



OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA

Minnesota State Lottery

February 19, 2004

Major Findings:

- In 2002, the Minnesota State Lottery spent close to two-thirds more of its sales revenue on operating expenses than comparable state lotteries. As a result, less funding was available for environmental and other programs funded by lottery profits.
- The Minnesota Lottery has more autonomy and is less accountable to elected officials than other Minnesota state agencies and lotteries in most other states.
- The Lottery spends more than \$400,000 annually to support the Minnesota Pro/Am Bass Tour and devotes considerable time to assist in the tour's operation, despite the tour's limited value for lottery sales.
- The Lottery has a traveling exhibit trailer—called the Environmental Experience vehicle—that is costing the Lottery about \$1.4 million over five years but is infrequently used and is of questionable value.
- The Lottery spends \$1.2 million annually for the production and distribution of a television program that has questionable benefits for the Lottery.
- The Lottery has never competitively bid any of the work done by Media Rare—which is also the owner of the bass tour—and has overpaid the firm in a number of instances.

The Minnesota State Lottery should be more accountable to the Governor and the Legislature.



Key Recommendations:

- Like state agency budgets, the Lottery's budget for operating expenses should be reviewed every two years by the Department of Finance and approved by the Legislature.
- The Legislature should allow the Governor more discretion in removing and appointing the director of the Lottery.
- The Legislature and the Department of Finance should scrutinize the Lottery's spending in detail and consider additional reductions in the Lottery's fiscal year 2005 budget.
- The Lottery should reexamine its relationship with Media Rare, reassess the value of the services provided by that firm, and terminate its sponsorship of the Minnesota Pro/Am Bass Tour.

Report Summary

Since its inception in 1990, the Minnesota State Lottery has provided \$1.1 billion for state-financed programs. During the 2003 legislative session, however, the Lottery was criticized for spending \$50 million on operating expenses during fiscal year 2002. Although previous legislatures had never established a budget for the Lottery, the 2003 Legislature capped the Lottery's annual operating expenses at \$43.5 million beginning with fiscal year 2004.

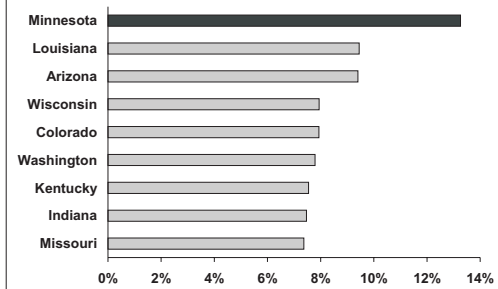
The Lottery has higher operating expenses and lower profits than similar lotteries.

The Legislative Audit Commission also wanted an in-depth review of the Lottery's spending. Our evaluation examined the Lottery's operating expenses in detail and found significant problems with the Lottery's spending and procurement practices. This report recommends that the Legislature and the Governor consider further reductions in the Lottery's budget. We also recommend statutory changes to make the Lottery and its director more accountable to the state's elected officials.

The Minnesota Lottery Has Significantly Higher Operating Expenses than Comparable Lotteries

In 2002, the Minnesota State Lottery spent more than 13 percent of its sales revenues on operating expenses, while similar state lotteries spent an average of 8 percent. The Lottery had about 50 percent more staff per \$1 million in sales than other lotteries, as well as considerably more office and warehouse space. The Minnesota Lottery spent almost one-fourth more than comparable lotteries on advertising and more than six times as much as other lotteries on promotional activities. The Lottery's expenses for ticket production and distribution were 40 percent higher than the average for other lotteries. The Lottery also had significantly higher depreciation and other expenses. As a result, the Minnesota State Lottery returned only 21 percent of its sales revenue to the state for environmental and other public programs, compared with an average of 27 percent in states with similar lotteries.

Lottery Operating Expenses as a Percentage of Sales, FY 2002



During the 2003 legislative session, Lottery officials attributed much of the difference in spending and profits to differences in the cost of living and the higher share of sales for scratch games in Minnesota. But we estimate that, in 2002, only a little more than one-fourth of the difference in profits was due to these factors. Minnesota has more charitable gambling than other states, but the additional competition does not appear to explain the Lottery's higher spending and lower profit margin. Recent budget cuts have reduced the Lottery's staff size and budget, but the Lottery's 2004 operating expenses as a percentage of sales are expected to significantly exceed the 2002 average for other lotteries.

The Lottery Is Funding a Number of Promotional Activities That Have Limited Value

The Minnesota Lottery has significantly higher promotional spending than other lotteries, but some of this spending is of questionable value. The Lottery spends about \$400,000 annually to support the Minnesota Pro/Am Bass Tour. In addition, unlike other sponsored events, the Lottery devotes significant staff resources to planning and operating the tour and has paid for up to eight staff and a driver to attend tour events. While the Lottery eliminated all but a few of its sponsorships due to recent budget cuts, the Lottery planned to continue its sponsorship of the bass tour. In our view, this sponsorship has significantly less promotional value than some of the eliminated sponsorships.

