	Improve methods for safeguarding and accounting for state assets by: (a) ensuring all ticket counter employees follow the established warrant procedure, including storing blank warrants in a locked safe until needed; (b) installing at all four Lottery ticket offices cash registers with the capability to lock in-between transactions and record scratch ticket sales; (c) developing and implementing standard procedures for conducting audits and communicating findings, and ensuring that all staff conducting audits follow the established procedures; and (d) requiring vendors to check out state-owned video equipment for specific projects and return it to the Lottery at the end of those projects.	Colorado Lottery	Agree	a. Implemented b. Implemented c. September 2008 d. Implemented
10	59	Develop effective and efficient processes for analyzing and evaluating different types of sales promotions and deciding the types and frequency of promotions to be held in the future. These should include capturing and analyzing information about the financial and nonfinancial returns generated from conducting the promotions.	Colorado Lottery	Agree	July 2009

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
11	64	Ensure that the role and responsibilities of the Lottery Commission are clearly defined by: (a) developing and adopting a charter or governance manual that outlines the organizational and decision-making responsibilities and boundaries of the Commission and the Lottery; (b) reevaluating the new Commission member orientation and expanding the scope to include information on the Commission's role and responsibilities, including how the rulemaking process works; (c) reviewing current statutory language regarding the Commission's authority to identify outdated provisions and working with the General Assembly to make necessary statutory changes; and (d) reviewing and revising Lottery rules to ensure they are consistent with the Commission's current authority as a Type 2 entity.	Colorado Lottery  Colorado Lottery Commission	Agree  Agree	a. January 2009 b. January 2009 c. July 2009 d. October 2009
12	67	Evaluate options to improve the timeliness of the scratch ticket game approval and rulemaking process. Options considered should include: (a) identifying ways to shorten the internal portion of the rulemaking process, and (b) working with the General Assembly to seek statutory change to eliminate the rulemaking requirement for individual scratch ticket games and/or for ticket reorders on existing games.	Colorado Lottery  Colorado Lottery Commission	Agree  Agree	a. December 2008 b. July 2009  July 2009
13	69	Comply with statutes and ensure the background investigation process adequately protects the security and integrity of the Lottery by: (a) developing and implementing standard background investigation policies that address who should receive a background investigation, how investigations should be conducted, how the results of investigations should be used, and when follow-up investigations should occur, and (b) completing background investigations on all Lottery Commission members and fiscal and IT staff appointed or hired since 2004 who have not had a documented background investigation completed, and taking action as needed.	Colorado Lottery	Agree	a. October 2008 b. September 2008

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
14	71	Ensure retailer licensing fees reflect the actual cost of background investigations by: (a) developing and implementing a mechanism for tracking the number of retailers licensed each year requiring a background investigation and assessing the cost of the retailer licensing background investigation process, and (b) revising the licensing fee as needed to ensure it covers the actual cost of the initial background investigation and all subsequent checks.	Colorado Lottery	Agree	a. Implemented b. July 2009
15	75	Seek an Attorney General's opinion to determine whether House Bill 06S-1023 and the Secure and Verifiable Identity Document Act apply to the Lottery, specifically with respect to retailer licensing and redeeming winning lottery tickets, implementing procedures to comply as necessary.	Colorado Lottery	Agree	Request to be submitted by October 2008
16	78	Establish data collection standards and direct Lottery contractors to use these standards when conducting the annual tracking study.	Colorado Lottery	Agree	January 2009

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# Description of the Colorado Lottery

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## Background

Colorado voters passed a referendum in 1980 that added Article XVIII, Section 2(1) to the Colorado Constitution, which allows the establishment of a state-supervised lottery. Proceeds from the lottery were to be used for parks, recreation, and other state projects deemed necessary by the General Assembly. In 1982 the Colorado Lottery (Lottery) was created as a division within the Department of Revenue (Department) through the passage of Senate Bill 82-119. The Bill also established the Lottery Commission (Commission) to help govern the Lottery. The Lottery began operation in July 1982 and sold its first ticket in January 1983. The Lottery is considered a cash-funded enterprise for budget and TABOR purposes.

## Lottery Games and Sales

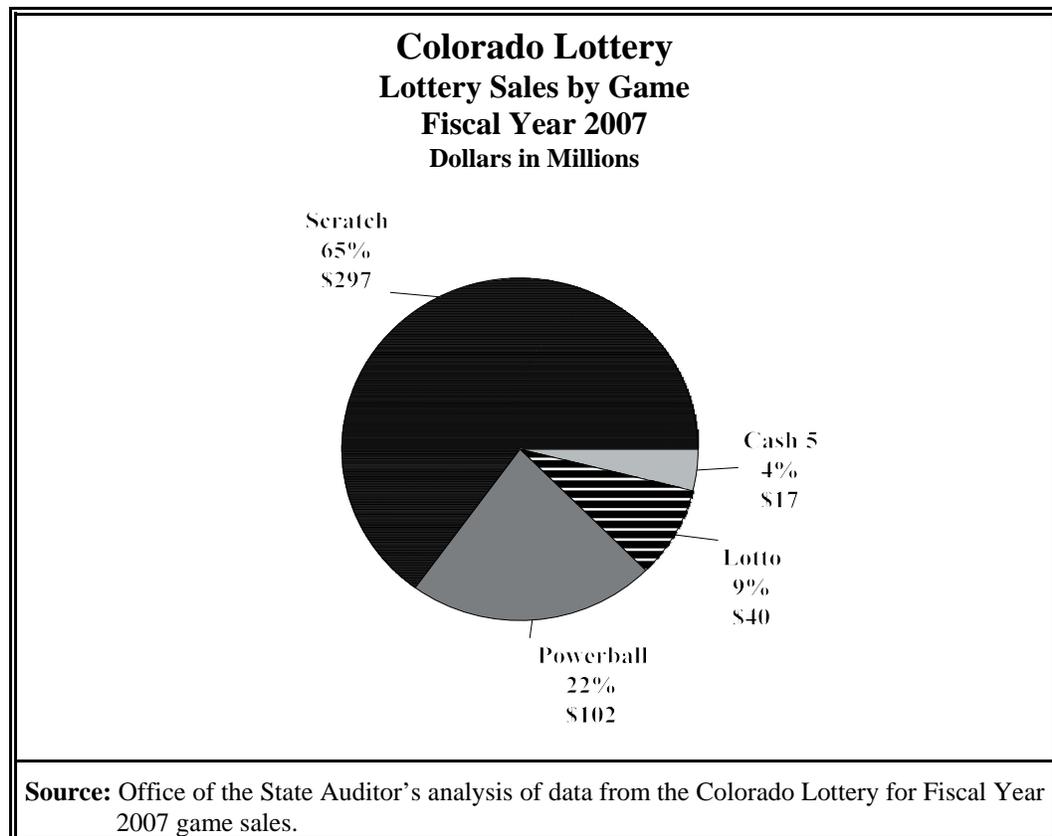
The Lottery generates revenue primarily through lottery ticket sales. For its first six years in operation, the Lottery's only product was scratch ticket games. Since that time, the Lottery has expanded the number of scratch ticket games offered at one time and has introduced three jackpot games. The Lottery's current games include:

- **Scratch.** Players scratch the surface of a ticket to instantly determine if the ticket has a winning combination based on the type of game. Over its 25-year history, the Lottery has offered more than 400 different scratch ticket games. Currently, the Lottery offers approximately 30 different scratch games at any given time. Prices for scratch games range from \$1 to \$20 per ticket and prize amounts range from \$1 to \$1 million. In Fiscal Year 2007 the Lottery offered 44 different scratch ticket games, which generated about \$297 million in sales.
- **Powerball.** Powerball is a jackpot game in which players attempt to match 5 out of 55 numbers and 1 "Powerball" number between 1 and 42. The game is offered by 30 state lotteries collectively, including Colorado. Powerball has a minimum jackpot of \$15 million, which increases in value with each drawing until someone wins the jackpot. Powerball drawings are held twice a week. In Fiscal Year 2007 Powerball sales accounted for about \$102 million in revenue.
- **Lotto.** Lotto is a jackpot game in which players attempt to match 6 out of 42 numbers. Lotto has a minimum jackpot of \$1 million, which increases in value with each drawing until someone wins the jackpot. Lotto drawings are

held twice a week. In Fiscal Year 2007 Lotto sales generated approximately \$40 million in revenue.

- **Cash 5.** Cash 5 is a fixed jackpot game, which means the jackpot is set at \$20,000 for each drawing. Cash 5 drawings are held six times a week. In Fiscal Year 2007 Cash 5 sales accounted for about \$17 million in revenue.

In Fiscal Year 2007 the Lottery recorded about \$456 million in ticket sales. This is a 233 percent increase from Fiscal Year 1983, the Lottery's first year of operation, when ticket sales totaled about \$137 million. The following chart shows the breakout of Fiscal Year 2007 sales by game.



The Lottery sells its games at approximately 2,900 retailers statewide. Retailers include grocery stores, convenience stores, gas stations, and various other businesses. In Fiscal Year 2007 these retailers included the following:

- 1,602 convenience stores
- 512 liquor stores
- 427 grocery stores
- 83 tobacco/cigarette stores
- 58 bars and restaurants

- 196 other locations (e.g., grocery fuel centers, truck stops, and casinos/racetracks)

## **Lottery Expenses**

In Fiscal Year 2007 the Lottery's expenses totaled \$339.7 million and included the following:

- Prize expenses of about \$280 million.
- Retailer compensation of about \$33.7 million.
- Administrative expenses of about \$29.1 million, including \$8.1 million for ticket production and vendor fees, \$8.9 million for marketing and communication expenses, and \$8.6 million for wages and benefits. Other administrative expenses totaled about \$3.5 million and included items such as motor pool leasing, online telecommunications, travel, equipment, and materials and supplies.
- Powerball prize variance credit of about \$3.1 million.

The Lottery's expenses are discussed in more detail in Chapter 2.

## **Lottery Proceeds**

The Lottery's mission is to maximize revenue generated to support its beneficiary agencies. When the Lottery was first created in 1982, statute directed that 50 percent of Lottery proceeds be distributed to the State Capital Construction Fund, 40 percent to the Conservation Trust Fund, and 10 percent to the Division of Parks and Outdoor Recreation. Over the years, Colorado voters and the General Assembly have approved changes to the distribution formula for Lottery proceeds. In 1988 the General Assembly amended statute [Section 24-35-210, C.R.S.] to cap distributions to the Conservation Trust Fund and the Division of Parks and Outdoor Recreation at specified dollar amounts, with excess funds going to the State Capital Construction Fund.

In November 1992 Colorado voters approved an initiative that added Article XXVII to the Colorado Constitution, which created the Great Outdoors Colorado Trust Fund (GOCO) to preserve, protect, enhance, and manage the State's wildlife, park, river, trail, and open space heritage. Article XXVII, Section 3 directed that for each year through Fiscal Year 1998, 40 percent of Lottery proceeds be distributed to the Colorado Conservation Trust Fund, 10 percent to the Division of Parks and Outdoor

Recreation, and additional amounts to the State's Capital Construction Fund for specified payments of debt service on existing projects until November 30, 1998. Any proceeds remaining after the debt service payments were to be distributed to GOCO. For Fiscal Year 1999 and subsequent years, Article XXVII, Section 3 directed that 40 percent of Lottery proceeds be distributed to the Colorado Conservation Trust Fund, 10 percent to the Division of Parks and Outdoor Recreation, and remaining moneys up to \$35 million (adjusted for inflation from 1992 levels) to GOCO. Any excess proceeds were to be allocated to the General Fund.

In 2000 voters passed Referendum E, which required that excess Lottery proceeds (after distributions were made to the Colorado Conservation Trust Fund, the Division of Parks and Outdoor Recreation, and GOCO) go to the State Public School Fund Contingency Reserve rather than the General Fund, as discussed below.

Pursuant to the State Constitution, in Fiscal Year 2007 the Lottery directed \$119 million in net proceeds (net proceeds equal total revenue minus prizes and expenses) to the following beneficiary agencies:

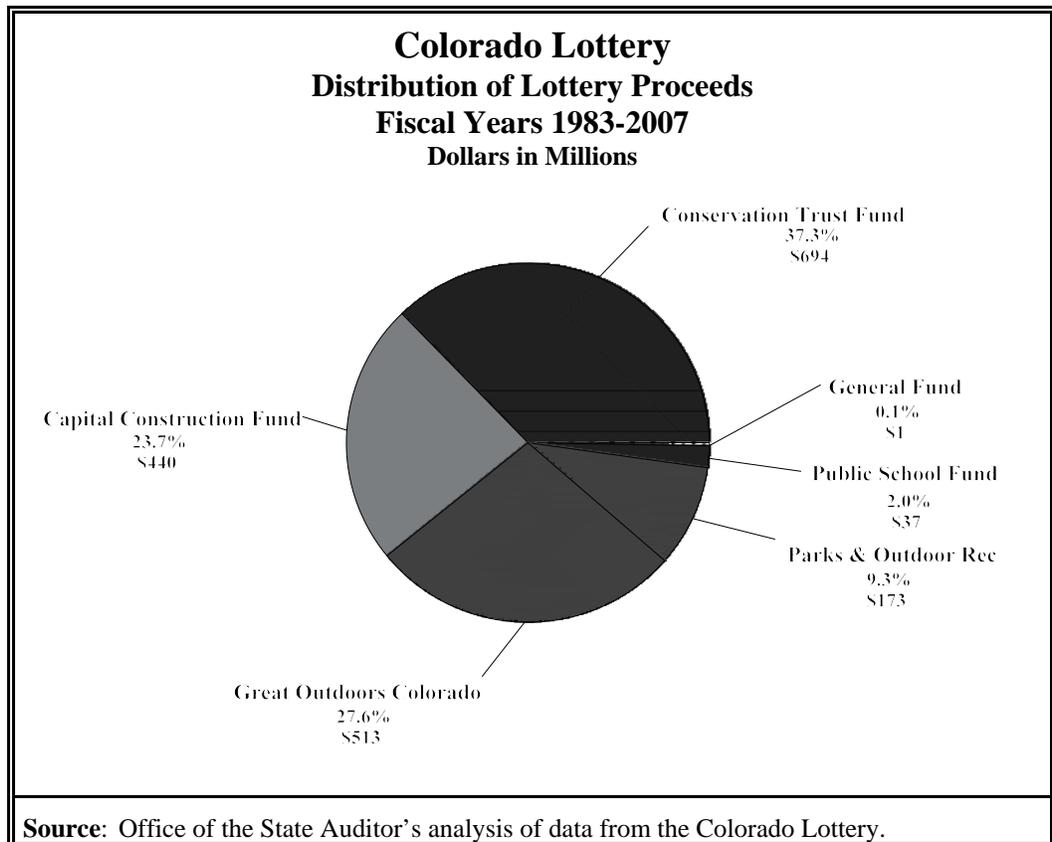
- **GOCO.** GOCO receives 50 percent of the Lottery's proceeds; however, this distribution is capped at \$35 million annually, adjusted for inflation from the 1992 Consumer Price Index of Denver. As discussed above, GOCO funds are to be used for the State's wildlife, park, river, trail, and open space heritage. Since Fiscal Year 2002 the Constitution has directed the Lottery to distribute any amounts in excess of this cap to the State Public School Fund Contingency Reserve, which we discuss below. Prior to Fiscal Year 2002 funds in excess of the cap were distributed to the State General Fund. In Fiscal Year 2007 GOCO received \$51 million in Lottery proceeds, the maximum amount allowable under the Constitution.
- **Colorado Conservation Trust Fund.** The Colorado Conservation Trust Fund is administered within the Department of Local Affairs and receives 40 percent of Lottery proceeds. Colorado Conservation Trust Fund dollars are distributed to more than 450 eligible local governments, including counties, cities, towns, and Title 32 special districts that provide public park and recreation services. In Fiscal Year 2007 the Colorado Conservation Trust Fund received \$48 million in Lottery proceeds.
- **Colorado Division of Parks and Outdoor Recreation.** The Division, which is within the Department of Natural Resources, receives 10 percent of Lottery proceeds. The Division is to use Lottery moneys for trail construction and maintenance, land acquisition, equipment and facility

purchases, and maintenance of state parks facilities. In Fiscal Year 2007 the Division received \$12 million in Lottery proceeds.

- State Public School Fund Contingency Reserve.** In years when Lottery proceeds dedicated to GOCO exceed the constitutional limit of \$35 million (adjusted for inflation from 1992 levels), the spillover is paid to the State Public School Fund Contingency Reserve. The Fund is administered by the Colorado Department of Education and dedicated to improving school health and safety. In Fiscal Year 2007 more than \$8 million in proceeds was distributed to the State Public School Fund Contingency Reserve.

During the 2007 Legislative Session the General Assembly passed House Bill 07-1237, which created the Lottery Proceeds Contingency Reserve Fund. This Bill requires that beginning in Fiscal Year 2008 all proceeds exceeding the GOCO cap be distributed to the Lottery Proceeds Contingency Reserve Fund, to be used for improving the health and safety of public school facilities, rather than to the State Public School Fund Contingency Reserve.

Since it began selling tickets in 1983, the Lottery has distributed about \$1.9 billion to its beneficiaries. The following chart shows the breakout of how these proceeds have been distributed since that time.



## Organization and Budget

The Lottery is headquartered in Pueblo with satellite offices in Denver, Fort Collins, and Grand Junction. In Fiscal Year 2008 the Lottery was appropriated about \$382 million in cash funds and 126 FTE. The Colorado Lottery is organized into several sections, as described below.

The **fiscal** section includes accounting, budgeting, purchasing, and policy and planning. In addition, the fiscal section is responsible for all retailer billing, reconciliations of daily ticket transactions, and financial transfers to Lottery beneficiaries.

The **security** section helps maintain the integrity of Lottery scratch and jackpot games by conducting the following activities:

- Overseeing the Lottery's warehouses, where scratch tickets and promotional inventory are stored.
- Supervising the receipt of scratch tickets after they are produced and the distribution of scratch tickets to the Lottery's 2,900 retailers statewide.
- Supervising the receipt of Lottery gaming terminals from the manufacturer and their distribution to retailers.
- Investigating suspicious incidents to help prevent game fraud.
- Conducting drawings for the Lottery's Lotto and Cash 5 jackpot games, which use an automated drawing machine.
- Issuing licenses to retailers to sell Lottery tickets.
- Performing background investigations of licensed retailers, Lottery and vendor employees, and Lottery Commission members.

The **marketing, sales, and communications** section is responsible for product and point-of-sale advertising, consumer research, public and media relations, delivery of scratch tickets, retailer staff training, and new retailer recruitment.

The **information technology** section is responsible for maintaining all of the Lottery's internal systems, including the Wang and Oracle platforms.

The **operations** section is responsible for operating the ticket counters and customer reception at the Lottery's four offices. In addition, the operations section oversees the Project Management Office, which is responsible for the Lottery's computer system software design, development, testing, and implementation.

The **administration** section includes Lottery's executive leadership and senior administrative staff, including the Lottery Director, Deputy Director, Chief Operating Officer, program assistant, and jackpot drawing manager. The executive

leadership team's responsibilities include managing Lottery operations and overseeing the Lottery's contracts.

## **Lottery Commission**

The Lottery Commission is composed of five members appointed by the Governor and confirmed by the State Senate. According to statute [Section 24-35-207, C.R.S.], the Commission must include at least one certified public accountant, at least one attorney, and at least one law enforcement officer; no more than three members can belong to the same political party. Members serve four-year terms with a maximum of two terms. The Commission is statutorily authorized [Section 24-35-208, C.R.S.] to govern certain aspects of the Lottery's operations, which include:

- Promulgating rules related to Lottery games and operations.
- Determining the need for changes in statutes or rules related to the Lottery's administration.
- Conducting hearings related to complaints of possible violations of Lottery rules.
- Assisting in the process of negotiating agreements regarding the Lottery's participation in multi-state lottery games (i.e., Powerball).

## **Scope and Methodology**

This report includes the results of our audit of the Colorado Lottery and the Lottery Commission. Statute [Section 24-35-218(1)(b)(II), C.R.S.] requires the State Auditor to conduct an analysis and evaluation of the Lottery at least every five years. Our last performance audit of the Lottery was released in 2003. In accordance with statute, our audit reviewed:

- Contractor compliance with Lottery contracts.
- The amount of revenue generated by the Lottery for its beneficiaries.
- The administrative and other expenses of Lottery dollar collections as compared with revenue derived.
- The effectiveness of the Lottery's complaint, investigation, and disciplinary procedures.
- The socioeconomic profile of the Lottery player population and any changes in that population.
- Whether statutory changes are necessary to improve the Lottery's operations.
- Whether the Lottery performs its statutory duties efficiently and effectively.

We identified issues in all of these areas related to the Lottery's operations, including contracts and contract management practices, as discussed in Chapter 1; revenue and

expenses, as discussed in Chapter 2; and administration, including background investigations and player demographics, as discussed in Chapter 3. Throughout this report we discuss the efficiency and effectiveness of the Lottery's performance and identify several areas where statutory changes may be necessary.

Further, in accordance with statute our audit reviewed the following areas of Lottery operations. In these areas, on the basis of the work we performed, nothing came to our attention to indicate lack of compliance with state laws or other concerns.

- **Gifts and gratuities received by Lottery employees and Commission members.** Statute [Section 24-35-209, C.R.S.] prohibits Lottery employees and Commission members from receiving any gifts or gratuities from individuals and businesses working with the Lottery. During our audit, we reviewed statutes, rules, and Lottery policies related to employees' and Commissioners' acceptance of gifts and gratuities; interviewed staff and Commissioners to determine whether anyone had received or been offered gifts or gratuities; and requested written confirmation from current and former Lottery contractors and interviewed retailers to determine whether they had offered any Lottery staff or Commissioners gifts or gratuities. We found that Lottery staff and Commission members appear to have complied with the statutory prohibition on acceptance of gifts and gratuities.
- **The Lottery Commission's effectiveness at encouraging public participation in its decisions.** We reviewed Commission meeting minutes and notices, observed a monthly Commission meeting, and interviewed Commission members and Lottery staff. We found that the Commission has effectively encouraged public participation in its proceedings.
- **Trends in organized crime related to gambling in Colorado.** We analyzed data from Calendar Years 2004 through 2007 on organized crime related to gambling in Colorado and interviewed Colorado law enforcement staff. We did not identify any correlation between the growth of the Lottery and increases in organized crime related to gambling in the State.

During the audit, we analyzed Lottery data; reviewed statutes, rules, and Lottery policies and procedures; and interviewed Department of Revenue and Lottery staff, Commission members, contractors, and retailers. We also surveyed each of the Lottery's beneficiary agencies and three other state lotteries (Arizona, Minnesota, and Wisconsin), which are similar to Colorado with respect to overall ticket sales and the types of games offered, to gain insight about their practices related to administrative costs, background investigations, retailer compensation, and prize structures.

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# Lottery Operations

## Chapter 1

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### Background

The Colorado Lottery (Lottery) sells scratch and jackpot tickets at 2,900 licensed retailers and at four Lottery offices statewide. Scratch tickets are sold at retailer counters as well as through vending machines in stores. Jackpot games, which include Lotto, Cash 5, and Powerball, are sold through electronic gaming terminals located at retailer counters. In Fiscal Year 2007 the Lottery sold \$297 million in scratch tickets and \$159 million in jackpot tickets, for a total of \$456 million in ticket sales.

A significant portion of the Lottery's operations are performed through contracts with outside vendors. The Lottery contracts with outside vendors for gaming terminals and related services, ticket production services, and other professional services such as multimedia advertising. Gaming terminals are the computer systems that retailers use to process jackpot ticket sales and to redeem winning jackpot and scratch tickets. These terminals are connected through a central gaming system, which is a centralized software system that processes all Lottery ticket transactions, records sales and inventory data, and provides the network linking the Lottery to all 2,900 retailers. The gaming system and the gaming terminals are critical to the Lottery's operations because they are needed to sell and redeem Lottery tickets. The Lottery's six largest contracts—for services related to the gaming system, scratch ticket production and delivery, advertising, and IT maintenance—represent an overall total contract value of \$111.8 million over the life of the contracts. These contracts range from one year to nine years in length, with several contracts having options for one- or two-year extensions. As shown in the following table, Fiscal Year 2007 expenses for the Lottery's six largest contracts totaled about \$17.6 million, which is 60 percent of administrative costs.

<b>Colorado Lottery Expenses for Major Contracts Fiscal Year 2007</b>		
<b>Contractor</b>	<b>Service Provided</b>	<b>Fiscal Year 2007 Expense</b>
Scientific Games International	Gaming System and Jackpot Games <sup>1</sup>	\$6,752,000
	Scratch Ticket Game Development and Production	\$1,278,000
<b>Subtotal for Scientific Games International</b>		<b>\$8,030,000</b>
Karsh & Hagan	Advertising	\$8,368,000
Oberthur Gaming Technologies	Specialized Scratch Ticket Game Development and Production <sup>2</sup>	\$816,000
United Parcel Service	Scratch Ticket Delivery	\$178,000
Getronics/Wang	IT Maintenance and Disaster Recovery	\$167,000
<b>TOTAL</b>		<b>\$17,559,000</b>
<p><b>Source:</b> Office of the State Auditor's analysis of Colorado Lottery expense data for six largest operations-related contracts.</p> <p><sup>1</sup> In addition to providing the Lottery's gaming terminals and central gaming system, Scientific Games provides the technology and supplies, such as paper for printing tickets, that are necessary for the Lottery to sell tickets for its jackpot games.</p> <p><sup>2</sup> Specialized scratch tickets require special designs, inks, and other unique printing capabilities.</p>		

The Lottery's largest contract with Scientific Games, for services related to the Lottery's gaming system and jackpot games, is a nine-year, \$58.1 million contract that began in 2003 and expires in 2012. The Lottery has the option of extending the contract for an additional two-year period. If exercised, the option would bring the total contract value up to \$70.6 million. In addition, the Lottery has a contract with Scientific Games for scratch ticket game development and production services. This contract is a two-year, \$8.1 million contract with an optional renewal period. During Fiscal Year 2008, Scientific Games acquired Oberthur, a vendor that provides specialized scratch tickets and assumed Oberthur's contract with the Lottery. This contract was originally a two-year, \$5.7 million contract with three optional one-year renewal periods. Fiscal Year 2007 was the last year of the Lottery's contract with Karsh & Hagan for advertising services. During Fiscal Year 2008 the Lottery entered into a three-year, \$25.1 million contract with Cactus Marketing Communications for advertising and marketing services.

As required under statute [Section 24-35-218, C.R.S.], our audit evaluated whether the Lottery performs its statutory duties efficiently and effectively and whether the Lottery's contractors comply with the terms of Lottery contracts. Specifically, we reviewed the Lottery's management of systems that are vital to its operation. This included evaluating the Lottery's progress in migrating off of its legacy computer system, the Wang system, which has been a foundation of Lottery operations since the Lottery began in 1982; the Lottery's management of its contract with Scientific Games for services related to its gaming system; and the Lottery's overall contract management practices. We identified significant issues related to how the Lottery has managed efforts to migrate off the Wang computer system and its management of contracts, and in particular the Scientific Games contract for the gaming system, as discussed throughout this chapter.

## Wang Migration

Since its inception in 1982, the Lottery has used a Wang computer system to manage accounting and administrative support functions that are critical to operating the State's Lottery. These functions, generally referred to as back office functions, include the following (shown with Fiscal Year 2007 volume):

- Processing retailer billings related to total ticket sales of \$456 million (scratch ticket sales of \$297 million and jackpot ticket sales of \$159 million) and total ticket redemptions of \$280 million.
- Managing an inventory of 107 million scratch tickets printed during the year.
- Calculating and tracking \$207,000 in bonuses earned by Lottery sales representatives during the year.
- Tracking 230 marketing and sales events that occurred during the year.
- Managing \$105,000 worth of promotional inventory used during the year.
- Reconciling daily cash transactions involving ticket sales and redemptions at the Lottery's four ticket office counters.

Ticket sales and redemption transactions are initially recorded on the gaming system provided by Scientific Games. These data are then transmitted to the Wang system and used by Lottery staff to perform accounting functions, which include recording revenue and expense data that are uploaded to the State's central accounting system.

We determined that the Lottery's continued use of the Wang puts the State at risk of suffering substantial disruption in the Lottery's ability to perform basic functions, such as billing retailers in a timely manner for millions of dollars in revenue from ticket sales, should the Wang system fail and the maintenance vendor be unable to repair the system. The foundation of the Wang system is more than 25 years old and the availability of replacement parts, knowledgeable IT staff for the Wang, and

industry support services is limited and continues to decrease over time. We reviewed the Lottery's migration off the Wang and found that, overall, the Lottery has made little progress in moving back office functions off the system. Twelve years after first indicating its intention to implement a new back office system, the Lottery is still using the Wang for most of its back office functions. The following table shows six of the Lottery's most critical back office functions. As the table shows, as of July 29, 2008, with the exception of the stolen scratch ticket database, all of these functions are still operating on the Wang.

<b>Colorado Lottery Progress in Migrating Back Office Functions Off the Wang System<sup>1</sup> As of July 29, 2008</b>			
<b>Back Office Function</b>	<b>Function Migrated Off Wang?</b>	<b>System Currently Operating Function</b>	<b>System Intended to Operate Function After Migration</b>
Retailer billing	No	Wang	Scientific Games gaming system
Scratch ticket inventory	No	Wang	Scientific Games gaming system
Cash reconciliation at Lottery ticket counters	No	Wang	Oracle database
Sales and marketing events	No	Wang	Oracle database
Promotional inventory management	No	Wang	Oracle database
Stolen scratch ticket database	Yes	Oracle database	Oracle database
<b>Source:</b> Office of the State Auditor's analysis of the Colorado Lottery Wang Migration Update.			
<sup>1</sup> This table shows six of the most critical back office functions for the Lottery. This table does not include all of the Lottery's back office functions.			

These six back office functions were to be migrated to either the Scientific Games gaming system or the Lottery's new Oracle database. In its 2003 gaming system contract with the Lottery, Scientific Games agreed to take on several of the Lottery's back office functions, including two of the most critical back office functions, retailer billing and scratch ticket inventory. The Lottery planned to transfer other back office functions, including the four listed above, to a new Oracle database that was purchased in 2005. The stolen scratch ticket database, which was transferred to the Oracle database in October 2007, is the only one of the six functions listed above

that has been successfully migrated off the Wang as of July 2008. Neither retailer billing nor scratch ticket inventory has been fully migrated to the Scientific Games gaming system.

The Lottery's continued use of the Wang for back office functions increases the risk of a system malfunction that may not be repairable, which could affect the Lottery's ability to account for and collect millions of dollars in annual ticket sales. There are significant operational risks to the Lottery if the Wang system fails. For example, as discussed previously, the Lottery uses data transferred from the gaming system to the Wang to process retailer billings. In the event of a major Wang system failure, Lottery staff would have to manually process monthly billings totaling, on average, about \$38 million for its 2,900 retailers. This process would take significant staff resources and increase the likelihood of errors. A system malfunction would also result in an overall slowdown of the Lottery's business processes and make it difficult for the Lottery to account for and keep track of its scratch ticket inventory. This would increase the risk of errors or irregularities occurring in the handling of tickets.

The Lottery's use of outdated technology also has limited its ability to expand the number and type of games it can offer and generate additional proceeds for its beneficiaries. Twice during Calendar Year 2006, the Lottery cancelled plans to implement a new jackpot game called Match Play because management did not believe either the Wang or the Scientific Games gaming system could adequately support the increased volume of accounting data and other functional requirements for a new game. According to Lottery projections, had Match Play been implemented it would have generated about \$19.4 million in revenue during the game's first year.

Further, by not following through with its stated intention of migrating off the Wang system, the Lottery has not provided the technological environment in which Scientific Games expected to operate when it contracted to provide the Lottery's gaming system. As a result, Scientific Games has had to implement measures to interface its gaming system to the Lottery's Wang system. The Lottery's failure to migrate off the Wang is one factor that has contributed to the difficulties between the Lottery and Scientific Games with respect to the implementation of portions of the gaming system contract. Staff report that the Lottery and Scientific Games have been unable to come to an agreement as to what Scientific Games is to provide with respect to retailer billing and scratch ticket inventory. Finally, the Lottery reports that because its staff have been dedicated to resolving the issues surrounding the Scientific Games contract, there have not been sufficient resources available to complete the transfer of other back office functions to the Oracle database from the Wang. In the next section we discuss the Lottery's management of the Scientific Games contract and, specifically, the lack of clarity in the contract related to the

Lottery's performance expectations of Scientific Games with respect to retailer billing and scratch ticket inventory.

The Lottery has publicly stated its intention to migrate off the Wang for the past 12 years, and the risks to the Lottery and the State of continuing to operate on the Wang have been raised on numerous occasions. In 1996 the Lottery first reported to the Lottery Commission and the State's Commission on Information Management its intention to upgrade to a new back office system. At the request of the State's Commission on Information Management (a precursor to the Governor's Office of Information Technology), the Lottery hired PricewaterhouseCoopers in 1999 to review the Lottery's information technology infrastructure. PricewaterhouseCoopers identified concerns about the Lottery's continued use of the Wang system and recommended that the Lottery immediately begin planning a strategy for moving to a new system. Further, annual financial audits conducted since Fiscal Year 2002 have repeated the concerns about using the Wang system for reconciling accounting data. These audits also recommended the Lottery have regular, independent reviews of the Wang performed as long as the Lottery continued to use the system due to the critical functions the Wang performs. The Lottery's response to the recommendations each year reemphasized its plans to migrate off the Wang, and the recommendations were never implemented.

Although the Lottery has been aware of the need to replace the Wang since at least 1996, the Lottery has not taken the necessary steps to adequately plan how to successfully achieve the migration. This includes assessing the Lottery's business requirements with respect to a back office system. The State's *Information Technology Life Cycle Management Policy*, which was developed by the Governor's Office of Information Technology in 2004, states that when planning for an information technology project, an agency should identify technology risks early and manage those risks before they become problematic. The policy also recommends that an agency confirm that its business requirements are well defined so the system can be designed to meet those requirements. In addition, agencies should establish an organizational structure with appropriate levels of authority to provide timely direction, coordination, control, review, and approval.

When the Lottery requested an appropriation for Fiscal Year 2003 to implement a new system, the Lottery had not systematically planned how to achieve its migration off the Wang, nor had it adequately reviewed its business processes to identify opportunities for improving the efficiency of those processes when implementing a new system. Lottery and Department of Revenue staff indicate that their primary focus since 2003 has been on trying to replicate the Wang's functionality on the gaming system, rather than on creating greater efficiencies and determining how Scientific Games' system could be used, as designed, to serve the Lottery's back office business needs. This approach has caused interfacing issues and performance

problems, and five years into its contract with Scientific Games, the Lottery is still performing almost all of its back office functions on the Wang. Additionally, neither the Department of Revenue nor the Lottery established an organizational structure with the appropriate levels of authority to oversee the migration. The lack of clear leadership over the migration and performance problems, specifically with respect to Scientific Games, is discussed further in the next section.

During our audit, the Lottery hired an independent contractor to perform a business process review of its operations and back office system. Lottery management has indicated it intends to use the results of this review, which was completed June 30, 2008, to decide upon the best course of action to take with respect to implementing a new back office system. This will include determining which back office functions should be handled internally by Lottery staff on a new back office system or the Oracle database and which functions, if any, should be performed by its vendor for the gaming system. Initiating this business process review is a step in the right direction, and one that should have been taken when the Lottery first started to discuss migrating off the Wang. The Lottery should use the results of this review to develop a plan for the best way to transfer all back office functions on the Wang to a new system. As part of this planning process, the Lottery should also consider whether the Scientific Games gaming system should play a role in the back office functions since the contract with Scientific Games expires in 2012. The Lottery should clearly document and convey its expectations of Scientific Games related to the migration. Finally, the Lottery should ensure that an organizational structure with appropriate levels of authority is established to oversee the planning and the actual migration. Migrating off the Wang and implementing a new back office system should be one of the Lottery's top priorities. This will ensure the Lottery not only is able to support its current operations, but also will be able to expand its offerings of games and generate additional revenue for the State.

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### **Recommendation No. 1:**

The Colorado Lottery should migrate off the Wang system and fully implement a new back office system as soon as possible. Steps to accomplish this should include, but not be limited to:

- a. Using the results of the business process review to develop and implement a Wang migration plan that ensures any new system implemented will address the Lottery's fundamental business needs and interface effectively with an outside vendor's gaming system, as necessary. The migration plan should include a timeline for completion as well as benchmarks for critical milestones in the migration process.