The Lottery has leased and improved a tractor/trailer to serve as a traveling exhibit highlighting the use of lottery profits for

The Lottery has some inappropriate procurement practices and business relationships.

environmental projects. Over five years, the Lottery is expected to spend about \$1.4 million on its Environmental Experience vehicle. This vehicle, as well as the portable kiosks purchased by the Lottery, has been used infrequently. In addition, the Lottery mismanaged the acquisition and improvement of the vehicle. Among other problems, the Lottery committed to making lease payments that were about equivalent to the cost of the vehicle, yet the lease agreement did not give the Lottery any ownership rights to the vehicle or its extensive permanent improvements at the end of the five-year lease period.

The Lottery also spends about \$1.2 million annually for the production and distribution of a weekly television program called the Environmental Journal. In addition, the Lottery spends about \$0.4 million per year for one-minute radio spots called the Environmental Journal and the Player Spotlight. Although the television program is seen on some commercial stations, it is primarily aired on public access cable stations. The value of this program, as well as the radio spots, has not been estimated by the Lottery or any independent source. The producer of the show has estimated their value, but those estimates are flawed and outdated.

All of these activities involve a company called Media Rare with which the Lottery has had a long-standing relationship. Media Rare produces the television program and radio spots, leases the Environmental Experience vehicle to the Lottery, and is the owner of the bass tour. The Lottery also paid Media Rare to improve the tractor/trailer that became the Environmental Experience vehicle. The Lottery has never competitively bid the work that Media Rare does for the Lottery, and has a loose contractual arrangement with Media Rare. The Lottery has not had adequate contracts for Media Rare's services and has paid the company through the Lottery's advertising firm. In addition, the Lottery has overpaid Media Rare for its work on the Environmental Experience vehicle and the Environmental Journal television program.

The Lottery Has Not Adequately Evaluated the Impact of Its Advertising and Promotional Activities

Advertising is generally expected to be effective in stimulating lottery sales. But sales of scratch tickets fell 31 percent in inflation-adjusted dollars between 2000 and 2003. The Lottery has not attempted to measure the effectiveness of its advertising since 1997 and needs to reassess its advertising strategy given the decline in scratch ticket sales.

The Lottery measures the benefits and costs of sponsorships and has attempted to evaluate the impact of retail promotions on sales. However, Lottery staff overstate the benefits of sponsorships and understate the costs. Lottery sales managers have misinterpreted the results of the evaluation of retail promotions.

Other Lottery Spending Needs to Be Scrutinized

There needs to be further scrutiny of other Lottery expenses besides promotions and advertising expenses. For example, the Lottery's ticket expenses are high relative to other states. While the contract for online services is set for another four years, the contract for scratch tickets expires in a year. In the past, the Lottery has not placed enough emphasis on the cost of tickets when selecting a vendor and has paid for additional ticket features that do not seem to have resulted in increased sales.

Even after recent budget cuts, the Lottery has about one-fourth more staff per \$1 million of sales than comparable lotteries had in 2002. The Lottery also has more assistant agency heads, managers, and supervisors per employee than most other state agencies in Minnesota. With the reduction in staff, the Lottery now has about 54 percent more office space per employee than comparable lotteries had in 2002.

The Legislature should transfer the Lottery's remaining unclaimed prize money to a state fund.

The Lottery is also continuing to supplement prize levels of selected scratch games using accumulated unclaimed prize money. Although the 2003 Legislature required the Lottery to return any future unclaimed prize money to the state, the Lottery was left with \$2.5 million that was unclaimed prior to fiscal year 2004. The Legislature should take the remaining money away from the Lottery, since lottery games with supplemented prize levels have had lower profits than other games.

Some Lottery Expenses Have Been Unnecessary or Inappropriate

Until recently, the Lottery permitted 11 Lottery employees to use Lottery vehicles to commute to and from work. Some commuted more than 20,000 miles per year. This practice violated state law and caused unnecessary and extensive expenses. The Lottery purchased coffee for its employees, rented plants for its office, and used a department head expense account inappropriately. The Lottery also incurs business meeting expenses without legal authority to do so. On occasion, the Lottery has permitted some managers and staff to use tickets and merchandise for purposes we consider unnecessary.

Travel expense advances to the former director of the Lottery violated state policy and were not promptly settled. The former director also received reimbursement for overnight lodging and meals at a fishing tournament in the Twin Cities area. Lottery accounting staff do not consistently check mileage reimbursement claims to see if a lottery vehicle could be used instead of an employee's personal vehicle. Finally, the Lottery spent about \$4,200 to send the former director and three employees to a fishing tournament, although the Lottery received minimal promotional benefits from the tournament. The former director and another employee also fished for free in the tournament and thus received a gift that may be prohibited by state law.

The full evaluation report, *Minnesota State Lottery* (#pe04-01), includes the agency's response and is available at 651/296-4708 or:

**[www.auditor.leg.state.mn.us/
ped/2004/pe0401.htm](http://www.auditor.leg.state.mn.us/ped/2004/pe0401.htm)**

Summary of Agency Response:

In a letter dated February 19, 2004, Acting Lottery Director Michael Vekich wrote that the report "provides an insightful and fundamentally fair representation of the Lottery." He said that the Lottery accepts the report's recommendations with minor exceptions. Of the 49 recommendations directed to the Lottery, the Lottery has implemented 11 recommendations and expects to complete action on the remaining recommendations within one to four months.

Mr. Vekich noted that Lottery sales and payments to the state have increased during the first six months of fiscal year 2004. He said the Lottery would "continue to explore every opportunity to increase efficiency, to review every facet of our operation, and, most importantly, to increase the revenue returned to the state."