- b. Clearly documenting the role Scientific Games is to play in the migration.
- c. Establishing an organizational structure with appropriate levels of authority to oversee the planning and migration processes.

### **Colorado Lottery Response:**

Agree.

- a. Implementation date: Implemented. The Lottery has already embarked on this planning process by identifying a Project Manager, Project Steering Committee, and Project Plan (with benchmarks and critical milestones for completion). The Lottery issued a Request for Proposal in August 2008 for solicitation of the system, software, and consulting support to implement the new back office system.

It should be noted this is a “replacement” of the Wang back office system and not a “migration” of the software operating on the Wang. This decision is based on the results of the Business Process Review project completed in June 2008, which recommended a complete re-work of the business applications to achieve “best practices” in the business applications based upon industry standards today.

- b. Implementation date: April 30, 2009. As a part of this project, the Lottery will define the expectations and requirements needed for Scientific Games to interface with the new back office system, including software changes and data transfers. This will be memorialized in an addendum to the Scientific Games contract.
- c. Implementation date: Implemented. The Lottery has made the organizational changes needed to provide direction, oversight, and coordination of this project.

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## **Scientific Games Contract**

In June 2003 the Department of Revenue (Department) entered into a contract with Scientific Games to provide a gaming system for the State’s Lottery. As discussed previously, a gaming system is the centralized computer system that processes all Lottery ticket transactions, records data, and provides the network linking the Lottery to all 2,900 retailers. The gaming system is critical to the Lottery’s ability to operate and sell tickets. The contract, valued at \$58.1 million over the nine-year term, is set

to expire in October 2012, with the option for the Department to extend the contract for one two-year period at an additional cost of \$12.5 million. Under the terms of the contract, Scientific Games is required to meet minimum performance requirements which relate to providing:

- Gaming terminals that sell and redeem scratch and jackpot tickets.
- Scratch ticket vending machines.
- Tax reporting capabilities for high-dollar Lottery winners.
- Various data reports on items such as ticket sales and individual retailer sales activity.
- A telecommunications network that connects retailer gaming terminals.
- Maintenance and support of all gaming terminals, which includes repairing malfunctioning terminals and stocking gaming supplies such as ticket paper.
- Training for Lottery staff and retailers on how to operate the gaming terminals and the gaming system.

In addition, the contract requires that Scientific Games provide back office functions, including a retailer billing system and a scratch ticket inventory system. As discussed previously, the contract was executed in 2003 and according to the original terms of the contract, Scientific Games was required to implement all components of the gaming system, including the agreed-upon back office functions, by November 2004. However, Scientific Games did not implement the gaming system until six months later in May 2005.

We reviewed the Department's and the Lottery's oversight of the \$58.1 million Scientific Games gaming system contract and identified significant problems with how the contract has been managed. Specifically, we found that neither the Department nor the Lottery has clearly defined the lines of authority and responsibility for overseeing the contract or the performance expectations surrounding the contract. Additionally, we found that neither the Department nor the Lottery consistently assessed liquidated damages against Scientific Games for nonperformance. As a result, neither the Department nor the Lottery has held Scientific Games accountable for complying with the terms of the contract. The contract has not been fully implemented three years after the gaming system first became operational in May 2005 and it is questionable whether the State has received full value for the \$22 million spent on the contract as of June 30, 2008.

In the following two sections we discuss the Department's and the Lottery's management of the contract including the lack of adequate contract oversight and clearly defined performance expectations and liquidated damages.

## Contract Management

We found that, despite the size and critical nature of the Scientific Games contract, neither the Department nor the Lottery has effectively managed the contract. The Colorado Department of Personnel & Administration provides guidance to state agencies on drafting and managing contracts in its *State Contract Procedures and Management Manual*. According to the *Manual*, a contract should represent an agency's requirements in clearly worded, understandable, and legally enforceable terms so that a contractor is clear regarding the agency's performance expectations. The *Manual* goes on to state that once a contract has been entered into, the primary responsibility for contract performance rests with the contractor. However, the State is ultimately responsible for the quality and quantity of the goods and services provided. Therefore, according to the *Manual*:

... it is imperative that the agency or institution monitor its contracts for adequate performance to protect the State's (and the contractor's) interests. Post award administration should be a series of organized and coordinated actions tailored to the type of contract and contractor involved. Careful monitoring will avoid misunderstandings and prevent small difficulties from becoming major problems. Typically, the more complex the contract, the more extensive the monitoring activity.

Additionally, the *Manual* states that the number of participants in a state contract can vary depending on the size and complexity of the project. However, early in a project a single contract monitor should be identified to manage the project and coordinate other staff involved with the contract. A contract monitor's primary responsibilities include:

- Monitoring the contractor's progress and performance to ensure goods and services provided conform to contractual requirements;
- Exercising state remedies, as appropriate, where a contractor's performance is deficient; and
- Resolving disputes in a timely manner.

In our 2003 *Colorado Lottery Performance Audit* report, which was released several months after the Lottery entered into its gaming contract with Scientific Games, we discussed the importance of the Lottery implementing strong monitoring procedures to help mitigate potential problems with the contract. We recommended that the Lottery establish milestones and deadlines for completion of the design and implementation of the new gaming system and procedures for reporting and resolving all system problems. The Lottery agreed to implement this recommendation.

### **Contract Oversight**

We reviewed the Scientific Games gaming system contract and identified two primary areas where the Department and the Lottery have failed to adequately manage the contract. First, we found that for the first five years of the contract since it was executed in 2003 neither the Department nor the Lottery clearly defined lines of responsibility and authority for overseeing the contract. Specifically, neither the Lottery nor the Department identified an individual to oversee the contractor's performance; serve as a primary contact for Scientific Games staff; and coordinate the various Lottery staff, including IT, operations, fiscal, and security staff involved with using and designing the gaming system. Instead, there were multiple Lottery and Department staff at various levels involved in different aspects of overseeing the contract, such as reviewing gaming system performance, recommending the amount of liquidated damages to be assessed, and drafting contract modifications. There was little coordination among these individuals. Additionally, none of these individuals was given the authority to make contract-related decisions, such as approving the amount of liquidated damages to be assessed or determining the actions to be taken to address nonperformance issues. According to the Lottery, the Lottery Director had limited involvement with the contract, and most decisions were made by the Executive Director of the Department. Scientific Games reports that the Lottery's lack of dedicated leadership and clear direction with the contract has been the biggest obstacle to Scientific Games' ability to resolve outstanding performance issues, meet all performance requirements, and fully implement the contract. In February 2008, nearly five years after the Lottery entered into the contract, the Executive Director appointed the Lottery's newly hired Chief Operating Officer as the contract manager and primary Lottery contact for Scientific Games. Subsequently, this individual was given decision-making authority over the contract for approving the amount of liquidated damages to assess.

### **Performance Expectations**

Second, we found that neither the Department nor the Lottery has clearly defined and communicated to Scientific Games performance expectations related to the contract. We reviewed the original 2003 contract between the Department and Scientific Games and subsequent modifications made to the contract and found that the contract language is vague and does not sufficiently define the Lottery's performance expectations with respect to some deliverables, such as the retailer billing and scratch ticket inventory systems. The complete contract comprises three parts: 1) the main contract and modifications, 2) the Lottery's Request for Proposal (RFP), and 3) Scientific Games' proposal. According to the contract, the RFP provides the primary description of the scope of work, but the contractor's proposal also can be used to interpret performance requirements. We found, however, that neither the contract, RFP, nor proposal provides details about what the retailer billing or scratch ticket

inventory systems are to include, nor what the Lottery's expectations are with respect to these systems; all documentation related to these two systems is in very general terms.

In addition, we found that the Department and the Lottery have not communicated consistent performance expectations to Scientific Games or modified the contract to reflect changes in expectations. For example, in December 2007 the Department issued a letter to Scientific Games outlining six deliverables, including the retailer billing and scratch ticket inventory systems, that had not been fulfilled according to the terms of the contract and requesting that Scientific Games provide a timeline for delivering the outstanding items. Two months later, in February 2008, the Department sent a second letter to Scientific Games discussing 12 deliverables that were considered outstanding. In addition to increasing the number of outstanding deliverables from 6 to 12, the Department changed the deliverables included. For example, the Department stated that no further action was needed on the retailer billing system and added a deliverable related to transaction processing. As of June 30, 2008, the contract had not been amended to remove retailer billing as a contractual requirement.

We also found that the Department and the Lottery have not amended the contract to reflect how the Lottery's expectations have changed due to its continued use of the Wang system. The Lottery stated in its RFP that it intended to implement a new back office system in conjunction with the contractor's gaming system. Therefore, Scientific Games' proposal for its gaming system was based on the Lottery having a new back office system in place that operated off of newer technology. As discussed in Recommendation No. 1, however, the Lottery has not yet migrated off the Wang system. As a result, Scientific Games representatives report that the company has had to redesign its gaming system to be able to interface with the outdated technology of the Wang. According to Scientific Games, this has resulted in unanticipated costs and additional workload outside the scope of the contract.

Finally, we found that the Lottery has not consistently set deadlines for implementing performance expectations. For example, the Department has issued two option letters, the first in November 2005 and the second in June 2006, that changed the contract and lowered the amount of monthly fees paid to Scientific Games, citing nondelivery of various performance requirements. However, neither option letter included deadlines by which Scientific Games was to correct the problems. As of June 2008, the Lottery reported that these performance requirements were still outstanding.

The Department's and the Lottery's failure to effectively manage the Scientific Games contract has cost the State money and severely impacted the implementation of the contract. According to the contract, the Lottery is to pay Scientific Games

1.713 percent of gross monthly ticket sales as compensation for services provided under the contract. In June 2006 the Department reduced the rate to 1.458 percent of ticket sales based on the Lottery's assessment of Scientific Games' failure to meet certain performance requirements. In December 2007 the Department reinstated the full compensation rate in a show of good faith for Scientific Games to implement all performance requirements. However, as of the time of our audit, the Lottery reported that significant functions, in addition to the retailer billing and scratch ticket inventory systems, had not been implemented. Therefore, from December 2007 to May 2008, the Department paid Scientific Games approximately \$628,000 for functions the Lottery has determined have not been provided. These include functions such as:

- **Real-time reports.** The gaming system should produce real-time reports, or reports containing data from transactions that occurred immediately before the reports were generated. The Lottery states that the gaming system does not produce real-time reports; instead, Lottery staff often must rely on day-old information to monitor ticket sales and track scratch tickets for security-related issues, such as investigations of stolen tickets.
- **Retailer transaction reports.** The gaming system should allow Lottery staff to access real-time reports showing data specific to individual retailers, such as a store's ticket sales, ticket redemptions, and scratch ticket deliveries received. The Lottery states that its staff are unable to access these reports and must rely on Scientific Games staff to pull the reports at a later time.
- **Tax reporting software.** The gaming system should produce tax forms for individuals winning \$600 or more in prizes in one year. The Lottery reports that Scientific Games has not implemented the necessary software on the gaming system to produce these forms.

It is critical that the Department and the Lottery establish effective contract management practices with respect to the Scientific Games gaming system contract. This includes establishing clear lines of authority and responsibility for overseeing the contract, clearly defining performance expectations, and developing a plan for resolving all outstanding performance issues. Although in February 2008 the Lottery's Chief Operating Officer was designated the contract manager for the contract, effective July 2008, this individual was appointed as the Lottery Director. We question whether this individual, as Director with overall responsibility for Lottery operations, can dedicate the resources needed to manage the contract on a daily basis. Therefore, the Department and the Lottery should determine the most effective way to manage the contract. This should include determining where decision-making authority related to the contract lies and designating a contract monitor to oversee the contract on a daily basis. Once these roles have been

established, the Department and the Lottery should work with Scientific Games to develop a plan for resolving all outstanding performance issues and modify the contract, as necessary, to ensure all performance expectations are clearly and consistently documented and communicated to Scientific Games. The contract should also include deadlines for meeting performance expectations, and the Department and the Lottery should hold Scientific Games accountable for complying with these deadlines.

Since the Scientific Games contract was executed, the Department has changed the format of its contracts to help clarify performance expectations. Specifically, the Department has incorporated the relevant sections of the RFP into the contract and discontinued its practice of including the entire RFP as part of the legally binding contract. The Department indicates this change was made to help ensure performance expectations are clearly outlined in the contract itself.

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## **Recommendation No. 2:**

The Department of Revenue and the Colorado Lottery should improve management of the Scientific Games gaming system contract by:

- a. Establishing clear lines of authority and responsibility for overseeing the contract. This should include designating a contract monitor to oversee the contract on a day-to-day basis and determining where decision-making authority related to the contract lies for matters such as approving assessments of liquidated damages and contract amendments.
- b. Developing a plan for resolving all outstanding performance issues and modifying the contract, as necessary, to clearly reflect current performance expectations and setting deadlines for meeting those expectations. The Lottery should hold Scientific Games accountable for complying with those deadlines.

## **Department of Revenue Response:**

Agree.

- a. Implementation date: Implemented. The Executive Director implemented an analysis of the Wang migration and the Scientific Games contract in 2007. That analysis was performed by the Northhighland Company, which made some specific recommendations with regard to organizational structure, business process analysis, and management of the project. Following the completed analysis, the Chief Operating

Officer position was created within the Lottery and subsequently filled in January 2008. After a brief orientation period, the Chief Operating Officer became the designated manager and decisionmaker regarding both the Wang migration and the Scientific Games contract and implemented the business process analysis project. The Chief Operating Officer also oversees and approves the assessment of liquidated damages and contract amendments.

- b. Implementation date: June 30, 2009. The Executive Director, working in conjunction with the Governor's Office of Information Technology and the Lottery's Chief Operating Officer, reviewed the reports from Northhighland and the Business Process Review and has put in motion the plan to secure a bid on the migration off of the Wang to a new back office system and identify the process regarding the Internal Control System vendor (see Recommendation No. 4). The Department of Revenue will work with the Lottery, the Joint Budget Committee, and Scientific Games to outline any changes necessary in appropriations and the Scientific Games contract. Clear deliverables will be identified and alterations to the current contract language will probably be necessary.

### **Colorado Lottery Response:**

Agree.

- a. Implementation date: Implemented. The Lottery assigned contract oversight of the Scientific Games contract to the Chief Operating Officer of the Colorado Lottery in February 2008. This individual now fulfills the Lottery Director's position and will continue to manage the oversight of the contract until the Chief Operating Officer position is filled, which is expected to occur in September 2008. All liquidated damages are reviewed by this person on at least a monthly basis for possible assessment in accordance with contract conditions.
- b. Implementation date: June 30, 2009 for establishing timelines and amending the contract; ongoing for monitoring Scientific Games' compliance with the contract. The Lottery continues to work with Scientific Games on developing a timeline for delivery of the outstanding items from the contract. As a result of the recently completed Best Practices review of the back office system, the Lottery may opt to have some applications, previously required of Scientific Games, moved to the new back office system. Movement of these systems will be

accompanied by appropriate timelines and amendments to the existing contract with Scientific Games.

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## Liquidated Damages

The Lottery's gaming system contract with Scientific Games includes provisions allowing the Lottery to assess liquidated damages against the contractor. Liquidated damages are financial penalties, similar to fines, that the Lottery may levy against Scientific Games to compensate the Lottery for the contractor's failure to comply with contractual terms. The purpose of liquidated damages is to compensate the Lottery for the cost of actual losses incurred as a result of Scientific Games' failure to perform. From May 2005 when the gaming system was first implemented through January 2008, the Lottery assessed \$2.4 million in liquidated damages against Scientific Games.

The gaming system contract includes 12 categories of performance issues for which the Lottery can assess liquidated damages. Five of these categories include:

- **Gaming system malfunctions.** If the gaming system malfunctions and cannot process scratch or jackpot Lottery ticket transactions, the Lottery can assess liquidated damages based on how long the problem lasts and the time of day the malfunction occurs. The Lottery has assessed, in total, \$130,000 in damages for gaming system malfunctions.
- **Degraded system performance.** The Lottery can assess liquidated damages if the central gaming system malfunctions and causes certain performance problems. These problems include a reduction in how many ticket transactions can be processed simultaneously and issues with tracking the sales status of scratch ticket games at individual retailer locations. The Lottery has assessed, in total, \$1 million in damages for degraded system performance.
- **Failure to repair or re-supply gaming terminals.** Scientific Games is required to replace or repair malfunctioning gaming terminals at retailer locations within specified time periods. In addition, the contractor must replenish gaming supplies, such as the paper used for printing jackpot tickets, at retailer gaming terminals. The Lottery can assess liquidated damages if Scientific Games does not address these issues within the required time frames. The Lottery has assessed, in total, \$201,000 in damages for Scientific Games' failure to repair or re-supply gaming terminals within specified time frames.

- **Failure to perform preventive maintenance.** The Lottery can assess liquidated damages if Scientific Games does not perform preventive maintenance on retailer gaming terminals according to a pre-determined schedule. The Lottery has assessed, in total, \$50,000 in damages for Scientific Games' failure to perform preventive maintenance.
- **Failure to provide critical functions or reports.** The Lottery can assess damages if the gaming system malfunctions and adversely affects critical operational tasks, such as retailer billing, winner payments, or security alerts. In addition, the Lottery can assess damages if Scientific Games does not provide reports containing data related to these functions. The Lottery has assessed, in total, \$872,000 in damages due to Scientific Games' failure to provide these critical functions and reports.

In addition to these five categories, the Lottery has assessed Scientific Games about \$160,000 in liquidated damages for failing to install gaming terminals and game options at retailer locations and failing to provide additional required reports.

We reviewed the Lottery's assessment of liquidated damages against Scientific Games from July 2006 through January 2008. During this time, the Lottery assessed about \$435,000 in liquidated damages. We found that overall, the Lottery has not used this mechanism effectively to address contractor performance problems. Specifically, we identified two concerns with the Lottery's assessment of damages against Scientific Games. First, the Lottery has not consistently assessed liquidated damages in a timely manner. Lottery operations staff review Scientific Games' performance each month and recommend what, if any, damages to assess. Prior to February 2008 operations staff would forward their recommendations on a monthly basis to the Lottery Director for initial review and then to the Department of Revenue's Executive Director for a final decision. From July through December 2006 these recommendations were approved and liquidated damages were assessed monthly. We found, however, that the Department did not approve any of the damages that Lottery staff recommended each month during Calendar Year 2007. According to the Department, liquidated damages were not assessed during this time to allow the Department's new administration time to evaluate the issues surrounding the contract. Since February 2008 the Lottery's newly hired Chief Operating Officer has had the authority to approve the amount of damages assessed and has approved approximately \$56,000 in damages for nonperformance issues that occurred during Calendar Year 2007.

Second, we found that the Lottery may have inappropriately waived \$62,000 in liquidated damages that should have been applied for two months during Fiscal Year 2008. As discussed previously, from June 2006 through November 2007 the Lottery reduced the monthly fee paid to Scientific Games because of the contractor's failure

to comply with certain minimum performance requirements, such as providing data reports, contained in the contract. Since the Lottery reduced Scientific Games' monthly payments, the Lottery waived liquidated damages for failure to provide these data reports to avoid double penalizing the contractor during this period. In December 2007 the Lottery reinstated Scientific Games' full monthly fee as a good faith incentive for the contractor and the Lottery to resolve the outstanding performance issues described throughout this chapter. However, in December 2007 and January 2008 the Lottery continued to waive damages related to Scientific Games' failure to provide the required data reports, even though Scientific Games received its full monthly compensation during that time.

Liquidated damages protect the State's interests by providing immediate financial compensation if vendors do not fulfill their contractual obligations. However, this remedy loses its effectiveness if damages are not assessed in a timely manner. The Lottery should hold Scientific Games accountable for complying with the terms of the contract by assessing liquidated damages in a timely manner. The Chief Operating Officer, who was given the authority to assess liquidated damages, was named the Lottery Director effective July 2008. With the change in position, the Lottery needs to ensure that liquidated damages continue to be assessed timely. In addition, the Lottery should evaluate whether liquidated damages should be assessed for December 2007 and January 2008 due to Scientific Games' failure to provide all required reports during these two months.

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### **Recommendation No. 3:**

The Colorado Lottery should ensure the effectiveness of liquidated damages as a remedy for nonperformance by:

- a. Assessing liquidated damages in a timely manner.
- b. Evaluating whether liquidated damages should be assessed against Scientific Games as a result of not providing required data reports in December 2007 and January 2008 and, if so, assessing the appropriate amounts.

### **Colorado Lottery Response:**

Agree. Implementation date: Implemented.

- a. The Lottery reviewed the process and procedures for assessing liquidated damages again and initiated procedures to ensure a timely assessment of the appropriate amounts of liquidated damages to Scientific Games.

- b. The amount of liquidated damages for December 2007 and January 2008 have been determined and were assessed in August 2008.

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## Internal Control System

The Lottery follows industry practice by monitoring the accuracy and integrity of all ticket transactions using an electronic Internal Control System (ICS). The ICS is a software program that records a real-time copy of all ticket transaction data, such as ticket sales and redemptions, that occur on a lottery's gaming system. By comparing data on the ICS to data on Scientific Games' gaming system, Lottery staff can identify ticket sales or redemptions that do not match and could potentially indicate weaknesses in controls within the Scientific Games gaming system or instances of fraud or abuse. The Lottery's ICS is provided by a Canadian company called ESI Integrity, Inc.

We reviewed the management and operation of the Lottery's ICS to determine whether the system serves as an adequate and independent control to verify the accuracy and integrity of information contained on Scientific Games' gaming system. We found that the Lottery does not have appropriate oversight and management of the system to ensure the ICS functions as an independent verification system. Currently, the vendor that provides the Lottery's ICS is a subcontractor of Scientific Games, an arrangement agreed to in the Lottery's 2003 gaming system contract with Scientific Games. However, this reporting structure does not provide the Lottery with a truly independent mechanism to verify the accuracy of ticket transactions processed on the gaming system.

Since the main purpose of the ICS is to help the Lottery ensure the accuracy of information contained in the gaming system, the Lottery should have direct oversight of the ICS to ensure its independence. The Lottery's current contract with Scientific Games requires Scientific Games to provide an internal control system and assume the costs associated with providing this system. Therefore, the Lottery must work with Scientific Games to explore options for the Lottery to assume control of this function. Options may include the Lottery entering into a direct contractual relationship with the current ICS provider, ESI Integrity, Inc. Another option may be for the Lottery to provide its own internal control system. Lottery management has indicated that one of the new back office systems it is considering, as discussed in Recommendation No. 1, includes an internal control system. If the Lottery decides on this option, there would be no need to continue to contract out this function. Regardless of the option chosen, the Lottery should ensure that a truly independent internal control system is established as the Lottery moves forward with its back office migration plans.

### **Recommendation No. 4:**

The Colorado Lottery should ensure the independence of its Internal Control System by managing the system internally or contracting directly with the vendor that provides the Internal Control System.

#### **Colorado Lottery Response:**

Agree. Implementation date: July 1, 2009.

One of the major application areas for implementation on the new back office system is an Internal Control System (ICS). This application is expected to be operational by July 1, 2009. At that time, the full function of the ICS will be under the direct supervision and control of the Lottery. Scientific Games will no longer provide the service and its contract will be modified accordingly.

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## **Other Contract Monitoring**

Agencies are responsible for contract monitoring throughout the life of a contract from the time a project is initially conceptualized until the project is complete. Effective contract monitoring should include developing a clear scope of the services to be provided; overseeing the procurement process; managing and documenting ongoing, day-to-day contract issues; and monitoring progress of the contractor's work and performance to ensure the adequacy and quality of the services provided. Contract monitoring is critical to ensuring that contractors fulfill all of their legal obligations and the State receives appropriate value for the money it spends for a service. According to the *State Contract Procedures and Management Manual*, contracts should identify how the State will monitor the progress of the work performed by the contractor. For example, the contract may require that the contractor provide weekly written updates or status reports and that there be monthly meetings between the contractor and the contract monitor.

Lottery program staff in marketing, operations, IT, and warehousing oversee the Lottery's contracts. As discussed previously, the Lottery has six primary contracts, with Fiscal Year 2008 costs for these individual contracts ranging from \$172,000 to \$9.4 million. These contracts are for the gaming system, scratch ticket production, advertising, scratch ticket delivery, and maintenance services for the Wang system. We reviewed the Lottery's monitoring of these contracts and identified numerous areas where the Lottery needs to strengthen its contract monitoring practices:

- **Dedicated contract monitors.** The *State Contract Procedures and Management Manual* states that an individual, or individuals, should be designated as contract manager(s) for each contract. Although most Lottery contracts have designated contract monitors, we found that two of the Lottery's six primary contracts were not assigned a contract monitor. As discussed in Recommendation No. 2, until February 2008, five years into the term of the contract, the Lottery had not assigned a contract monitor to the Scientific Games gaming system contract. Additionally, as of the end of our audit, the Lottery had not assigned a contract monitor to its contract with United Parcel Service (UPS) for scratch ticket delivery. The lack of a dedicated contract monitor means that the Lottery does not have a systematic process to ensure that vendors are complying with the terms of the contract and that the State is receiving full value for its money. The Lottery should assign dedicated contract monitors to every contract.
- **Contract administration files.** The *State Contract Procedures and Management Manual* recommends that contract monitors maintain a contract administration file containing information such as a copy of the signed contract, contractor updates or status reports, general correspondence related to the contract, and copies of all invoices and payments. According to the *Manual*, the contract administration file provides a record of monitoring activities that have occurred, as well as a basis for settling claims and disputes that may arise with respect to the contract. We reviewed the Lottery's contract administration files for its six primary contracts and found that none of the files was complete because contract information was scattered among multiple Lottery and Department staff. Specifically, documents including copies of signed contracts, contract modification documents, performance status updates, correspondence related to the contract, and proof of insurance were stored in different files maintained by Lottery and Department staff. Although the Lottery was able to locate all components of the contracts, this information was not readily accessible and took some time to collect. The absence of consolidated contract administration files does not facilitate contract monitoring and makes it difficult to determine what contract monitoring has occurred. In addition, the lack of consolidation could hamper the State's ability to defend its position if a dispute arises with respect to a contract. The Lottery should require that staff maintain consolidated contract administration files for every contract.
- **Communication.** The *State Contract Procedures and Management Manual* states that one of the primary components of contract management is communication among the parties involved in the contract. We found that for several contracts, senior management at both the Lottery and Department have made contract-related decisions, but they have not always

communicated these decisions to the assigned contract monitors and relevant program staff. For example, the contract monitor for one of the Lottery's scratch ticket contracts recommended that liquidated damages be assessed against the contractor for misprinted tickets and failure to properly code winning tickets for redemption purposes. The recommendations were forwarded to Lottery and Department management, and although damages were assessed against the contractor in both instances, the contract monitor was never informed of these decisions. On another occasion, the Lottery reports that Department staff modified the Scientific Games gaming system contract without informing Lottery staff. If the Department and the Lottery intend to share responsibility for contract administration, communication between the Department and Lottery must occur to protect the State and ensure adequate oversight of the contract. The Lottery cannot ensure effective management of its contracts unless contract monitors, or other relevant staff, are informed of the Department's contractual decisions.

- **Vendor payments.** According to the *State Contract Procedures and Management Manual*, the contract monitor should be responsible for monitoring and approving payments. We reviewed the Lottery's six primary contracts and found that for five of the contracts either the contract monitor reviewed vendor invoices before approving payments, or fiscal staff were informed about contractor pricing agreements so they could ensure invoiced amounts were appropriate. For the UPS contract, however, fiscal staff approved payments even though staff had not been provided with and were not aware of the contractor's specific pricing agreements. Since the cost of scratch ticket deliveries varies based on the destination and shipment size, someone familiar with the pricing agreement and the shipments should review the invoices prior to approving payments to ensure the State receives the services billed. Best practice would be for the assigned contract monitor to review invoices and approve them for payment. As vendor payments are normally based on invoices that detail the nature of services performed and related expenses, the contract monitor is generally in the best position to know what services are required under the terms of the contract and whether the provided services meet those terms.

Additionally, we found the Lottery is not using its designated contract manager position to effectively manage contracts. In addition to the program staff assigned to monitor specific contracts, the Lottery employs a full-time contract manager as part of the fiscal section whose job responsibilities include monitoring all Lottery contracts for compliance and efficiencies, auditing billing on major contracts, and preparing contract modification documents (e.g., amendments, option letters, and change orders). We found, however, that this individual is not performing many of her assigned contract responsibilities and has limited involvement with the Lottery's

contracts other than to prepare contract modification documents at the direction of Department or Lottery management. We also found that this individual had no contract management experience prior to being assigned to the position and has received no contract management training. It is unclear whether the contract manager position contributes effectively to overall management of the Lottery's contracts.

Overall the Lottery needs to establish standard contract monitoring procedures that are consistent with the *State Contract Procedures and Management Manual* and best practice. These procedures should address all aspects of contract monitoring responsibilities, including assigning contract monitors, maintaining contract administration files, communicating contract-related decisions, reviewing invoices, and approving vendor payments. Once contract monitoring procedures are developed, the Lottery should ensure staff are trained on these procedures. None of the contract monitors we interviewed had received training on how to manage state contracts, and only one was familiar with the *State Contract Procedures and Management Manual*. Finally, the Lottery should evaluate whether the contract manager position adds value to the Lottery's procurement and contract management processes without duplicating responsibilities of program staff assigned to monitor individual Lottery contracts on a day-to-day basis. If the Lottery concludes that the position adds value, the Lottery should determine how to more effectively integrate the position into the contract management process.

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### **Recommendation No. 5:**

The Colorado Lottery should improve its contract monitoring practices for all contracts by:

- a. Developing contract monitoring procedures, similar to those discussed in Recommendation No. 2, that: (1) ensure all contracts are assigned dedicated contract monitors; (2) outline standard processes and expectations for staff who manage Lottery contracts, including what documentation should be maintained in contract administration files; (3) address communications regarding contract-related decisions; and (4) ensure contract monitors are familiar with pricing agreements and review and approve vendor invoices prior to payment.
- b. Providing periodic contract management training to Lottery staff responsible for monitoring contracts.
- c. Evaluating whether the role of the contract manager position adds value to the Lottery's procurement and contracting processes. If the Lottery

determines a need for the position, the Lottery should: (1) clarify the position's responsibilities in relation to staff contract monitors' responsibilities and (2) determine how to integrate the position into the contract management process.

### **Colorado Lottery Response:**

Agree. Implementation date: December 2008.

- a. The Lottery will make improvements to the contract management and monitoring processes by developing procedures, in accordance with the *State Contract Procedures and Management Manual*, that define roles and responsibilities of all staff involved in the procurement, contracting, and payment processes. These procedures will include the assignment of contract monitors to each contract to oversee the contract on a day-to-day basis; documentation requirements and responsibilities; establishment of authority for contract-related decisions and the communication of those decisions; and ensure contract performance and the review and approval of vendor invoices prior to payment.
  - b. The Lottery will evaluate the need for training and will provide the necessary training.
  - c. The Lottery has determined a need for the contract manager position and will: (1) clarify the position's responsibilities in relation to staff contract monitors' responsibilities and (2) determine how to improve the efficiency and effectiveness of this position within the contract management process.
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# Fiscal Issues

## Chapter 2

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### Background

The Colorado Lottery (Lottery) generated approximately \$1.8 billion in revenue during Fiscal Years 2004 through 2007. Lottery ticket sales have increased 14 percent during this time, from approximately \$401 million in Fiscal Year 2004 to approximately \$456 million in Fiscal Year 2007. Sales of jackpot and scratch tickets accounted for 98 percent of revenues over the four-year period. Other revenue sources included retailer licensing fees, interest income, liquidated damages assessed against the Lottery's gaming system contractor, and retailer bonding fees. Because the Lottery qualifies as a TABOR enterprise under Article X, Section 20 of the Colorado Constitution, all revenue is TABOR exempt.

Statute [Section 24-35-210(9), C.R.S.] requires the Lottery to disburse no less than 50 percent of revenue generated through Lottery ticket sales as prizes. The Lottery has implemented this requirement on a "per game" basis; that is, the prize payout for each individual jackpot and scratch ticket game is at least 50 percent of sales for that game. During Fiscal Years 2004 through 2007 the Lottery paid out \$1 billion, or 60 percent of ticket sales revenue, in prizes.

In addition to prize expenses, a portion of the Lottery's revenue is used to pay for expenses associated with operating the Lottery. The Lottery's operating costs have increased 1 percent over the past four years, from about \$62 million in Fiscal Year 2004 to \$62.8 million in Fiscal Year 2007. The Lottery's operating costs include retailer compensation and administrative expenses such as payments to vendors for scratch ticket production and gaming equipment, marketing and communication expenses, and personal services costs. As the following table shows, the Lottery has done a good job containing administrative costs, reducing these expenses 8 percent since Fiscal Year 2004. According to Lottery management, this decrease is the result of stronger internal controls over expenditures and reductions in fees related to the Lottery's gaming system and ticket production. Additionally, online telecommunications costs associated with connecting retailers to the gaming system have decreased 61 percent since Fiscal Year 2004 due to lower rates. As discussed later in this chapter, retailer compensation has increased 11 percent during this same period, while ticket sales increased 14 percent. From Calendar Years 2004 to 2007 the Denver Metro Area Consumer Price Index increased 8 percent.

<b>Colorado Lottery Administrative and Retailer Compensation Expenses Fiscal Years 2004 and 2007 (Dollars in Millions)</b>			
<b>Expense Item</b>	<b>Fiscal Year</b>		<b>Percent Increase/ (Decrease)</b>
	<b>2004</b>	<b>2007</b>	
<b>Administrative Expenses</b>			
Ticket Production and Vendor Fees	\$9,700,000	\$8,100,000	(16%)
Marketing and Communications	\$8,600,000	\$8,900,000	3%
Wages and Benefits	\$7,900,000	\$8,600,000	9%
Motor Pool Leasing	\$276,000	\$328,000	19%
Online Telecommunications <sup>1</sup>	\$726,000	\$284,000	(61%)
Other Operating Expenses <sup>2</sup>	\$4,500,000	\$2,900,000	(36%)
<b>Subtotal Administrative Expenses</b>	<b>\$31,702,000</b>	<b>\$29,112,000</b>	<b>(8%)</b>
Retailer Commissions and Bonuses	\$30,300,000	\$33,700,000	11%
<b>TOTAL</b>	<b>\$62,002,000</b>	<b>\$62,812,000</b>	<b>1%</b>
<b>Source:</b> Office of the State Auditor's analysis of Colorado Lottery audited financial statements for Fiscal Years 2004 and 2007.			
<sup>1</sup> Includes expenses for the telecommunications network that connects Lottery retailers to the electronic gaming system, allowing retailers to sell and redeem tickets.			
<sup>2</sup> Includes professional services, travel, equipment, materials and supplies, equipment maintenance, and other costs.			

The Lottery's goal is to maximize profits for distribution to beneficiary agencies by increasing revenue and minimizing expenses. We reviewed fiscal issues related to the Lottery and identified several areas where the Lottery may be able to reduce costs and thus, increase the amount of funds available for distribution to its beneficiary agencies. Specifically, we identified potential cost savings related to prize structures, retailer compensation, and the implementation of a new scratch ticket distribution and inventory management system. Additionally, we found the Lottery should strengthen its controls over state assets and promotional expenses. Each of these issues is discussed in this chapter.

## Prize Structure

In Fiscal Year 2007 the Lottery paid out approximately \$280 million in total prizes for all of its jackpot and scratch ticket games. As mentioned previously, statute [Section 24-35-210(9), C.R.S.] requires the Lottery to pay out at least 50 percent of aggregate sales on all games as prizes. Lottery staff establish a “prize structure” for each new scratch and jackpot game introduced into the market. The prize structure outlines the number and value of winning tickets that will be available for each game, and this information is posted on the Lottery’s website. With scratch ticket games, the prize structure specifically describes the number of winning tickets to be produced and sets a cap on the highest possible percentage of sales that will be paid out as prizes. For example, the prize structure for a \$1 scratch ticket set the total prize payout level for the game at approximately 61 percent. There were about 4.1 million tickets available for sale in the game, and 900,000 (22 percent) of these tickets were “winning” tickets. Prizes ranged from \$1 to \$5,000, with a total prize payout of about \$2.5 million. With jackpot games, a governing prize structure is established for each game that sets out the total allocation of prizes for each drawing.

We compared the amount Colorado paid out in prizes as a percentage of total sales in Fiscal Year 2007 with the amount paid out by three other state lotteries (Arizona, Minnesota, and Wisconsin) that are similar to Colorado with respect to overall sales and the types of games offered. Overall, we found that Colorado paid out a greater percentage of its sales as prizes than the other three states. As the following table shows, in Fiscal Year 2007 Colorado paid out 61 percent of its total sales in prizes, compared with 59 percent in Minnesota and Wisconsin and 56 percent in Arizona.

<b>Colorado Lottery Prizes as a Percentage of Ticket Sales Fiscal Year 2007 (Dollars in Millions)</b>			
<b>State Lottery</b>	<b>Total Sales</b>	<b>Total Prizes</b>	<b>Percent of Sales Paid In Prizes</b>
Colorado	\$455.9	\$280.0	61%
Minnesota	\$422.6	\$250.1	59%
Wisconsin	\$492.8	\$292.1	59%
Arizona	\$462.2	\$257.5	56%

**Source:** Office of the State Auditor’s analysis of Fiscal Year 2007 audited financial statements for the Arizona, Colorado, Minnesota, and Wisconsin Lotteries.

We also considered the Colorado Lottery's sales per capita, based on state population data, in our evaluation of the amount the Lottery pays out in prizes. According to Colorado Lottery staff, lottery sales per capita is a standard industry measure of a lottery's performance. Lottery staff indicated that although the Colorado Lottery pays out a higher percentage of its total sales as prizes than the three comparative states used in our analysis, the Colorado Lottery performs better than these states; that is, Colorado has higher per capita sales than Arizona, Minnesota, and Wisconsin. Further, staff stated that lowering prize payout percentages may negatively impact the amount of per capita sales.

To evaluate the relationship between per capita sales and prize payout percentages on a national level, we compared Colorado's data with data from the other 42 state lotteries without factoring in other variables such as the types of games offered by each state. Of the 25 state lotteries with Fiscal Year 2006 per capita sales higher than the Colorado Lottery's per capita sales of \$100, we found 13 (52 percent) pay out a lower percentage of their total sales as prizes than Colorado's 60 percent. Data on per capita sales and prizes as a percentage of total sales for all states can be found in Appendices A and B.

In addition, we compared prize structures for the Lottery's two in-state jackpot games, Lotto and Cash 5, and a sample of the Lottery's scratch ticket games at different price points (e.g., \$1, \$2, or \$10 scratch tickets) with prize structures for similar games in Arizona, Minnesota, and Wisconsin. We did not evaluate Powerball, as it is a multi-state game governed by a nonprofit organization that sets the same prize structure for all states where the game is offered. We found that for most games and price points reviewed, the Colorado Lottery's prize payouts are higher than those of the three other states. The following table compares Colorado's prize structures for each type of game and at each price point with the range of prize payouts for the other three states for similar games.

<b>Colorado Lottery                      Comparison of Prize Payouts by Game                      Fiscal Year 2007</b>		
<b>Game</b>	<b>Colorado's Prize Payout</b>	<b>Range of Prize Payouts for Comparative States<sup>1</sup></b>
Lotto <sup>2</sup>	58%	50% - 54%
Cash 5 <sup>2</sup>	55%	48% - 50%
\$20 Scratch Ticket	80%	70% - 74%
\$10 Scratch Ticket	72%	66% - 70%
\$5 Scratch Ticket	70%	65% - 68%
\$3 Scratch Ticket	65%	63% - 66%
\$2 Scratch Ticket	64%	60% - 66%
\$1 Scratch Ticket	61%	57% - 68%
<b>Source:</b> Office of the State Auditor's analysis of data from the Colorado, Arizona, Minnesota, and Wisconsin Lotteries. <sup>1</sup> Range of prize payouts for comparable games in Arizona, Minnesota, and Wisconsin. <sup>2</sup> Lotto and Cash 5 are jackpot games offered by the Colorado Lottery. These are compared with jackpot games offered in Arizona, Minnesota, and Wisconsin with the same price points and similar game characteristics.		

As discussed previously, the Lottery's mission is to generate revenue for its beneficiary agencies. By improving how it designs its game prize structures to maximize sales while limiting prize payouts, the Lottery can better fulfill its mission.

When the Lottery designs a new game, staff try to set the prizes to match what the public expects in terms of a return on its wager. The prize structure is also based on the game's price point and how many people are expected to play the game. For example, a jackpot game designed for a possible player population of 4 million will have more jackpot and second-tier (i.e., winning amounts less than the jackpot amount) prize winners than a game designed for a player population of 2 million. According to Lottery staff, jackpot prize structures must be revised periodically to maximize sales while accounting for growth and other changes in player populations. However, the Lottery has not revised the prize structures for its Lotto and Cash 5 games since their inceptions in 1989 and 1996, respectively. Colorado's population has increased by about 1.7 million people, or 52 percent, since Lotto was first introduced in 1989. The State's population has increased by 1.1 million people, or 29 percent, since Cash 5 was introduced in 1996. Since both games were

originally designed for smaller player populations, the Lottery may not be maximizing the amount of revenue generated by these games. For new scratch ticket games, the Lottery reports that staff typically duplicate or slightly modify the established prize structure used for existing games at the same price point, rather than study current player populations and revise the prize structures accordingly.

The Lottery needs to reevaluate the prize structures on a regular basis for all of its games to determine optimal prize payouts that will maximize the amount of revenue available for its beneficiary agencies. According to the Lottery, staff have begun evaluating the prize structures for its scratch ticket games and have modified the prize structures of some games to determine how these changes affect ticket sales. The Lottery should continue conducting these types of comparative studies for both jackpot and scratch ticket games to determine if changes in prize structures could increase the amount of revenue earned. The Lottery should also review available data from other states demonstrating how changes in prize structures have impacted the other states' sales and revenue. Through these evaluations, the Lottery can better design games and prize structures to maximize both ticket sales and revenue for beneficiaries.

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### **Recommendation No. 6:**

The Colorado Lottery should ensure it maximizes the amount of revenue available to beneficiary agencies by evaluating the prize structures on all jackpot and scratch ticket games on a regular basis to determine if adjustments should be made. This evaluation should include studies of prize payout modifications to determine the effect of the changes on sales and revenue and review of other states' data demonstrating how changes in prize structures have affected their ticket sales and revenue. The Lottery should use this information when designing games and prize structures.

### **Colorado Lottery Response:**

Agree. Implementation date: January 31, 2009.

The Lottery has conducted research on prize structures in the past and that is how we have arrived at the current prize structures for most scratch games. The Lottery has also been lowering the prize payout percentages of some scratch ticket games for the last year. The Lottery will evaluate and document other states' activities as well as sales performance results of games that have had their payout reduced on an annual basis. The Lottery's intent with this analysis is to place popular games that players like in the

market place with prize structures that will deliver the maximum return for our beneficiaries and maximum sale of products. We will also work with the Lottery's scratch ticket vendor on prize payout "optimization" considering sales and player likes/dislikes.

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## Retailer Compensation

The Lottery sells jackpot and scratch tickets through about 2,900 licensed retailers statewide. The Lottery's retailer base is primarily comprised of supermarkets, gas stations, convenience stores, and liquor stores. As part of the Lottery's Calendar Year 2008 compensation plan, licensed retailers earn commissions on individual ticket sales of 7 percent on each scratch ticket sold and 6 percent on each jackpot ticket (Powerball, Lotto, and Cash 5) sold. The Lottery also pays bonuses to retailers that redeem winning tickets, sell certain winning jackpot tickets, and meet sales forecasts along with displaying marketing materials in the store. The Lottery's retailer commission rates have been the same since 1998, and the bonus plan was last updated in 2008, with minor changes to marketing signage requirements and the form retailers complete to participate in the bonus program. In Fiscal Year 2007 the Lottery paid retailers \$33.7 million in compensation, which included \$30.3 million (90 percent) in commissions and \$3.4 million (10 percent) in bonuses. Since Fiscal Year 2004 the Lottery's retailer compensation expense has increased 11.2 percent, or by about \$3.4 million, while the number of retailers has stayed basically the same.

According to LaFleur's 2007 World Lottery Almanac, an independent lottery industry research publication, the Colorado Lottery is paying more in retailer compensation as a percentage of ticket sales than most other states. In Fiscal Year 2006 (the most recent year nationwide data were available), the Colorado Lottery paid 7.4 percent of total ticket sales in retailer compensation (commissions plus bonuses), compared with the national average of 6 percent and the median rate of 6.3 percent. Of the 42 state lotteries reporting data, only 3 states paid out more in retailer compensation as a percentage of ticket sales than Colorado. Data for all 42 states can be found in Appendix C. As shown in the following table, the Lottery's proportion of retailer compensation to ticket sales has only decreased slightly between Fiscal Years 2004 and 2007, from 7.6 percent to 7.4 percent.

<b>Colorado Lottery Retailer Commissions and Bonuses Fiscal Years 2004 through 2007 (Dollars in Millions)</b>					
	<b>Fiscal Year</b>				<b>Percent Increase/ (Decrease) Fiscal Years 2004 - 2007</b>
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	
<b>Commissions<sup>1</sup></b>	\$26.6	\$27.8	\$31.0	\$30.3	13.9%
<b>Bonuses</b>	\$3.7	\$3.9	\$3.7	\$3.4	(8.1%)
<b>Total Retailer Compensation</b>	<b>\$30.3</b>	<b>\$31.7</b>	<b>\$34.7</b>	<b>\$33.7</b>	<b>11.2%</b>
<b>Ticket Sales</b>	\$401.3	\$417.0	\$469.0	\$456.0	13.6%
<b>Percent of Retailer Compensation to Ticket Sales</b>	<b>7.6%</b>	<b>7.6%</b>	<b>7.4%</b>	<b>7.4%</b>	<b>(2.6%)</b>
<b>Source:</b> Office of the State Auditor's analysis of Colorado Lottery audited financial statements and data on retailer commissions and bonuses and ticket sales for Fiscal Years 2004 through 2007.					
<sup>1</sup> The Lottery pays retailers 7 percent commission on scratch ticket sales and 6 percent commission on jackpot ticket sales.					

Additionally, we found that the Colorado Lottery's average commission rate of 6.5 percent is higher than both the average and median commission rates nationwide. According to LaFleur's 2007 World Lottery Almanac, all 42 state lotteries reporting data pay commissions to retailers for selling jackpot and scratch tickets. On the basis of data provided by LaFleur's, we estimate the national average commission rate to be 5.7 percent, and the median rate to be 5.5 percent. Of the 42 state lotteries reporting data, 8 states had average commission rates equal to or higher than Colorado's average rate. Rates for all 42 states can also be found in Appendix C. If the Colorado Lottery had applied the national average commission rate of 5.7 percent, instead of Colorado's higher average rate of 6.5 percent, the Lottery would have saved about \$4.3 million in retailer compensation expense in Fiscal Year 2006. This cost savings could have resulted in the Lottery's beneficiary agencies receiving additional funds.

The Lottery's commission rates, as well as the proportion of revenue generated by the different games, significantly impact the total amount paid out in retailer compensation. As discussed previously, Colorado pays a 7 percent commission for each scratch ticket sold, compared with 6 percent for each jackpot ticket. Scratch

ticket sales represent 65 percent of Colorado's total Lottery ticket sales. Therefore, Colorado is paying the higher 7 percent commission rate on almost two-thirds of its ticket sales.

In our *2003 Colorado Lottery Performance Audit*, we recommended the Lottery reevaluate its retailer compensation plan to better link payments to outstanding sales performance. In response to this recommendation, the Lottery revised the bonus portion of its retailer compensation plan to include a requirement that retailers meet quarterly sales projections to receive a bonus. This change strengthened the bonus portion of the retailer compensation plan and decreased the amount paid out in bonuses 8 percent, from \$3.7 million in Fiscal Year 2004 to \$3.4 million in Fiscal Year 2007. However, the commission rate has stayed the same, and therefore the amount paid out in commissions has increased 14 percent over the period, or by the same percent of increased sales. The Lottery should reevaluate its retailer compensation plan to determine how lowering its retailer commission rate might affect ticket sales and retailers' willingness to sell and promote Lottery tickets. Lowering the amount of commission the Lottery pays to retailers could create potential cost savings for the Lottery, thereby increasing its contributions to the beneficiary agencies that rely on funding from ticket proceeds.

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### **Recommendation No. 7:**

The Colorado Lottery should consider cost-saving opportunities related to its retailer compensation plan by evaluating the potential effect of lowering commission rates to better align with national averages and determining the impact on the retailer base and on Lottery net proceeds, taking action as appropriate.

### **Colorado Lottery Response:**

Agree. Implementation date: October 1, 2009.

The Lottery will evaluate its retailer compensation plan as compared with other lotteries and the industry average. As was noted in the report, the Lottery compensation structure has remained the same over the last 10 years, and during this timeframe total Lottery sales have increased over \$125 million with \$100 million of this increase coming from the scratch product. The scratch product involves more labor for the retailer in the handling and stocking of dispensers, as well as requiring valuable counter or floor space, which the retailer provides at no additional charge to display these games. The Lottery pays its retailers a 7 percent commission rate on this product and believes that by being proactive and compensating retailers

at a higher rate than most lotteries, it has benefitted from greater cooperation and participation from the retailer network, resulting in sales gains. In fact, many states are looking at increasing their commission rates based upon feedback from their retailers. Three out of the four newest lottery states started with a 7 percent commission rate for scratch sales. While the Lottery believes that its current retailer compensation is fair, it agrees to evaluate the lowering of retailer commission rates and the potential impact of doing so.

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## Scratch Ticket Management

As discussed previously, there are approximately 2,900 retailers that sell Lottery jackpot and scratch tickets. Since the Lottery first began selling scratch tickets in 1983, the Lottery's sales representatives have delivered these tickets to retailers. The Lottery estimates that sales representatives spend about 60 percent of their time delivering scratch tickets. In Fiscal Year 2003 the Lottery began contracting with United Parcel Service (UPS) to deliver initial new scratch game shipments (usually consisting of 3 or 4 games) about every 5 to 6 weeks, or approximately 10 times per year. Lottery sales representatives have continued to deliver all subsequent orders of scratch tickets after the initial shipment. In Fiscal Year 2007 the Lottery distributed about 107 million scratch tickets to its 2,900 retailers, of which 37 million were delivered by UPS and 70 million were delivered by the Lottery's 32 sales representatives.

In the 2008 Long Bill, the Lottery received a \$4 million appropriation for Fiscal Year 2009 to implement a scratch ticket distribution and inventory management system. There are several different models for this type of system. If the Lottery were to implement a full-service model, the Lottery would contract with an outside firm that would be responsible for the warehousing, inventory, and distribution of scratch tickets and tracking retailer sales and inventory needs. Under this model, Lottery staff would no longer be responsible for performing these functions, but would instead oversee the contractor. In a less inclusive model, the Lottery would purchase a software package to help Lottery staff manage the warehousing and inventory management of scratch tickets, and a courier service would be used to deliver the tickets. The cost of the system will vary depending upon the model chosen. Regardless of the model implemented, the Lottery anticipates that through this new system, all scratch tickets will be delivered by courier rather than by sales representatives.

At the time of our audit, the Lottery was in the process of evaluating the various options available with respect to implementing a scratch ticket distribution and inventory management system. When conducting its evaluation, the Lottery should

also consider the opportunities for cost savings on reallocation of resources that would occur with the implementation of a new system. Depending upon the scratch ticket distribution and inventory management system implemented, the Lottery may be able to reduce administrative expenses in other areas, as discussed below.

- **Fleet.** Currently, the Lottery has 38 vans, which cost approximately \$6,000 annually per van, that sales representatives use to deliver scratch tickets. Regardless of the scratch ticket distribution and inventory management system implemented, the Lottery anticipates that all scratch tickets will be delivered using a courier service rather than by sales representatives. Therefore, once a new delivery system is in place, the Lottery should consider assigning sales representatives smaller, less expensive vehicles. If the Lottery were to replace the vans with cars, which each cost about \$2,500 per year, the Lottery could potentially save about \$133,000 annually.
- **Warehouses.** The Lottery rents three warehouses around the State (Pueblo, Denver, and Colorado Springs) that are used to store scratch tickets, equipment, and point-of-sale items; process scratch ticket orders and deliveries; and provide an office for customer service representatives and sales staff. In total, the Lottery pays about \$221,000 annually for these warehouses. If the Lottery implements a scratch ticket distribution and inventory management system that includes contracting out the warehousing of scratch tickets, the Lottery may no longer have a need for all three warehouses. Although it may still need space for other functions, the Lottery should consider reducing the number and/or size of its warehouses and thus, reduce administrative costs.
- **Staff.** Warehouse staff help process the initial ticket orders delivered by UPS and fill orders for sales representatives after the initial delivery of a scratch ticket game. Under a system that includes contracting out the warehousing and inventory management of scratch tickets, these positions may no longer be needed. Additionally, the Lottery employs 32 sales representatives who spend about 60 percent of their time delivering scratch tickets. With the implementation of the new scratch ticket distribution and inventory management system, sales representatives will no longer be required to deliver tickets. The Lottery will need to reevaluate the role of its warehouse and sales staff. Based on this evaluation, the Lottery should determine the number of staff needed for each function and identify opportunities to reduce the number of staff and/or reallocate staff to other functions and sales activities.

As discussed throughout this chapter, the Lottery's mission is to maximize the amount of funds distributed to its beneficiary agencies. By reducing administrative

expenses, the Lottery will have more funds available for distribution to fund Great Outdoors Colorado, the Colorado Conservation Trust Fund, and the Division of Parks and Outdoor Recreation. The Lottery should incorporate opportunities for reducing administrative expenses when evaluating options for implementing a new scratch ticket distribution and inventory management system.

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### **Recommendation No. 8:**

The Colorado Lottery should incorporate opportunities for reducing administrative expenses when evaluating options for its new scratch ticket distribution and inventory management system. Opportunities that should be explored include reductions and reallocations in its fleet, warehouses, and staff.

### **Colorado Lottery Response:**

Agree. Implementation date: July 1, 2010.

The Lottery will explore reducing administrative expenses as it develops and implements its new scratch ticket distribution and inventory management system. As stated in the report, the Lottery may be able to realize cost savings in three areas once this system is in place and fully operational: fleet, warehousing, and staff. The Lottery will evaluate its vehicles for the sales force, currently cargo vans, and may be able to order smaller vehicles due to the minimal inventory of scratch tickets that sales representatives will need to carry after courier delivery is introduced. Some warehouse facilities may also be downsized or closed, since the shipping and packaging of scratch tickets will likely be performed primarily out of the Lottery's Pueblo warehouse. While the intent of the new distribution system is to grow Lottery scratch sales and not reduce staff, the Lottery will evaluate both sales and warehouse personnel and their duties after this system is fully operational to determine if any positions should be reallocated or eliminated. The Lottery will need time after implementation, however, to study the impact of the new system on its retail network and the expansion of its business and products before any decisions regarding personnel could be finalized.

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## Controls Over Assets

Statute [Section 24-17-102, C.R.S.] requires state agencies to restrict access to state assets to authorized personnel in the performance of their assigned duties and to maintain adequate controls and record-keeping procedures to provide effective accounting of these assets. Additionally, State Fiscal Rules require state agencies to design and implement programs and controls to prevent, deter, and detect fraud and require state-owned equipment to be properly accounted for throughout its useful life. We identified two areas where the Lottery needs to strengthen its controls over state assets, as discussed below.

### Cash Controls

The Lottery has four ticket offices—in Denver, Pueblo, Fort Collins, and Grand Junction—where Lottery customers can buy tickets and redeem winning tickets for any amount. The Lottery requires that all winning tickets of \$600 or more be redeemed at one of these four offices rather than at one of the Lottery's 2,900 licensed retailers. The Lottery pays all prizes of \$600 or more by issuing a state warrant. In Fiscal Year 2007 these four offices sold \$486,000 in tickets and redeemed \$39.3 million in winnings.

We observed the Lottery's controls over cash assets, blank warrants, and ticket inventory at three of the four Lottery ticket offices and conducted a phone interview with staff at the fourth office. We identified four concerns about the Lottery's safeguarding and monitoring of cash assets and inventory at its ticket offices. First, we found that the Lottery does not adequately safeguard blank warrants at all offices. The Lottery's procedure for processing warrants states that ticket counter employees should store blank warrants in the office safe and retrieve a warrant from the safe at the time a prize is redeemed. However, we observed that during business hours, blank warrants at two of the four Lottery offices were stored in unsecured locations outside the safe that were accessible to other staff who are not responsible for redeeming winning tickets. The inconsistencies we noted indicate that some ticket counter employees are not following the Lottery's established procedure for handling blank warrants. Second, we found that during business hours at all four Lottery offices cash is kept in unlocked drawers. Improper safeguarding of the Lottery's cash assets and blank warrants increases the risk for fraud or abuse.

Third, we found that none of the Lottery's ticket offices has an electronic mechanism, such as a cash register, to record individual scratch ticket sales. Currently, ticket counter staff manually track unique identification numbers on sets of scratch tickets to determine how many tickets have been sold each day. Although staff reconcile the cash drawers each night, the inability to electronically record

individual scratch ticket sales increases the risk for errors in calculating the amount of cash that should be exchanged when customers purchase or redeem scratch tickets. It also limits the Lottery's ability to properly reconcile and account for scratch ticket inventory.

Finally, we found that the Lottery lacks consistent practices for performing and documenting audits of cash assets and scratch ticket inventory at the four ticket offices. Since September 2007 the Lottery has conducted 22 "surprise" audits across the four ticket offices. These audits generally focused on cash management practices at the claims counters by reconciling cash on hand, scratch ticket inventory, and the stock of blank state warrants. However, we found the Lottery has not been consistent in the frequency of these audits. Some offices were audited on a monthly basis, while others were audited every three months. Additionally, we found that the Lottery is not consistently documenting and communicating audit findings to the appropriate staff. The Claims Counter Manager is responsible for overseeing the four ticket offices, and this individual conducts a majority of the audits. However, to help with limited staff resources, security staff also review cash management practices when they conduct security reviews at the four ticket offices. We found, however, that security staff do not always notify the Claims Counter Manager of what they examined during these reviews and what problems, if any, they identified. For the reviews to be effective, the Claims Counter Manager must be aware of any problems identified so that they can be addressed immediately.

To ensure cash assets are adequately protected, the Lottery should ensure staff comply with established procedures for safeguarding blank warrants. The Lottery should also consider installing locking cash registers at all four ticket windows. Cash registers would help ensure that cash is always secured and also provide a mechanism for more accurately tracking scratch ticket sales and inventory. Finally, the Lottery should develop and implement standard procedures for conducting audits of cash assets and scratch ticket inventory at the four ticket offices. These procedures should address the frequency of the audits and how audit findings should be documented and communicated. The Claims Counter Manager and security staff should then coordinate with one another to ensure they are all following the same procedures, and the Claims Counter Manager should follow up on all problems found.

## **Asset Management**

We also found the Lottery has not maintained proper controls over the use and location of state-owned video equipment used by a contract videographer. The videographer, a subcontractor of the Lottery's advertising agency, uses the equipment to film footage of Lottery events, such as press conferences and activities involving Lottery beneficiaries, to be used for promotional purposes. The

subcontract agreement allows the videographer to use the Lottery's video camera, tripod, and related videography equipment, which was originally purchased by the Lottery for \$33,000, and to store the equipment at her home from February through August of each year. However, the contract restricts use of the equipment to state business only. Lottery staff could not provide documentation demonstrating when the equipment has been in the contractor's possession throughout the year versus when it has been in the Lottery's possession.

By not maintaining adequate controls over its video equipment, the Lottery increases the risk for misuse or misplacement of those assets. The Lottery should discontinue its practice of allowing the videographer to store state equipment at her home. Instead, the Lottery should require the videographer to check out the equipment for the duration of a specific project and then the equipment should be returned to the Lottery.

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### **Recommendation No. 9:**

The Colorado Lottery should improve its methods for safeguarding and accounting for state assets by:

- a. Ensuring that all ticket counter employees follow the established warrant procedure, including storing blank warrants in a locked safe until needed.
- b. Installing at all four Lottery ticket offices cash registers that have the capability to lock in-between transactions and record scratch ticket sales.
- c. Developing and implementing standard procedures for conducting audits and communicating findings, and ensuring that all staff conducting audits follow the established procedures.
- d. Requiring vendors to check out state-owned video equipment for specific projects and return it to the Lottery at the end of those projects.

### **Colorado Lottery Response:**

Agree.

- a. Implementation date: Implemented. Warrants are now kept in a locked vault at all offices. All offices are following the established warrant procedures. Due to the frequency of warrants produced at the counter in the Denver office, safe location, and time required to open the safe, three

to four warrants are secured in a locked cabinet located in the claims area during business hours only. Warrants are reconciled daily for accountability purposes.

- b. Implementation date: Implemented. A cash register solution was purchased for all offices in July 2008 and implemented in August 2008. The cash registers have locking drawers, require individual sign-on, record all sales, and track inventory.
- c. Implementation date: September 2008. The operations staff will seek guidance from our fiscal office for improving existing procedures, including developing and implementing any new procedures for conducting audits and communicating findings. All staff conducting audits will be properly trained on the established procedures.
- d. Implementation date: Implemented. The Lottery implemented a process in March 2008 for checking out video equipment and returning it.

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## Sales Promotions

Lottery sales representatives periodically conduct sales promotions, such as scratch ticket giveaways, at retailer locations around Colorado. In addition, during promotional events or while visiting retailers, Lottery staff may give promotional items, such as key chains, jackets, t-shirts, or lanyards, to customers and retailers. From July 2006 through December 2007 the Lottery held about 350 sales promotions and spent approximately \$169,000 on promotional items.

In our *2003 Colorado Lottery Performance Audit* we identified concerns related to the Lottery's controls over promotional inventory and the lack of pre- or post-evaluation of sales promotions and giveaways. During the current audit we found that, overall, the Lottery has improved its controls over promotional inventory and its review and evaluation of certain marketing activities, such as its sponsorship of the Colorado State Fair. However, we found the Lottery has not sufficiently implemented a process for analyzing and evaluating the effectiveness of sales promotions conducted at retailer locations. As a result, the Lottery does not know if promotional activity funds are being used effectively.

Sales staff track data about promotional events in the Lottery's Wang system, including a description and the cost of each event. Sales staff are also required to complete a sales promotion form for each event that includes information on the cost of the event compared with the estimated return on investment for the event, usually

calculated as an increase or decrease in ticket sales over a specified period, to determine whether the event was profitable for the Lottery. Although the Lottery is collecting these data, we found that sales staff do not analyze the data to: (1) identify sales trends associated with different types of promotions, or (2) determine which promotions generate a higher financial return than others. Lottery management also reported they do not use the cost analysis data to make informed organizational decisions about the use of promotional inventory and events. Additionally, the forms do not ask staff to assess any nonfinancial benefits, such as retailer goodwill and positive customer relations, that are achieved through the promotional events.

Once the Lottery implements its new scratch ticket delivery and inventory management system, as discussed earlier in this chapter, sales representatives may have more time available to conduct sales promotions, and the Lottery anticipates that it may spend more money on these promotions. Therefore, it is important that the Lottery implement processes for effectively analyzing and evaluating both the financial and nonfinancial benefits generated through sales promotions. One option may be to track and analyze sales promotion data electronically, including return on investment information, rather than in the current paper format. This would make the information centrally available for easy access and analysis by all sales managers and Lottery senior management. This information should then be used by both sales managers and senior management when making decisions about promotional activities in the future.

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### **Recommendation No. 10:**

The Colorado Lottery should develop effective and efficient processes for analyzing and evaluating different types of sales promotions and deciding the types and frequency of promotions to be held in the future. These processes should include capturing and analyzing information about both the financial and nonfinancial returns generated from conducting the promotions.

### **Colorado Lottery Response:**

Agree. Implementation date: July 1, 2009.

The Lottery understands the importance of promotional evaluation and agrees to develop processes for evaluating different types of sales promotions. The end result will likely include more than one type of evaluation method and criteria depending on the type, size, and scope of the promotion. As the Lottery's back office and reporting systems improve, these evaluations

should become more numerically driven and provide more detailed results in relation to sales improvements.

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# Lottery Administration

## Chapter 3

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Colorado's Lottery is overseen by both the Colorado Lottery (Lottery), a division within the Department of Revenue (Department), and the Lottery Commission (Commission). The State Lottery Director, who is the administrative head of the Division, is responsible for administering the Lottery in accordance with rules promulgated by the Commission and with statute. The Director's responsibilities include taking all necessary steps to ensure the efficient and economical administration of the Lottery. Under statute [Section 24-35-208(1)(c), C.R.S.], the Commission is responsible for carrying on a continuous study and investigation of the Lottery to identify areas where changes are needed to improve the administration and operation of the Lottery.

We evaluated the administration of the Lottery and identified several areas where improvements are needed. Specifically, we identified issues related to the role of the Commission, the rulemaking process, background investigations, retailer licensing fees, statutory requirements for lawful presence, and player demographic studies. Each of these is discussed in this chapter.

### Role of the Lottery Commission

The Lottery Commission is composed of five members who are appointed by the Governor to serve a maximum of two four-year terms. According to statute [Section 24-35-207, C.R.S.], the Commission must include at least one certified public accountant, one attorney, and one law enforcement officer; no more than three members can belong to the same political party. The Commission's responsibilities include promulgating rules governing the establishment and operation of the Lottery. These include, but are not limited to, rules governing the types of Lottery games to be conducted, the price of Lottery tickets, the number and size of the prizes on the winning tickets, the method and frequency of selecting winning tickets, and the amount of compensation paid to retailers for selling tickets. Additionally, the Commission is authorized to conduct hearings on Lottery-related complaints and to continuously study and investigate the Lottery to determine if changes are needed. The Commission is also authorized to recommend to the Governor, Attorney General, and legislative leadership statutory changes needed to improve the administration of the Lottery.

In 2004 Senate Bill 04-204 was enacted which, among other things, reclassified the Commission from a Type 1 commission to a Type 2 commission. With the reclassification, the Commission's authority was limited to promulgating rules and providing advice and input on the administration of the Lottery, as described above. Prior to 2004, the Commission operated as a Type 1 commission and had decision-making authority over all Lottery procurement documents and contracts, the Lottery's annual budget, and background investigations conducted on current and prospective Lottery employees.

We interviewed Commission members and reviewed the Commission's role and responsibilities since the 2004 change in authority and found that the role and responsibilities have not been clearly defined and communicated to Commission members. Some Commission members report they are not clear about the Commission's role and how their responsibilities differ from those of the Division Director. As a result, some members indicated they are hesitant to direct the topics of Commission meetings and question Lottery staff on the issues and proposed rules brought before them. We reviewed minutes for the 12 Commission meetings in Calendar Year 2007 to determine the types of issues the Lottery brought before the Commission and the decisions made by the Commission. We found that, overall, Lottery staff brought only a limited number of issues, other than those related to the game rulemaking process, before the Commission for discussion or consideration. These issues were related to marketing efforts, legislation impacting the Lottery, and sales data. The minutes reflected little discussion on other important issues such as the Lottery's gaming system contract with Scientific Games, product development, and licensing fees for some scratch ticket games. Further, according to the minutes, there were only four occasions during the year when a Commission member questioned the information provided by Lottery staff. With respect to rulemaking, the Commission adopted rules authorizing 44 new scratch ticket games. The Commission approved all of these game rules unanimously and did not adopt any other rules related to Lottery operations.

Although the Commission's authority has changed in recent years, the Commission still plays a critical role in helping to oversee Lottery operations. As mentioned previously, statute grants the Commission the authority to "carry on a continuous study and investigation of the Lottery" with the purpose of making recommendations to improve Lottery operations. Therefore, it is important that the Commission's role and responsibilities be clearly defined and communicated to Commission members so they can use their expertise to provide advice and assistance to the Lottery regarding Lottery operations.

Although statute clearly authorizes the Commission to promulgate rules governing the establishment and operation of the Lottery, statute does not provide direction as to what the Commission should do to "carry on a continuous study and investigation

of the Lottery.” A charter or bylaws could help clarify the Commission’s role and further define its relationship with Lottery staff and management. Best practices indicate that a board or commission should establish standards and systems to ensure accountability and effective oversight. These standards should clearly address the following:

- **Organizational structures and processes**, including how the body will ensure: (1) compliance with applicable statutes, regulations, and best practices; (2) economic, efficient, and effective use of public moneys; and (3) open and transparent communication with stakeholders on the entity’s mission, roles, objectives, and performance.
- **Roles and responsibilities**, including clearly documented: (1) responsibilities between the governing body and the governed agency; (2) management processes for policy development, decision-making, monitoring, control, and reporting; and (3) procedures for holding the chief executive accountable for ultimate performance of the entity and implementation of the governing body’s policies.

We reviewed the governance manuals for the Board of Trustees of the Colorado Public Employees’ Retirement Association and the State Deferred Compensation Committee and found that both groups have established a comprehensive set of self-governance practices that address the roles and responsibilities of the respective Board and Committee and clarify areas of decision-making.

The Lottery and the Lottery Commission should work together to develop a charter or governance manual that clearly establishes the Commission’s and the Lottery’s roles and responsibilities and clarifies areas of decision-making. The Lottery should communicate this information to new Commission members as part of their initial orientation. Although the Lottery currently provides an orientation to new Commission members, this orientation focuses on how the Lottery works and does not address the role of the Commission. Expanding the scope of the orientation to include information on the Commission’s role and responsibilities, including how the rulemaking process works, would better prepare Commission members for their duties and increase the value of their contributions to improving Lottery operations.

Outdated and conflicting statutes and rules have also added to the lack of clarity in the Commission’s role. We identified several instances where statutes and rules have not been updated to reflect the change in the Commission’s authority from a Type 1 to a Type 2. For example:

- Section 24-35-204(3)(i), C.R.S., requires that the Lottery Director gain the concurrence of the Commission or follow Commission procedures when entering into contracts.
- Section 24-35-204(3)(l), C.R.S., requires that the Lottery Director submit an annual division budget to the Commission for approval.
- Section 24-35-205(1), C.R.S., requires potential contractors to submit detailed information to the Commission for approval.
- Section 24-35-205(10), C.R.S., requires potential contractors to submit their fingerprints to the Commission for a Colorado Bureau of Investigation background check.
- Commission Rule 9 requires that the Commission review and approve all Requests for Proposals and final contracts valued greater than \$100,000.

These functions are not consistent with the authority granted to a Type 2 Commission. Some Commission members have expressed concern that statutes and rules appear to grant powers and duties to the Commission that are not allowed for a Type 2 entity. If a problem occurred related to one of these areas, some Commissioners are concerned that they may be held liable, although they no longer have any actual authority in these areas. Neither the Lottery nor the Commission has conducted a thorough analysis of statutes and rules to identify provisions that should be revised to reflect the Commission's current authority. The Lottery needs to work with the Commission to review existing rules and statutes to identify outdated and conflicting language, and then work with the Department and the General Assembly to seek necessary statutory changes.

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### **Recommendation No. 11:**

The Colorado Lottery should work with the Colorado Lottery Commission to ensure the role and responsibilities of the Commission are clearly defined by:

- a. Developing and adopting a charter or governance manual that outlines the organizational and decision-making responsibilities and boundaries of the Commission and the Lottery.
- b. Reevaluating the new Commission member orientation and expanding the scope of the orientation to include information on the Commission's role and responsibilities, including how the rulemaking process works.
- c. Reviewing current statutory language regarding the Commission's authority to identify outdated provisions and working with the General Assembly to make necessary statutory changes.

- d. Reviewing and revising Lottery rules to ensure they are consistent with the Commission's current authority as a Type 2 entity.

### **Colorado Lottery and Colorado Lottery Commission Response:**

Agree.

- a. Implementation date: January 1, 2009. The Lottery is working with the Commission to develop a governance manual that will clearly illustrate the decision-making responsibilities and boundaries of the Commission and the Lottery.
- b. Implementation date: January 1, 2009. Orientation materials created for new Commissioners will be reviewed and revised to include pertinent information concerning the role of the Commission and the State's rulemaking process.
- c. Implementation date: July 1, 2009. The Lottery and the Commission will work with the General Assembly to review existing statutes and make changes to outdated provisions, and Lottery rules will be revised to make them consistent with the Commission's authority as a Type 2 entity.
- d. Implementation date: October 1, 2009. The Lottery Commission is already working with staff to review and revise rules to ensure accuracy and consistency.

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## **Scratch Game Rulemaking**

In Fiscal Year 2007 the Lottery introduced 44 new scratch ticket games into the market. Statute [Section 24-35-208(2)(c), C.R.S.] requires the Lottery Commission to promulgate a rule approving every new scratch ticket game before that game can be marketed. The rule also establishes the game's prize structure, or the number and size of the prizes that can be won for that game. A 2005 formal opinion from the Colorado Attorney General further stated that "since a rule is required for attributes that change from one instant scratch game to another, the Commission is required by the statute to promulgate rules for each instant scratch game." This means that, according to the opinion, the Commission cannot promulgate one general rule that applies to all scratch ticket games; a separate rule must be promulgated for each game. Additionally, the Attorney General's opinion stated that the statutory

requirement applies to situations where the Lottery wants to reorder scratch tickets for an existing game that has sold out sooner than expected. Additional tickets ordered for an existing game change the game characteristics because these tickets increase the dollar amount and number of prizes available.

We reviewed the Lottery's process for introducing new scratch ticket games into the market and found that the process is not timely. Specifically, we reviewed the timeliness of the rulemaking process for 12 scratch ticket games that went through the process in Calendar Year 2007. We found that the rulemaking process took between 91 and 114 days for these 12 games. For example, for the \$2 game "Super 7-11-21," Lottery staff originally presented the proposed rule to the Lottery Commission at its monthly meeting in November 2006. After going through the entire rulemaking process, the rule approving the game became effective in March 2007, approximately four months after it was originally introduced.

The length of the rulemaking process makes it difficult for the Lottery to respond quickly to market demands. For example, many licensed scratch ticket games are developed for introduction to the market along with the premiere of a popular television show or movie to maximize the visibility of the game and its sales. In many cases, these games are not available for purchase by state lotteries until a month or two before the premiere of the show or movie. Since the Lottery's current rulemaking process takes three to four months, the Lottery often has to pass on these games because it would not be able to promulgate a game rule and order tickets in time to introduce the game in the market at the same time as the premiere of the show or movie. This can result in lost revenue for the Lottery, thereby reducing the proceeds it provides to its beneficiary agencies.

Many of the time requirements contributing to the length of the rulemaking process are imposed by the Colorado Administrative Procedures Act (APA). For example, the APA requires that notice of the hearing on the rule be published by the Secretary of State in the Colorado Register at least 20 days prior to the date of the hearing. Once the Commission votes to adopt the rule at the hearing, the Lottery must file the proposed rule with the Secretary of State for publication in the Colorado Register. The Secretary of State publishes hearing notices and proposed rules only on the 10th day of each month. Finally, the APA requires an additional 20-day waiting period after the proposed rule is published before it becomes effective.

Notwithstanding the time requirements imposed by the APA, the Lottery and the Commission could shorten the rulemaking timeline by reassessing their internal practices related to rulemaking. Historically, the Lottery has waited until the Commission's regularly scheduled monthly meetings to bring rules before the Commission for consideration and adoption. By doing so, we estimate the Lottery has extended the rulemaking process by about 40 days. When new marketing

opportunities arise and time is of the essence, the Lottery could hold teleconference “emergency” Commission meetings, separate from the regularly scheduled monthly meetings, for the sole purpose of approving a rule to implement a new scratch ticket game. Using this approach, we estimate the Lottery could shorten the rulemaking process to about 70 days, compared with the 110 days on average it currently takes.

Another option the Lottery and the Commission could consider is pursuing statutory change to eliminate the requirement that a new rule be promulgated for each new scratch ticket game and for ticket reorders on existing games. If statute was changed to allow the Commission to promulgate a single rule for all scratch ticket games, but still required the Lottery to obtain Commission approval of individual game guidelines prior to implementing new games, the Lottery could shorten the rulemaking process while preserving the Commission’s oversight role. This is similar to the current rulemaking process for jackpot games, such as Lotto and Cash 5. For these jackpot games, there is one rule for each game; a separate rule is not required for each drawing, although there are new winners each time.

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## **Recommendation No. 12:**

The Colorado Lottery and the Colorado Lottery Commission should work together to evaluate options to improve the timeliness of the scratch ticket game approval and rulemaking process. Options considered should include:

- a. Identifying ways to shorten the internal portion of the rulemaking process.
- b. Working with the General Assembly to seek statutory change to eliminate the rulemaking requirement for individual scratch ticket games and/or for ticket reorders on existing games.

## **Colorado Lottery Response:**

Agree.

- a. Implementation date: December 1, 2008. The Lottery will review the internal processes involved in rulemaking to identify areas where efficiencies may be achieved to reduce the time to create game rules. The Lottery has already conducted studies of other lotteries as to their particular rulemaking processes and has proposed changes to the Executive Director of the Department of Revenue and the Lottery Commission that will eliminate the need for rulemaking for each individual scratch game.

- b. Implementation date: July 1, 2009. This proposal is now a part of the Governor's Government Efficiency Management Study (GEMS) effort and the Lottery will be working with the Department of Revenue to seek these statutory changes.

### **Colorado Lottery Commission Response:**

Agree. Implementation date: July 1, 2009.

The Commission is aware of the Lottery's efforts to identify efficiencies in the game rulemaking process. The Commission supports seeking statutory change for this issue and will monitor progress to ensure that the proposed legislation allows the Commission appropriate oversight of Lottery games.

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## **Background Investigations**

The Lottery Director is required by statute [Section 24-35-204(3)(c), C.R.S.] to ensure the Lottery conducts full criminal background investigations of Lottery employees, employees of vendors contracting with the Lottery (e.g., Scientific Games, Cactus Marketing Communications, and United Parcel Service), Lottery Commission members, and officers of licensed retailers, as are necessary, to ensure the security and integrity of the operation of the Lottery. We reviewed the Lottery's background investigation process and found that for Lottery and vendor staff and Commission members, there are inconsistencies in who is being investigated and the frequency of the investigations. These inconsistencies indicate the Lottery is not in compliance with statutes requiring background investigations and limit the Lottery's ability to ensure the security and integrity of the organization. We did not find these inconsistencies in the background investigations conducted on licensed retailers. The inconsistencies we identified are discussed below.

First, we found that the Lottery has not conducted background investigations on the four new members appointed to the Commission since Fiscal Year 2004. According to the Lottery, in January 2004 the previous Department administration directed the Lottery to discontinue background investigations on Commission members. Second, we found the Lottery does not have documentation to show that four Lottery employees in the fiscal and IT sections had a background investigation completed prior to being hired. These four employees were hired during Calendar Year 2006 and at that time, staff in the fiscal and IT sections reported to management at the Department rather than Lottery management. Therefore, the Department was responsible for conducting background investigations on all staff hired for these two sections. Although the Department reports that it conducted background

investigations on these four individuals, the Department could not provide documentation to show that the background investigations actually occurred, what the investigations entailed, or the results. As of February 2008 fiscal and IT staff report to the Lottery Director. Finally, we found the Lottery has not been consistent in conducting follow-up investigations on employees, vendor employees, or Commission members since Calendar Year 2004. Prior to Calendar Year 2004, the Lottery had a policy in place that required annual follow-up background investigations for every Lottery and vendor employee. This follow-up investigation included updating personal information, such as changes in name or address, personal credit reports, and criminal history reports.

It is important that individuals involved with the Lottery maintain a high level of integrity. A security breach, or other fraud or abuse, by a Lottery employee, vendor, or Commission member could result in a financial loss to the Lottery and the State and harm the Lottery's credibility with the public. Moreover, by not conducting follow-up background investigations, the Lottery cannot verify that Lottery and vendor employees continue to uphold the standards that were expected of them when they were initially hired.

The Lottery should develop and implement standard background investigation policies for Lottery and vendor employees and Commission members. These policies should address issues such as who will be investigated, when follow-up investigations should occur, the types of investigations that should be conducted, and how the results of the investigations should be used. Prior to January 2004 the Lottery had background investigation policies, including follow-up policies, for each of these groups. However, according to Lottery management, in January 2004 the previous Department administration directed the Lottery to discontinue using its background investigation policies and instead directed the Lottery to follow general statutory requirements related to background investigations. These requirements are vague and do not sufficiently prescribe what sort of background investigations should be performed, who should be subject to a background investigation, or how often the investigations should be conducted. Additionally, the Lottery should ensure that background investigations are conducted on all Commission members and the four fiscal and IT staff identified during the audit.

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### **Recommendation No. 13:**

The Colorado Lottery should comply with statutes and ensure that its background investigation process adequately protects the security and integrity of the Lottery by:

- a. Developing and implementing standard background investigation policies that address who should receive a background investigation, how the investigations should be conducted, how the results of investigations should

be used, and when follow-up investigations should occur. Policies should address all groups specified in statute as requiring background investigations.

- b. Completing background investigations on all Lottery Commission members and fiscal and IT staff appointed or hired since 2004 who have not had a documented background investigation completed, and taking action as needed.

### **Colorado Lottery Response:**

Agree.

- a. Implementation date: October 1, 2008. The Department of Revenue is in the process of updating its Background Check Policy and the Lottery is in the final process of developing and implementing a standard background procedure to address how investigations will be conducted, how the results will be used, and the timeliness of follow-up investigations. Procedures will address all groups specified in statute as requiring background investigations.
- b. Implementation date: September 1, 2008. Background investigations have been conducted on all current Lottery Commission members. The Lottery has completed background investigations and is in the process of completing the documentation of the background investigations on those employees hired since 2004 in the fiscal and IT section who did not have a documented background investigation completed by the Department of Revenue.

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## **Retailer Licensing Fees**

As discussed previously, the Lottery sells its products through about 2,900 retailers statewide. Each retailer must be licensed by the Lottery before it is allowed to sell tickets. As part of the licensing process, the Lottery conducts a background investigation on all owners or officers of the retailer. The background investigation for the initial license generally includes a Department sales tax check, a state and federal fingerprint-based criminal history check, personal and business credit checks, and a Secretary of State business compliance check. The Lottery also requires retailers to renew their license on an annual basis. During the licensing renewal process, the Lottery performs a name-based criminal history check on the retailer owners and officers to determine if any crimes have been committed subsequent to initial licensure. At the time of initial licensure and during the annual renewal

process, retailers must pay a \$21 licensing fee. Statute [Sections 24-35-206 (7) and (10), C.R.S.] requires the Lottery to bill retailers for the cost of the background investigations.

We reviewed the retailer licensing process and found that the Lottery's annual licensing fees may not reflect the actual cost of the background investigations conducted, as required by statute. As a result, the Lottery may not be collecting sufficient funds to cover its costs. At the time of the audit, the Lottery did not know the full cost of its background investigation process. However, based on Lottery data, we estimated that the background investigation conducted at the time of initial licensure costs, on average, \$160 per retailer and the annual renewal check can cost up to \$7 per retailer. Therefore, the Lottery's costs for conducting background investigations for the first two years of licensure is about \$167 per retailer. However, the Lottery only collects \$42 from the retailer during these two years. This would mean that the Lottery is failing to collect about \$125 per retailer during the first two years of licensure.

The Lottery raised the licensing fee from \$15 to \$21 in 2002 due to an increase in the cost of fingerprint checks. However, the Lottery did not conduct an analysis at that time to determine whether this fee was sufficient to cover the actual cost of the entire background investigation, not just the fingerprint check. To conduct this analysis, the Lottery would need to know how many new retailers, on average, are added to the retailer base each month and how much it costs, on average, for a retailer to go through the background investigation process. At the time of the audit, the Lottery did not track data on the number of new retailers added to the retailer base each month and did not know the full cost of background investigations, including staff time spent on the investigations. The Lottery needs to develop a mechanism for tracking these data, use these data to assess the actual cost of background investigations, and revise licensing fees, as necessary, to reflect these costs.

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### **Recommendation No. 14:**

The Colorado Lottery should ensure that retailer licensing fees reflect the actual cost of background investigations by:

- a. Developing and implementing a mechanism for tracking the number of retailers licensed each year requiring a background investigation and assessing the cost of the retailer licensing background investigation process.
- b. Revising the licensing fee as needed to ensure it covers the actual cost of the initial background investigation and all subsequent checks.

## Colorado Lottery Response:

Agree.

- a. Implementation date: Implemented. In October 2007 the Lottery Licensing Unit implemented a mechanism for tracking the number and cost of licensing retailers and will use this information to assess the cost of the retailer licensing background investigation process.
- b. Implementation date: July 1, 2009. The Lottery will use the information obtained from this evaluation to ensure the licensing fee covers the average costs of the initial and subsequent background investigations for retailers.

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## Lawful Presence

Since 2003 the General Assembly has passed several laws designed to ensure that only those persons lawfully present in the United States receive public benefits. We reviewed the Lottery's implementation of and compliance with two of these laws that may affect the Colorado Lottery: House Bill 06S-1023 (Article 76.5 of Title 24 of the Colorado Revised Statutes) and the Colorado Secure and Verifiable Identity Document Act (Article 72.1 of Title 24 of the Colorado Revised Statutes). As discussed below, there are provisions in both of these laws that indicate the laws may apply to the Colorado Lottery, specifically with respect to issuing retailer licenses and verifying the identity of Lottery winners. However, the language in the Bill and the Act is not clear on applicability. Therefore, the Lottery should obtain an Attorney General's opinion as to whether the Bill and the Act apply to the Lottery's issuance of retailer licenses and redemption of winning Lottery tickets.

**Retailer Licenses.** House Bill 06S-1023 [Section 24-76.5-103, C.R.S.] requires state agencies that issue a public benefit to verify each applicant's lawful presence in the United States. The Bill references federal law [8 U.S.C. Sec. 1621], which defines "public benefit" as any grant, contract, loan, professional license, or *commercial license* provided by an agency of a state or local government. According to House Bill 06S-1023, lawful presence can be verified by requiring an applicant to provide one of the following: (1) a valid Colorado driver's license or a Colorado identification card, (2) a United States military card or a military dependent's card, (3) a United States Coast Guard Merchant Mariner Card, or (4) a Native American Tribal Document. The Bill also requires applicants to execute an affidavit stating that he or she is a United States citizen or legal permanent resident or that he or she is otherwise lawfully present in the United States pursuant to federal law. For an

applicant who has executed an affidavit stating that he or she is an alien lawfully present in the United States, the Bill requires the state agency to verify lawful presence through the federal Systematic Alien Verification of Entitlement (SAVE) Program database. Finally, effective August 1, 2006, House Bill 06S-1023 requires agencies to submit an annual report to the State, Veterans, and Military Affairs committees of the Senate and House of Representatives with regard to compliance with the Bill.

As discussed previously, the Lottery issues licenses to retailers to sell Lottery games. It is not clear whether a retailer license is a “commercial license” and whether it therefore meets the federal definition of “public benefit.” If so, the Lottery would be required by House Bill 06S-1023 to verify that retailer licensing applicants are in the United States lawfully. According to the Lottery, in some cases it does check retailer licensing applicants’ identification documents. However, the Lottery does not require that the identification documents be one of those listed in the Bill, and the Lottery does not consistently document that identification was checked. We reviewed a sample of 30 retailer licensing files and found that only 5 of the 30 files (17 percent) contained documentation to show that one of the approved forms of identification had been checked prior to licensure.

We also found the Lottery does not require retailer licensing applicants to execute an affidavit stating that they are United States citizens, legal permanent residents, or otherwise lawfully present in the United States pursuant to federal law. None of the 30 retailer licensing files we reviewed contained this affidavit. Additionally, we found that the Lottery is not verifying lawful presence through the SAVE database for aliens who have indicated they are in the United States lawfully, as required by Section 24-76.5-103(7), C.R.S. We identified one retailer in our sample who was not a United States citizen. However, we found there was no documentation in the file for this retailer to show that the Lottery verified the individual’s lawful presence in the United States through the SAVE database. Finally, we found the Lottery has not submitted an annual report to the State, Veterans, and Military Affairs committees as required by the Bill. The first report would have been due on August 1, 2007.

**Lottery Winners.** The Secure and Verifiable Identity Document Act stipulates that a public entity “shall not accept, rely upon, or utilize an identification document *to provide services* unless it is a secure and verifiable document.” [Emphasis added.] The Act defines a secure and verifiable document as “a document issued by a state or federal jurisdiction or recognized by the United States Government and that is verifiable by federal or state law enforcement, intelligence, or homeland security agencies.” [Section 24-72.1-102(5), C.R.S.]

As discussed previously, the Lottery operates four offices around the State that sell and redeem Lottery tickets. All winning tickets of \$600 or more must be redeemed

at one of the Lottery's four offices, rather than at a licensed retailer. Although individuals do not have to show an identification document to buy a Lottery ticket, the Lottery currently requires individuals redeeming winning tickets at one of the Lottery's offices to show an identification document in two circumstances: (1) if the back of a winning ticket of any amount has been signed, the Lottery asks for an identification document to verify that the individual redeeming the ticket is the person who signed the ticket, and (2) if a winning ticket is for \$600 or more, the Lottery verifies the winner's identity by asking for an identification document and social security number and checking that information against a personal background check website. If a winner is not a United States citizen, the individual can show his or her immigration papers, visa or green card, passport, or resident alien card, and Lottery staff do not verify their name through the SAVE database.

It is not clear whether redeeming a winning Lottery ticket is considered "providing a service" under the terms of the Act. If so, since the Lottery requires winners of \$600 or more to provide an identification document to redeem a winning ticket in certain situations, according to the Act, the identification document would need to be secure and verifiable. We found, however, that the Lottery has not established a list of acceptable identification documents that could be considered "secure and verifiable" under the terms of the Act. Although we found that some of the identification documents accepted by the Lottery could be considered "secure and verifiable," others may not be. For example, according to Lottery staff, they have accepted student identification documents when an individual did not have any other form of identification. These identification documents are not considered secure and verifiable documents under the Act.

Due to the complexity of the Act and the Bill and the lack of clear guidance on applicability, the Lottery should seek an Attorney General's opinion as to whether House Bill 06S-1023 and the Secure and Verifiable Identity Document Act apply to the Lottery's issuance of retailer licenses and redemption of winning Lottery tickets. If the Attorney General determines that the Lottery is subject to these statutory requirements, the Lottery should implement procedures to ensure its compliance.

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## **Recommendation No. 15:**

The Colorado Lottery should seek an Attorney General's opinion to determine whether House Bill 06S-1023 and the Secure and Verifiable Identity Document Act apply to the Lottery, specifically with respect to retailer licensing and redeeming winning lottery tickets. If the Attorney General determines that one or both of these statutes apply, the Lottery should develop and implement procedures to ensure compliance with the applicable requirements.

### **Colorado Lottery Response:**

Agree. Implementation date: The request will be submitted to the Attorney General by October 2008.

The Lottery will be requesting the Attorney General's opinion as to whether House Bill 06S-1023 and the Secure and Verifiable Identity Document Act apply to the Lottery's issuance of retailer licenses and redemption of winning Lottery tickets. If it is deemed that the Lottery is subject to these statutory requirements, the Lottery will implement procedures to ensure its compliance.

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## **Player Demographics**

Statute [Section 24-35-218(1)(c)(VI), C.R.S.] requires the Lottery to assess changes or trends in the types of individuals playing Lottery games. The Lottery contracts with its advertising agency, Cactus Marketing Communications, to conduct an annual "tracking study." The purpose of this study is to monitor the Lottery's player population and how that population perceives the Lottery and its games. Both Lottery and Cactus staff use this information to develop the Lottery's annual marketing plan. Typically, the Lottery's advertising agency has subcontracted out the collection of data for the tracking study to firms that specialize in these types of studies. The following table shows demographic information for the Lottery's player population for Fiscal Years 2005 through 2007 and compares the change in the player population with the change in the State's general population over the same period. As the table shows, there have been more changes in the Lottery's player population than in the State's general population over this period. For example, Lottery players aged 35 to 44 increased 90 percent, whereas this age group in the general population decreased 3 percent. In addition, Lottery players with incomes between \$75,000 and \$100,000 increased 63 percent, while the general population at this income level increased 13 percent.

<b>Colorado Lottery Socioeconomic Profile of Lottery Players Fiscal Years 2005 through 2007</b>					
<b>Demographic Category</b>	<b>Fiscal Year</b>			<b>Lottery Players Percent Increase/ (Decrease) 2005-2007</b>	<b>State Population Percent Increase/ (Decrease) 2005-2007</b>
	<b>2005 Players</b>	<b>2006 Players</b>	<b>2007 Players</b>		
<b>Age</b>					
18-24	4%	14%	7%	75%	3%
25-34	9%	21%	14%	56%	(5)%
35-44	10%	20%	19%	90%	(3)%
45-54	24%	20%	21%	(13)%	0%
55-64	24%	12%	15%	(38)%	7%
65+	23%	13%	18%	(22)%	2%
No Response	6%	0%	6%	0%	0%
Total	100%	100%	100%	N/A	N/A
<b>Gender</b>					
Male	48%	50%	46%	(4)%	0%
Female	52%	50%	54%	4%	0%
Total	100%	100%	100%	N/A	N/A
<b>Income</b>					
<\$20,000	10%	7%	7%	(30)%	(10)%
\$20,000-\$40,000	12%	14%	14%	17%	(7)%
\$40,000-\$60,000	12%	16%	17%	42%	3%
\$60,000-\$75,000	8%	12%	13%	63%	6%
\$75,000-\$100,000	8%	10%	13%	63%	13%
\$100,000+	9%	12%	12%	33%	30%
No Response	41%	29%	24%	(41)%	0%
Total	100%	100%	100%	N/A	N/A
<b>Education<sup>1</sup></b>					
<12 Years	3%	5%	3%	0%	5%
HS Graduate	25%	25%	21%	(16)%	2%
Some College	19%	23%	27%	42%	1%
College Graduate	32%	28%	30%	(6)%	(6)%
Postgraduate Degree	19%	16%	17%	(11)%	(1)%
No Response	2%	3%	2%	0%	0%
Total	100%	100%	100%	N/A	N/A
<b>Ethnicity<sup>2</sup></b>					
White/Non Latino	N/A	78%	84%	8%	(1)%
Hispanic/Latino	N/A	8%	7%	(13)%	2%
African/American	N/A	3%	2%	(33)%	0%
Native American	N/A	1%	1%	0%	0%
Asian	N/A	1%	1%	0%	1%
Other	N/A	2%	1%	(50)%	0%
No Response	N/A	7%	4%	(43)%	0%
Total	N/A	100%	100%	N/A	N/A
<b>Source:</b> Office of the State Auditor's analysis of the Colorado Lottery's Fiscal Year 2007 tracking study of Lottery players. The Lottery's study was conducted by a third-party research company (Core Insights Inc.).					
<sup>1</sup> State population education data are only available through 2006, resulting in a two-year trend only.					
<sup>2</sup> Lottery ethnicity data were not collected in 2005.					

We reviewed the Lottery’s tracking studies to determine what demographic data the Lottery collects and to assess changes in the Lottery player population. Specifically, we reviewed demographic data collected by the Lottery’s contractors on the Lottery player population from Fiscal Years 2004 through 2007. These data included information on the age, gender, ethnicity, education, and income level of the respondent Lottery player. We found a lack of consistency in the ethnicity and income data collected, which makes it difficult to fully analyze trends and changes in the Lottery player population. The problems we found are described below.

First, we found that the contractor did not collect ethnicity data in Fiscal Year 2005. Second, we found the contractor did not use the same income parameters in Fiscal Year 2004 that were used in the three subsequent years. The table below shows the different income parameters that were used during Fiscal Year 2004 and the following years. The Lottery could not provide an explanation for why ethnicity data was not collected in Fiscal Year 2005 or why different income parameters were used.

<b>Colorado Lottery Comparison of Income Parameters Used in Lottery Demographic Studies Fiscal Years 2004 through 2007</b>	
<b>2004</b>	<b>2005 – 2007</b>
< \$15,000	< \$20,000
\$15,000-\$24,999	\$20,000-\$40,000
\$25,000-\$34,999	\$40,000-\$60,000
\$35,000-\$49,999	\$60,000-\$75,000
\$50,000-\$74,999	\$75,000-\$100,000
\$75,000+	\$100,000+
<b>Source:</b> Office of the State Auditor’s analysis of Lottery demographic studies for Fiscal Years 2004 through 2007.	

The lack of consistent and comparable demographic data on a year-to-year basis makes it difficult to analyze trends and changes in the Lottery player population and compare this information with trends and changes in the State’s general population. These types of comparisons can help identify which, if any, segments of the Lottery player population have been increasing or decreasing at different rates than the State’s general population. The Lottery can then use this information to more effectively target its marketing efforts. Currently, the Lottery does not specify the data collection ranges that the contractors must use when collecting demographic information on Lottery players as part of the annual tracking study. The Lottery

should standardize its data collection parameters and direct its contractors to use these parameters when conducting the annual tracking study.

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### **Recommendation No. 16:**

The Colorado Lottery should establish data collection standards and direct its contractors to use these standards when conducting the annual tracking study.

### **Colorado Lottery Response:**

Agree. Implementation date: January 31, 2009.

The Lottery understands the importance of capturing and tracking consistent player base information and will ensure this happens in the future by directing the advertising agency, in a documented manner, to follow an established, consistent format for gathering specific information concerning player demographics.

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# **Appendices**

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## Appendix A

<b>State-Operated Lotteries Ranked by Percent of Sales Paid in Prizes Fiscal Year 2006<sup>1</sup></b>					
<b>Rank</b>	<b>State Lottery</b>	<b>Total Sales (in millions)</b>	<b>Per Capita Sales<sup>2</sup></b>	<b>Total Prizes (in millions)</b>	<b>Percent of Sales Paid In Prizes</b>
1	Massachusetts	\$4,501.2	\$705	\$3,234.6	72%
2	Oregon	\$363.1	\$100	\$239.5	66%
3	Missouri	\$913.5	\$158	\$572.8	63%
4	Vermont	\$104.9	\$169	\$66.5	63%
5	Maine	\$229.7	\$174	\$142.1	62%
6	Connecticut	\$970.3	\$276	\$587.4	61%
7	Georgia	\$2,955.4	\$350	\$1,815.6	61%
8	South Carolina	\$1,144.6	\$269	\$702.3	61%
9	Texas	\$3,774.7	\$169	\$2,310.6	61%
10	Washington	\$477.9	\$76	\$291.8	61%
<b>11</b>	<b>Colorado</b>	<b>\$468.8</b>	<b>\$100</b>	<b>\$281.6</b>	<b>60%</b>
12	Florida	\$3,929.0	\$227	\$2,340.9	60%
13	Indiana	\$816.4	\$130	\$493.1	60%
14	Kentucky	\$742.3	\$178	\$445.0	60%
15	Minnesota	\$449.7	\$88	\$267.8	60%
16	West Virginia	\$218.1	\$120	\$131.9	60%
17	Illinois	\$1,964.3	\$156	\$1,158.2	59%
18	New York	\$6,487.1	\$337	\$3,853.3	59%
19	Ohio	\$2,220.9	\$194	\$1,311.1	59%
20	Pennsylvania	\$3,070.3	\$247	\$1,804.9	59%
21	Rhode Island	\$261.1	\$243	\$154.8	59%
22	Idaho	\$131.3	\$92	\$76.7	58%
23	Maryland	\$1,560.9	\$279	\$904.1	58%
24	New Hampshire	\$262.7	\$200	\$152.4	58%
25	Tennessee	\$927.6	\$167	\$537.8	58%
26	Wisconsin	\$509.1	\$92	\$293.9	58%

## Appendix A

<b>State-Operated Lotteries Ranked by Percent of Sales Paid in Prizes Fiscal Year 2006<sup>1</sup></b>					
<b>Rank</b>	<b>State Lottery</b>	<b>Total Sales (in millions)</b>	<b>Per Capita Sales<sup>2</sup></b>	<b>Total Prizes (in millions)</b>	<b>Percent of Sales Paid In Prizes</b>
27	Michigan	\$2,212.4	\$218	\$1,268.2	57%
28	New Jersey	\$2,406.5	\$276	\$1,380.4	57%
29	South Dakota	\$39.4	\$51	\$22.4	57%
30	Virginia	\$1,365.3	\$180	\$773.6	57%
31	Nebraska	\$113.1	\$64	\$63.7	56%
32	Arizona	\$468.7	\$79	\$259.1	55%
33	Washington, DC	\$266.4	\$470	\$146.7	55%
34	Kansas	\$236.1	\$89	\$131.0	55%
35	New Mexico	\$154.6	\$80	\$84.6	55%
36	California	\$3,585.0	\$99	\$1,932.7	54%
37	Oklahoma	\$204.8	\$58	\$109.7	54%
38	Delaware	\$124.6	\$148	\$64.9	52%
39	Montana	\$39.9	\$43	\$20.7	52%
40	North Carolina	\$229.5	\$26	\$119.0	52%
41	Louisiana	\$332.1	\$73	\$168.2	51%
42	North Dakota	\$22.3	\$35	\$11.0	49%
43	Iowa	\$339.5	N/A <sup>3</sup>	\$122.3	36%
<b>Average</b>		<b>\$1,199.9</b>	<b>\$174</b>	<b>\$717.4</b>	<b>60%</b>
<p><b>Source:</b> Office of the State Auditor's analysis of figures from LaFleur's 2007 World Lottery Almanac and the September 2006 issue of LaFleur's Magazine related to product sales and prizes data for all U.S. Lotteries.</p> <p><sup>1</sup> Fiscal Year 2006 is the most recent year data are available for U.S. Lotteries as of July 2008.</p> <p><sup>2</sup> Per capita sales data are calculated by dividing a state's total sales by total population.</p> <p><sup>3</sup> Per capita sales data were unavailable for the Iowa Lottery.</p>					

## Appendix B

<b>State-Operated Lotteries Ranked by Per Capita Sales Fiscal Year 2006<sup>1</sup></b>			
<b>Rank</b>	<b>State Lottery</b>	<b>Per Capita Sales<sup>2</sup></b>	<b>Percent of Sales Paid In Prizes</b>
1	Massachusetts	\$705	72%
2	Washington, DC	\$470	55%
3	Georgia	\$350	61%
4	New York	\$337	59%
5	Maryland	\$279	58%
6	Connecticut	\$276	61%
7	New Jersey	\$276	57%
8	South Carolina	\$269	61%
9	Pennsylvania	\$247	59%
10	Rhode Island	\$243	59%
11	Florida	\$227	60%
12	Michigan	\$218	57%
13	New Hampshire	\$200	58%
14	Ohio	\$194	59%
15	Virginia	\$180	57%
16	Kentucky	\$178	60%
17	Maine	\$174	62%
18	Vermont	\$169	63%
19	Texas	\$169	61%
20	Tennessee	\$167	58%
21	Missouri	\$158	63%
22	Illinois	\$156	59%
23	Delaware	\$148	52%
24	Indiana	\$130	60%
25	West Virginia	\$120	60%
<b>26</b>	<b>Colorado</b>	<b>\$100</b>	<b>60%</b>
27	Oregon	\$100	66%

## Appendix B

<b>State-Operated Lotteries Ranked by Per Capita Sales Fiscal Year 2006<sup>1</sup></b>			
<b>Rank</b>	<b>State Lottery</b>	<b>Per Capita Sales<sup>2</sup></b>	<b>Percent of Sales Paid In Prizes</b>
28	California	\$99	54%
29	Idaho	\$92	58%
30	Wisconsin	\$92	58%
31	Kansas	\$89	55%
32	Minnesota	\$88	60%
33	New Mexico	\$80	55%
34	Arizona	\$79	55%
35	Washington	\$76	61%
36	Louisiana	\$73	51%
37	Nebraska	\$64	56%
38	Oklahoma	\$58	54%
39	South Dakota	\$51	57%
40	Montana	\$43	52%
41	North Dakota	\$35	49%
42	North Carolina	\$26	52%
43	Iowa	N/A <sup>3</sup>	36%
<b>Average</b>		<b>\$174</b>	<b>60%</b>
<p><b>Source:</b> Office of the State Auditor's analysis of figures from LaFleur's 2007 World Lottery Almanac and the September 2006 issue of LaFleur's Magazine related to product sales and prizes data for all U.S. Lotteries.</p> <p><sup>1</sup> Fiscal Year 2006 is the most recent year data are available for U.S. Lotteries as of July 2008.</p> <p><sup>2</sup> Per capita sales data are calculated by dividing a state's total sales by total population.</p> <p><sup>3</sup> Per capita sales data were unavailable for the Iowa Lottery.</p>			

## Appendix C

<b>State-Operated Lotteries<sup>1</sup></b>				
<b>Retailer Commission Rates &amp; Compensation Data</b>				
<b>Fiscal Year 2006<sup>2</sup></b>				
<b>State Lottery</b>	<b>Average Commission Rate</b>	<b>Total Retailer Compensation<sup>3</sup> (in millions)</b>	<b>Total Ticket Sales (in millions)</b>	<b>Retailer Compensation/ Ticket Sales</b>
Arizona	6.5%	\$31.3	\$468.7	6.7%
California	6.0%	\$252.5	\$3,585.0	7.0%
<b>Colorado</b>	<b>6.5%</b> <b>(7%, scratch; 6%, jackpot)</b>	<b>\$34.7</b>	<b>\$468.8</b>	<b>7.4%</b>
Connecticut	5.0%	\$54.1	\$970.3	5.6%
Delaware	5.0%	\$8.0	\$124.6	6.4%
Washington, DC	5.0%	\$16.5	\$266.4	6.2%
Florida	5.0%	\$221.2	\$3,929.0	5.6%
Georgia	6.0% (5%, scratch & jackpot; 7%, Cash 3 game)	\$208.3	\$2,955.4	7.0%
Idaho	5.0%	\$7.8	\$131.3	5.9%
Illinois	5.0%	\$99.3	\$1,964.3	5.1%
Indiana	5.8% (5.5%, scratch; 6%, jackpot)	\$56.7	\$816.4	6.9%
Kansas	5.0%	\$13.6	\$236.1	5.8%
Kentucky	5.0%	\$46.7	\$742.3	6.3%
Louisiana	5.0%	\$17.3	\$332.1	5.2%
Maine	6.5% (8%, scratch; 5%, jackpot)	\$16.3	\$229.7	7.1%
Maryland	5.5%	\$102.7	\$1,560.9	6.6%
Massachusetts	5.0%	\$224.9	\$4,501.2	5.0%
Michigan	6.0%	\$165.3	\$2,212.4	7.5%
Minnesota	5.5%	\$27.3	\$449.7	6.1%
Missouri	5.0%	\$56.5	\$913.5	6.2%
Montana	5.0%	\$2.3	\$39.9	5.8%
Nebraska	5.0%	\$7.1	\$113.1	6.3%

## Appendix C

<b>State-Operated Lotteries<sup>1</sup></b>				
<b>Retailer Commission Rates &amp; Compensation Data</b>				
<b>Fiscal Year 2006<sup>2</sup></b>				
<b>State Lottery</b>	<b>Average Commission Rate</b>	<b>Total Retailer Compensation<sup>3</sup> (in millions)</b>	<b>Total Ticket Sales (in millions)</b>	<b>Retailer Compensation/ Ticket Sales</b>
New Hampshire	5.0%	\$14.2	\$262.7	5.4%
New Jersey	5.0%	\$133.6	\$2,406.5	5.6%
New Mexico	6.0%	\$9.9	\$154.6	6.4%
New York	6.0%	\$389.0	\$6,487.1	6.0%
North Carolina	7.0%	\$16.1	\$229.5	7.0%
North Dakota	5.0%	\$1.2	\$22.3	5.4%
Ohio	5.5%	\$139.8	\$2,220.9	6.3%
Oklahoma	6.0%	\$12.9	\$204.8	6.3%
Oregon	7.5%	\$32.3	\$363.1	8.9%
Pennsylvania	5.0%	\$170.7	\$3,070.3	5.6%
Rhode Island	6.5% (5%, scratch; 8%, jackpot)	\$32.0	\$261.1	12.3%
South Carolina	7.0%	\$81.1	\$1,144.6	7.1%
South Dakota	5.0%	\$2.2	\$39.4	5.6%
Tennessee	7.0%	\$65.0	\$927.6	7.0%
Texas	5.0%	\$188.8	\$3,774.7	5.0%
Vermont	5.75%	\$6.2	\$104.9	5.9%
Virginia	5.0%	\$76.2	\$1,365.3	5.6%
Washington	6.0%	\$30.4	\$477.9	6.4%
West Virginia	7.0%	\$15.3	\$218.1	7.0%
Wisconsin	5.9% (5.5%, scratch; 6.25%, jackpot)	\$32.2	\$509.1	6.3%

**Source:** LaFleur's 2007 World Lottery Almanac.

<sup>1</sup> Retailer compensation data are not available for the Iowa Lottery.

<sup>2</sup> Fiscal Year 2006 is the most recent year data are available for U.S. lotteries as of July 2008.

<sup>3</sup> Includes commissions and bonuses paid to retailers.

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